

THE MACRO REPORT | FEBRUARY 2019

# Tipping points and the economy

The global economy continues to slow. But there are signs that more supportive policies, including a dovish U.S. Federal Reserve, will keep growth within a certain range. In the United States, there is scope for more conflict between President Trump and Congress as negotiations continue over government funding and border security. In late January, Trump signed a short-term spending bill into law, ending the longest government shutdown in history amid a fight over building a border wall. However, the conflict has affected consumer confidence.

Across the pond, the eurozone's economy is suffering its biggest slowdown in half a decade, raising questions over whether the European Central Bank (ECB) will be able to raise interest rates in 2019. Meanwhile, China's economy may stabilize as the central bank continues to take steps to cushion the slowdown. The United States and China launched new trade talks, fueling hope that the tariff conflict would soon be resolved. The outcomes of the issues mentioned above could be enough to tip the global economic outlook one way or another.

## THIS MONTH

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U.S. gridlock clouds the horizon



The ECB's next step



Keeping China afloat

# U.S. gridlock clouds the horizon

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The conflict between President Trump and Congress over border security has influence on consumer confidence and negotiations to resolve the U.S.–China trade spat.



The longest shutdown in U.S. history ended on January 25, after 34 full days. President Trump agreed to reopen the federal government for at least three weeks while negotiations continued over border security, backing down from his initial promises to build a wall. The gridlock surrounding the partial government shutdown was clearly harmful, rippling across the economy. And the failure to negotiate a border-security compromise continues as a political fault line.

The shutdown adversely effected some economic variables, but the majority of the losses will be recouped. The Congressional Budget Office (CBO) published estimates of the cost of the shutdown. While it is hard to be definitive, the CBO estimates that GDP in the fourth quarter of 2018 was about 0.1% lower than anticipated and that first-quarter 2019 GDP will be lower by about 0.2%. The CBO projects that 0.02% of GDP will not be

recovered, or about \$3 billion in economic loss. Consumer confidence is heavily influenced by the labor market, oil prices, and headlines out of Washington. We can safely say the drop in confidence was partly the result of the government shutdown.

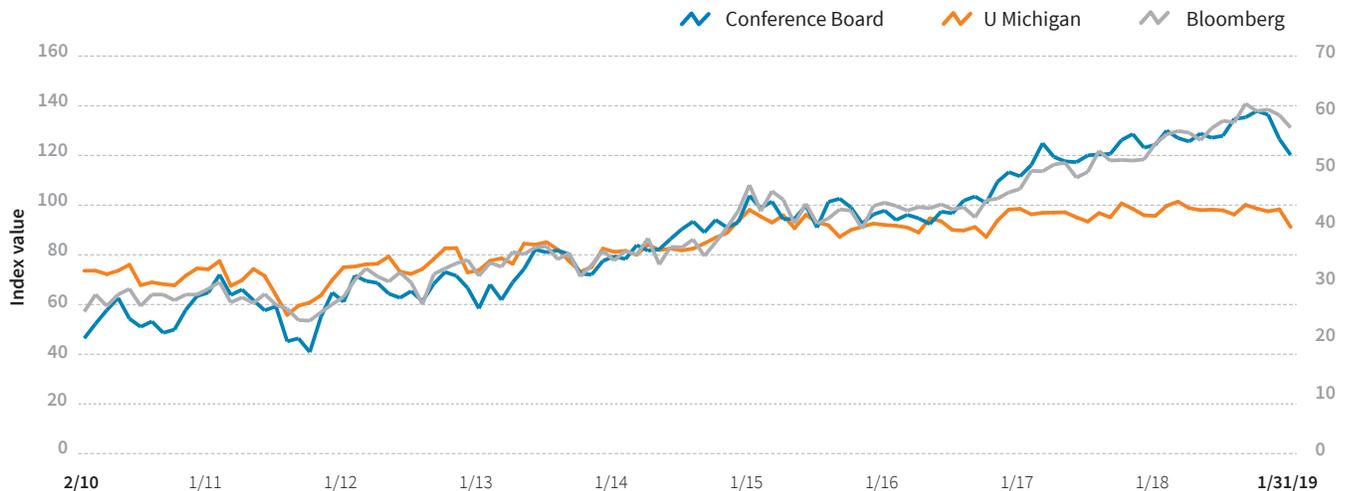
## Debt ceiling looms

There is plenty of scope for more conflict between the White House and Congress in the coming months. Regardless of whether an immediate solution is eventually reached, the debt ceiling will start to bind later in 2019, putting the topic back in the spotlight. We don't expect major changes in the fiscal outlook; tax and spending plans are effectively locked. However, Trump has threatened to shut down the government again. While this doesn't seem very likely, it cannot be dismissed as an empty threat. In January, Trump caved as soon as the Republican consensus in the Senate began to crack, and it's hard to imagine the Senate would want to go through all that again. At the same time, the President's decision-making remains hard to forecast. This has implications for the China trade talks.

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## Government shutdown has impacted household confidence

(month-on-month)



Sources: The Conference Board, University of Michigan, Bloomberg, as of January 2019.

### Playing by different rules in U.S.–China trade talks

China and the United States, two of the world's largest economies, are headed to the negotiating table again. The deadline for the trade talks is close to the deadline for talks on border security. One can't help wondering how the odds of success on one could affect the odds of success on the other. If Trump fails to secure a border wall, will it push him to a harder line on trade? If he wins on the wall, will it push him to a harder or softer line on trade? We see no change in the underlying dynamics in the trade talks with China; the Chinese appear prepared to buy more U.S. products to narrow the bilateral trade gap.

The Chinese also seem prepared to take a somewhat harder line on intellectual property theft. However, there is no sign of any Chinese willingness to address U.S. Trade Representative Robert Lighthizer's deeper concerns about the openness of China or ways in which capital is allocated across the economy. Any new deal in the coming weeks will likely fall short of what the administration wants. The key question is whether Trump will accept the deal. In a White House with clear decision-making processes, the border wall outcome would have little relevance to U.S.–China trade. However, the Trump White House plays by different rules.

### High stakes game

The economic stakes are somewhat greater for the trade conflict than they are for the border wall (which is more symbolic). An agreement with China will clear the air over global trade, while imposing the next round of tariffs will probably add to the difficulties facing global manufacturing. Trade and immigration were key issues in Trump's campaign, and something that can be sold as progress on both fronts is important to the President's re-election campaign.

We do not know how this will play out. Our best guess is that Trump gets a border security deal that falls short of the wall. He could try to pursue the national emergency route, but he will face legal problems. Politically harmed by this, how likely will Trump be to reject the China trade deal that will be on offer? The tone of his tweets seems a little softer; he has said nothing will be finalized until he meets in person with Chinese President Xi Jinping. We anticipate Trump will take the deal Xi offers. This would lift the cloud over the outlook.

## The ECB's next step

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The central bank has turned a little more dovish on interest rates amid ongoing signs of economic weakness and speculation of new, cheap loans to banks.



The European Central Bank (ECB) recently cut its 2019 growth projection, acknowledging that risks to the outlook for the euro-area economy had increased. One of the biggest surprises in the global economy has been the eurozone's weak performance. Why is the region continuing to surprise negatively? The problem is that the eurozone's three biggest economies — Germany, France, and Italy — are barely growing. In Germany, businesses are nervous about the global outlook, and the struggles of the auto industry have had a big impact. Italy's economy contracted in the fourth quarter of 2018, largely due to weak domestic demand and the slowdown in its main trading partners, such as China and Germany.

The political stresses in the region may be affecting economic data. In France, civil protests have started to weigh on the economy. The chaos surrounding Brexit — prompted by the United Kingdom's parliament voting to reject Prime Minister Theresa May's Brexit deal in January

2019 — has weighed on investor sentiment. In addition, Trump's trade protectionist measures have harmed business confidence since the eurozone is a big exporter to China and to emerging markets.

### Was the ECB wrong?

Regional policies may have played a greater role than we anticipated. Although Germany relaxed fiscal rules this year, the overall policy stance is quite tight. In addition, the failure to move forward on the eurozone's financial architecture has played a role in the conflict with Italy and the slow progress in dealing with the region's banking system. Italy's populist government had clashed with the European Union over the country's fiscal policy. There is also a possibility the region's monetary policy was too tight.

One of the biggest surprises in the global economy has been the eurozone's weak performance.

Recent research illustrates the inaccuracies in the ECB's inflation and unemployment forecasts. The forecast errors have been large and persistent. Indeed, the estimates for core inflation have been too high since they were first published in 2013, and the forecasts for unemployment have been too low. This strongly suggests that the ECB's assessments of the eurozone's economic fundamentals were wrong. The ECB was running an easy policy during this period, including quantitative easing (QE). However,

## Eurozone GDP continues to slip

(% quarter-on-quarter)



Source: Putnam, as of January 2019.

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 policy stance may not have been as loose as the ECB believed because of the stresses in the banking system. Perhaps, the Germanic wing of the governing council, the decision-making body of the ECB that consists of six members of the executive board and 19 national central bank governors, was just too strong to put a looser policy in place.

### A new type of stimulus

The ECB recently shifted its policy message. At its meeting on January 24, ECB President Mario Draghi warned of “downside” risks to economic growth in the region and reaffirmed the central bank’s stance to keep key interest rates at their present levels through the summer of 2019 and “longer, if necessary.” The central bank left policy on hold at the policy meeting. Draghi said he did not think the markets were wrong in their assessment that there would be no interest-rate increases this year.

The central bank ended its €2.6 trillion bond-buying program, or QE, in December 2018, but will keep its plans to reinvest cash from maturing bonds for an extended period of time. There are now expectations that it will turn to other instruments to keep credit flowing. A new round of cheap multi-year loans to banks, known as targeted long-term refinancing operations (TLTRO), was widely seen as the first port of call. Draghi said in January that TLTROs had been raised by several policy makers, but no decision had been taken.

There is renewed talk about the possibility of moving away from a negative deposit rate to improve the position of the region’s banks. However, it will be hard to raise the deposit rate without sending a hawkish message, and it may well be that this is where the design of the TLTRO will be important. The ECB does not want to tighten its stance, even though, like the Bank of Japan, it is worried about the harmful side effects of its current policy.

# Keeping China afloat

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The economy seems closer to stabilization as policy makers take measures to halt the slowdown amid the ongoing trade negotiations with the United States.



China's economy is slowing, but there are emerging signs of stability. Policy makers are taking the slowdown seriously. In recent weeks, the government has taken measures to prevent further deceleration and shift the economy to a slightly stronger path. Some analysts make a living adding up all these measures and generating a measure of “policy stimulus,” and by such metrics the authorities have done a lot. Similarly, we expect the economy to show clearer signs of improvement by the summer of 2019.

We are not willing to join the ranks of the China bears who think disaster is just around the corner.

As the Chinese economy grows in size and sophistication, the policy challenges will mount. The chance of a policy mistake will rise, especially because of the growing disjunction between economic needs and policies being implemented. On the other hand, we are not willing to join the ranks of the China bears who think disaster is just around the corner. China has major challenges and the risks are rising, but we don't expect China to spark a global recession.

## Resuming trade talks

These economic risks include the trade conflict with the United States and China's high investment ratio. The trade spat raises doubts about China's export capacity over the short and long terms. And China can't be confident about Trump's response to the offers that it is placing on the negotiating table. Still, it is an opportunity for China because it allows reformers in President Xi Jinping's government to advance their agenda.

## Lacking a social safety net

China's high levels of investment — without the corresponding increase in domestic consumption — is a key risk because of the close relationship between investment and savings. The difference is the current account: A country that invests more than it saves has to import capital, and a country that saves more than it invests has to export the capital. The focus of China skeptics is often on investment, but we could describe

## China's growth holds steady

(% quarter-on-quarter)



Source: Putnam, as of January 2019. 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.

China as a country with a whole lot of savings, rather than a country with a whole lot of investments. If you think China's problem is that it invests too much, then you spend too much time worrying about government policies on investment and the exchange rate.

But what if China's "problem" really is that its households save too much? The country ends with far more capital than it can productively invest. All sorts of factors go into the decision households make about saving. Age, income, wealth, and uncertainties all play a role. China embarked on economic reforms without private wealth. The reforms also damaged the social safety net — the iron rice bowl — that was administered through rural communes and urban state-owned companies. China's one-child policy has also lowered the savings capacity. Globally, having children is one of the most important ways to save. When households began to earn wages through the market, they started to save to build wealth and to insure themselves against uncertainty.

The government has also restricted the type of savings consumers can access, leaving households with few options other than low-return bank deposits. These problems have only eased slightly. There is no social safety net, and uncertainty remains high.

### Boosting consumer spending

For consumption to grow faster than income, the rate of saving has to decline. For consumption to grow at the same pace as income, the rate of saving has to remain unchanged. This point is largely lost in most commentary on China. A serious set of policy initiatives designed to shift the economy to a path of greater reliance on domestic consumption spending would have to address the incentives households face to save.



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 rebounds

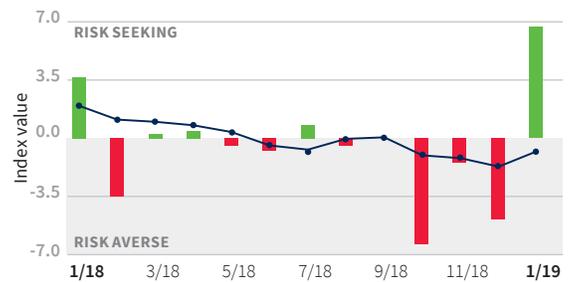
## SHORT-TERM TREND

January was the strongest risk-on month since May 1989

Risk **ON** OFF

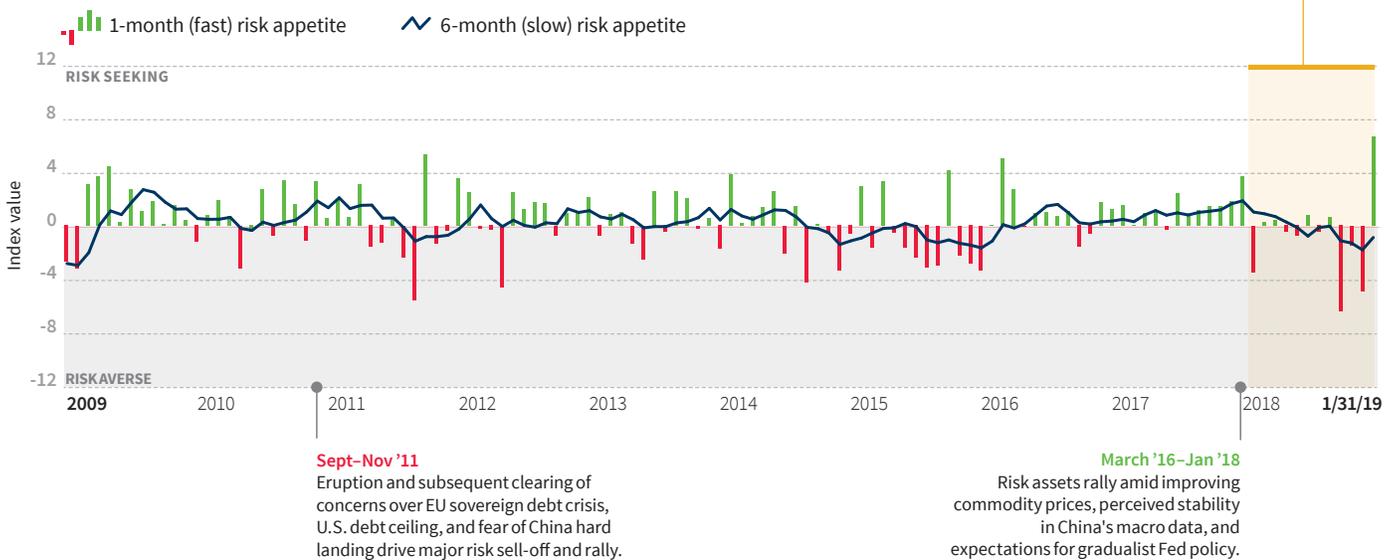
- U.S. risky assets, such as stocks, underperformed globally
- Emerging-market and international equities outperformed the United States
- Fixed-income asset classes had positive returns
- Energy-related commodities gained

█ 1-month (fast) risk appetite  
 ~ 6-month (slow) risk appetite



## LONG-TERM CYCLE

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



Source: Putnam. Data as of January 31, 2019. 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 slips

## SHORT-TERM TREND

Economic expansion continues to erode

▲ 2.24%

Growth among G10 countries slowed, with the eurozone, Japan, and Canada leading the decliners. The United Kingdom’s economic data improved. In the eurozone, manufacturing and business sentiment dropped. In Japan, the growth path dipped precipitously. Growth slowed in Mexico. China’s growth held steady.



## LONG-TERM CYCLE

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



**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 January 31, 2019. 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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