THE MACRO REPORT | MAY 2019

Central banks walk growth tightrope

Global economic growth in 2019 is showing signs of picking up amid recovery in the eurozone and China, the world's second-largest economy. The prospect of a deeper slowdown in China has been one of the biggest concerns for the global economy this year. The U.S. economy, while outperforming other developed countries, will sputter along as the fiscal stimulus fueled by tax cuts wanes and investments slow. Despite some improvement in the data flow, we expect to see headwinds from trade, interest rates, market volatility, and fiscal policies.

The Federal Reserve's policy switch, meanwhile, continues front and center in the markets. Many global central banks have turned more dovish on interest rates, and Wall Street has hung on to every word Fed chair Jerome Powell uttered this year. Powell faces a tricky task as some of his comments have fueled the idea that there is a Powell "put" — that the Fed under his leadership will act like an option contract to prevent stocks from falling too much. Over in Japan, the central bank continues to struggle with low inflation and limited monetary policy options.

THIS MONTH

The growth cycles

The Powell "put"

Chasing inflation in Japan

The growth cycles

Global economic growth is showing some tentative signs of recovery as the eurozone and China post GDP numbers that beat market expectations.

Putnam's Global GDP Nowcast indicates economic growth has picked up quite sharply over the past month (see page 9). The eurozone's economy grew a seasonally adjusted 0.4% in the first quarter of 2019 from 0.2% in the fourth quarter of 2018. China's economy expanded 6.4% in the first quarter from a year earlier, beating expectations. The U.S. economy also grew at a faster pace than expected in the first quarter. Still, we are hesitant to put too much emphasis on the improvements in the data.

Eurozone may be turning a corner

There were a few genuinely good signs in the eurozone. In France, domestic demand picked up regardless of the ongoing disruptions caused by the protests. In Germany, household consumption increased despite the struggles of the export-oriented manufacturing sector. While the overall potential growth rate remains low, domestic services are doing well. The globally integrated manufacturing sectors, however, face challenges. In the April macro report, we wrote that global manufacturing is still struggling with all the consequences of the Trump administration's trade policies.

The region's growth rate is typically not very volatile. It has a large public sector and powerful automatic stabilizers in a downturn. We expect manufacturing will pick up as political tensions ebb. China's recovery will also benefit Europe's large exporters this year. But there are headwinds. The latest round of U.S.-China trade talks ended on May 10 without a deal. China imposed tit-for-tat tariffs on U.S. exports. So, there will be a limit to the upside in eurozone exports from growth in China, while the confusion surrounding Brexit is unlikely to dissipate over the next few months. We expect the eurozone's economy to expand at a slow pace.

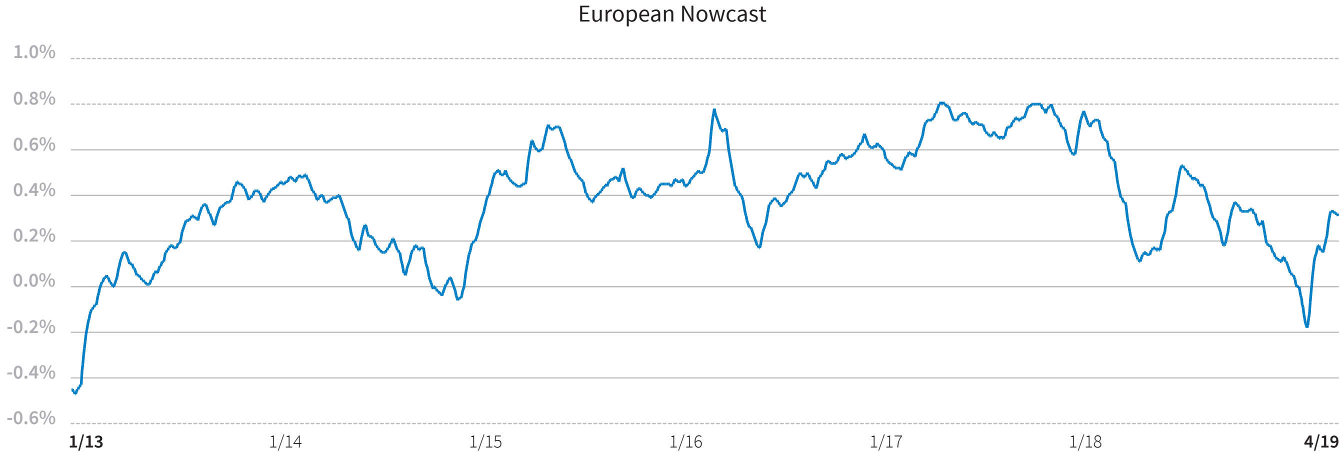
China shows renewed signs of life

The world's second-biggest economy grew slightly more than expected in the first quarter of 2019. Industrial production and retail sales also rose in the first quarter. The People's Bank of China (PBoC) has dialed back some of its monetary stimulus as the economy strengthens. It tightened liquidity via its medium-term lending facility, pushing 3-month rates higher. The PBoC plans to maintain the growth of money supply and not step up counter-cyclical measures, according to an April statement. It plans to focus on supporting small and medium-sized enterprise (SMEs) financing, limiting leverage, and ensuring financial stability.

Still, we are cautious about the near-term outlook. As we have said before, the timing of the Lunar New Year makes it difficult to interpret the data, and the manufacturing sector

Eurozone GDP growth improves slightly

% quarter-on-quarter



Source: Putnam, as of April 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.

grew slower than expected in April. The markets may be pricing in a stronger and earlier recovery in China than what is actually underway. The PBoC's statements also make us cautious. A focus on structural reform signals that China is pleased with growth. But growth will not be buoyed by new measures. And if growth strengthens, it may be met by some tightening. China's ability to sustain global demand is unclear because that depends on trade patterns and financial flows.

U.S. economy faces headwinds

Our U.S. GDP Nowcast* has not been very volatile. It has been hard to tease a coherent story out of recent data given the distortions created by the government shutdown, the winter months, and businesses trying to deal with trade policies. The economy grew at a 3.2% annual rate in the first quarter of 2019, a far better outcome than expected. But the headline growth mainly reflected inventory rebuilding and net trade. Real final sales to domestic purchasers, which is simply GDP minus inventories and trade, rose at only a 1.4% annualized pace. We believe the "true" pace of U.S. growth will be between 1.4% and 3.2% and will be a bit weaker in the second half.

The manufacturing sector still reflects global risks, including trade policies. Corporate investment remains lackluster. The labor market is strong, but there are hints that it may be turning. While hiring rose in April and unemployment fell to a 50-year low, wage gains eased. The key issue is the economy's ability to generate jobs without wage pressures. There are also policy headwinds. The fiscal stimulus from the 2017 tax cuts is waning. Last year's rate hikes are still working their way through the economy. While yields on long-term Treasury bonds have declined, rates on short-term notes are holding steady. Short-term rates influence household spending, consumer debt, auto purchases, and credit cards. As debt service burdens rise, so do economic stresses. A stronger dollar, rising stock markets and a relatively high policy rate are creating headwinds for the economy.

* We base our U.S. GDP Nowcast on a tailored methodology that captures daily data releases for the most essential growth characteristics for the United States, 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 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 Powell "put"

The Fed's dovish stance on interest rates has some on Wall Street betting that the central bank will rescue the economy from a possible recession.

One of the most important stories of the past five months, perhaps the key story, has been the Federal Open Market Committee (FOMC) — the 12-member monetary policymaking body of the Federal Reserve. The Fed's interest-rate hike in December 2018, and signals that it would continue to tighten policy in 2019, caused a meltdown in global financial markets. This hawkish tone was quickly followed by a pivot to a more dovish stance, which then rippled around the world. The European Central Bank (ECB) extended its stimulative rate policy to at least the end of 2019, and many central banks in smaller, advanced countries have indicated lower rates.

The central banks of New Zealand and Australia have put rate cuts on their agendas as economic data flow continues to disappoint. The Bank of Canada has turned more dovish. We expect all three central banks to lower interest rates at their next policy meetings. Sweden's Riksbank in April backed off from plans to raise interest rates and postponed an expected hike to the "end of the year or at the beginning of next year." In the United Kingdom, there's not a lot that monetary policy can do while Brexit uncertainty remains high. This has impeded the Bank of England from joining this global swing.

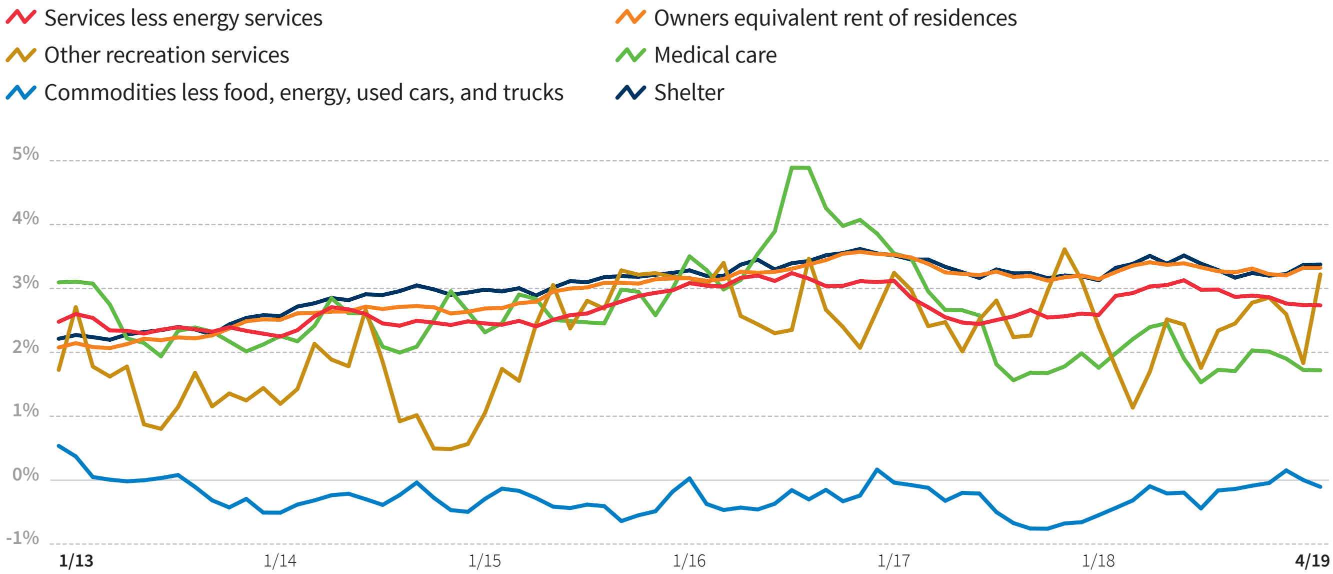
Markets reel over Fed's "transitory" comment

It has been hard to interpret exactly how dovish the Fed is right now. In part, this is because there remain a range of voices within the Fed and, because serious Fed watchers are still struggling to understand Chairman Jerome Powell. As a result, there is more attention on comments from other Fed officials. Vice Chair Richard Clarida is often seen as a voice at the Fed. And the dovish regional Fed presidents are getting more attention because they often seem more interesting than the regional hawks. After all, the hawks don't really say much other than complaining that rates are too low. The Fed is also evaluating the tools and targets of monetary policy. The idea of targeting "average inflation" is under discussion.

The fed funds futures were pricing 25 basis points of easing by December 2019. Traders have been speculating that weaker economic data — such as inflation — or a particularly dovish speech would translate into a rate cut. But at the Fed meeting in May, Powell said the central bank still sees low inflation as the result of "transitory" factors, such as portfolio management services and lower airfares. The word "transitory" was sufficient for markets to reverse course on rate-cut expectations. Treasury yields fell, the U.S. dollar strengthened, and stocks sold off after Powell's comment.

Key components of core inflation

% year-on-year



Source: U.S. Bureau of Labor Statistics, as of April 2019.

We expect the Fed will hold interest rates steady until something changes. The Fed lowered the interest on excess reserves (IOER) — the interest paid on balances above the level of reserves that depository institutions are required to hold — by five basis points. One can argue that this was a dovish move; it was designed to get more liquidity into a key part of the market where there obviously wasn't enough. But it does not have the same force as a change in the key policy rate target. The most likely economic trajectory would not call for a move either way.

Risks on the downside

The Fed, like other central banks, remains rather constrained. Growth prospects are neither so good nor so bad that a decisive shift is warranted. We also project inflation to hold steady. Risky assets are another constraint; they will decline if the Fed takes a hawkish turn. But if markets keep soaring, we will hear a lot more about risks to financial stability.

If the markets' downward spiral gets bad, it will bring the Fed into play.

We believe the risks of weaker economic performance are greater than the risks of stronger performance. As a result, a rate cut is more likely than a rate hike. But the more likely way to get to a policy change would involve the asset markets. If risky assets price in a stronger global outlook than the actual outcome, they may have to adjust downward. If the markets' downward spiral gets bad, it will bring the Fed into play. Conversely, we remain convinced that any Fed rate hike would have to be quickly reversed because of the effects of higher real rates on risky assets and the clear evidence of a Fed put. The Fed put refers to the notion that the central bank will respond to market turmoil by loosening policy and providing liquidity.

Nominations up in the air

Separately, there are two vacancies on the Fed's seven-member board. Trump's preferred choices for the central bank — Stephen Moore and Herman Cain — took their names out of consideration after opposition from Republicans in the Senate. It is fair to say that Republican lawmakers finally found the moral fiber to object to these absurd nominations. We are spared the spectacle of the Senate that found Nobel-prize winning MIT professor Peter Diamond unsuitable for the Fed, approving Moore or Cain.

Chasing inflation in Japan

The central bank is struggling with stubbornly low price gains, leaving it with little flexibility in pursuing monetary policy options.

Japan has been on a long holiday. The annual Golden Week was extended because Emperor Akihito abdicated in favor of his son, Naruhito. With a new emperor comes a new era: Reiwa, the era of "beautiful harmony," according to the official translation. The timing of the holiday has affected data flow. Japanese demand for vacation packages surged ahead of the unprecedented 10-day holiday, pushing up the prices and core inflation. While the jump in inflation was striking, we do not believe it has any lasting implications. Core inflation is likely to fall quite sharply over the summer months because mobile telephone charges are set to drop in the near future.

The Bank of Japan (BoJ) held its April meeting just before the long holiday began. The meeting came against a backdrop of weaker economic data and increasing commentary in the markets about the adverse effect on the financial system from holding interest rates at low levels for so long. This meeting also saw the publication of the BoJ's forecasts for 2021.

The persistence of below-target inflation and concerns about the adverse consequences of existing policy pose a problem for the BoJ.

The central bank said that core consumer price gains will average no better than 1.6% until at least the fiscal year ending in March 2022. That is well below the 2% target and is hardly consistent with the BoJ's pledge to overshoot the target to rebuild confidence in its ability to achieve that target. But the persistence of below-target inflation and concerns about the adverse consequences of existing policy pose a problem for the BoJ.

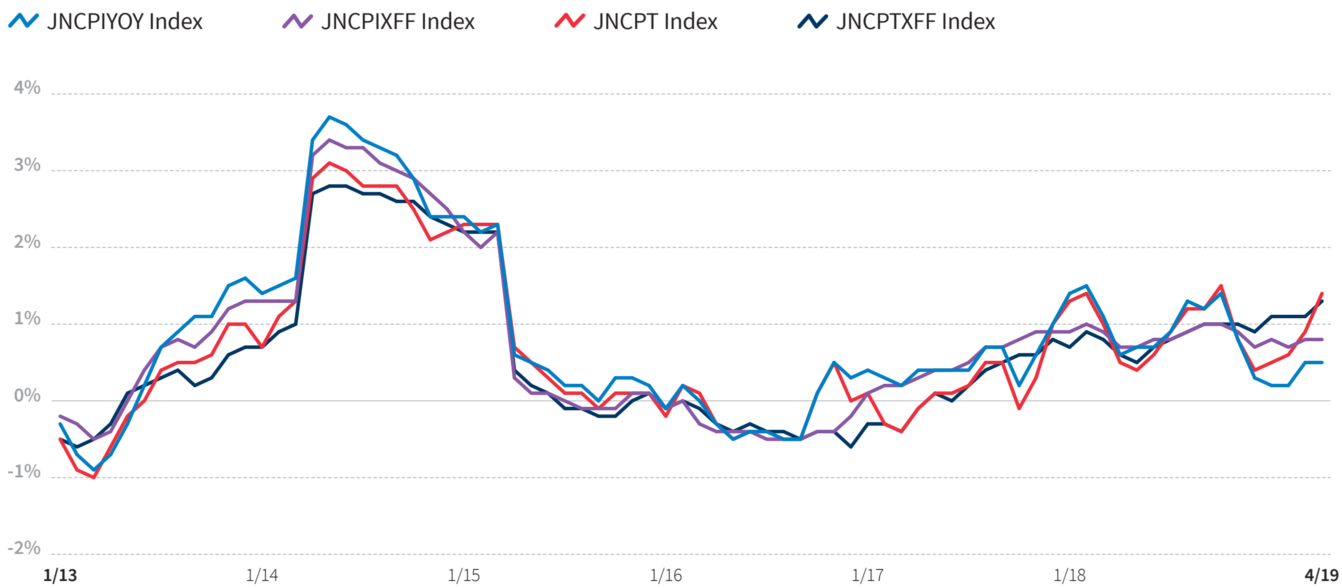
Policy doubts increase

In the past, BoJ Governor Haruhiko Kuroda stressed the importance of expectations in determining inflation. His initial policy measures were designed to shock inflation expectations higher. But these measures clearly did not succeed. The longer the BoJ persists with an unchanged policy stance despite projecting below-target inflation, the less likely it seems that expectations will move higher.

Reluctant to admit it is stuck, the BoJ did at least make a couple of tweaks to its policy stance. It adjusted the terms and conditions on which it lends to banks. Collateral requirements were eased across a range of the BoJ's lending programs, measures designed to help the profitability of lending by commercial banks despite the BoJ policy of controlling the yield curve. It also created an ETF lending facility. The facility allows the BoJ to offset,

Japan's inflation trends

%, year-on-year



Source: Statistics Bureau of Japan, as of April 2019.

at least in part, the impact on market liquidity of its very high levels of ownership of a range of ETFs. All of these measures can be interpreted as attempts by the central bank to minimize the adverse effects on the financial sector of current policy.

Sowing seeds of confusion

The BoJ also introduced new guidance on its rate policy. The central bank left its key monetary settings unchanged in April, but changed the wording of its "forward guidance." It had previously pledged to hold rates at the current level for an "extended period" that was vaguely linked to a sales-tax hike set for October. It now says interest rates will be on hold until at least the spring of 2020. This new policy does not differ much from the previous pledges to keep rates unchanged for an "extended period of time" and until after the effects of the scheduled October 2019 tax hike had passed. We interpreted this to mean at least six months after October, which brings us to the spring of 2020.

The reality is that the BoJ is out of substantive options.

We can interpret the change in the forward guidance several ways. The calendar guidance tool can be extended, and it is possible this could be used to loosen the central bank's monetary policy stance. And it would allow the BoJ to reduce its Japanese government bonds (JGBs) without creating expectations for a hike in the policy rate. These are very fine points. The reality is that the BoJ is out of substantive options. The BoJ wanted to keep pace with the dovish stance of other global central banks. Many policy makers from Europe to Asia have paused interest-rate hikes or turned dovish again. As mentioned earlier, the Fed signaled it won't hike interest rates for a while, while the ECB offered fresh stimulus. But there is not a lot the BoJ can do. It will be in a difficult position when the next global downturn hits.

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.

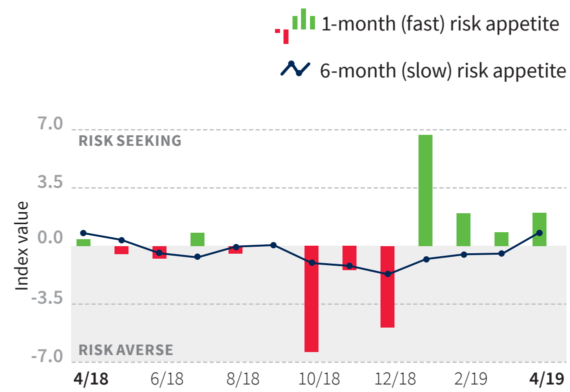
Risk appetite continues to improve

SHORT-TERM TREND

Global growth optimism lifts risk appetite in April

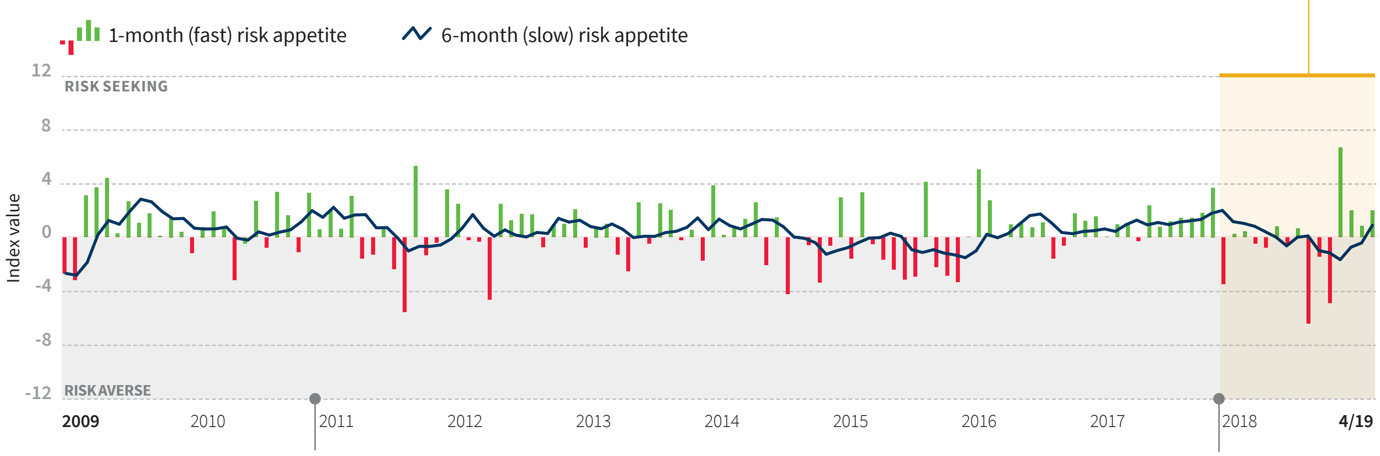
Risk ON OFF

- Risky assets, including equities, rallied.
- Core rates moved higher and the U.S. dollar rose on better growth outlook.
- Emerging market assets have wavered slightly.



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 April 30, 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.

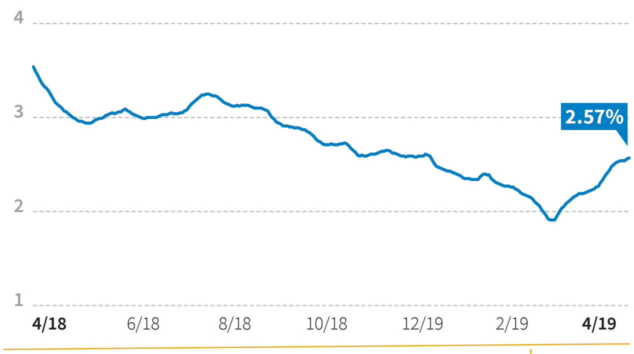
Global economic growth bounces back

SHORT-TERM TREND

The economy looks a little stronger, but downside risks remain

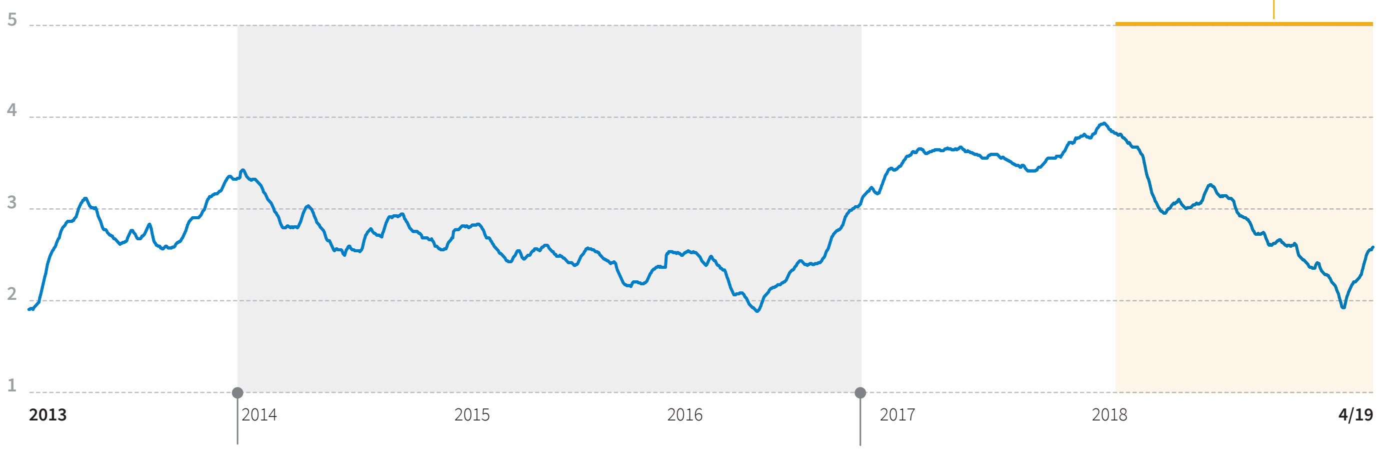
▲ 2.57%

Growth among G10 nations improved, led by the United Kingdom, the eurozone, and the United States. In the eurozone, industrial production gained. In the United States, consumer confidence, retail sales, and trade were positive contributors. In China, rising industrial output and housing stats contributed to growth. However, growth slowed in New Zealand, Malaysia, and Singapore.



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 April 30, 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.

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.

United States
Putnam Investments
100 Federal Street
Boston, MA 02110
Phone: 617-292-1000

Germany
Putnam Investments Limited
Niederlassung Deutschland
Siemensstrasse 8, D-63263 Neu-Isenburg
Phone: +49 (0) 6102 56059 00

Australia
Putnam Investments Australia
Pty Limited
Level 13
167 Macquarie Street
Sydney, NSW 2000
Phone: +612 8083 9900

Japan
Putnam Investments Securities Co., Ltd.
Kamiyacho MT building
18th Floor
4-3-20 Toranomon, Minato-ku
Tokyo, 115-0001
Phone: +81 3 5404 5800

United Kingdom
16 St. James's Street
London, SW1A 1ER
Phone: +44 (0) 207 907 8200

Singapore
The Putnam Advisory Company, LLC
Singapore Branch
8 Marina View #28-01
Asia Square Tower 1
Singapore 018960

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.

Michael Atkin
Portfolio Manager
Investing since 1988
Sovereign debt,
global growth analysis

Albert Chan, CFA
Portfolio Manager
Interest-rate derivatives,
government debt, risk analysis

Onsel Emre, PhD
Analyst
Inflation, risk analysis,
global growth dynamics

Sterling Horne
Analyst
Politics and economics

Irina Solyanik, CFA
Analyst
Quantitative analysis,
growth forecasting

Izzet Yildiz, PhD
Analyst
Labor market analysis,
global growth dynamics

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