Waiting for the next wave of growth

We believe the global economy will continue to bounce around the current growth pace. Trade, manufacturing, and oil, along with geopolitical risks, will play a role in determining the trajectory. The dramatic drone strike that killed Iranian general Qassem Soleimani in January propelled the United States and Iran to the brink of war (and back) and roiled financial markets. The standoff between President Trump and Iran’s supreme leader Ayatollah Ali Khamenei also caused fluctuations in the volatile oil markets. Crude prices surged after the attack in anticipation of a response from Iran that would disrupt Middle East oil flows.

Slow growth continues to exert pressure on the eurozone’s politics. Spain has a precarious, new coalition made up of center-left and hard-left parties after Prime Minister Pedro Sánchez broke nine months of gridlock in forming a government. Britain will leave the European Union on January 31 three-and-a-half years after the Brexit referendum. There will be a transition period until the end of 2020. And China’s policymakers have sanctioned more measures, including a new loan prime-rate system, in response to economic malaise.

THIS MONTH

Oil tracks U.S.–Iran tensions  Growing pains  Fine-tuning China’s economy

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President Trump’s decision to authorize the killing of Iranian General Qassem Soleimani has undoubtedly raised geopolitical risks. But, more importantly, there are two reasons why this matters for the economic outlook: oil prices and Trump’s decision-making processes. And even as political stresses wax and wane, oil has reached our estimate of fair value.

When political risk rises in the Middle East, oil prices rally. As news broke of Soleimani’s death, Brent crude rose from $66.50 to an intra-day peak of $69.70, and as high as $71 a day later. A $10 jump matters for the global outlook, but only if higher prices last longer than a few days. Recent events — including the September drone attack on Saudi Arabia’s oil facilities — suggest prices usually slip back. The upward momentum rarely turns into sustained supply disruptions. Oil producers outside the Middle East, and OECD nations can, and do, release oil from their stockpiles if global exports are threatened.

Calculating the impact on growth

Still, there could be a significant supply shock if the United States and Iran enter a full-scale war that disrupts output and shipping in the Strait of Hormuz. Most analysts think it is unlikely Iran will provoke a war that it will certainly lose, and the United States’ appetite for another Mideast adventure is limited. Short of a full-scale war, two scenarios may affect oil supplies: Iran could use its military or proxy groups to strike oil infrastructure, and there could be disruptions in Iraq’s oil production.

Iraq is in the middle of the conflict between the United States and Iran. Its Shia population is drawn to Iran, and the United States has worked to keep Iraq out of the Iranian orbit. The mood in Iraq is grim, and it’s easy to see a return of instability, which would threaten crude output from its southern oil fields. Under these scenarios, the key question for the global outlook is how the events will affect oil prices and for how long. We think further spikes are highly likely as we expect periodic deterioration in Iran–U.S. relations.

But short of an all-out war, we struggle to see any significant damage in oil export capacity that will have a lasting impact on prices. There is tail risk that a major military conflict between the United States and Iran could push prices higher over the long term and hurt the economic outlook. This is not our central scenario. Also unlikely is the opposite outcome — that U.S. military action destabilizes Iran and creates a new government that would allow the United States to lift sanctions, leading to a dramatic rise in Iranian oil exports.
Fair value edges lower

The steady upward drift in oil prices in November and December brought them to our fair value estimates before the spike driven by renewed tensions between the United States and Iran. Fair value has drifted down over the course of this year. The underlying story remains one of OPEC+ needing to restrain output to keep prices where the bloc wants it. The outlook suggests there will be some difficult talks within OPEC about another extension in the coming months.

In terms of the ongoing hostilities between the United States and Iran, it’s hard to know, from day to day, how the mood in Washington and Tehran will develop. It seems clear that neither the United States nor Iran wants a full-scale military conflict. The United States, or at least the current administration, wants to reduce its footprint in the region, and Iran is so weak it would lose the war. If rational actors prevail, there seems very little chance of the kind of military conflict that would disrupt production and exports of oil from the Gulf.

The risk comes from the chance that rational actors will not prevail. The United States has stumbled into military conflicts in the region recently. As for Iran, it is not clear how much control Tehran exerts over its regional proxies, most of which were creatures of the slain Soleimani. As U.S. sanctions tighten the noose on Iran’s economy, the government may become desperate. Moreover, it’s clear the two countries’ medium-term objectives are fundamentally incompatible.

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Iran wants a nuclear weapon, and its clerics want to stay in power. The United States wants a nuclear-free Gulf and a different government in Tehran. Tension is inevitable, and it may not always be possible to manage it.

There’s every reason to expect bursts of oil market volatility even if military conflict is avoided. But short of
significant disruptions to Gulf oil exports, which we think is very unlikely, this will be happening against a backdrop of oil prices that are trending a bit lower over the course of 2020.

“Wag the dog” theories and Trump

The second risk to global growth revolves around decision-making and goal-setting in the Trump administration. Trump’s approach to policy issues is idiosyncratic. The decision to assassinate Soleimani is entirely consistent with what we have learned about his approach in the first three years of his Presidency. This is relevant for the future of the trade war and for Trump’s chances for re-election.

For the trade war, the question is what to make of the phase-one deal signed by China and the United States on January 15. Is the key message that a deal can be struck, and so a more comprehensive phase-two deal can be expected later in the year? Or is the message that Trump and his advisers have simply misjudged their negotiating partner and have gained little at considerable cost? The hasty manner in which the deal was announced, the contradictory leaks, the fuzzy math of Chinese agricultural purchases, and the vague promises about markets opening all suggest the deal is underwhelming.

Trade uncertainty remains high, in spite of the phase-one deal.

Trade uncertainty remains high, in spite of the phase-one deal. We expect a few months of calm before China trade issues return to the front burner of the election campaign. It’s too potent an electoral issue for Trump’s base for him to ignore it. For the re-election campaign, the issue is not really the “wag the dog” theories that seem to be beloved by some Democrats. Rather, the buildup to and the execution of the attack in Baghdad and the justification of it afterward illustrate the strategy behind Trump’s reelection campaign. He will make no effort to appeal to undecided voters; his strategy is designed to bolster his base.

The killing of Soleimani doesn’t affect Trump’s re-election chances, in our view. We won’t have a clear view on this until we know who his opponent will be and can assess how successful the second plank of Trump’s reelection strategy — to suppress Democrat turnout by denigrating his opponent — will be. But this confirms his electoral strategy. This matters for the economy because it’s a risky strategy for a President with consistently low approval ratings. It also raises the likelihood of a major change in economic policy after the election.
Growing pains

The global growth outlook is little changed as U.S. economic risks skew to the downside and Europe grapples with waning voter support for center-left socialist parties.

The global Nowcast is drifting sideways. If one were disposed to optimism, one could say that perhaps we are moving from a phase of stabilization in growth to a phase of slightly faster growth. But we think the global economy is still bouncing around the current growth pace. Globally integrated manufacturing is not doing very well, but more domestically oriented services are doing better.

U.S. economy remains vulnerable

In the United States, overall growth has not changed much. Activity in the services sector rose slightly in December, but manufacturing activity shrank for a fifth month. Auto sales are flat, and corporate investment remains weak. The labor market report was a little disappointing, with December’s payroll and wage growth missing expectations. Nonfarm payrolls increased by 145,000 while the unemployment rate held steady at 3.5%. Average hourly earnings rose by just 2.9%.

The weakness in wages is a bit puzzling. The contribution of trade — one of the largest sectors of the labor market — to overall wage growth declined in November and December 2019. And another big sector — education and health — showed a similar, if much less pronounced, development. This may be an oddity that reverses in the near future, or it may be a sign that we are approaching a turn in the labor market. Wage growth hasn’t been fast enough to put pressure on corporate profit margins. This signals a low-investment, low-productivity growth recovery. The data confirms steady, slow growth over the short term and highlights vulnerabilities in the economy. To put it another way, the risks are to the downside.

Eurozone politics remain center stage

The eurozone’s Nowcast is improving, but the growth rate is what it was over the summer. The region’s economies are growing at about a 1% annualized pace. Manufacturing activity remains weak, but the services sector is doing better. Slow growth continues to exert pressure on the region’s politics.

Spain has a government after two national elections in 2019 that revealed a deeply divided electorate. A coalition government — the first in the country’s recent democratic history — will involve Prime Minister Pedro Sánchez’s Socialist Party (PSOE) and the far-left Unidas Podemos and Catalan separatist party, Esquerra Republicana de Catalunya (Catalan Republican Left). It is not clear how long this coalition will survive.

Sanchez’s policy program includes repealing the 2012 labor market reform and raising taxes on companies and
higher-income Spaniards. He also plans a higher minimum wage and changes to pension reforms. The administration doesn’t have a majority in parliament and will have to cut ad hoc deals with various regional parties to pass legislation. So, it’s possible that not all the proposals will become law. But the economic agenda amounts to a considerable change in direction. We will monitor how the economy performs under this set of reforms.

This type of coalition, of the center-left and the hard left, has been in place in Portugal for a while and comes against the backdrop of conventional center-left socialist parties doing very badly in most of Europe. The United Kingdom was the latest to join this trend, with the remarkably weak performance of the Labour Party in the December election. In Germany, regional governments have this type of center-left and hard-left coalition. The appetite for new approaches is also on display in Austria, where the Greens have joined a coalition with the conservative People’s Party. Although macro policy will not change much, the new government will implement a reasonably ambitious green agenda.

**Elections and Brexit**

The U.K.’s electoral system produced a clear, pro-leave Brexit result. Britain will officially leave the EU at the end of January and begin an 11-month transition. During this time, the government hopes to negotiate a comprehensive deal on the terms of its future relationship with its European neighbors. In our view, this isn’t going to happen; the only deal that could be inked by the end of 2020 is a very limited one. So, Boris Johnson’s government will jump up and down and scream and shout and extend the transition period.

It is important to note these talks will ultimately determine the extent of economic damage Brexit does to the United Kingdom. A close relationship would minimize the damage; indeed, it could make it barely detectable. A distant one would cause substantial short-term disruption and be a drag on growth for many years. The business community has now begun lobbying in earnest for a close relationship. But the economic policy record of the Conservatives is poor, especially on macro issues, and it’s hard to be confident that good sense will prevail.
Our view is that China’s policy will not seek to push growth onto a stronger path. The backdrop is slowing growth, driven by a whole host of structural factors and by policymakers’ concerns that fast growth could bring problems in the financials sector. But the government has not abandoned its desire to manage growth along this decelerating trajectory. President Xi Jinping and his government’s approach to policy is highly activist. While China looks to be doing a bit better in the near term, its growth will not bail out the rest of the world.

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The number of measures taken is almost entirely irrelevant. China is not taking step after step as some kind of experiment to find the one measure that will push the economy onto a significantly stronger path. It is trying to manage growth given the pressures from structural reforms in the financials sector and the need to address the large, residual state-owned enterprises in heavy industries. Policymakers are also trying to curtail the headwinds from trade tensions with the United States.

Easing monetary policy

Around the turn of the year, the People’s Bank of China (PBoC) announced two measures for the world’s second-largest economy. The central bank has asked banks to price outstanding loans with the new rates. Commercial banks will be required to replace old benchmark lending rates with the loan prime rate (LPR) in pricing their floating-rate loans issued before January 1, 2020. The move will effectively scrap the old benchmark lending rates. There are a lot of bells and whistles on the policy, and banks have some time to revise their loan documentation. But the net effect will be to lower the cost of credit to the private sector. There have been estimates that this revision would lower rates by as much as 40 basis points over 2020. Since most people expect some policy rate cuts this year, we will end up with two effects from this move: lower rates and tighter spreads. But the overall move in interest rates will be quite modest and amounts to about half of the rate cut over the 2015–16 period.

Similarly, the PBoC trimmed the portion of deposits (cash) that commercial banks are required to set aside as reserves. The required reserve ratio for lenders was lowered by 50 basis points starting on January 6, a move that essentially releases about $115 billion into the
financial system. While this is clearly an easing action, it is modest. The PBoC released an estimate that it would release credit worth around 0.75% of GDP. China cut the bank reserve ratio three times in 2019.

These measures together are consistent with the story we have been trying to tell for a long time. Repeated policy actions are likely until the authorities are comfortable with the growth performance of the economy. But they are not trying to lift China onto a significantly higher growth path — 6% or so will be the growth rate this year.

Emerging markets tracking sideways
China remains an important trading and financial partner for many developing economies. In these markets as a whole, various PMIs and leading economic indicators show that not a whole lot has changed. The overall pattern of the data suggests a slow pace of growth. While PMIs in emerging markets look a bit better than in advanced countries, the difference shows that consumption goods production globally is doing better than the production of capital goods. That in turn indicates the weak performance of corporate capital expenditures and the relative strength of household consumption spending.

There is more production of consumer goods in emerging markets and more production of capital goods in advanced countries. The slight outperformance of emerging markets reflects a production system that is better geared to areas of the global economy where demand growth is a bit stronger.
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 picks up in December

**SHORT-TERM TREND**
“Risk-on” sentiment in December was stronger than previous months.

- Equity markets rallied, and international stocks outperformed.
- The U.S. dollar depreciated against most other international currencies.
- Bonds that are more sensitive to risk sentiment gained.
- Treasury yields lagged the sell-off in European sovereign bonds.
- Oil prices, which behave just like a risk asset, gained.

**LONG-TERM CYCLE**
This 10-year illustration captures the cyclicality of investors’ appetite for risk.

Source: Putnam. Data as of December 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 growth moves sideways

SHORT-TERM TREND
Low-growth environment continues in December.

Among G-10 economies, the United States and New Zealand had positive data flow. In the United States, the Bloomberg Consumer Comfort Index (a gauge of consumer sentiment) and housing indicators improved. Britain recorded a decline in economic activity, with manufacturing, retail sales, and composite PMI trending lower. Economic indicators deteriorated in Russia, Turkey, and Chile. China’s growth held steady.

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

Source: Putnam. Data as of December 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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