THE MACRO REPORT | MARCH 2019

Balancing growth and interest rates

The global economy continues to slow. Higher interest rates, weaker demand from China, political troubles in the eurozone, and protectionist tariffs have kept the lid on economic growth. Still, that downward trend may be easing, and we are likely to see waves of optimism and pessimism about growth in the coming months. The Federal Reserve's dovish pivot on interest rates has boosted markets and prompted investors to bet against further hikes. The Fed will also take a more flexible approach to shrinking its balance sheet.

Meanwhile, China continues to fine-tune measures to cushion its cooling economy. Amid this flow of supportive measures, we expect growth in the world's second-largest economy will stabilize. China and the United States are also close to a trade deal, and any truce would be a positive step. In Venezuela, meanwhile, sanctions have essentially ended crude exports to the United States, causing fluctuations in global oil prices.

THIS MONTH

The Fed turns dovish

China's growth playbook

Venezuela crisis weighs on oil

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The Fed turns dovish

Low inflation and a moderate deceleration in economic growth may prompt the Fed to pause on future rate increases.

Federal Reserve policy makers are closely watching the unfolding interplay between growth, inflation, wages, and other economic indicators to manage interest rates. The U.S. economy slowed at the end of 2018. Gross domestic product — the broadest measure of goods and services produced in the country — grew at a 2.6% annual rate in the final three months of last year. Consumer spending, the bedrock of the economy, increased, exports rebounded, and businesses stepped up their investments.

In addition, the U.S. services sector, as measured by the Institute for Supply Management's (ISM) non-manufacturing purchasing managers index, expanded at a faster rate in February. If the sector's rebound becomes a pattern, then hawks at the Fed will start to spread their wings. There will be talk about another interest-rate hike. However, we believe that higher rates — either by the Fed raising short-term rates or the markets pushing longer-term rates up — will be harmful to risky assets and the economic outlook. Conversely, a set of weaker data will likely push interest rates lower, creating some stimulus for the economy.

Winners and losers in the labor market

The labor market remains strong despite the slowdown in job creation in February, which is allowing household income and spending to grow. It is all happening at a steady pace, consistent with GDP growth of about 2%. Although hiring slowed last month, wages are edging up, the economy is inching toward full employment, and there are some signs of a cyclical top. However, the pace of job creation slowed because of rising labor costs. With inflation contained by global factors, employers can't pay higher wages and pass the higher costs on in the form of higher prices. So, they resist higher wages when they can, and they reduce employment growth where they cannot.

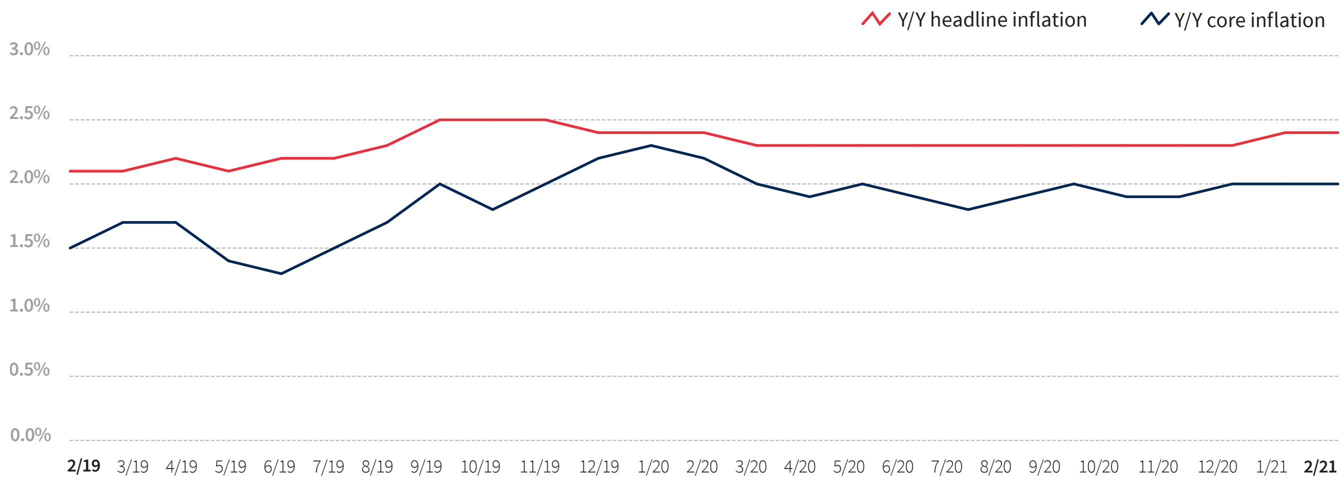
Changing minds?

We doubt the February jobs report (20,000 new jobs) will change any minds at the Fed. The FOMC has made it clear it pays attention to price, rather than wage, inflation. Even with accelerated wage gains, it's not clear how, or how quickly, this would translate into higher consumer price inflation. It could simply result in slower job creation. The economy is still adjusting to reduced fiscal stimulus and the lagged effects of 2018's interest-rate increases.

We've heard quite a lot from the Fed recently. Officials have sought to clarify their views on the outlook for the economy and interest rates. Richard Clarida, the vice chair of the Fed's Board of Governors, is stressing the importance

Inflation expected to hold steady

(% year-on-year)



Source: Putnam, as of February 2019.

of low inflation in permitting the Fed to be patient about its next rate move. If the labor market remains strong, the Phillips curve warriors at the Fed will start to get nervous and talk of another hike will resurface. With the yield curve so flat, an interest-rate increase would be very damaging to risky assets. But should the yield curve steepen because of rising inflation expectations, it would be a different story.

Balance sheet plans

Fed Chair Jerome Powell has announced a plan to stop shrinking the estimated $4 trillion balance sheet that was built up during the 2008 financial crisis. The balance sheet was stable at about 6% of GDP before the crisis. It peaked at about 25% of GDP post-crisis, and it is now below 20% of GDP. Powell was clearly trying to avoid being too specific, but he hinted at a GDP level of 16% to 17% for the Fed's balance sheet. This is a fairly wide range, and the time span needed to reach that level matters to markets and investors. Perhaps the key point is that the Fed's balance sheet is going to remain large, keeping the central bank at the heart of asset markets for the foreseeable future.

In addition, there has been some focus on possible changes to the Fed's strategy. The key issue: With a low and perhaps permanently neutral interest rate, it is likely the Fed will be constrained by the zero-nominal bound on interest rates in a future downturn. What should the Fed do about this? Academics have favored price-level targeting, but the Fed views this as too complicated to explain to the public. The idea that seems to be gaining popularity is "average inflation" targeting. That would enable the Fed to make up past inflation undershoots (or overshoots). Under the current system, the target is reset every year. But we are a long way from this being possible.

If the Fed were to raise interest rates this year, it will be in a context of stronger economic performance.

The Fed continues to talk about being patient on the direction of interest rates. The overall tone is dovish. If the Fed were to raise interest rates this year, it will be in a context of stronger economic performance.

China's growth playbook

The world's second-biggest economy may be stabilizing as policy makers cushion some of the slowdown with more supportive measures.

The Lunar New Year always makes the early months of the calendar year hard to interpret. Our Nowcast for China's growth, however, has slipped a little. Still, in recent months, the government has taken further measures to shore up the cooling economy amid ongoing trade negotiations with the United States.

In early March, China lowered its goal for economic growth and announced a major tax cut, as policy makers seek to pull off a gradual deceleration while grappling with the trade standoff with the United States. In the annual economic report, Premier Li Keqiang set the gross domestic product (GDP) growth target for the year at a range of 6% to 6.5%. That compares with last year's "about" 6.5% goal. The point is not so much the actual GDP growth number given the uncertainties around China's accounting, but that Premier Li himself presented the report to the National People's Congress. He has signaled how the government views the economy — that a slight slowdown is expected in 2019.

Supportive policy measures have continued to flow out of Beijing. The latest measures include the tax cuts, a reduction in corporate social security contributions, and an increase in local government bond sales to finance infrastructure projects.

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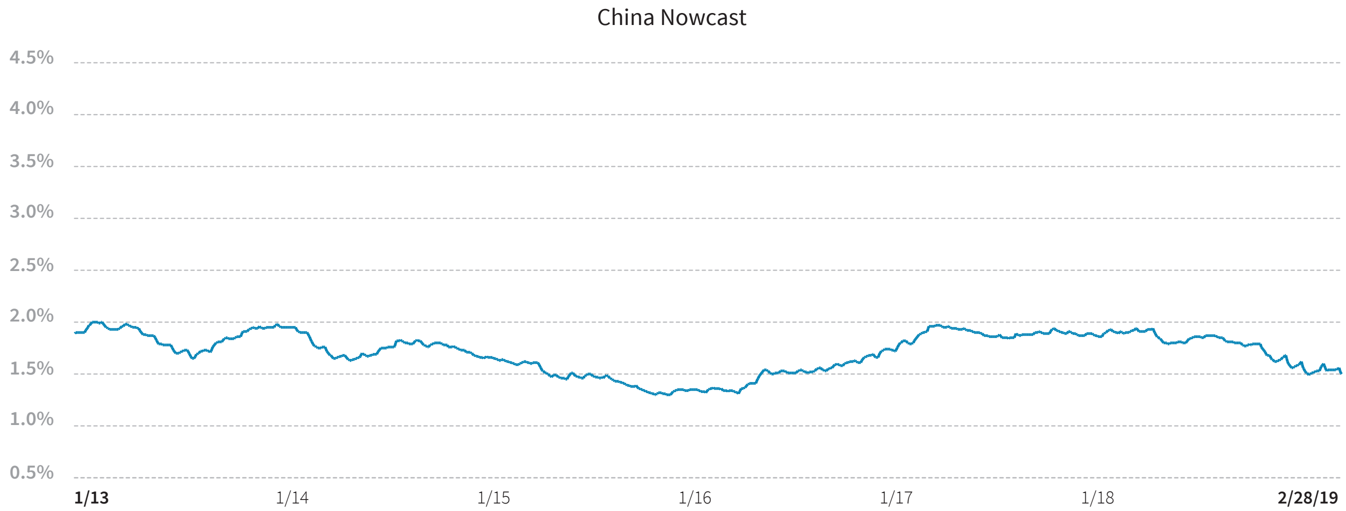
Growth to stabilize

Overall, our view of China has not changed. We expect the downshift in growth to stabilize soon. This may already be happening, and we expect growth to stay in a narrow range for the remainder of 2019. Actual, realized growth is likely to pick up because of the policy stimulus in the pipeline. There may be some downside risk if the U.S. trade deal falls through or if it breaks down quickly because of perceived Chinese infractions.

There is also growing realization in Beijing of the constraints on policy. Dressed up in the Marxist lingo that fills pronouncements from officials of the Communist Party of China are clear warnings about the dilemmas facing policy makers and the difficulty of supporting growth while limiting leverage. If you add to the economic report the recent political commentary by President Xi Jinping, in which he stressed the importance of economic

China's growth slips

(% quarter-on-quarter)



Source: Putnam, as of February 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.

stability to prevent political upheaval and secure the position of the Communist Party, then it is clear that "limiting leverage" is the most vulnerable policy.

Xi's speech, presented before a hastily gathered assembly of local government officials, reinforced the hardline and centralized tilt of his administration.

Xi's speech, presented before a hastily gathered assembly of local government officials, reinforced the hardline and centralized tilt of his administration. He called for the tighter policing of the internet and a greater effort to ensure the youth in China do not drift into a looser interpretation of Marxism. However, the increase in centralization risks denying local government officials the flexibility they need to address the rising economic challenges.

Optimism surrounding trade deal

There are clear indications from Washington and Beijing that a trade deal is near. It appears the Chinese government is preparing to spin some concessions to the United States as measures that will help the business environment and thereby support the local private sector. It is also clear that President Trump has undercut Robert Lighthizer, the U.S. trade representative. But Lighthizer is an accomplished bureaucratic warrior, and he is not going to roll over easily. Our guess is that he is busy inserting into the text of the deal all sorts of phasing provisions with progress reviews and safeguards that will effectively turn the trade war not into a lasting peace, but into a set of minor ongoing skirmishes.

Any deal with China will provide some reassurance to markets and businesses and lift an important cloud. But the risk is that the issue won't go away completely given the protectionist instincts of the Trump administration.

Venezuela crisis weighs on oil

Economic sanctions have essentially shut Venezuelan oil out of the U.S. market and caused fluctuations in global oil prices.

Oil prices rose in mid-February before erasing some of the gains later in the month. Crude prices are holding in a fairly narrow range. Still, prices are below our estimate of fair value. That said, the gap between fair value and prices in the spot market is not very large. A number of developments have influenced prices on the supply side, including U.S. actions against Venezuela, which has the world's largest oil reserves.

President Trump slapped surprise oil sanctions on Venezuela aimed at toppling President Nicolás Maduro. The sanctions announced by the Treasury Department in late January 2019 banned United States companies and individuals from dealing with Venezuela's state-run oil company, Petróleos de Venezuela (PDVSA), which provides about 90% of the country's hard currency.

As a result of the sanctions, the United States has stopped importing crude from Venezuela. That has caused some temporary price anomalies on the Gulf Coast as the refiners that are set up to process the very low-quality, mud-like Venezuelan crude are scrambling to find other sour crudes. This has some implications for refinery run rates, for gasoline supplies, and ultimately for crude prices.

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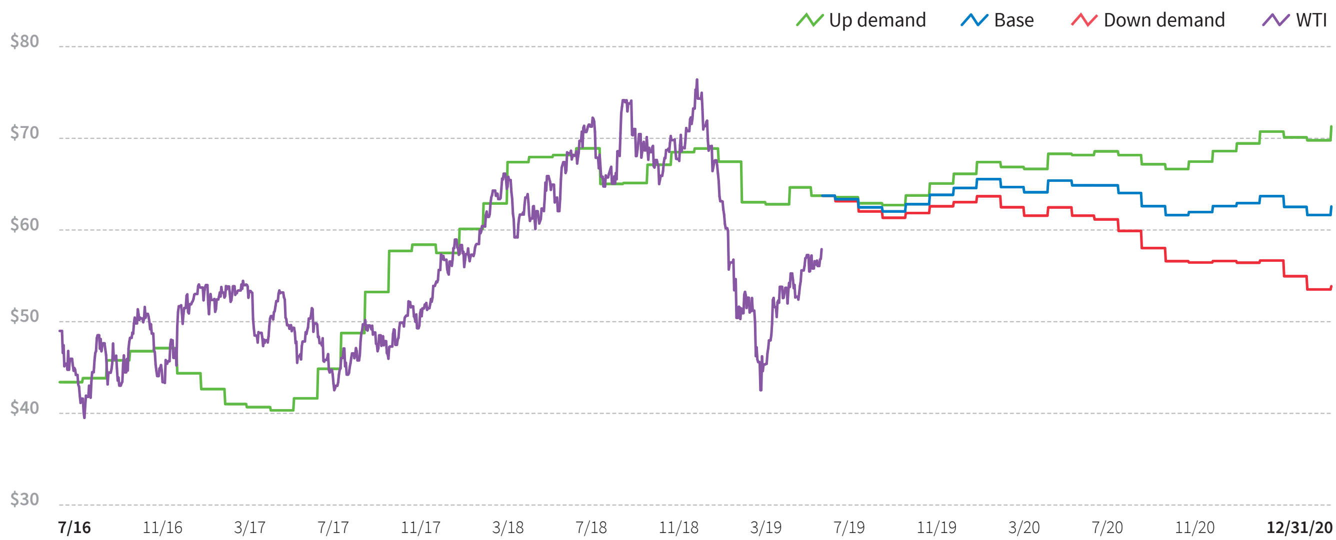
The price of political uncertainty

We don't really know what is happening with Venezuela's oil output and exports. Russia and China have been supplying the additives that refiners need to process Venezuela crude. Bloomberg, however, reports that there are about 14 million barrels of crude from Venezuela floating in the Gulf of Mexico as PDVSA struggles to find buyers.

There aren't that many refiners that can process the crude and risk U.S. sanctions. They are probably only prepared to buy it at large discounts. All this will get sorted out when, and if, Maduro leaves office and a new government takes power. For now, however, Maduro's administration is holding on to power.

Oil's fair value

(US$ per barrel, daily)



U.S. Texas Intermediate crude (WTI)

Sources: U.S. Energy Information Administration, Bloomberg, Putnam, as of February 2019.

Dynamics within OPEC and beyond

In addition to Venezuela, OPEC's output discipline, Iran's sanctions, and U.S. shale production have affected the supply of oil. OPEC's output was 30.5 million barrels per day in February, about 2 million barrels lower compared with October 2018, the reference month for OPEC quotas. Given what we know about output from exempt countries, and the big cut in Saudi Arabia's production, it seems Russia is the only OPEC+ player that is not living up to its obligations.

In Iran, tanker tracker data suggest oil exports are rising and shipments have increased to Japan and Korea. These importers are two of the eight countries that have exemptions from U.S. sanctions on Iran. The waivers, granted in November, are only valid for six months. The United States will be pressing to reduce the waivers one way or another. We will have to wait and see what kind of waiver extensions are granted by the Trump administration.

In the United States, shale output still doesn't seem to be doing much. The rig count is a little lower, but output looks broadly constant. U.S. exports of crude have risen, and the infrastructure to move oil from wellheads is now largely in place. This has allowed differentials within the United States to normalize. But current prices are not high enough to encourage a large increase in U.S. output.

On the demand side, it's clear that China's oil imports continue to grow steadily. Some of this may be going into storage, but overall, it's consistent with a Chinese economy that isn't doing too badly.

And finally, OPEC's compliance on crude output is impressive. But how long OPEC can keep up this discipline is anyone's guess. OPEC members are scheduled to meet in April 2019 to discuss oil quotas for the remainder of this year. Saudi Arabia has signaled that it is prepared to make a disproportionate share of the cuts. That said, cartel dynamics are inherently unstable.

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.

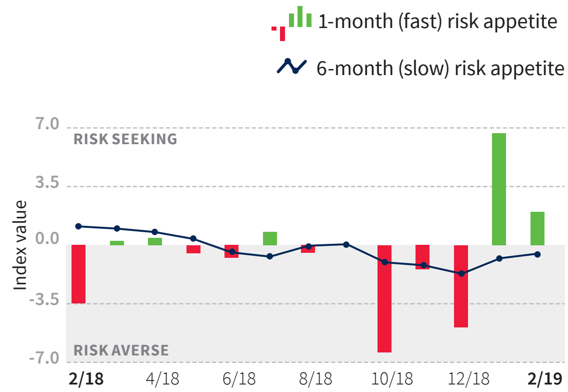
Risk appetite continues to rebound

SHORT-TERM TREND

February was another decent risk-on month

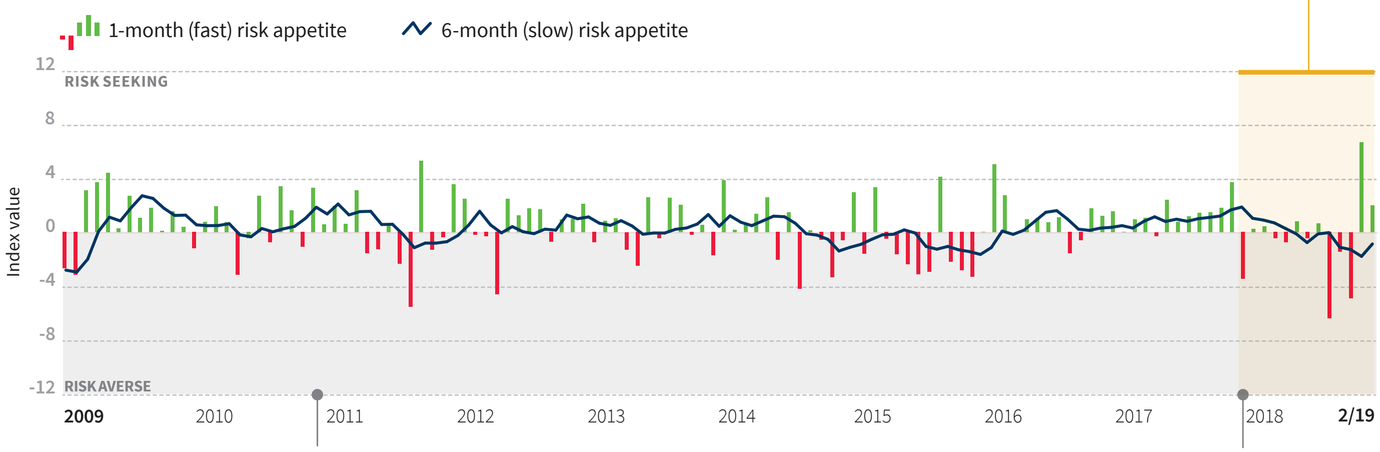
Risk ON OFF

- There was greater differentiation among asset classes such as equities and bonds.
- U.S. risky assets, including stocks, and the dollar slightly outperperformed globally.
- The majority of asset classes were in positive territory on a three-month basis.



LONG-TERM CYCLE

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



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 sell-off 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 February 28, 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.

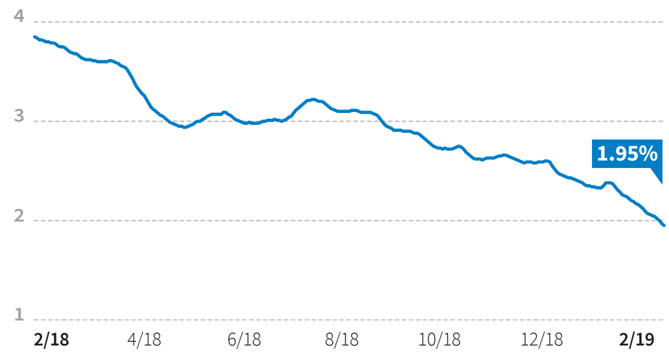
Global economic growth extends slide

SHORT-TERM TREND

Economic expansion loses momentum

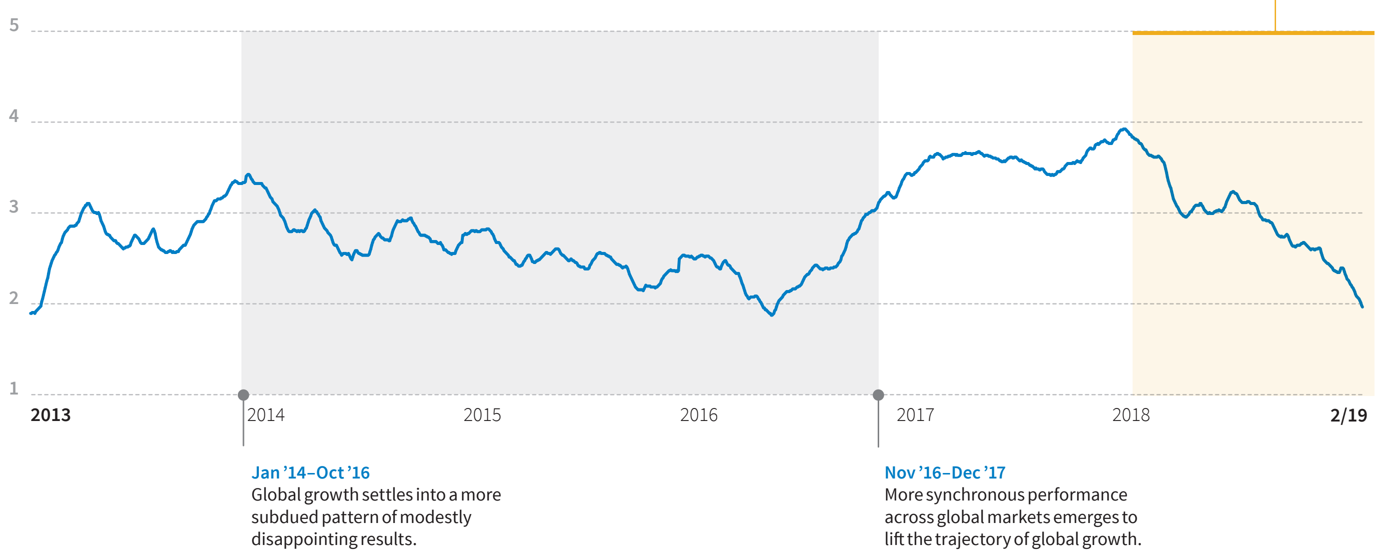
▲ 1.95%

Growth among G10 countries was mixed, with the eurozone leading the decliners. In the eurozone, the services sector and industrial production dropped. The United States' economic indicators, including the ISM non-manufacturing, disappointed. Latin America's growth was buoyed by Brazil. Growth slowed in Asia, including China.

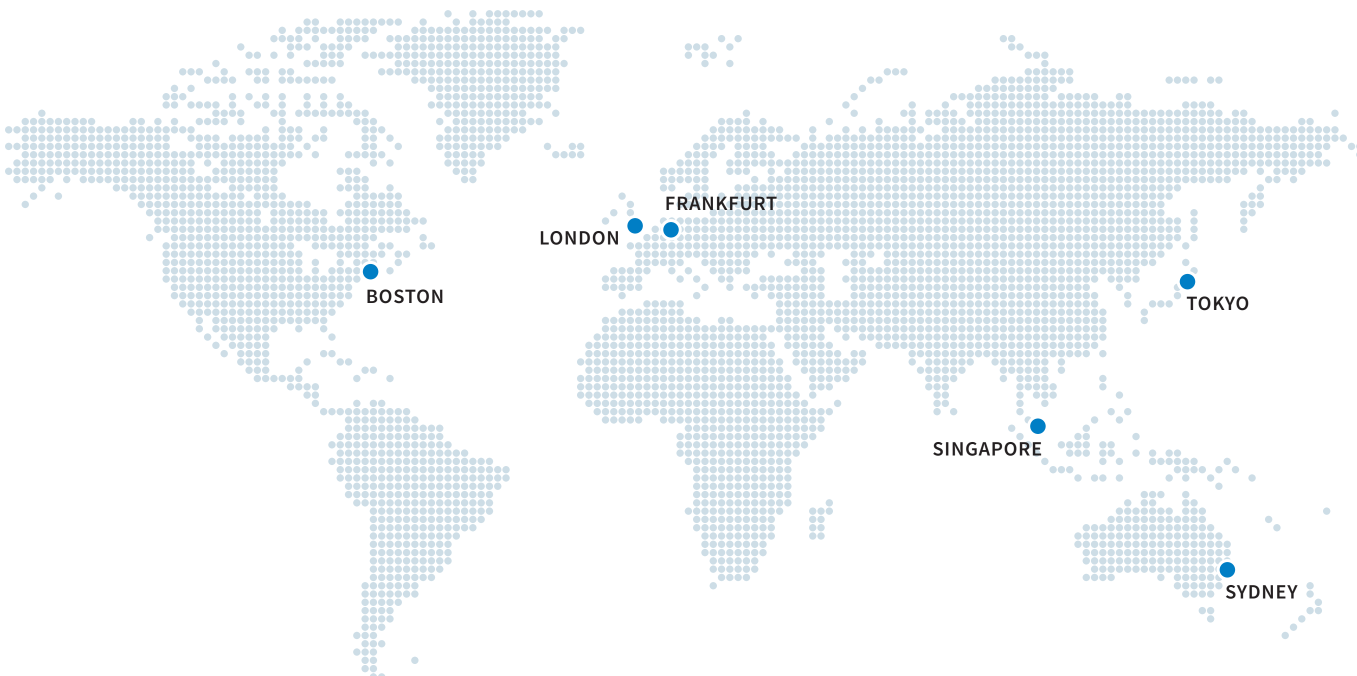


LONG-TERM CYCLE

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



Source: Putnam. Data as of February 28, 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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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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