FRANKLIN TEMPLETON INVESTMENTS

Global Economic Perspective

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Perspectives from the Franklin Templeton Fixed Income Group

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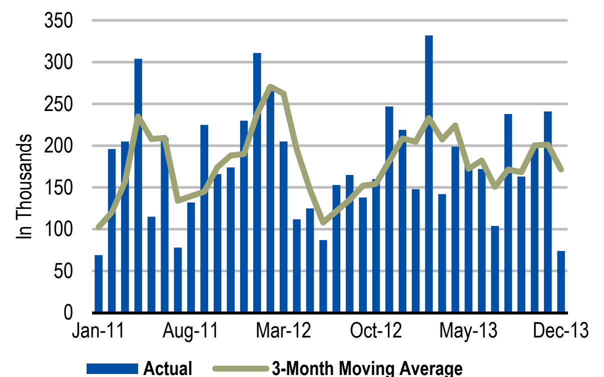
JOBS CONUNDRUM CLOUDS IMPROVING US ECONOMY

After a sharp upward revision in the third-quarter US gross domestic product (GDP) reading, many analysts have been lifting their forecasts for growth in the United States. The 18 December announcement by the US Federal Reserve (Fed) that it would begin cutting its monthly asset purchases from US$85 billion to US$75 billion in January can be interpreted as a vote of confidence in the US economy even as different barometers show a rise in activity and confidence among businesses and consumers, with the latter helped in large part by the "wealth effect" induced by broadly rising asset prices.

Rising interest rates have served to cool the housing market somewhat, but they have been offset by some easing of credit standards, and while business investment was somewhat sluggish in 2013, forward indicators such as purchasing managers' indexes (PMIs) and durable goods orders, together with gathering confidence, mean we should soon see positive data on this front. The signing of a bipartisan agreement on federal government budget levels for the coming two years, which reduces the uncertainty that has overshadowed US fiscal policy (in part at least), plus the fading of the fiscal drag effects that weighed on the US economy in 2013, has fuelled optimism that America could be able to weather a gradual rise in market interest rates. In addition, although the Fed has started to reduce its monthly asset purchases, it has provided strong forward guidance that it will not raise short-term interest rates for an extended period of time, thus helping to prevent an overly sharp steepening of the yield curve.

The US economy's one major question mark concerns the state of the labour market. Nonfarm payroll figures for December were well below consensus expectations, while a drop in the unemployment rate to 6.7% from 7.0% in November was seen as reflecting a further decline in the participation rate rather than any inherent improvement in the jobs picture. But we would add that one month's figures do not make a trend and can often be volatile. Particularly bad weather may have distorted job creation in December, and it is worth noting the quite strong upward revision in the nonfarm payroll figure for November. However, the decline in the participation rate to 62.8% of the working age population—close to a 35-year low—suggests that the US has yet to shift decisively into a higher gear.

Chart 1: US Job Creation
Change in US Nonfarm Payrolls
January 2011–December 2013



Source: US Bureau of Labor Statistics. Data as at 10 January 2014.

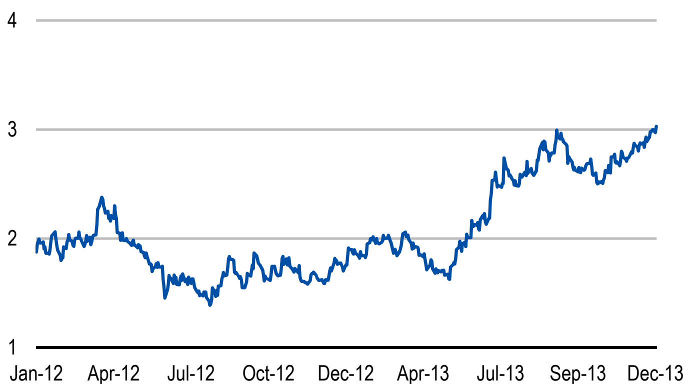
Nonetheless, despite the conundrum posed by the latest jobs figures, there appears to be general optimism that the US economy should continue to grow this year, with many of the obvious risks seeming to come from potentially negative developments elsewhere than in North America. Some see the possibility of a significant rise in long-term interest rates if the pick-up in growth continues to surprise on the upside and if the amount of liquidity released into the economy finally triggers inflation. However, we think there is a relatively sound basis for believing that bond yields are unlikely to rise as much in 2014 as they did in 2013. The yield on 10-year US Treasuries rose to over 3% at the very end of

2013, compared to a low point of 1.63% set in May, as the market sought progressively to adjust to changes in the Fed's quantitative easing programme. But the adjustments have largely been made at this stage—so the thesis goes—meaning the scope for further large increases in interest rates could be limited, especially as much of the improvement in the domestic, consumer-led economy is being driven by the wealth effect caused by financial market and home-price gains, while fundamental wage growth has remained soft. The weak jobs figures for December have also helped to reverse the year-over-year rise in yields. In addition, disappointing auto sales and a sharp slowdown in retail spending overall in December were signs of just how fickle US consumer spending can be. The Fed's affirmation that it will "proceed cautiously" in slowing down its asset purchases therefore seems justified, even as the unemployment rate inches closer toward the 6.5% rate. Previously, the Fed has said it would start to look at interest rates again when unemployment reached 6.5%, but in December, the central bank made it understood that it would keep rates low, "well past" a jobless rate of 6.5%, further underlining its dovish approach to an economy that still is not running on all cylinders.

Chart 2: Interest Rates (%)

10-Year US Treasury Yield—Daily Yields

January 2012–December 2013



Source: Bloomberg, data as at 31 December 2013. **Past performance does not guarantee future results.**

Nonetheless, we believe economic fundamentals in the United States this year should generally be better than in the other big advanced countries. Since the financial crisis, the country has moved well ahead of Europe and Japan in terms of normalisation, with the retreat from unconventional central banking measures already under way, as exemplified by the Fed's December decision. After two years of fiscal austerity, the US budget deficit is less than half of what it was in 2010, while plentiful energy reserves, the housing recovery and growing signs of business confidence also argue in favour of continued US revival. The coming year may not be a supercharged one, but we think the US economy has the potential to grow faster than those of many other leading industrial countries, most notably in Europe.

A DIFFERENTIATED PICTURE FOR THE WORLD ECONOMY

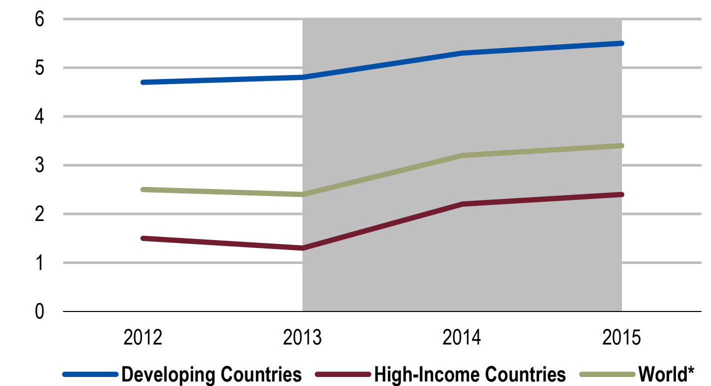
In mid-January, the World Bank announced improved growth forecasts for the world economy, ahead of a similar upward revision in growth predictions from the International Monetary Fund. Indeed, along with the pick-up in the United States and Europe, a string of data was suggesting China had recovered from its mid-year downturn, while the authorities there pushed ahead with the announcement of a slate of large-scale financial reforms and loosened their grip on deposit interest rates. And select emerging markets have started to perk up as global economic conditions have improved, leading investor sentiment to begin to shift from a fear of emerging-market assets to a fear of missing out on potential growth opportunities by staying on the sidelines. Indeed, a number of emerging markets have performed well recently, with the United Arab Emirates supplying some of the world's best stock-index performances for 2013 as a whole. In addition, the announcement that the Fed would begin cutting its monthly asset purchases from US$85 billion to US$75 billion and the rise in the benchmark 10-year US Treasury yield above 3% by end-December (its highest level since July 2011) had a much more muted effect than in the August–September period, when speculation about the Fed's intentions proved especially damaging.

Chart 3: Global GDP Growth (%)

Quarter-Over-Quarter Annualised

2012–2015 Estimate

*World Bank members.



Source: The World Bank. 2014. Global Economic Prospects, Volume 8, January 2014, World Bank, Washington, D.C. doi: 10.1596/978-1-4648-0201-0 License: Creative Commons Attribution CC BY 3.0. Shaded areas represent estimates. **There is no assurance that any estimate will be realised.**

The question is whether the generally positive trends established in the last couple months of 2013 will remain in place. We think there are plenty of reasons to believe they can. Low base interest rates in the developed world, forward indicators showing that global economic growth has been gaining momentum, and generally healthy corporate fundamentals all provide a positive backdrop. Changes in banking regulations mean that it is hard for us to imagine a re-run of the financial crisis of 2007–2008, at least in the developed world.

The outlook for the United States seems particularly bright to us, thanks to that country's unrivalled flexibility and dynamism. A large number of countries in Asia, Latin America, and central and eastern Europe also display strong fundamentals and show relatively attractive risk/return characteristics, in our view. Most countries have coped very well so far with the rise in US Treasury yields, in part thanks to the large currency reserves built up in the wake of the credit crises of the late 1990s.

But the situation might be less clear-cut in some countries. Whereas base interest rates plunged in Europe and the United States following the financial crisis, some countries have had to raise interest rates in the face of inflation and currency concerns, or, like China, have had to withdraw excess cash from the financial system to head off asset bubbles. In addition, this year will see important parliamentary and/or presidential elections in countries such as India, Brazil, Turkey, Indonesia, South Africa and Thailand. Each of these countries needs a serious reformer to be elected—someone willing to improve governance and iron out important stumbling blocks to development. Many of these countries run current account deficits, leaving them exposed to fickle capital inflows and thus the effects of rising US Treasury yields. It is generally thought that these countries may have sufficient currency reserves to allow them to ride out short-term volatility, but US tapering still has some way to go.

This year will be a decisive one for Japan as well. The Japanese central bank continues to pump liquidity into the market (giving support to Asian asset classes in general even as the Fed starts to step back), but the government's attempts to achieve a sustainable step-up in growth could come unstuck if structural reforms do not gain traction and if a substantial hike in the sales tax planned for April pummels the domestic economy (especially as wage growth has yet to take off). Geopolitical tensions with China have also been rising. However, should Japan's attempts at structural reform continue to disappoint and should efforts to reflate the economy unravel, one can be reasonably certain that the Bank of Japan will continue to provide extra liquidity, in our view, thus potentially helping support asset markets across Asia. However, we expect to see ever-widening differentiation in the performance of individual countries across the world in the year ahead.

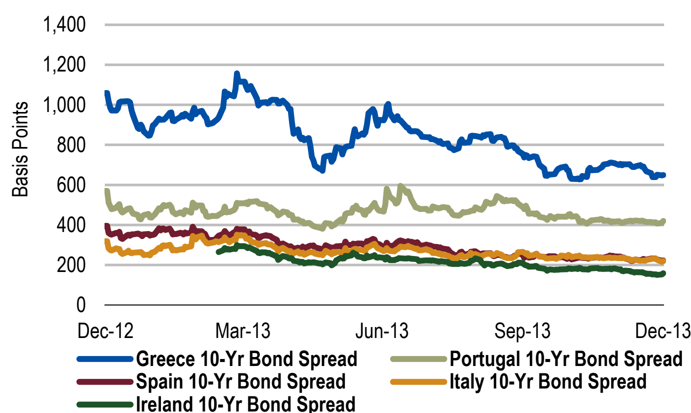
EUROPEAN OUTLOOK

The European economy started 2014 on a bright note, with indications of a strong rebound in business activity, while eurozone retail sales made the biggest monthly jump in 12 years in November. According to the composite PMI compiled by Markit, activity in Europe's manufacturing sector rose in December at its fastest pace since mid-2011, while services activity also rose, albeit at a slower pace. Indeed, the improvement in economic performance and outlook is perhaps the most salient feature of the past half year. UK growth in the second half of 2013 was far higher than consensus forecasts at the beginning of the year, and crisis-ridden countries such as Ireland and Spain emerged from recession. There are signs that some painful adjustments to improve competitiveness in the most crisis-ridden countries are paying off, with activity and new orders in the services sector, which accounts for half of the Spanish economy, rising at their fastest pace in six-and-a-half years in December, according to Markit's PMI data. France has been somewhat left behind in the region's generally improving economic picture, but we think it can be expected to benefit from what have been brightening conditions in other European economies in the months ahead.

Jobs growth has started to pick up in some of the countries most blighted by unemployment such as Ireland and Spain, and Portugal may soon exit the emergency bailout programme in the same way that Ireland did in December. The sovereign debt crisis, which saw a huge spike in peripheral European bond spreads over German Bunds, has been stopped as financial markets have become generally calmer and more resilient. Indeed, a surge in investor demand for Irish government bonds allowed Dublin to easily raise almost half its funding target for this year at a bond auction on 7 January, its first since it exited its international bailout programme in December. In broad terms, those who embraced Irish, Spanish and Italian government bonds last year ended up with strong performance results. Even Greek government bonds have rallied, and the reduction in borrowing costs for peripheral European countries in general has helped ease the financial fragmentation that was becoming increasingly evident in the eurozone. The institutional framework has also changed for the better, with a form of banking union pushed through in December and closer inspection of countries' fiscal policies.

Chart 4: 10-Year Government Bond Yield Spreads over German Bonds

1-Year Period Ended 31 December 2013



Source: Bloomberg LP, data as at 31 December 2013. **Past performance does not guarantee future results.**

Table 1: Unemployment Rates in Select Eurozone Countries
As at November 2013

	Unemployment Rate (%)	Youth Unemployment Rate (%)
Greece*	27.3	54.8
Spain	26.7	57.7
Portugal	15.5	36.8
Ireland	12.3	24.8
France	10.8	25.6
Italy	12.7	41.6
Germany	5.2	7.5
Eurozone	12.1	24.2

*Data as at September 2013.
Source: *Eurostat,* data as at 8 January 2014.
Eurozone consists of 18 member states of European Union that have adopted the euro as their common currency.

Of course, Europe still faces many problems. Official data show that the modest recovery has as yet produced few new jobs. Unemployment in the eurozone as a whole remains stubbornly high (12.1% in November, unchanged from October), with joblessness continuing to rise in Italy. Credit provided by banks to companies continues to contract, and core consumer inflation (excluding food and energy) slowed to 0% in December—the lowest level ever since Eurostat began to compile data and well off the European Central Bank's (ECB's) target of "below but close to 2%."

Some combination of lack of demand and pronounced prudence on the part of banks required to reinforce their capital structures is undoubtedly at the heart of the problem of poor bank credit numbers. But the uptick in business activity, aided by continued loose monetary policy and the ECB's latest review of banks' asset quality (due to be completed in October 2014), may help turn things around on this front. With the ECB taking over supervision for a large chunk of Europe's banking sector at the end of this year, and with banks having spent the last three years shoring up their capital ratios, confidence in the European banking system should therefore grow. Likewise, fears that Europe is facing Japan-style deflation may prove overdone if demand picks up and unemployment declines.

The ECB itself does not believe the eurozone faces deflation, merely a prolonged period of low inflation. Just in case, the ECB still has ammunition left to try to kickstart growth and inflation. The central bank has already reduced its refinancing rate to 0.25% and extended its undertaking to provide banks with unlimited amounts of short-term funding until mid-2015, but on 9 January, the ECB seemed to go further, saying it "strongly emphasises that it will maintain an accommodative stance of monetary policy for as long as necessary," suggesting it might look at more unconventional methods to facilitate growth. It could, for example, introduce negative interest rates—charging banks to deposit money at the ECB—despite questions regarding the effectiveness of such a policy.

In essence, however, it may turn out that Europe is not the master of its own destiny this year. Apart from the uncertainty that hovers over some large emerging markets that have been helping drive European export growth, there is the question of rising market interest rates. We believe the United States should be able to cope—especially as rising rates would likely mean a repatriation of US money held abroad—but rising rates could cause substantial problems for the most heavily indebted European countries. Investors and the media have applauded the drop in peripheral European bond yields, with the successful Irish bond auction early in January seen as an important sign of confidence. But, as one Irish commentator put it, "Let's be clear: the reason that the country is borrowing again is that we can't pay our way." Indeed, public debt as a percentage of nominal GDP is continuing to rise in Ireland, reaching over 117% in 2013, according to Eurostat. In the case of Italy and Portugal, the ratio is over 130%. Therefore, we believe one of the most negative scenarios for Europe would be a rise in market rates that dashes hope for growth in southern Europe, potentially sparking another spike in government bond yields and renewed political instability.

All investments involve risks, including possible loss of principal. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging-market countries involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Such investments could experience significant price volatility in any given year.

EUROLAND MACROECONOMIC DATA

FINAL OUTPUT				
Gross Domestic Product (GDP)[1]	4Q12	1Q13	2Q13	3Q13
GDP, Y/Y (%)	-1.0	-1.2	-0.6	-0.4
Private Consumption, Y/Y (%)	-1.5	-1.2	-0.6	-0.4
Gross Fixed Capital Formation, Y/Y (%)	-4.8	-5.6	-3.5	-2.5
ECONOMIC INPUTS[1]				
	AUG 13	SEP 13	OCT 13	NOV 13
Retail Sales, Y/Y (%)	-0.2	0.0	-0.3	1.6
Unemployment Rate (%)	12.1	12.1	12.1	12.1
Industrial Production, Y/Y (%)	-1.5	0.2	0.2	—
INFLATION & WAGE PRESSURE				
Inflation Indicators[1]	SEP 13	OCT 13	NOV 13	DEC 13
Consumer Price Index (CPI), Y/Y (%)	1.1	0.7	0.9	0.8
Core CPI, Y/Y (%)	1.0	0.8	0.9	0.7
FINANCIAL MARKETS				
	SEP 13	OCT 13	NOV 13	DEC 13
Dow Jones EURO STOXX 50 Price Index EUR, Trailing P/E Ratio[2]	16.33	17.32	17.42	17.51
ECB Refinance Rate (%)[3]	0.50	0.50	0.25	0.25
10-Year Yield—German Bunds (%)[2]	1.78	1.67	1.69	1.93
BALANCE OF PAYMENTS[1]				
Trade Balance	JUL 13	AUG 13	SEP 13	OCT 13
Billion Euro	18.18	7.08	10.88	17.16
Current Account Balance	4Q12	1Q13	2Q13	3Q13
% GDP	2.6	1.0	2.2	2.2

JAPAN MACROECONOMIC DATA

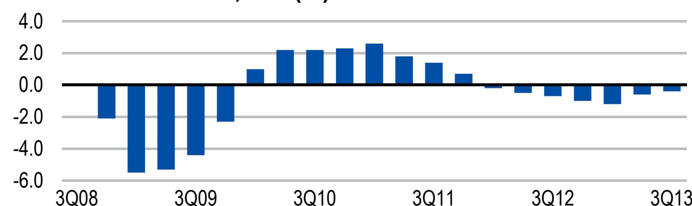
FINAL OUTPUT				
Gross Domestic Product (GDP)[4]	4Q12	1Q13	2Q13	3Q13
GDP, Q/Q ar (%)	0.6	4.5	3.6	1.1
Private Consumption, Q/Q ar (%)	0.1	2.8	1.7	1.9
Fixed Capital Formation, Q/Q ar (%)	-2.4	-4.1	3.8	0.0
ECONOMIC INPUTS				
	AUG 13	SEP 13	OCT 13	NOV 13
Unemployment Rate (%)[5]	4.1	4.0	4.0	4.0
Industrial Production, Y/Y (%)[6]	-0.4	5.1	5.4	5.0
Tertiary Index, Y/Y (%)[6]	0.9	2.3	1.9	—
Corporate Activities	1Q13	2Q13	3Q13	4Q13
Corporate Profit Growth (%)[7]	6.0	24.0	24.1	—
Tankan Quarterly Survey (index level)[8]	-8	4	12	16
INFLATION				
Inflation Indicators[5]	AUG 13	SEP 13	OCT 13	NOV 13
Consumer Price Index (CPI), Y/Y (%)	0.9	1.1	1.1	1.5
CPI ex-Fresh Food, Y/Y (%)	0.8	0.7	0.9	1.2
FINANCIAL MARKETS[2]				
	SEP 13	OCT 13	NOV 13	DEC 13
Nikkei 225, Trailing P/E Ratio	20.9	20.7	22.6	23.5
3-Month Yield—JGBs (%)	0.035	0.070	0.047	0.060
10-Year Yield—JGBs (%)	0.686	0.595	0.605	0.741
BALANCE OF PAYMENTS				
Monthly Trade Balance[7]	JUL 13	AUG 13	SEP 13	OCT 13
Billion Yen	-943	-886	-875	-1092
Current Account Balance[9]	4Q12	1Q13	2Q13	3Q13
% GDP	1.0	0.9	1.0	1.0

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

1. Source: © European Union 1995–2013.
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 (ESRI), 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.

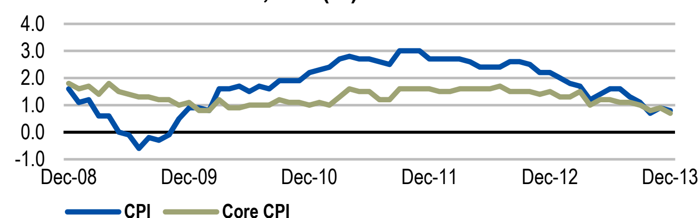
Past performance does not guarantee future results, and results may differ over future time periods.

Eurozone Real GDP, Y/Y (%)



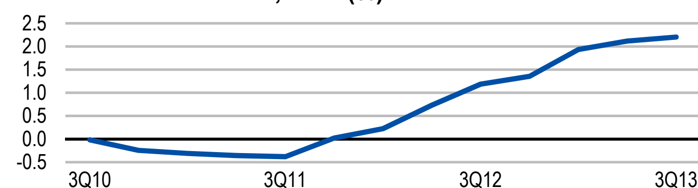
Source: © European Union 1995–2013, as at September 2013.

Consumer Price Index, Y/Y (%)



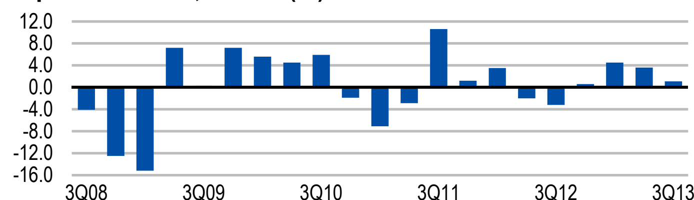
Source: © European Union 1995–2013, as at December 2013.

External Trade Balance, GDP (%)



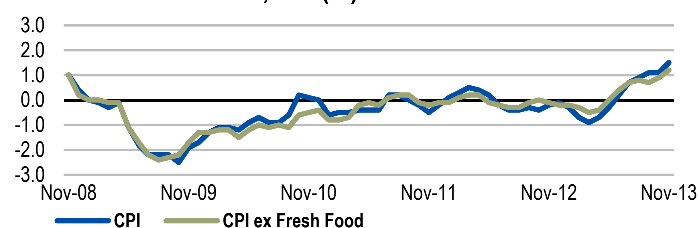
Source: © European Union 1995–2013, as at September 2013.

Japan Real GDP, Q/Q ar (%)



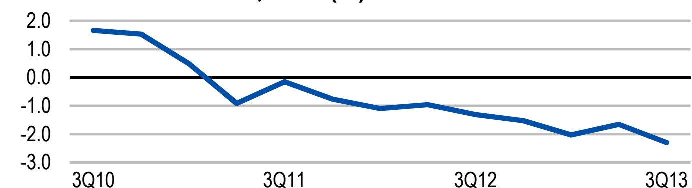
Source: ESRI, Cabinet Office, Government of Japan, as at September 2013.

Consumer Price Index, Y/Y (%)



Source: Ministry of Internal Affairs and Communications, Japan, as at November 2013.

Visible Trade Balance, GDP (%)



Source: Ministry of Finance, Japan and Economic and Social Research Institute, Cabinet Office, Government of Japan, as at 30 September 2013.

US MACROECONOMIC DATA

FINAL OUTPUT				
Gross Domestic Product (GDP)[1]	**2Q13**	**3Q13**	**4Q13E**[2]	**1Q14E**[2]
Q/Q ar (%)	2.5	4.1	1.5	2.6
ECONOMIC INPUTS				
CONSUMPTION/FINAL DEMAND				
Income/Savings[1]	**AUG 13**	**SEP 13**	**OCT 13**	**NOV 13**
Consumer Spending, Y/Y (%)	3.2	2.9	3.1	3.5
Personal Income, Y/Y (%)	4.0	3.9	3.4	2.3
Savings Rate (%)	4.9	5.1	4.5	4.2
Employment	**SEP 13**	**OCT 13**	**NOV 13**	**DEC 13**
Unemployment Rate (%)[3]	7.2	7.3	7.0	—
Participation Rate (%)[3]	63.2	62.8	63.0	—
Nonfarm Payrolls (in thousands)[3]	175	200	203	—
Jobless Claims, 4-wk average (in thousands)[4]	305	358	324	359
Housing[5]	**AUG 13**	**SEP 13**	**OCT 13**	**NOV 13**
Existing Home Sales (in millions)	5.39	5.29	5.12	4.90
Y/Y Change (%)	11.4	10.7	6.0	-1.2
INVESTMENT				
Corporate Earnings[6]	**2Q13**	**3Q13**	**4Q13E**	**1Q14E**
Earnings, Y/Y (%)	3.8	4.8	5.4	6.9
Production & Utilisation[7]	**AUG 13**	**SEP 13**	**OCT 13**	**NOV 13**
Industrial Production, Y/Y (%)	2.8	3.2	3.4	3.2
Capacity Utilisation (%)	78.0	78.3	78.2	79.0
Nonresidential Fixed Investment[1]	**4Q12**	**1Q13**	**2Q13**	**3Q13**
Y/Y (%)	5.0	2.4	2.4	3.5
INFLATION & PRODUCTIVITY				
Inflation Indicators	**AUG 13**	**SEP 13**	**OCT 13**	**NOV 13**
Personal Consumption Expenditure (PCE), Y/Y (%)[1]	1.1	0.9	0.7	0.9
Core PCE, Y/Y (%)[1]	1.2	1.2	1.1	1.1
Consumer Price Index (CPI), Y/Y (%)[1]	1.5	1.2	1.0	1.2
Core CPI, Y/Y (%)[3]	1.8	1.7	1.7	1.7
Producer Price Index (PPI), Y/Y (%)[3]	1.4	0.3	0.3	0.7
Core Producer Prices, Y/Y (%)[3]	1.1	1.2	1.4	1.3
Productivity[3]	**4Q12**	**1Q13**	**2Q13**	**3Q13**
Productivity, Q/Q ar (%)	-1.7	-1.7	1.8	3
Unit Labour Costs, Q/Q ar (%)	11.8	-3.5	2.0	-1.4
FINANCIAL MARKETS				
Valuation	**NOV 13**	**DEC 13E**	**JAN 14E**	**FEB 14E**
P/E S&P 500[6]	16.92	17.42	—	—
Fed Funds Rate[7,8]	0.25	0.25	0.09	0.10
BALANCE OF PAYMENTS				
US Monthly Trade Deficit[1,9]	**AUG 13**	**SEP 13**	**OCT 13**	**NOV 13**
Billion USD	-38.9	-43.0	-39.3	-34.3
US Current Account Deficit	**4Q12**	**1Q13**	**2Q13**	**3Q13**
Quarterly (in USD billion)[1]	-102.3	-104.9	-96.6	-94.8
Annualised (% GDP)[10]	-2.7	-2.6	-2.5	-2.4

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

1. Source: US Bureau of Economic Analysis, as at 31/12/13.
2. Source: Bloomberg Economic Forecasts, as at 31/12/13.
3. Source: US Bureau of Labor Statistics.
4. Source: US Department of Labor.
5. Source: Copyright National Association of Realtors®. Reprinted with permission.
6. Source: Bloomberg. Corporate Earnings and P/E S&P 500 represented by Bloomberg's calculation of the earnings of S&P 500 Index components, as at 31/12/13. Standard & Poor's®, S&P® and S&P 500® are registered trademarks of Standard & Poor's Financial Services LLC.
7. Source: US Federal Reserve. At the 16 December 2008 meeting, the Federal Reserve cut the main US interest rate to "a target rate" between zero and 0.25%.
8. Source: Chicago Board of Trade (30-Day Federal Funds Futures Rate for January 2014 and February 2014), as at 31/12/13.
9. Source: US Census Bureau.
10. Source: Bloomberg Indexes.

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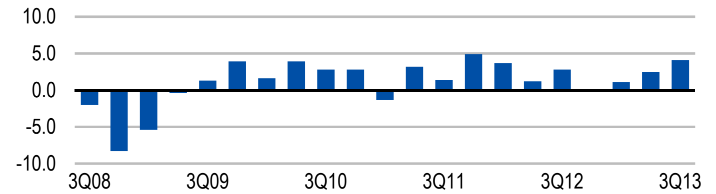
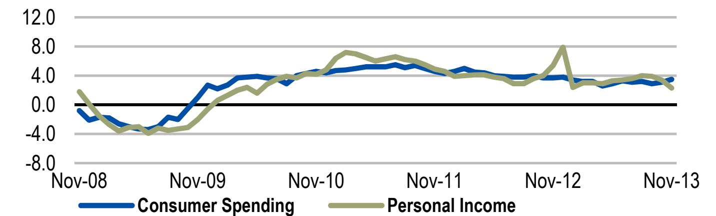
Gross Domestic Product (GDP), Q/Q ar (%)



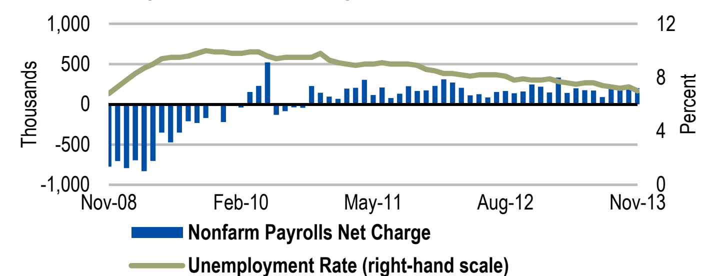
Source: US Bureau of Economic Analysis, as at September 2013.

Personal Income & Expenditures, Y/Y (%)



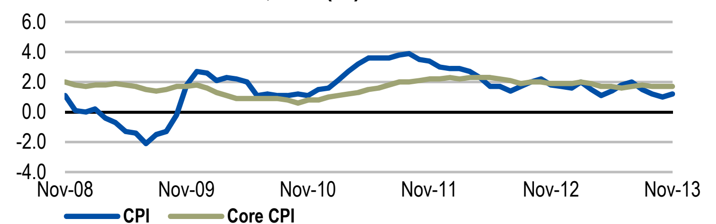
Source: US Bureau of Economic Analysis, as at November 2013.

Nonfarm Payrolls & Unemployment Rate



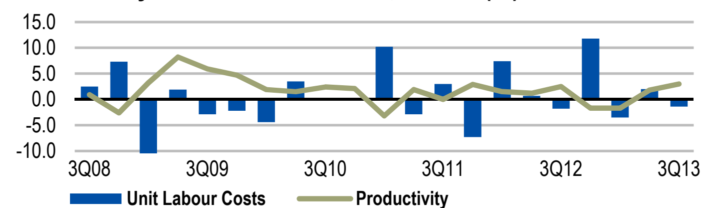
Source: US Bureau of Labor Statistics, as at November 2013. All figures seasonally adjusted.

Consumer Price Index, Y/Y (%)



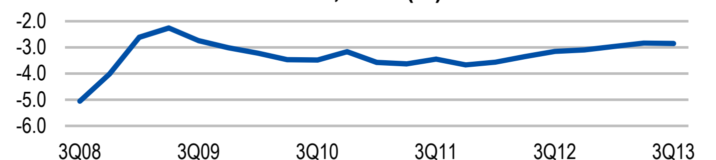
Source: US Bureau of Labor Statistics, as at November 2013.

Productivity & Unit Labour Costs, Q/Q ar (%)



Source: US Bureau of Labor Statistics, as at September 2013.

US Annualised Trade Deficit, GDP (%)



Sources: US Census Bureau and US Bureau of Economic Analysis, as at September 2013.

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