THE MACRO REPORT | JANUARY 2019

A delicate balance

Forecasting 2019 means interpreting the interactions between economic growth, interest rates, and risky assets. Global growth is slowing. In the United States, waning fiscal stimulus measures and higher rates will trigger the pace of expansion to moderate this year. While we do not forecast a recession, markets remain on edge and investors are betting a slowdown will prevent the Federal Reserve from raising interest rates. A growing chorus of Fed officials have in recent weeks indicated the central bank will need to assess the economy before considering additional monetary tightening.

Meanwhile, China's economy — the world's second largest and an anchor for other emerging markets — continues to face headwinds. The central bank has taken steps to cushion the slowdown. President Donald Trump and Chinese President Xi Jinping agreed to hold off on further tariffs until March 1, 2019, to allow time to negotiate a trade agreement. Elsewhere, emerging markets remain vulnerable to rising interest rates and cooling growth.

THIS MONTH

Global growth set to slip

The Fed: All bets are off

Emerging markets stay afloat

Global growth set to slip

A Goldilocks scenario for 2019 would require economic growth that boosts risky assets but is not so strong that it pushes up interest rates.

Economic growth is slipping in most of the world. If there's one forecast about 2019 that we can make with confidence, it is that the configuration of growth and asset market performance of 2018 is not likely to be repeated. 2018 was a tough year for risky assets because they are leveraged to growth. The rise in real interest rates, anxiety about Fed policy in 2019, uncertainties generated by the trade war, and the Trump administration's policies have weighed on growth and sentiment. The longstanding economic challenges facing China and the eurozone are other factors.

China, eurozone face slowdown

China and the United States, two of the world's largest economies, wrapped up three days of trade talks in Beijing in January 2019. So far, both parties have given few details about the outcome. U.S. Trade Representative Robert Lighthizer is in charge of these negotiations, and he has a folder with a long list of "broken promises" by the Chinese on trade issues. Lighthizer will present demands that the Chinese simply will not accept. The question really is whether his view will prevail or whether Trump and Xi will privately reach a deal that will calm tensions.

In the eurozone, economic indicators continued to disappoint. The weakness among eurozone economies, especially in the second half of last year, was one of the largest surprises in the global economy in 2018. Growth is slowing, inflation is below market expectations, and domestic consumption remains sluggish. With the overall economic outlook not changing very much, it is looking more and more likely that 2019 will pass without an interest-rate hike by the European Central Bank [ECB]. The ECB ended its quantitative easing program in December. Italy, the eurozone's third-biggest economy, continues to contend with high debt levels and a shrinking economy. In December, the European Union reached a deal with Italy on its 2019 budget, which allows the country to avoid disciplinary action.

The forecasting dance

The link between growth, interest rates, and risky assets are central to this year's outlook. Every day we observe this dance that involves the real economy and its prospects, the financial markets, and policy makers. There are missteps and shocks. All three variables interact, react, and influence each other. Recent market movements are an adjustment to a weaker growth profile and an acknowledgement that there are downside risks. Much will depend on the Federal Reserve's monetary policies.

Global growth continues to slip

(% quarter-on-quarter, annualized)

Source: Putnam, as of December 2018.

U.S. economy cooling

The U.S. economy is moderating amid rising interest rates, a shifting fiscal policy, and uncertainties generated by the Trump administration's trade policies. Our central scenario is for growth to slow to its pre-2018 range. Still, recession risks remain low. Economic indicators have started to moderate. The Institute for Supply Management's (ISM) closely watched manufacturing index showed that U.S. factory activity in December slowed more than expected. Investors follow the ISM index even though it is an inferior indicator. Corporate investment has underperformed, and forecasts for investment spending are slipping.

And the cost of capital in the U.S. corporate sector is rising. Corporate bond and high-yield bond spreads — the difference between the yields of two bonds with similar maturities — have widened. This means there is a material shift in the cost of debt, and it will affect the economic outlook. The U.S. Treasury yield curve is exceptionally flat and is indeed inverted on some measures, a sign that bond investors expect the economy to slow.

Some bright spots

The December jobs report showed that U.S. payrolls surged by 312,000 jobs and wage growth accelerated. Jobs were created in education and health, two sectors that were lagging. But detailed analysis of the jobs report indicates that not much has changed. Wage increases are still being driven by a few sectors. Consumer confidence and the quit rates (the number of people who leave their jobs) appear to have rolled over. But consumer demand is holding up well and could help buoy the economy as we roll into 2019. Manufacturing accounts for about 12% of gross domestic product (GDP). While the sector is cyclical, it would take a much larger decline in the manufacturing ISM to make us worried about a decline in GDP.

For the outlook, the risks remain asymmetric. The possibility that we are at the early stages of a capex/productivity growth phase seems even more remote now. A trade peace deal could be signed soon, but we are not sure this would provide much positive shock. We are left with the very real risk the Fed will be too aggressive, placing too much weight on the labor market — which is at best a contemporaneous indicator — and not enough on the erosion of the economy's prospects.

The Fed: All bets are off

Financial markets stumbled up and down on worries the Fed was moving too quickly, but Powell's recent wavering is raising the odds of a pause.

In December, the Fed raised its benchmark interest rate by 25 basis points, lowered growth projections, and limited the number of future hikes. The central bank took the federal funds rate to a range of 2.25% to 2.50%, the fourth increase of 2018 and the ninth since it began normalizing rates in December 2015. The Fed also made a slight modification in its December statement, stating that it expects "some" further gradual increases in rates. In a press conference following the rate meeting, Fed chair Jerome Powell said recent market developments have not "fundamentally altered the outlook." The markets nosedived.

Since then, the Fed seems to be struggling a bit to get its message across. Part of the problem is the uncertainty over exactly what the message should be. At Powell's press conference in December 2018, the central bank exposed the box it has put itself in by banging on about the current strength of the economy when it's the outlook that matters.

It may also be the case that the Federal Open Market Committee (FOMC), which sets rates, was distracted by Trump's public ruminations about firing Powell.

The Fed seems to be struggling a bit to get its message across.

Just days after Powell spoke, New York Fed President John Williams was on CNBC to try to "clarify" the FOMC's message. Williams said the central bank is listening "very carefully" to the market's concerns on growth but believes the U.S. economy is in good shape. Since then, we have heard from a number of other FOMC members, offering one insight or another. In early January, Powell said that low inflation would allow the Fed to be "patient" in deciding whether to continue raising interest rates. He also said the bank will "watch" how the economy evolves. Those comments were welcomed by investors.

Listening to the markets

It's becoming clear the Fed is beginning to take seriously what is now worrying the markets — weaker global growth, the widening consequences of the China–U.S. trade war, and financial market volatility. The U.S. economy is less dependent on global demand than the economies of most of other countries. Still, China is large enough and well-enough integrated globally that even the United States cannot shrug off its deceleration.

More important is the sheer uncertainty about the trade relationship with China and the rest of the world. If there is a deal between Trump and Chinese President Xi Jinping, what will it cover? Will the administration impose tariffs on autos imported from Europe? There is genuine uncertainty among investors about these issues.

What will cause the markets to stabilize? One of the key indicators is the central bank. In almost all instances, we saw a central bank, especially the Fed, react to market volatility. The bond market rally of the past two months probably reflects expectations that the Fed will step up to ease volatility, if necessary. The overnight index swaps (OIS) market is signaling the Fed may hold interest rates steady in 2019 and puts some probability of a rate cut at the end of the year and into 2020. OIS uses an overnight rate index, such as the federal funds rate, as the underlying rate for its floating portion. Interest-rate swaps involve the overnight rate being exchanged for a fixed interest rate.

But the Fed has not capitulated yet. Policy makers only reduced rate-hike expectations for 2019. For bond markets to rally further and for markets to stabilize, this is probably not enough, at least not yet.

But the Fed has not capitulated yet.

Finding stability amid chaos

Another indicator that can cause markets to react is investor retreat. There has been a lot of talk of withdrawals by institutional investors and fast money. But exchange-traded funds (ETFs) are still attracting inflows. ETFs are big, they have not yet been tested by a major selloff. When they produce outflows, they are likely to move the markets in unexpected ways.

A third indicator is fundamental valuation, but this is difficult for investors to assess. Exactly what are the relevant fundamentals, and how confident can investors be that they can be assessed properly? Will global growth continue to deteriorate or not? Will the trade war end? If global growth stabilizes, emerging-market assets would look attractive at today's levels. If the global environment deteriorates, that appeal would disappear. But the outlook for global growth is not determined by emerging markets.

A pause?

The sensible course of action for the Fed will be to hold off from raising interest rates. But we are not yet ready to forecast the first cut. It is also important to note the Fed is not there yet. Clearly, the Fed is having these discussions, and there are some FOMC members who have come to the conclusion that at least a lengthy pause is warranted.

The strong labor market and future indicators of wage growth and declining unemployment will prompt many members of the FOMC to call for further tightening. A shift to a pause would be a decisive shift in the Fed's assessment. We think risky asset markets are likely to remain vulnerable until we get a clearer signal from the Fed. And if we don't get such a signal, we will be talking about a policy mistake, with all its attendant consequences.

Emerging markets stay afloat

While some emerging-market assets have started to rebound, their economies remain vulnerable to a slowdown in China and rising global interest rates.

Emerging markets' manufacturing purchasing managers index (PMI) edged up in December, signaling that conditions in manufacturing sectors are much healthier than a few months ago. Indonesia and Hungary, in particular, accelerated, while Mexico, Brazil, and Russia stabilized. But the manufacturing sector in China and the more advanced Asian economies weakened. Emerging-market assets have started to rally, currencies have stabilized, and dollar debt markets are looking better. Still, we need more clarity on global developments before turning bullish.

China's cooling economy

There are many headwinds facing China's economy, and the trade war with the United States is one of them. Still, the government has the tools and the determination to keep overall growth at its target. China is not a major source of risk for the global economy as evidenced by weaker PMI data and the central bank cutting the reserve requirement ratios for banks. The China–U.S. trade war, which creates some economic problems, also creates policy options. China can calibrate what kind of concessions they are prepared to offer with an eye on the domestic economy.

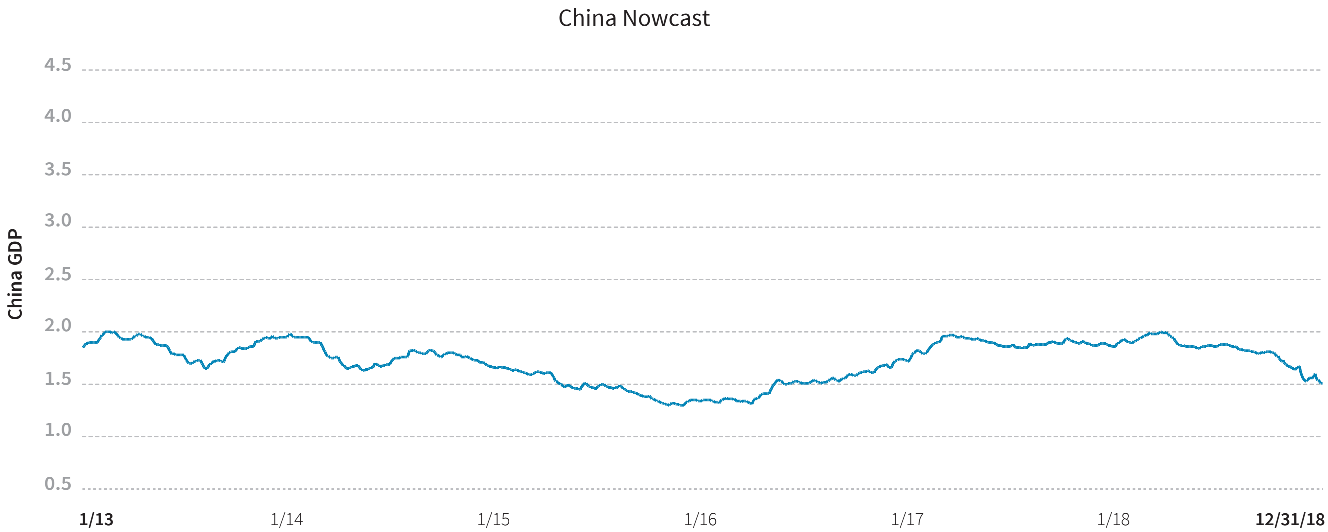
However, as the economy grows and becomes more sophisticated, the policy challenge will mount, and the chance of a policy mistake will rise. The Chinese authorities are used to having a great deal of control over the economy and being able to fine-tune economic outcomes as closely as they fine-tune political outcomes. Their ability to do this is shrinking over time, and more real economic volatility is likely as a result. But this does not mean that China will be the source of the next global recession. For the time being, we do not see this as a major risk.

Risks in emerging markets

Emerging markets are a small piece of the puzzle. It's the tail, not the dog. Like other risky assets, emerging markets do well in a Goldilocks environment. But they are different from other risky assets because they are more exposed to dollar movements. Developing markets thrive when the dollar weakens or holds steady, interest rates fall or remain low, and there is decent economic growth. These markets do badly when the dollar and interest rates rise and growth slips.

China's growth trends lower

(% quarter-on-quarter)



Source: Source: Putnam, as of December 2018. We base our proprietary China GDP Nowcast on a tailored methodology that captures quarterly data releases for China's most essential growth characteristics including purchasing managers' index data, industrial production, retail sales data, job market metrics, real estate activity indexes, sentiment indicators, and numerous other factors. 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.

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In the current global environment, we expect emerging markets to remain a bit vulnerable. If our central forecast proves to be correct, emerging markets will do quite well; we expect decent global growth and the Fed to be on hold. The dollar is always a bit of a mystery, but the chances of a sharp dollar appreciation do not seem worryingly large. The problem is how we get there from here. With markets still unsure about recession risks and with lingering uncertainty over exactly how the Fed is looking at the year, assets remain somewhat vulnerable. We expect to turn bullish on emerging-market assets at some point, but not just yet.

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.

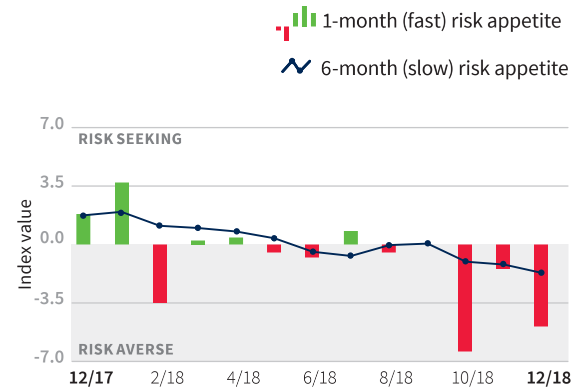
Risk appetite plummets

SHORT-TERM TREND

December was another brutal month amid rising interest rates, trade woes

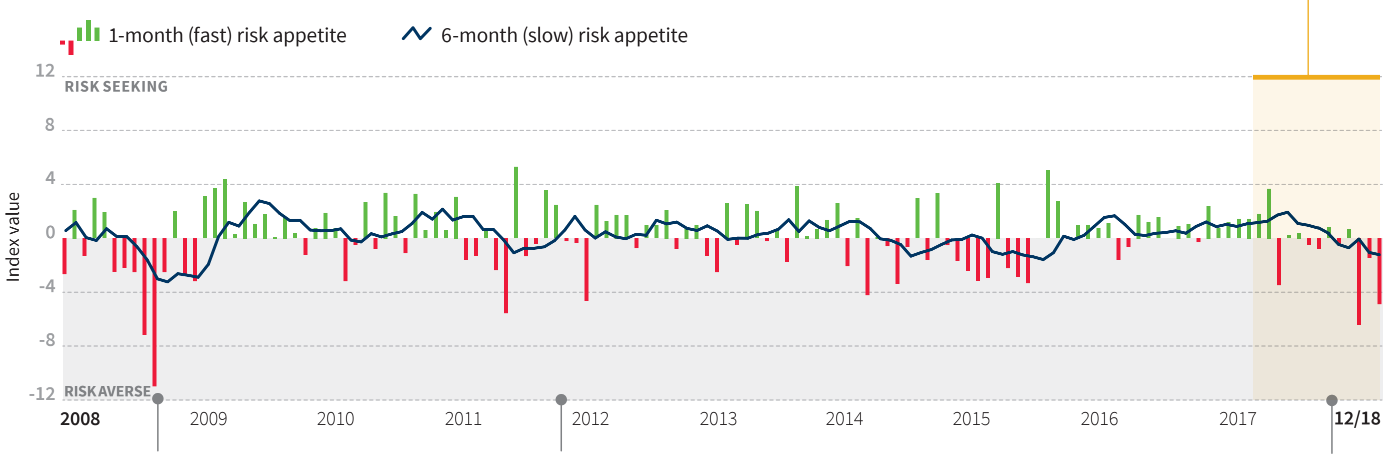
Risk ON OFF

- U.S. and global stocks declined across the board
- Commodities fell, and precious metals rallied
- Emerging-market fixed-income assets outperformed other bonds



LONG-TERM CYCLE

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



Sept '08
With Lehman Brothers' bankruptcy and the onset of the global financial crisis, appetite for risk all but disappears.

Sept–Nov '11
Eruption and subsequent clearing of concerns over EU sovereign debt crisis, U.S. debt ceiling, and fear of China hard landing drive major risk selloff and rally.

March '16–Jan '18
Risk assets rally amid improving commodity prices, perceived stability in China's macro data, and expectations for gradualist Fed policy.

Source: Putnam. Data as of December 31, 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.

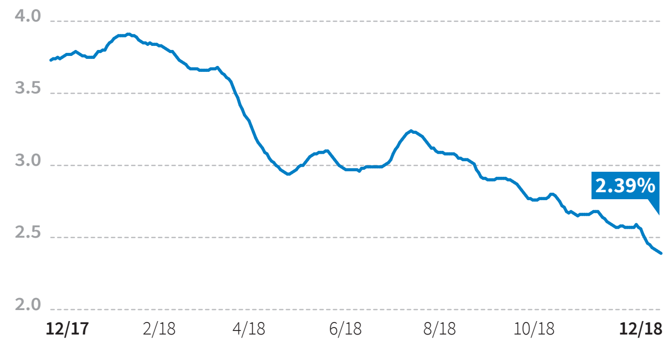
Global economic growth slows

SHORT-TERM TREND

Economic expansion slipped across most of the world

▲ 2.39%

Growth among G10 countries was mixed, with the eurozone leading the decliners. New Zealand's economic indicators improved. In the eurozone, manufacturing and services PMI dropped; business sentiment disappointed in Italy and France. Growth in the CEEMEA improved due to South Africa. China's growth cooled.



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 December 31, 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.

Serving clients around the globe

At Putnam, we have built a global market presence that offers local market expertise. Our dedicated institutional specialists focus on building relationships and providing solutions aligned with client objectives.

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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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