

## THE MACRO REPORT | JUNE 2019

# The Fed's growth conundrum

The global economy has weakened a little and asset markets have tumbled because of the United States' trade disputes with China and other nations. The U.S. economy also faces headwinds from escalating trade tensions, a stronger dollar, and higher short-term rates. Federal Reserve chair Jerome Powell said that the central bank was prepared to act to sustain the economic expansion if the various trade spats weakened the economy. We predict the Fed will cut its policy rate by 50 basis points by the end of 2019.

In Europe, the elections for the European Parliament shook up domestic politics in a number of countries,

including Germany and Italy. While the results showed an increase in support for right-wing populist parties, the feared populist wave fell short of expectations. German Chancellor Angela Merkel, who is widely regarded as the leader of Western Europe, will not seek a fifth term after her current term expires in 2021. Tracking the downward trend in risky assets, oil prices fell sharply in May amid concerns that rising trade tensions will weaken the global economy and hurt demand for crude.

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**THIS MONTH**

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Fed is inching toward a cut



European elections deepen divide



Oil pendulum swings lower

# Fed is inching toward a cut

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A decelerating economy, volatile financial markets, and escalating trade tensions could force the Fed's hands on interest rates.



The U.S. economy is facing headwinds with a number of elements placing stresses on economic expansion. First, the trade war and the Trump administration's approach to protectionist tariffs are creating uncertainties among businesses. Second, corporate investment is not doing very much even after the corporate tax cuts. And third, higher rates are exerting pressure on debt that is tied to the front end of the Treasury yield curve, especially consumer credit.

## Fed rate cut in the cards

In recent weeks, the trade war has escalated. Rising trade tensions between the United States and China have ricocheted through financial markets; risky assets tumbled in the second half of May, and investors fled to safe-haven investments. The Treasury yield curve inverted further, and there were calls in the market for the Federal Reserve to cut interest rates. Fed Chair Jerome Powell provided some soothing words, and risky assets rallied sharply.

We are not at all convinced this is a rerun of late 2018 when the Fed's decision to shift to a neutral stance laid the groundwork for the strong rally in risky markets in the first quarter of 2019. We can't blame the weakness in risky asset on interest rates. Rates have been falling, and the Fed has been busy stressing patience and neutrality. Markets are reacting to the reality of slower growth and to the prospects of a further slowdown.

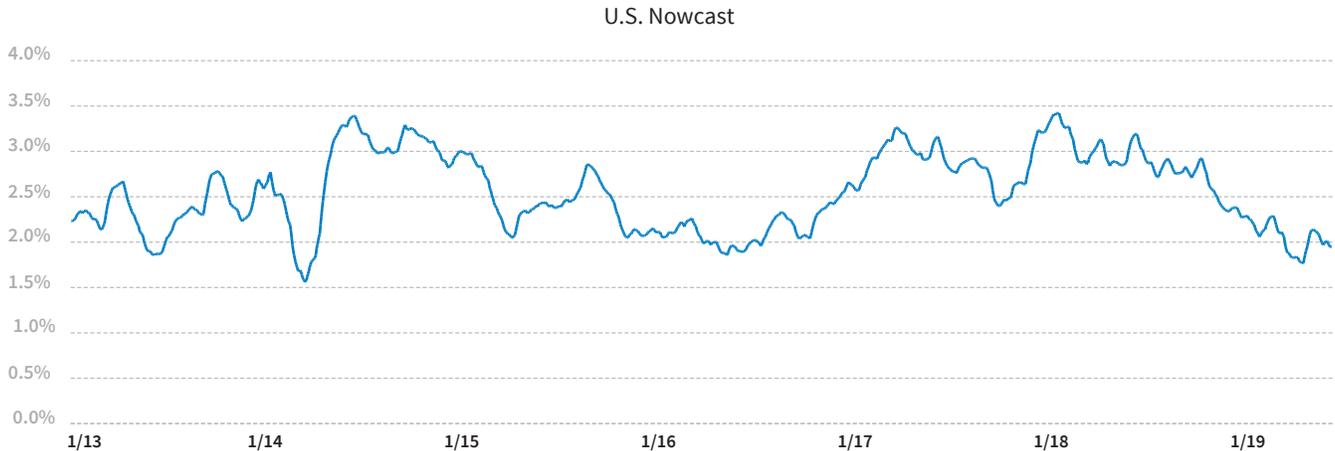
As we have noted before, an [inverted yield](#) curve is a powerful signal that something is awry. While an inverted curve alone does not cause or predict a recession, it is a signal of serious, potential stresses in the asset markets. Those stresses, if unchecked, can threaten the economy's prospects. The easiest way to get some steepness into the curve is for the Fed to cut rates. But generating a steeper curve by increasing long-term rates, while short rates remain unchanged, is simply implausible at this time since neither a rise in inflation expectations nor a jump in the equilibrium global real rate seem remotely likely.

**We expect a rate cut soon; the Fed will likely lower its policy rate by 50 basis points by the end of 2019.**

Speaking at a Fed conference in Chicago in early June, Powell said the Fed "will act as appropriate" to sustain economic expansion. That was the dovish signal asset markets were looking for. We expect a rate cut soon; the Fed will likely lower its policy rate by 50 basis points by the

## U.S. GDP growth slips

% annualized, quarter-on-quarter



Source: Putnam, as of May 2019. 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.

end of 2019. But there is still a hurdle to be crossed; we will need to see more financial market turbulence or a run of weaker data, or both.

If the president finds a way to make peace on the various trade battles, if global the economy recovers, and if asset markets track sideways or higher, then the chances of a rate cut will fall. But right now, we believe that is unlikely. Too much damage has been done to a global economy already facing headwinds, and the domestic U.S. economy, facing its own challenges and trade war uncertainties, is not strong enough to shrug off these headwinds.

### May jobs report disappoints

The sharp decline in the pace of hiring in May was a surprise. The government reported that employers added just 75,000 jobs last month, a far cry from what economists had expected. Although the unemployment rate held steady at 3.6%, the lowest in about 50 years, average hourly earnings increased by just 3.1% from a year earlier, less than projected. The slowdown in job creation was quite broad across the economy.

And once again, there are no signs of widespread wage pressures. We don't see this U.S. payrolls report as so weak that it will force the Fed's hand on rates; rather, it illustrates that the economy is slowing. We think the trade wars are weighing on the labor market. Overall, this is consistent with our view that the economy is weakening a little and that the headwinds from the trade war are raising the risks. In this context, it makes sense to think that the Fed will cut rates, but it doesn't mean the June meeting will bring that cut.

### Recession risk trends higher

We believe the risks to the economy are rising. Growth is slowing, and policy risks (trade) are increasing. The markets for risky assets are nervous. It would not take much to tip the economy into a weaker path. In this sense, the probability of a recession on our favored models appears much more likely to rise than to fall.

# European elections deepen divide

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Politics remain a worry in the region after the European Parliament elections strengthened Italy's right-wing maverick, Matteo Salvini.



The elections for the European Parliament produced some interesting results and are shaking up domestic politics in a number of countries. Overall, the elections increased voter support for right-wing populist parties, but this fell short of the wave that some had expected. So, pro-European Union (EU) parties from the center — from the moderate left to the moderate right — remain a majority in the Parliament. The results are playing out in interesting ways in a number of countries, including Germany and Italy.

## Germany's Green surge

In Germany, the Green Party enjoyed the greatest increase in support at the European elections. The election upset is making Chancellor Angela Merkel's coalition government look shaky. Andrea Nahles, the leader of the Social Democrats (SPD) — Merkel's coalition partner — resigned due to party infighting over its future direction. This struggle was exacerbated by the EU elections and growing fear within the SPD that the compromises it made to join the national coalition are weakening its electoral

prospects. The SPD will later this year pick a new leader and review its role in the coalition.

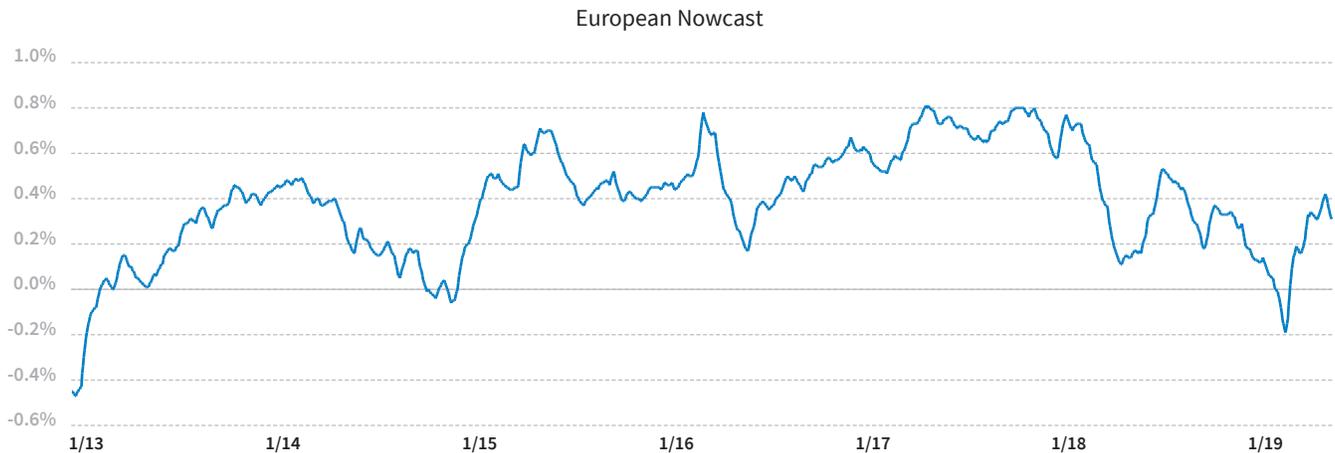
With Merkel on the way out, it looks possible that the end of 2019 could bring an end to the coalition, especially if the new SPD leader turns the party to the left. This set of developments does not portend an immediate shift in German domestic policy or European policy, but it does illustrate that Germany is not immune to the political stresses evident elsewhere in Europe. For now, the Christian Democratic Union and the SPD are too weak to walk away from the coalition. This arrangement, however, is not stable over the long run.

## Italy's League party comes ahead in EU elections

In Italy, the strong showing by Deputy Prime Minister Matteo Salvini's League party had the expected effects: Salvini has started to express himself more openly and is trying to assert his own priorities within the coalition. The comparatively weak performance by the 5 Star Movement in the EU elections has caused its leader, Luigi Di Maio, to cede some ground to Salvini. Broadly speaking, the League has doubled its electoral support, and 5 Star has seen its support halved. This is a simple, straightforward message, and it is easy to see its electoral appeal. Lower, simpler taxes would be popular with pretty much any electorate, and the idea that European rules are holding Italy back is popular with the League's base. The real question is how far Salvini is willing to push against the eurozone's orthodoxy. Over the past year and after a number of missteps, the government has found a way to make some fiscal expansion, but not enough to alienate the EU, undermine the BTP (bonds offered by the government) market, or weaken the sovereign credit rating.

## Eurozone growth dips slightly

%, quarter-on-quarter



Source: Putnam, as of May 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 real question is how far Salvini is willing to push against the eurozone's orthodoxy.

This dance is now starting up again, but the music is a little different. First, the economy is weaker than the government expected. First-quarter real GDP growth was revised down to 0.1%, following a contraction of 0.1% in the fourth quarter. Nominal GDP growth has been running at below 1% year on year. This has placed some strain on the debt-to-GDP ratio. Finance Minister Giovanni Tria has blamed the slowdown on the external environment and not on any fiscal slippage on the part of the government. The EU has taken note and started an excessive deficit procedure (EDP), an action by the European Commission against any EU member state that exceeds the bloc's budgetary deficit ceiling. This is a long process and inevitably highly political, and at the end of the day it may not amount to very much in and of itself, but it will raise the political temperature a little and it will give Salvini a punching bag. The key issue is the effect it has on Buono del Tesoro Poliennale (BTP) yields. Salvini's rising political

clout is also an important change. He is making demands that seem increasingly likely to result in early elections.

### Room for missteps and market volatility

We don't think Salvini and his advisors believe that departure from the eurozone is feasible. But we also believe they are serious about making a sustained effort to relax the eurozone's fiscal rules as a second-best way to recapture some policy autonomy. This is not going to be an easy battle to win; we doubt they will get much more than a token or two.

But there is clearly a significant risk of market volatility. If Salvini decides to cause a collapse in the government to usher in new elections, we expect some volatility in the markets in the near future. That volatility may continue if he wins and a new government drafts the budget for 2020. We expect the dance to end the way it did last year, with the financial markets acting as the disciplinary force on the government's ambitions and the government stepping down. But we have to get there from here, and there are many opportunities for missteps along the way.

# Oil pendulum swings lower

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**Oil prices fell sharply in May and are now trading at below fair value amid concerns about tariffs and weaker global growth.**



Oil prices fell sharply in May, tracking the downward trend in risky assets. Prices dipped lower on fears that rising trade tensions will weaken the global economy and hurt demand for oil. The U.S. Department of Energy’s inventory report showed a sharp increase in inventories. That has puzzled many analysts since the figures for reported inventories do not match those implied by production, exports, and imports. We note that there are discrepancies in data, and for the most part we assume these “errors and omissions” cancel out over time. Still, these inventory issues are large.

**Saudi Arabia is offsetting the weakness among the Organization of the Petroleum Exporting Countries (OPEC) by increasing output.**

There has been no major change in supply and demand dynamics. Exports of oil from Venezuela and Iran continue to decline. Saudi Arabia is offsetting the weakness among the Organization of the Petroleum Exporting Countries (OPEC) by increasing output. Problems with Russia’s Druzhba pipeline surfaced in late April, when crude in the line was discovered to be heavily contaminated with organic chlorides. The issues affected prices for Brent, the global benchmark for crude. Russia is still struggling with the contamination problem and has recently been producing a little less than 11 million barrels per day — slightly below its quota under the OPEC+ coalition deal (OPEC+ refers to non-member countries such as Russia). So, for now, there continues to be supply discipline on the part of the major producers.

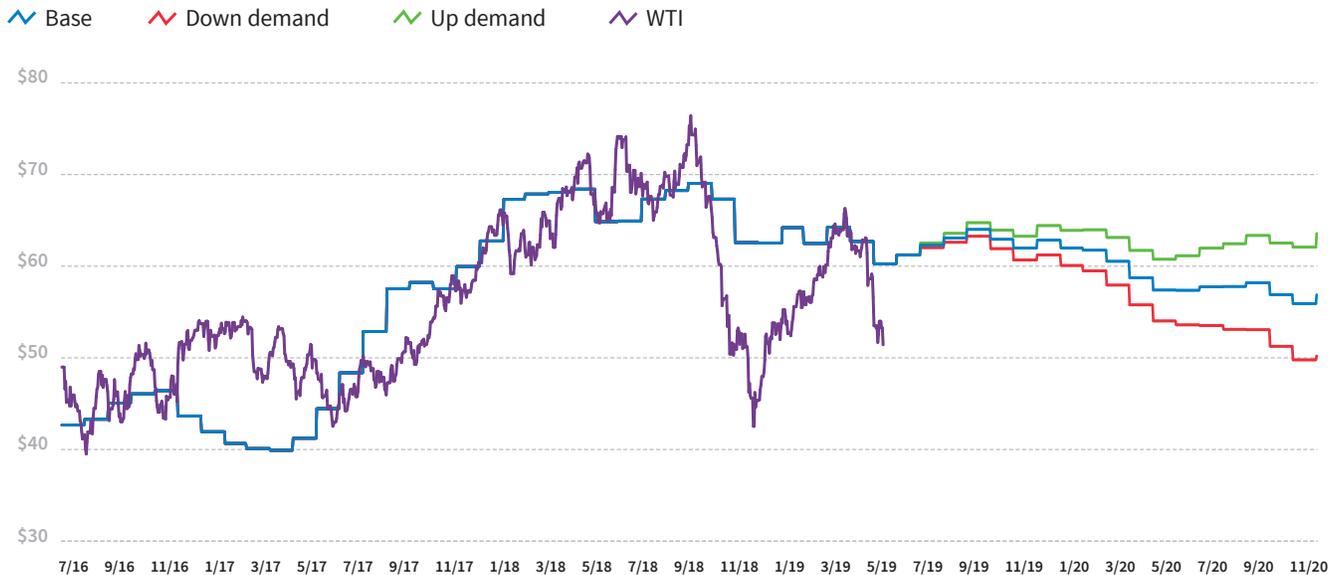
On the demand side, there are a few hints of weakness. Refinery runs in Europe are down, and the Russian oil contamination remains a problem. Demand for diesel in the United States seems to be a little weak, but at least this, in part, reflects the floods in the Midwest and major delays in the planting session. Fewer tractors chugging up and down fields at a time when there is a substantial seasonal peak in agricultural demand will disrupt the seasonal adjustment factors. There are also signs of some weakness in demand from Asia.

## **Fair value drifts lower in 2020**

Prices have fallen below what we think is fair value given trends in supply and demand. We forecast that the fair value estimate for oil will move lower later this year. Obviously, this requires assumptions about trends in supply and demand. The gentle drift down in prices signals three things.

## Crude oil's fair value

Oil fair value — Baseline (daily)



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

First, it's hard to see what would push oil prices significantly higher than the current fair value. Still, in the near term, anything can happen, and an event like a war in the Middle East would have a major impact. The attacks on two tankers in the Gulf of Oman in June have sent the United States and Iran, two longtime adversaries, careening toward potential crisis. But short of this type of disturbance, there is enough capacity around to ensure a cap on prices. Second, OPEC+ discipline imposes a burden on Saudi Arabia. Russia has recently indicated that it expects to keep cooperating with OPEC, but that the Saudis want a higher price than Russia feels it needs.

Currently, we don't have a U.S. recession in the forecast, but the risks of a worse outcome are rising.

### Risks of a steep decline in U.S. growth are rising

Internal disputes have caused troubles for OPEC in the past and could do so again. U.S. sanctions on Venezuela and Iran have had the effect of making OPEC discipline easier to maintain, but that doesn't mean we can rely on discipline to continue indefinitely. The third factor is demand. As we mentioned earlier, the global economy is slipping a little, and the risks seem to be to the downside. If the economy weakens further, oil demand will be affected. Currently, we don't have a U.S. recession in the forecast, but the risks of a worse outcome are rising.



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.

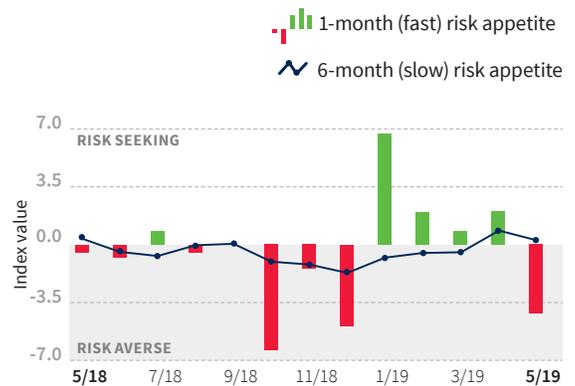
# Risk appetite drops

## SHORT-TERM TREND

It was a typical risk-off month in May

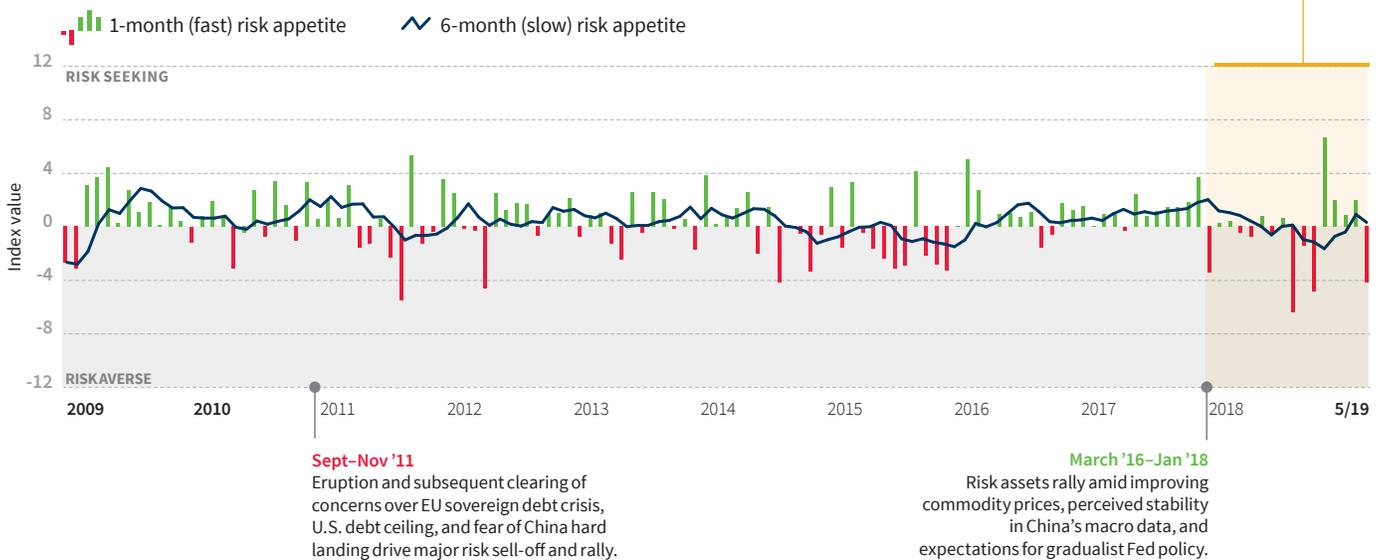
Risk  ON  OFF

- Equities and the most risk-sensitive fixed-income assets posted negative returns.
- U.S. Treasuries led the global rates rally.
- Precious metals gained, buoyed by the weakness in global stocks and other assets.
- Oil prices declined.



## LONG-TERM CYCLE

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



Source: Putnam. Data as of May 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 weakens slightly

## SHORT-TERM TREND

The economic expansion is at risk from rising trade tensions

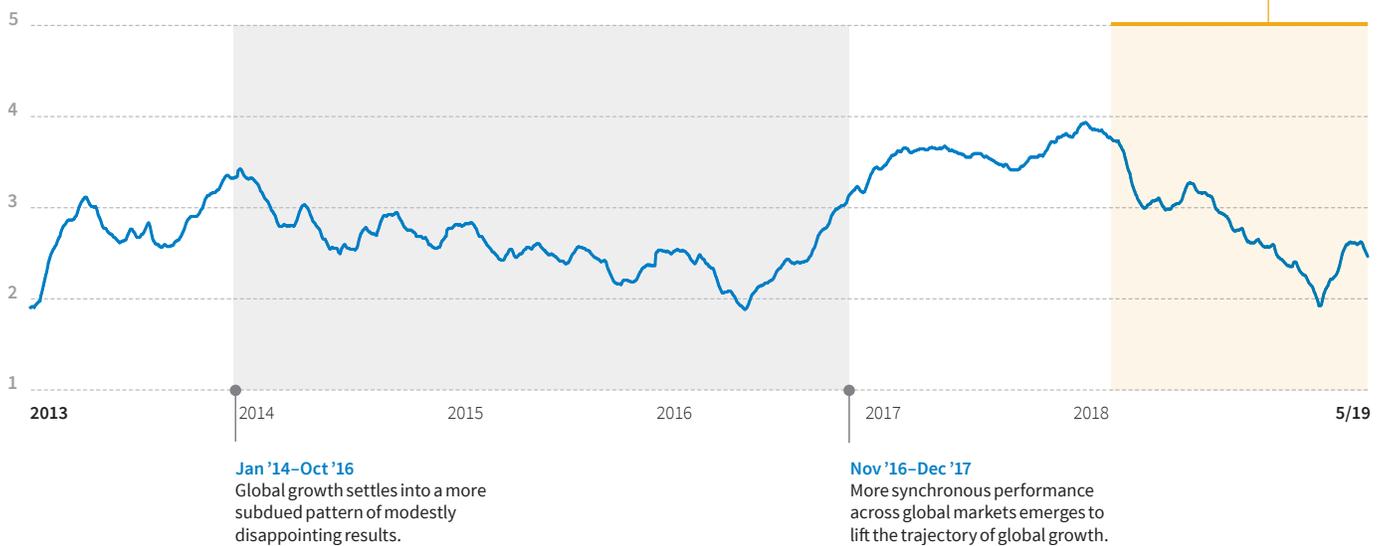
▲ 2.45%

Growth among G10 nations was little changed. Economic indicators in Canada, New Zealand, and Japan improved while those in the remaining G10 countries slowed. In the United States, industrial production faltered, setting the growth path lower. Economic indicators weakened in China, Russia, and Turkey. In Latin America, Brazil’s economy grew the slowest.



## LONG-TERM CYCLE

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



Source: Putnam. Data as of May 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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