THE MACRO REPORT | DECEMBER 2018

The U.S. economy's slow fizzle

There are signs of weakness in major U.S. economic indicators, including home building and investments, raising concerns that one of the longest periods of economic growth in U.S. history may be coming to an end. These signs also indicate the United States has joined the global economic deceleration amid rising interest rates and tumbling stock markets. In addition, the Fed raised its benchmark interest rate four times as of the end of December 2018, and projects at least two hikes in 2019.

In Europe, France and Spain are grappling with political stresses as Italy's economy shrinks and the European Central Bank weighs monetary policy. Political uncertainties keep bubbling up, reflecting popular dissatisfaction with the status quo. The eurozone's reform agenda and economic growth continue to struggle against the difficult backdrop. Adding to the global malaise are falling oil prices. Weakness in oil prices forced OPEC and its allies to try to stabilize the market with production cuts as the United States reimposed economic sanctions on Iran.

THIS MONTH

U.S. growth poised to cool

There are indications the economy is losing momentum, including a weaker housing market and slowing corporate investment.

There are emerging pockets of weakness in the United States, including in manufacturing, investment, housing, and job growth. The economy expanded at a 3.5 % annual pace during the third quarter, and the unemployment rate hit 3.7%, the lowest level in half a century. But that is just half the story.

The latest data indicate the United States has joined the global economic deceleration. The housing market has weakened, reflecting higher interest rates. But the weakness is spreading beyond housing. While the weekly jobless claims data has been hinting at a shift in the direction of the labor market, what really caught our attention was weakness in corporate investment. And in October, U.S. durable goods orders fell by the largest amount in 15 months.

The corporate tax cuts were supposed to usher in a new era of investment-led high productivity growth, and, so far, it just isn't happening. Investment in energy production increased due to higher energy prices and "deregulation" of the fossil fuel industry by opening up public lands to exploration. Still, lower pollution control will shift the costs of pollution from the polluter to the economy as a whole. Relaxed pollution control does not lower costs overall or improve economic efficiency. Outside energy, there is precious little sign of a shift in investment behavior.

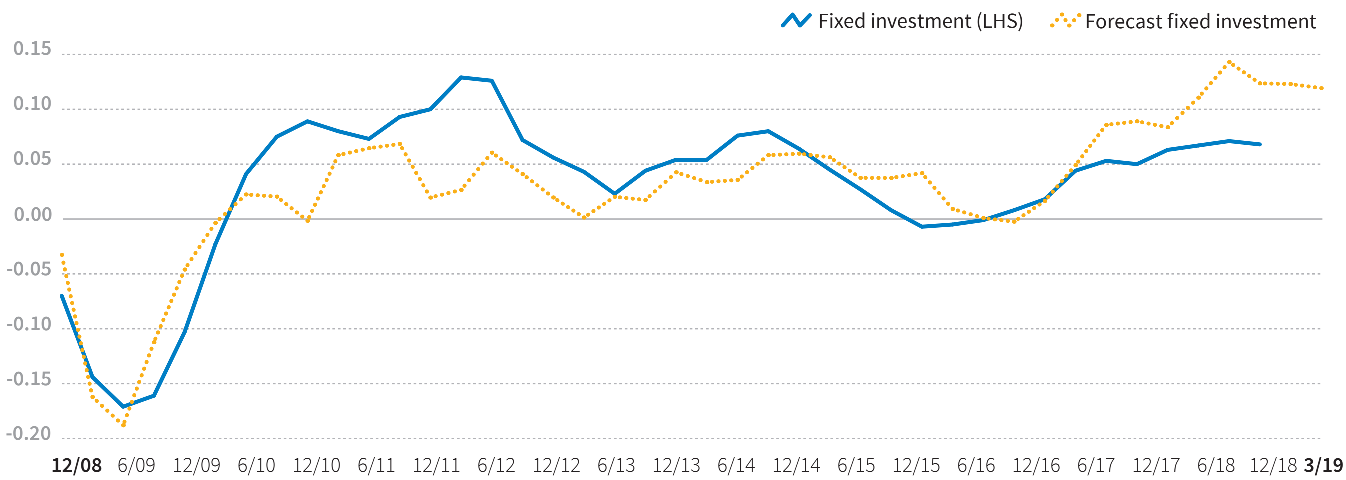
A main reason for this is the uncertainty generated by the trade war. Tariffs have harmed the profitability of some major industries, and everyone who is following the Trump administration's trade policy is struggling to understand exactly what is going on. Will there be auto tariffs or not? When? How big? What exactly is going on with China? The difficulty in getting clear answers to these questions is apparent and could be harming investment prospects.

Core inflation ticks down

A closely watched price index ticked further below the Federal Reserve's target in October, a fresh sign of weakening inflationary pressures. Core inflation as measured by the personal consumption expenditures price index (PCE) rose 1.8% in October from a year earlier and has hovered at an annualized 1.5% over the past six months. Our inflation forecast points to a dip in both headline and core inflation in the first half of 2019. Energy prices account for much of this. However, our forecast shows core inflation will not drift above the Fed's 2% inflation target until the end of October 2020. We wonder about the optics of the Fed hiking rates in the spring of next year when inflation is falling. The Fed has already raised its benchmark interest rate four times as of the end of December 2018, and projects two hikes in 2019.

U.S. fixed investments trend lower

% year-on-year



Sources: Morgan Stanley and Bureau of Economic Analysis via Bloomberg, Putnam, as of November 2018.

We wonder about the optics of the Fed hiking rates in the spring of next year when inflation is falling.

A senior official on the Federal Open Market Committee (FOMC), which sets rates, recently said it is puzzling and a problem that inflation has been so low over the long term. The Beige Book, prepared ahead of the December FOMC meeting, indicates the economy is slowing. According to the report, "optimism has waned…as contacts cited increased uncertainty from impacts of tariffs, rising interest rates and labor market constraints." Many market participants and economists are forecasting annualized growth of around 2.5% in the fourth quarter of 2018. We would be lucky to sustain that pace of growth in 2019.

Wage pressures increase a little, but pace of job creation weakens

The November labor market report was consistent with the deceleration story. Some of the weakness in the jobs number was weather-related because in some parts of the United States, Thanksgiving was the coldest in a century. The Bureau of Labor Statistics said the number of people missing work because of the weather was larger than normal in November. Wages do look as though they are ticking up in some sectors of the economy. But the pace of job growth has clearly decelerated, and a few other details point to a genuine deceleration. The U6 unemployment rate, which includes workers who have quit looking for a job and part-time workers who are seeking full-time employment, ticked up, and there was a shift in the pattern of people who are not in the labor force.

Growth risks still asymmetrical

For the outlook, the economic risks remain asymmetric. The possibility that we are at the early stages of a capex/productivity growth phase seems more remote than it did last month given the data flow. Perhaps the risk the Fed will be too aggressive is slightly lower now because of market developments and the latest Fed commentary. Still, trade war risks linger.

Europe's political divide

Opposition to productivity reforms and budget compromises compound debt issues as the European Central Bank weighs monetary policy.

Political stresses are becoming more evident in different places across the continent, including in France and Spain. These stresses keep bubbling up, reflecting popular dissatisfaction with the status quo. As a result, nationalist, anti-immigrant, and populist parties have fared well in recent years throughout Europe. And the eurozone's reform agenda and economic growth continue to struggle against the difficult political backdrop.

France faces another burst of Poujadism

In France, the government recently raised taxes on diesel and gasoline. A typical driver filling a 50-liter diesel tank every week would spend an extra 13 euros a month. This was the spark that lit a fire of protest, encouraged by social media with expressions of inchoate anger reminiscent of the Poujadist movement (the political philosophy and methods advocated in France during the 1950s by Pierre Poujade, who in 1954 founded a populist right-wing movement). The protests have inevitably become a challenge to the broad reform agenda of President Emmanuel Macron's administration. Protesters insist the new "green" taxes illustrate that Macron is the president of the rich and does not speak for the working masses. They issued a list of demands, including lower fines for traffic violations and more efficient public spending. Macron's government eventually agreed to suspend the fuel tax for a few months.

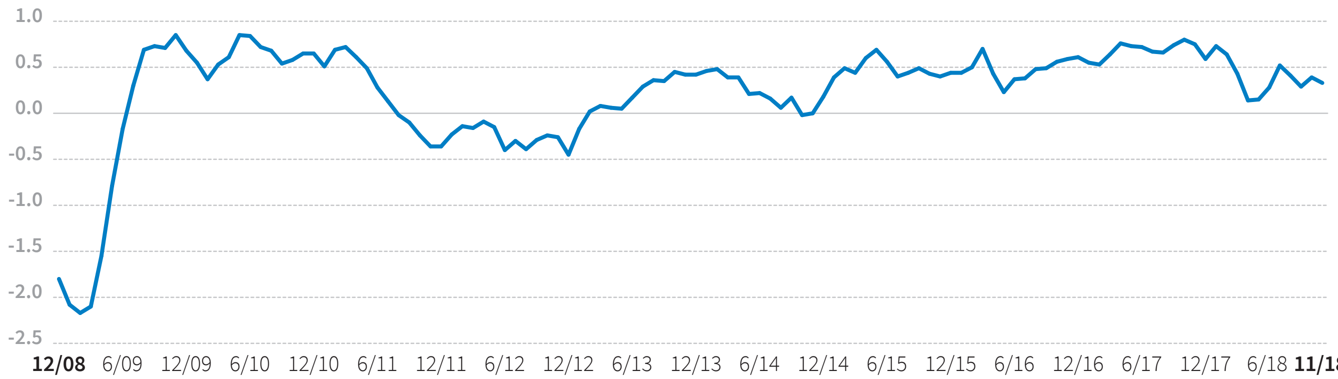
The demonstrations reveal weaknesses in the central government and the President's political capital. This matters because there are changes to the pension and unemployment insurance system that are on the docket for 2019. These reforms will face some opposition.
For many people, Macron embodies a set of reform possibilities and a counterweight to the free-form anger that inspires so much of the populist right. It would be disappointing to see these possibilities ruled out. Past reform efforts in France have frequently failed because of this Poujadist street opposition.

Far-right party succeeds in Spain

The success of the far-right party Vox in regional elections in Andalusia (southern Spain) has sent shock waves through the country's political establishment. The nationalist party won 12 seats in the region's local assembly after the vote, far exceeding a prediction that it would win only two or three seats. Prime Minister Pedro Sanchez's Socialist party lost seats in what had traditionally been a major stronghold. VOX is a fairly standard right-wing European party, conservative on social issues, hard line on "law and order," and opposed to large scale migration.

Eurozone's growth trends lower

% quarter-on-quarter



Source: Putnam, as of November 2018.

We base our proprietary European GDP Nowcast on a tailored methodology that captures quarterly data releases for Europe's most essential growth characteristics. The mix of factors used may change over time as new indicators become available from data sources or if certain factors become more, or less, predictive of economic growth.

The VOX party is opposed to autonomy for Spain's regions and are hostile toward the European Union because of their stress on Spanish centralized sovereignty. This is nothing out of the ordinary, and VOX only gained a handful of seats in the regional assembly. It's interesting, however, because it increases the difficulty of running a coalition at the federal level, where the Socialist-led government has to pass a budget and needs support from other parties. These parties can now see the weaker state of the government and the threat posed by VOX. It also shows how widespread these political stresses are across Europe.

Italy's ongoing debt debacle

Italy's economy contracted by 0.1% in the third quarter of 2018 as domestic demand declined. If the economy is shrinking, the debt dynamics facing the country are awful, and this is not lost on the politicians in Rome, government securities (BTPs), or the eurocrats in Brussels. The government continues to debate its deficit target for 2019. While Italy doesn't seem to care much about eurozone rules, it does care about the markets and whether it can finance budget plans. The European Commission has indicated it expects to launch an excessive deficit procedure (EDP) against Italy. This could come fairly soon, and it signals displeasure. The move would only matter if the ratings agencies or the markets viewed it as important. High levels of debt, widening deficits, and sluggish growth are a toxic combination, and Italy urgently needs reforms to buoy potential growth.

The ECB's dilemma amid growth woes

Economic data across the eurozone continued to slip since the summer. But we believe things are not as bad as they look given that some European confidence indicators are stabilizing. The gap between the sentiment indicators and the manufacturing purchasing managers index (PMI) was quite large, and how this divide closes will be important. Part of the problem is Italy; it's such a large economy, and the economic contraction weighs on the area's aggregates. Eurozone inflation, on the other hand, was slightly weaker than expected in October due to weakness in food prices. We forecast one further move by the ECB in the second half of 2019. However, our confidence in this is falling, and the chances are rising that this cycle will end without an ECB hike.

OPEC, Iran, and oil prices

Weakness in oil prices forced OPEC and its allies to try to stabilize the market with production cuts as the United States reimposed economic sanctions on Iran.

In early December, OPEC and its allies reached an agreement to slash oil production amid the sharp drop in prices. Members of OPEC and Russia, an oil producer outside the cartel, also engaged in some elaborate diplomacy about output levels for 2019. The deal, which should help eliminate excess supply, has prompted oil prices to edge up slightly. Crude futures have tumbled by more than a third since climbing to four-year highs in early October 2018. Rising concerns about oversupply, higher inventories, and the risk of a global economic slowdown have all placed downward pressure on the value of a barrel of oil.

Oil is currently trading at several dollars above its recent lows. However, our fair value for oil has dropped by a few dollars, partly because the U.S. dollar has risen, partly because inventories are a bit higher than we expected, and partly because our annual recalibration of the parameters model for prices. But the fair value estimate is very much higher than current prices. We also note that the futures market positioning for crude oil has shifted dramatically in the past few weeks.

Market prices are well below our fair value estimate

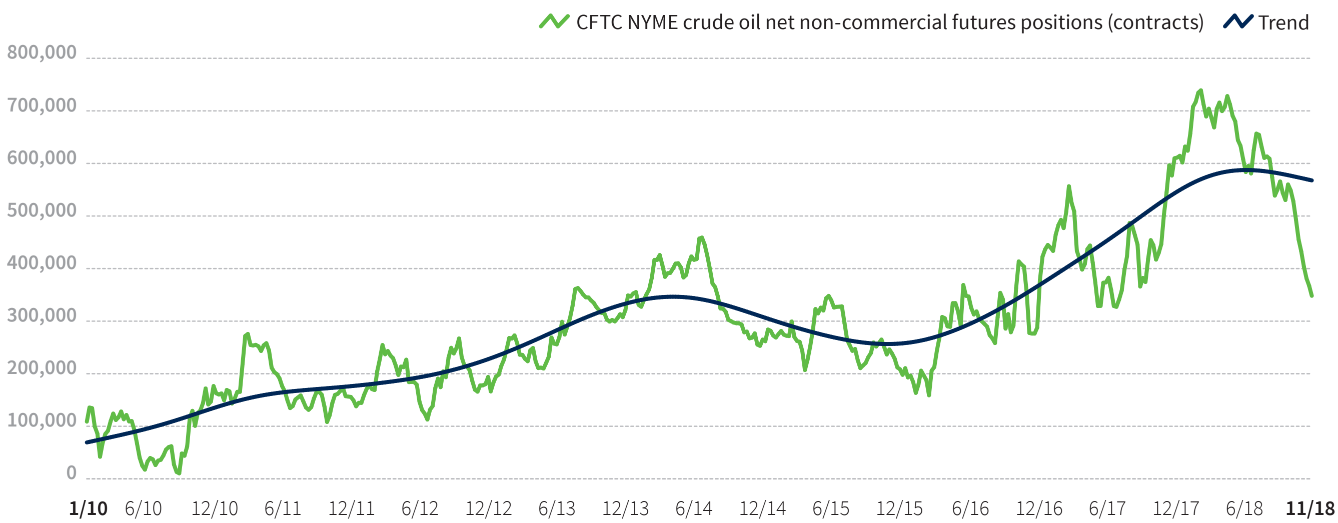
Back in the spring of this year when prices were higher than today and rising, inventories were dropping. There was concern that, with the threat of U.S. sanctions looming, Iranian exports would drop sharply. The fantasy was that, if Iran were completely shut out of the market, prices could rise to $100. But since April, Iranian production declined by about 0.8 million barrels per day while OPEC and Russia increased production by an estimated 1.7 million barrels per day. With the increase in U.S. production, total supply rose by an estimated 3.0 million barrels per day.

The U.S. has become a net exporter of oil and oil products for the first time since 1949.

The United States has become a net exporter of oil and oil products for the first time since 1949. The boom in shale has made the country one of the world's top oil producers. The first tanker of U.S oil exported to China has recently unloaded at Rizhao in Shandong province. Demand has been growing at a fairly steady pace and is likely to continue to do so in the absence of a recession.

Oil futures positions

Contracts, week-on-week



Sources: Commodity Futures Trading Commisson via Bloomberg, Putnam, as of November 2018

Iran's exports are falling, but not as steeply

The latest data suggest that oil exports from Iran are continuing to decline. According to tanker tracker data, Iran is now exporting about 1.1 million barrels of oil per day. In April, the country's exports were close to 2.2 million barrels of oil per day. The U.S. reimposed sanctions on Iran in November but exempted eight countries from the bruising sanctions. The exemptions mean at least some supplies from OPEC's third-biggest producer will keep flowing into international markets.

And in Canada, the province of Alberta imposed some cuts on output. If we combine our estimates of demand with these supply data, it is easy to see the numbers that shaped the OPEC discussions. If you strip aside everything about base levels, the deal, on paper, amounts to a cut of about 1.2 million barrels of oil per day. OPEC will cut about 800,000 barrels of oil per day, and non-OPEC will cut about 400,000 barrels of oil per day. Some of the countries will not meet their quota cuts, so Saudi Arabia will have to do the hard work. Saudi oil minister Al Falih said Saudi produced 10.6 million barrels of oil per day in October and 11.1 million barrels of oil per day in November, and will cut output to 10.2 million barrels of oil per day in January 2019. If this does happen, there may be some quota cheating elsewhere in OPEC, and the OPEC+ supply cut could easily reach 1.2–1.3 million barrels of oil per day. This would be enough to bring oil back to our fair value estimate.

We do think it is likely that prices will rise over the coming months as long as the current economic deceleration does not turn into a recession.

The United States is a major marginal producer now. If prices fall, U.S. production is not going to grow much, if at all. If prices rise a lot, U.S. output can rise. The message the Saudis seem to be sending is that they want to stabilize prices at a level a bit higher than where they are now. How oil production in Saudi Arabia and the United States interacts will be the most important factor in determining how successful the Saudis are. But we do think it is likely that prices will rise over the coming months as long as the current economic deceleration does not turn into a recession.

The Putnam Global Risk Appetite (RA) Index is a proprietary quantitative model that aims to measure investors' willingness to invest in risky assets, including equities, commodities, high-yield bonds, and other spread sectors. With a composite view of risk-appetite signals across a broad mix of asset types, Putnam's RA Index provides a framework for discussing investor preferences and can signal trend changes in broad market sentiment.

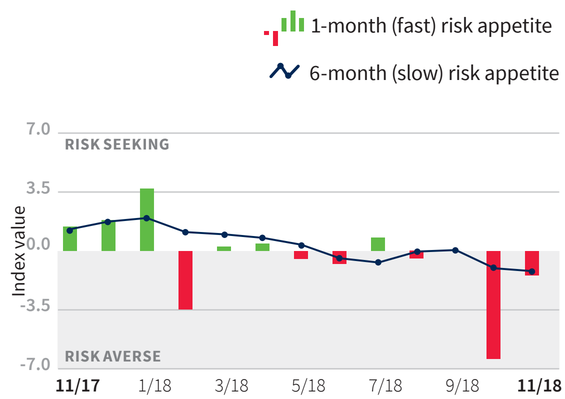
Risk appetite tumbles

SHORT-TERM TREND

November was another risk-off month

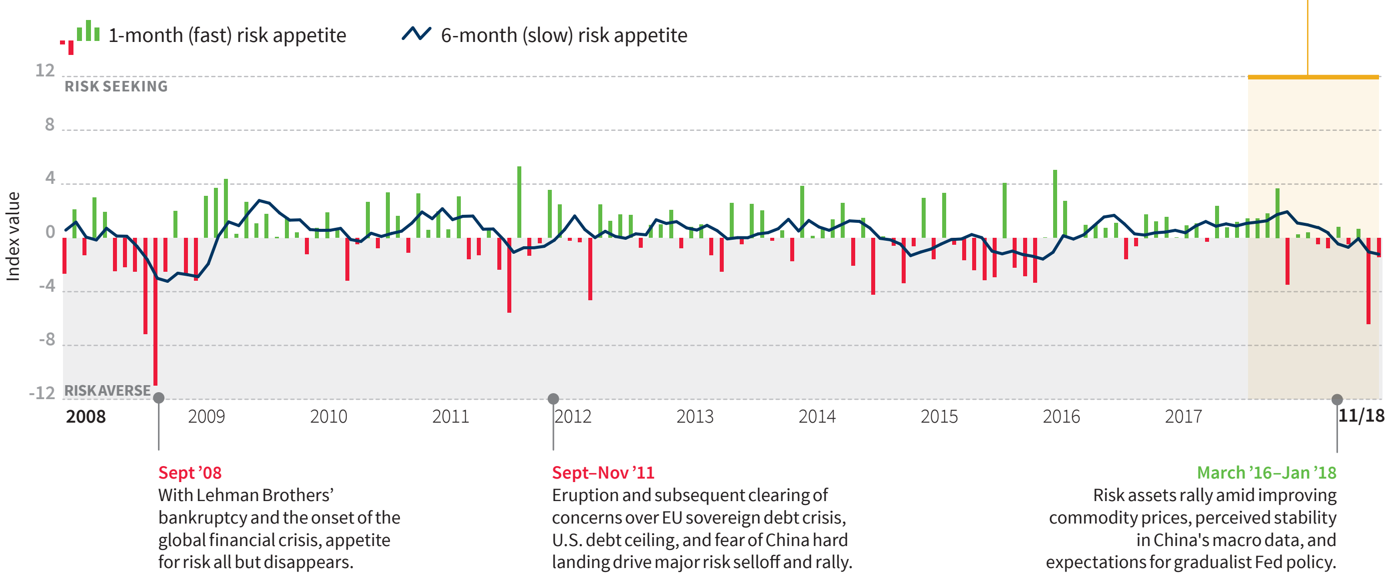
Risk ON OFF

- The gap between equity and fixed-income risk appetite narrowed
- U.S. assets, including bonds, outperformed global markets overall
- Treasuries and other fixed-income assets rallied on rate outlook
- Emerging-market assets gained
- Oil prices declined



LONG-TERM CYCLE

This 10-year illustration captures the cyclicality of investors' appetite for risk.



Source: Putnam. Data as of November 30, 2018. To create the Global Risk Appetite Index, we weigh the monthly excess returns of 30 different asset classes over 3-month T-bills relative to the trailing 2-year volatility of each asset class. The higher the excess return and the lower the volatility, the greater the risk appetite; conversely, the lower the excess return and the higher the volatility, the stronger the risk aversion.

The Putnam Global GDP Nowcast Index is a proprietary GDP-weighted quantitative model that tracks key growth factors across 25 economies. This index and individual country indexes are used as key signals in Putnam's interest-rate and foreign-exchange strategies.

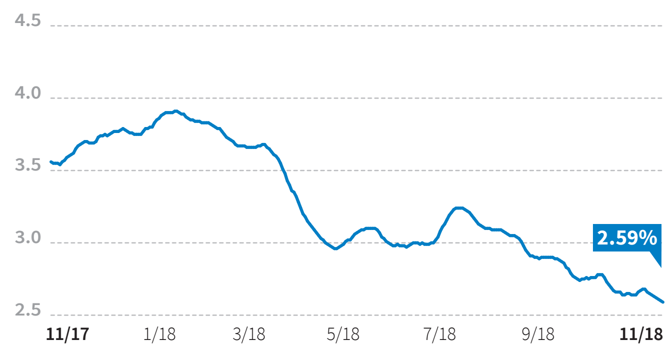
Global economic growth slows

SHORT-TERM TREND

The global economy continues to decelerate

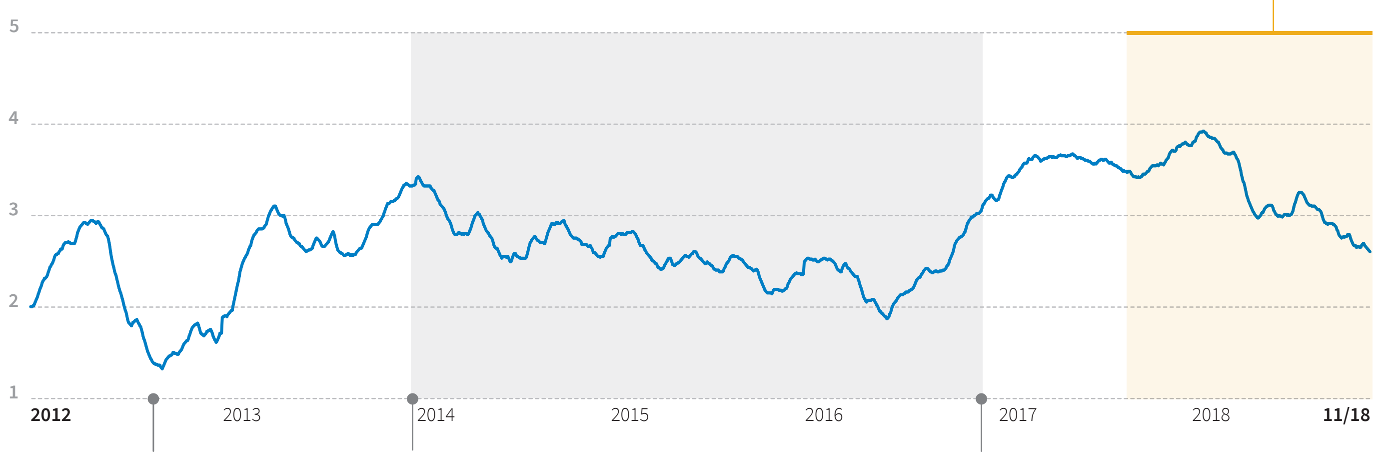
▲ 2.59%

Growth among G10 countries was mixed. Economic indicators for the Unite States were flat, while those for the eurozone and the United Kingdom slowed. In Japan, positive manufacturing, services, and composite PMI indexes signaled economic growth. Growth improved in the CEEMEA region but slowed in Asia due to China.



LONG-TERM CYCLE

This six-year illustration captures GDP gyrations since the financial crisis.

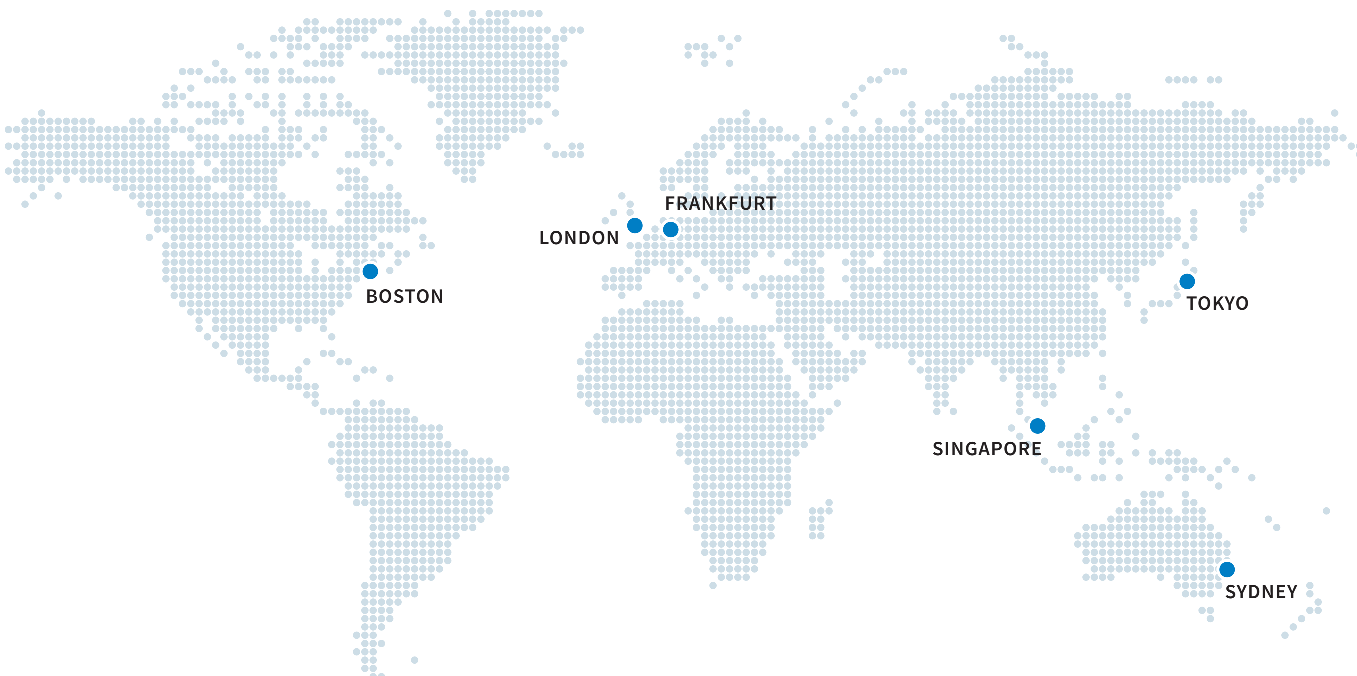


Sept '12–Dec '13
Global growth swings dramatically, under pressure from sovereign debt crises and darkening global growth prospects amid fitful recoveries.

Jan '14–Oct '16
Global growth settles into a more subdued pattern of modestly disappointing results.

Nov '16–Dec '17
More synchronous performance across global markets emerges to lift the trajectory of global growth.

Source: Putnam. Data as of November 30, 2018. We base our Global GDP Nowcast on a tailored methodology that captures daily data releases for the most essential growth characteristics for each of 25 countries — including purchasing managers' index data, industrial production, retail sales data, labor market metrics, real estate price indexes, sentiment indicators, and numerous other factors. The mix of factors used for each market may change over time as new indicators become available from data sources or if certain factors become more, or less, predictive of economic growth.



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The Macro Report is written by members of Putnam's Fixed Income team. With backgrounds in applied economics, currency and interest-rate analysis, and sovereign and local bond market dynamics, this group conducts macroeconomic research in support of Putnam's global fixed-income strategies.

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