



Global Economic Perspective

PERSPECTIVE FROM THE FRANKLIN TEMPLETON FIXED INCOME GROUP®



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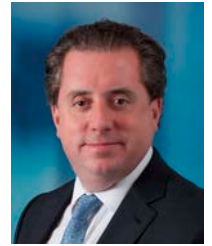
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IN THIS ISSUE:

- Strong US Economy Showing Few Signs of Trade Concerns
- The Bank of Japan's Move Could Indicate a More Significant Monetary Shift
- Domestic Strength Underpins Growth in Eurozone despite Trade Headwinds



Strong US Economy Showing Few Signs of Trade Concerns

The US economy has continued to perform well on many fronts, with positive readings for growth, employment and inflation. In terms of growth, the stimulus effect from tax cuts was clearly visible in second-quarter 2018 data, and could be maintained for at least another quarter, in our view. We would expect to see a gradual rise in both wage growth and the rate of inflation, as companies respond to labour market shortages and try to push through price increases. We believe the main uncertainty facing the economy remains the ultimate impact of the Trump administration's trade policies. As the mid-term congressional elections approach—and with little sign of negative economic or political consequences domestically from President Donald Trump's actions thus far—any tempering of his administration's unilateral agenda on trade seems unlikely.

Second-quarter gross domestic product (GDP) data provided confirmation of the current favourable conditions for the US economy. The annualized growth rate of 4.1%—the quickest pace of expansion in four years—was boosted by higher consumption and investment, as tax cuts passed late in 2017 stimulated spending. The figures also contained some evidence of changes in trade patterns due to concerns among overseas customers about future tariffs, particularly relating to agricultural products. A near 10% rise in exports during the second quarter was driven by a sharp increase in soybean and corn shipments. Overall, trade accounted for nearly 1% of the increase in GDP, although much of this effect was offset by a decline in inventories. A reversal of these effects could occur in the next quarter, should distortions due to tariff concerns be unwound.

Consensus third-quarter GDP estimates remained close to 3%, and the statement from the US Federal Reserve's (Fed's) July meeting reflected the steady flow of positive data. Growth, spending, investment and the labour market were all deemed by policymakers to be strong. Interest rates were left on hold, but the Fed's messaging bolstered widespread expectations among market participants that the year's third rate increase would likely occur in September.

“ Though overall business and consumer credit conditions remained relatively tight, the Fed’s latest survey of senior loan officers indicated a moderate share of banks have been easing standards in some categories of residential real estate loans. ”

Earlier, some attention was given to Fed Chair Jay Powell’s use of the caveat “for now” in comments referring the central bank’s policy of continued rate increases. In the remarks, he flagged the potential risks from protectionism, stressing that the outcome of trade disputes would play a significant part in determining the future course of the economy. Early in August, the US and China announced further tariffs on the other’s imports, increasing the total amount affected to US\$100 billion. Uncertainty over trade was reflected in the fed funds futures market, which pointed to a fourth rate rise in December, but indicated a pause until June 2019 before a subsequent rate hike was likely to occur.

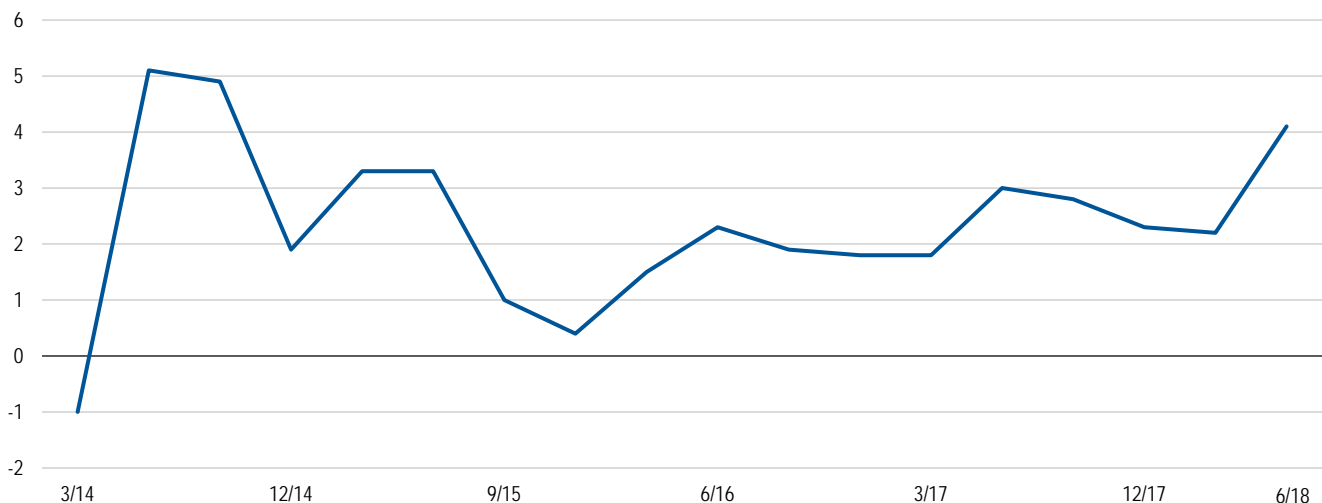
July’s Institute for Supply Management survey of US manufacturers suggested their level of activity remained solid, if somewhat constrained by labour shortages, supply chain issues and rising input costs—in some cases including sharp hikes in tariff-affected steel and aluminum prices. During a strong second-quarter earnings season, a number of companies expressed confidence in their ability to recoup some of these higher costs through price increases.

There were some signs access to credit was becoming easier, as occurred in the later stages of the previous economic cycle. Though overall business and consumer credit conditions remained relatively tight, the Fed’s latest survey of senior loan officers indicated a moderate share of banks have been easing standards in some categories of residential real estate loans. Combined with a set of sharp upward historical revisions to the US savings rate, such a development appeared to increase the possibility consumer spending could maintain the strong trend seen in recent quarters.

Elsewhere, US inflation data were mixed. Wage growth was unchanged at 2.7% year-on-year (y/o/y) in July’s labour market report. It failed to respond to the solid pace of job creation, which maintained momentum to show an average of roughly 224,000 positions added over the past three months. The June reading for the Fed’s favoured gauge of inflation, the core personal consumption expenditures price index, stayed at 1.9% y/o/y, remaining just shy of the central bank’s 2% target for the third consecutive month. However, July’s core Consumer Price Index data beat consensus forecasts, with an annual rise of 2.4% marking its highest point since 2008. Expectations in the Treasury Inflation-Protected Securities market for the path of inflation generally held steady despite the strong economic data, as the relatively high readings in August and September of 2017 looked set to have a potentially dampening effect on y/o/y calculations in the coming months.

US Economy Grows at Quickest Rate Since 2014

Exhibit 1: US Real GDP % Annualized
Q1 2014–Q2 2018



Source: Bureau of Economic Analysis.



The Bank of Japan's Move Could Indicate a More Significant Monetary Shift

The Bank of Japan's (BoJ's) meeting at the end of July saw a shift in the central bank's monetary policy, as the range allowed for 10-year JGB yields was widened from 0.1% to 0.2%, even though the overall target of keeping these yields at zero was maintained. Ahead of the announcement, there was conjecture among market participants that the BoJ might follow other leading central banks and signal a reduction of its sizable monetary stimulus program. Such sentiment helped to push 10-year Japanese Government Bond (JGB) yields up to their highest level in 18 months, prompting the BoJ to intervene with purchases aimed at maintaining yields within its upper limit. Despite policymakers reiterating their commitment to an extremely accommodative monetary stance, it remained unclear whether the BoJ was merely adjusting existing policy or cautiously introducing incremental changes in a way that it hoped would minimize market volatility.

Concerns among international investors about the outlook for Turkey ratcheted up even further in August, as the country's currency, which has been under pressure for most of the year, fell around 15% against the US dollar in a single day's trading. The Turkish lira's slump underlined the structural weaknesses of the Turkish economy, including surging inflation, a wide current account deficit and high levels of foreign currency debt. One of the catalysts for the lira's latest depreciation was President Trump's move to double tariffs on US imports of Turkish steel and aluminum, amid a sharp deterioration in relations between the United States and Turkey.

With little sign that Turkey's President Recep Tayyip Erdogan was prepared to step back from his unorthodox economic policies and raise interest rates to stem the lira's slide—widely seen as prerequisites for any assistance package from the International Monetary Fund—a damaging balance-of-payments crisis appeared increasingly likely. The Turkish leader's uncompromising response was to warn that the country could be forced to seek new allies, calling into question Turkey's historically strategic role as a member of NATO (the North Atlantic Treaty Organization).

“As risk aversion rose among investors due to Turkey's deepening crisis, the US dollar climbed to its highest level against its major trading partners in more than a year, increasing volatility in emerging-market currencies.”

As risk aversion rose among investors due to Turkey's deepening crisis, the US dollar climbed to its highest level against its major trading partners in more than a year, increasing volatility in emerging-market currencies. In the case of Russia, the announcement of another set of sanctions against the country by the United States created further pressure. Amid speculation the latest US measures might represent the start of new and more comprehensive curbs that could weaken the Russian economy, the Russian ruble fell to its lowest point against the US dollar since mid-2016. As a result, Russia's central bank said it would temporarily cut the amount of foreign currency it purchases.

China's central bank also responded to currency weakness, as it raised the costs of speculating on a further decline in the Chinese renminbi. Trade tensions have sparked a sharp selloff in the Chinese stock market in recent months. Additionally, second-quarter GDP figures revealed the weakest pace of growth in the Chinese economy since 2016, as government measures to rein in debt appeared to have had some success in curbing credit growth. The combination of factors underlined the difficult backdrop for Chinese policymakers, as they have attempted to balance competing objectives of maintaining an acceptable rate of growth while reducing leverage in the economy.

With the Fed and more recently the European Central Bank (ECB) moving toward a normalization of monetary policy, the focus on the BoJ's asset purchase program has increased. The changes announced by the BoJ in July may have appeared minor, but we would argue their significance should not be underestimated.

US Dollar Strengthens Further Amid Turkey Crisis

Exhibit 2: US Dollar Spot Index
January 4, 2017–August 8, 2018



Source: Bloomberg.

Understandably, the Japanese central bank remains keen to avoid sparking the market volatility that an overt move toward a less accommodative stance would likely trigger. But a widening of the trading band for JGB yields could indicate the BoJ is not impervious to the moves of its peers, and indeed that its broader aims may have changed. From a wider perspective, any such change of stance by the BoJ—albeit at the margin—could spill over into other markets, possibly reducing the impetus toward flatter yield curves that has been such a feature of global interest rates in recent years.

Domestic Strength Underpins Growth in Eurozone despite Trade Headwinds

Figures for the second quarter showed the eurozone economy had continued its measured slowdown since the start of the year, though the annual growth rate of 2.2% remained relatively healthy. Part of the reason for the slower growth appeared to be concerns among exporters over trade. In June, new orders among German manufacturers registered their largest monthly fall since the start of 2017. Moreover, one of the country's main indicators of business expectations declined in July for the eighth successive month. But a more conciliatory tone in trade negotiations between the European Union (EU) and the United States offered some encouragement on that front. The two sides agreed to hold off on any new tariffs for the time being, lifting the immediate threat of measures against European car manufacturers.

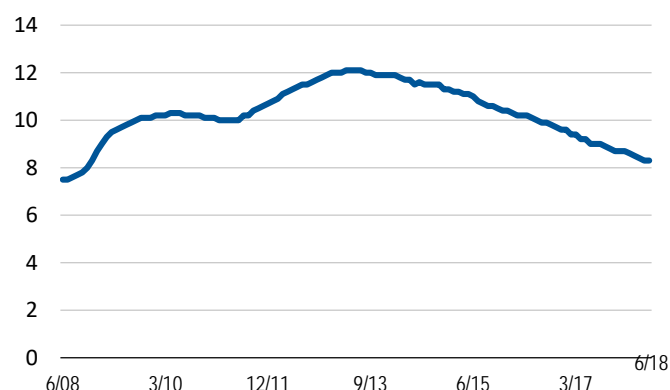
At its July meeting, the ECB reiterated its belief the eurozone's expansion was sufficiently robust for it to cease its bond purchases by the end of 2018, as first announced in June. In a subsequent monthly bulletin, the ECB emphasized the importance of the labour market's continued improvement in helping to boost consumption. June's unemployment rate remained at 8.3%, the lowest level since 2008. ECB President Mario Draghi echoed his US counterpart by flagging the risks from protectionism, but he also described uncertainty about the future path of inflation as "receding." July data showed the eurozone's annual headline inflation rate at 2.1% and the equivalent core figure at 1.1%, up from 0.9% in the previous month.

In early August, 10-year Italian bond yields increased, close to the high point seen earlier in the year, when political uncertainty surrounded the formation of a new coalition government.

“ June’s unemployment rate remained at 8.3%, the lowest level since 2008. ”

Improvement in Eurozone Labor Market Underpins Recovery

Exhibit 3: Eurozone Unemployment Rate
June 2008–June 2018



Source: Eurostat.

Investors reacted nervously to news the coalition had begun budget negotiations earlier than previously expected, though volatility was exaggerated by a holiday-related lack of liquidity. The policies of the main partners in Italy's populist government—the left-wing Five Star party and the right-wing League—differ in many areas, but both have proposed significant increases in public spending, potentially setting the stage for a clash with the EU over the fiscal limits it sets for member countries.

The Bank of England (BoE) raised interest rates at its meeting at the start of August, and stated that more increases would be required to ensure the UK economy's growth did not push inflation further above the central bank's target of 2%. However, the BoE roadmap for future UK monetary policy contained some significant assumptions, not the least of which was a reasonably positive outcome to negotiations on the terms of the United Kingdom's departure from the EU. Further comments from BoE Governor Mark Carney highlighted the risks to the UK economy of the failure to reach such an agreement, and as a result market expectations for a further rate hike later in the year were scaled back, while the British pound weakened against most other major currencies.

With growth in the eurozone still at a reasonable level, the path for the ECB to cease its bond purchases at the end of 2018 looks relatively clear, in our view. Domestic fundamentals are strong in several countries, most importantly Germany, and a slight lessening of trade tensions between the EU and the United States—which had been creating something of a headwind—may help to bolster sentiment among European businesses. But we think the ECB is wise to retain some flexibility over the timing of its transition to more conventional monetary policies. The central bank has voiced concerns over the impact of the Turkish crisis on some European lenders. Additionally, volatility can be exaggerated at this time of year, as shown by the extent of recent moves in Italian bond markets.

EUROLAND MACROECONOMIC DATA

FINAL OUTPUT

Gross Domestic Product (GDP) ¹	Q3:17	Q4:17	Q1:18	Q2:18
GDP, Y/Y (%)	2.8	2.8	2.5	2.2
Private Consumption, Y/Y (%)	1.9	1.4	1.6	-
Gross Fixed Capital Formation, Y/Y (%)	2.6	2.8	3.6	-

ECONOMIC INPUTS¹

	Mar 18	Apr 18	May 18	Jun 18
Retail Sales, Y/Y (%)	1.7	1.6	1.6	1.2
Unemployment Rate (%)	8.5	8.4	8.3	8.3
Industrial Production, Y/Y (%)	3.2	1.6	2.6	2.5

INFLATION & WAGE PRESSURE

Inflation Indicators ¹	Apr 18	May 18	Jun 18	Jul 18
Consumer Price Index (CPI), Y/Y (%)	1.3	1.9	2.0	2.1
Core CPI, Y/Y (%)	0.8	1.1	0.9	1.1

FINANCIAL MARKETS

	Apr 18	May 18	Jun 18	Jul 18
Dow Jones EURO STOXX 50 Price Index EUR, Trailing P/E Ratio ²	15.99	15.40	15.69	16.30
ECB Refinance Rate (%) ³	0.00	0.00	0.00	0.00
10-Year Yield—German Bunds (%) ²	0.56	0.34	0.30	0.44

BALANCE OF PAYMENTS^{1,3}

Trade Balance	Feb 18	Mar 18	Apr 18	May 18
Billion Euro	18.37	25.48	16.69	16.51
Current Account Balance	Q2:17	Q3:17	Q4:17	Q1:18
% GDP	2.3	4.6	4.6	2.8

JAPAN MACROECONOMIC DATA

FINAL OUTPUT

Gross Domestic Product (GDP) ⁴	Q3:17	4Q:17	Q1:18	Q2:18
GDP, Q/Q ar (%)	2.3	0.8	-0.9	1.9
Private Consumption, Q/Q ar (%)	0.8	2.0	-1.5	3.0
Fixed Capital Formation, Q/Q ar (%)	4.8	3.1	2.0	5.2

ECONOMIC INPUTS

	Mar 18	Apr 18	May 18	Jun 18
Unemployment Rate (%) ⁵	2.5	2.5	2.2	2.4
Industrial Production, Y/Y (%) ⁶	2.4	2.6	4.2	-0.9
Tertiary Index, Y/Y (%) ⁶	0.8	1.2	1.3	0.7
Corporate Activities	Q3:17	Q4:17	Q1:18	Q2:18
Corporate Profit Growth (%) ⁷	5.5	0.9	0.2	-
Tankan Quarterly Survey (Index Level) ⁸	22	25	24	21

INFLATION

Inflation Indicators ⁵	Mar 18	Apr 18	May 18	Jun 18
Consumer Price Index (CPI), Y/Y (%)	1.1	0.6	0.7	0.7
CPI ex Fresh Food, Y/Y (%)	0.9	0.7	0.7	0.8

FINANCIAL MARKETS²

	Apr 18	May 18	Jun 18	Jul 18
Nikkei 225, Trailing P/E Ratio	17.1	16.8	16.1	16.3
3-Month Yield—JGBs (%)	-0.145	-0.155	-0.136	-0.191
10-Year Yield—JGBs (%)	0.055	0.040	0.036	0.062

BALANCE OF PAYMENTS

Monthly Trade Balance ⁷	Mar 18	Apr 18	May 18	Jun 18
Billion Yen	1188	574	-304	821
Current Account Balance ⁹	Q3:17	4Q:17	Q1:18	Q2:18
% GDP	4.0	4.0	4.0	4.0

Abbreviations: Q/Q ar: Quarter-over-quarter annualized rate. Y/Y: Year-over-year.

1. Source: © European Union 1995–2018.

2. Source: Bloomberg. P/E ratios of Dow Jones EURO STOXX 50 Price Index and Nikkei-225 Stock Average as calculated by Bloomberg.

3. Source: European Central Bank.

4. Source: Economic and Social Research Institute, Cabinet Office, Government of Japan.

5. Source: Ministry of Internal Affairs and Communications, Japan.

6. Source: Ministry of Economy, Trade and Industry, Japan.

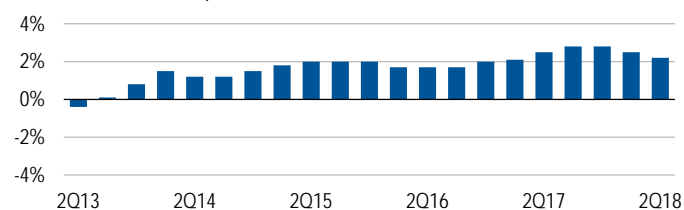
7. Source: Ministry of Finance, Japan.

8. Source: Bank of Japan.

9. Source: Bloomberg Indexes.

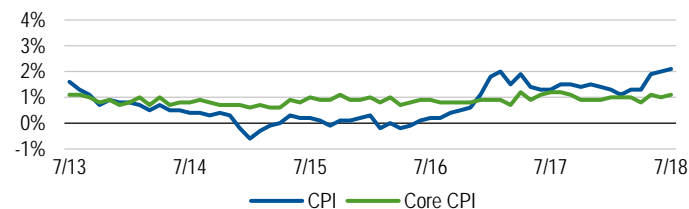
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Eurozone Real GDP, Y/Y



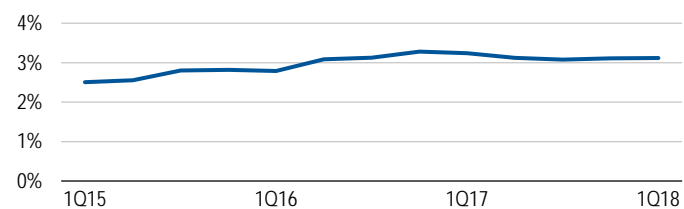
Source: © European Union 1995–2018, as at June 2018.

Consumer Price Index, Y/Y



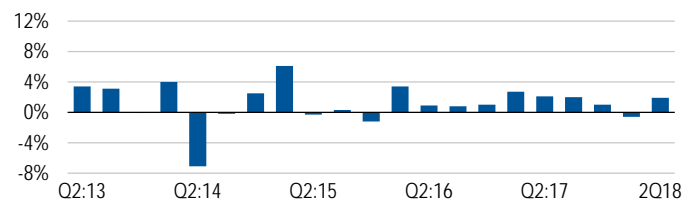
Source: © European Union 1995–2018, as at July 2018.

External Trade Balance, GDP



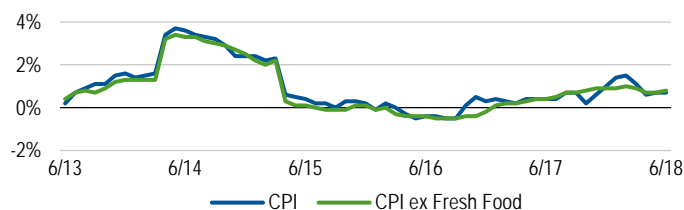
Source: © European Union 1995–2017, as at 31 March 2018.

Japan Real GDP, Q/Q ar



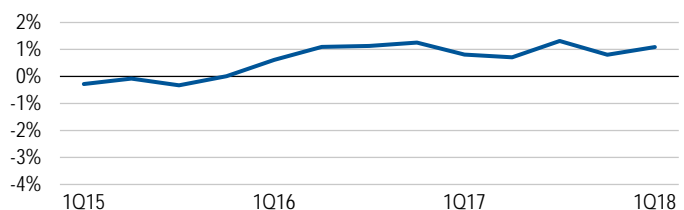
Source: ESRI, Cabinet Office, Government of Japan, as at June 2018.

Consumer Price Index, Y/Y



Source: Ministry of Internal Affairs and Communications, Japan, as at June 2018.

Visible Trade Balance, GDP



Source: Ministry of Finance, Japan and Economic and Social Research Institute, Cabinet Office, Government of Japan, as at 30 June 2018.

US MACROECONOMIC DATA

FINAL OUTPUT

Gross Domestic Product (GDP) ²	Q1:18	Q2:18	Q3:18E ¹	Q4:18E ¹
Q/Q ar (%)	2.2	4.1	3.0	2.8

ECONOMIC INPUTS

CONSUMPTION/FINAL DEMAND

Income/Savings ²	Mar 18	Apr 18	May 18	Jun 18
Consumer Spending, Y/Y (%)	4.3	4.6	4.9	5.1
Personal Income, Y/Y (%)	4.3	4.6	4.6	4.9
Savings Rate (%)	7.2	6.9	6.8	6.8
Employment	Apr 18	May 18	Jun 18	Jul 18
Unemployment Rate (%) ³	3.9	3.8	4.0	3.9
Participation Rate (%) ³	62.8	62.7	62.9	62.9
Nonfarm Payrolls (in Thousands) ³	175	268	248	157
Jobless Claims, 4-Wk Average (in Thousands) ⁴	222	223	225	215
Housing ⁵	Mar 18	Apr 18	May 18	Jun 18
Existing Home Sales (in Millions)	5.60	5.45	5.41	5.38
Y/Y Change (%)	-1.2	-1.6	-3.4	-2.2

INVESTMENT

Corporate Earnings ^{6, 11}	Q1:18	Q2:18	Q3:18E	Q4:18E
Earnings, Y/Y (%)	7.8	24.3	20.2	18.3
Production & Utilisation ⁷	Mar 18	Apr 18	May 18	Jun 18
Industrial Production, Y/Y (%)	3.6	3.7	3.2	3.8
Capacity Utilisation (%)	77.5	78.2	77.7	78.0
Nonresidential Fixed Investment ²	Q3:17	Q4:17	Q1:18	Q2:18
Y/Y (%)	5.0	6.3	6.7	6.7

INFLATION & PRODUCTIVITY

Inflation Indicators	Apr 18	May 18	Jun 18	Jul 18
Personal Consumption Expenditure (PCE), Y/Y (%) ²	2.0	2.2	2.2	-
Core PCE, Y/Y (%) ²	1.9	1.9	1.9	-
Consumer Price Index (CPI), Y/Y (%) ²	2.5	2.8	2.9	2.9
Core CPI, Y/Y (%) ³	2.1	2.2	2.3	2.4
Producer Price Index (PPI), Y/Y (%) ³	2.4	4.1	4.0	4.2
Core Producer Prices, Y/Y (%) ³	1.9	2.2	2.2	2.4
Productivity ³	Q2:17	Q3:17	Q4:17	Q1:18
Productivity, Q/Q ar (%)	1.7	2.6	0.3	0.4
Unit Labour Costs, Q/Q ar (%)	-1.2	1.0	2.5	2.9

FINANCIAL MARKETS

Valuation	Jun 18	Jul 18	Aug 18E	Sep 18E
P/E S&P 500 ⁶	19.77	20.49	-	-
Fed Funds Rate ^{7, 8}	2.00	2.00	1.91	1.95

BALANCE OF PAYMENTS

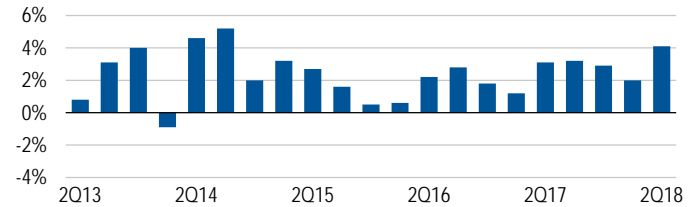
US Monthly Trade Deficit ^{2, 9}	Mar 18	Apr 18	May 18	Jun 18
Billion USD	-47.2	-46.1	-43.2	-46.3
US Current Account Deficit	Q2:17	Q3:17	Q4:17	Q1:18
Quarterly (in USD Billion) ²	-121.8	-103.5	-116.2	-124.1
Annualised (% GDP) ¹⁰	-2.4	-2.3	-2.4	-2.3

Abbreviations: Q/Q ar: Quarter-over-quarter annualized rate. Y/Y: Year-over-year. E: Estimate.

- Source: Bloomberg Economic Forecasts as of 31/7/18.
- Source: US Bureau of Economic Analysis.
- Source: US Bureau of Labor Statistics.
- Source: US Department of Labor.
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- Source: Standard and Poor's.
- Source: US Federal Reserve. At the 6/13/18 meeting the US Federal Reserve raised the main US interest rate to "a target rate" between 1.75% and 2.00%.
- Source: Chicago Board of Trade (30-Day Federal Funds Futures Rate for August 2018 and September 2018), as of 14/8/18.
- Source: US Census Bureau.
- Source: Bloomberg Indexes.
- Source: Bloomberg calculations are share-weighted y/y. Estimates as of 13/8/18.

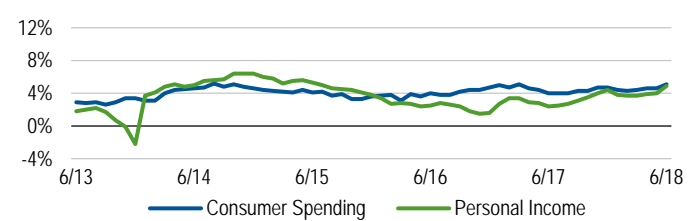
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Gross Domestic Product (GDP), Q/Q ar



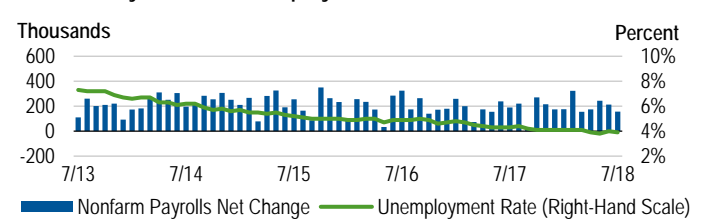
Source: US Bureau of Economic Analysis, as at June 2018.

Personal Income and Expenditures, Y/Y



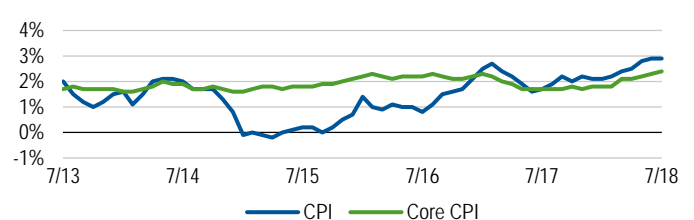
Source: US Bureau of Economic Analysis, as at June 2018.

Nonfarm Payrolls and Unemployment Rate



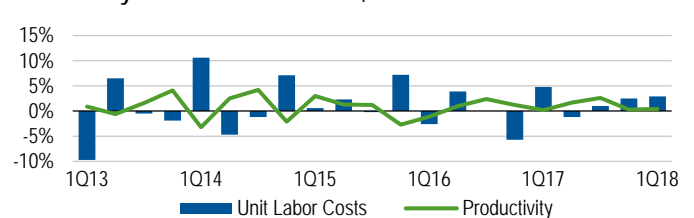
Source: US Bureau of Labor Statistics, as at July 2018. All figures seasonally adjusted.

Consumer Price Index, Y/Y



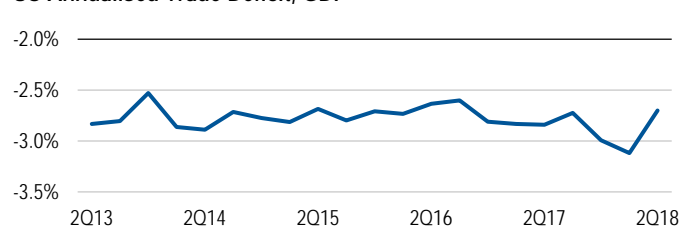
Source: US Bureau of Labor Statistics, as at July 2018.

Productivity and Unit Labour Costs, Q/Q ar



Source: US Bureau of Labor Statistics, as at March 2018.

US Annualised Trade Deficit, GDP



Source: US Census Bureau and US Bureau of Economic Analysis, as at June 2018.

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