FRANKLIN TEMPLETON INVESTMENTS

GLOBAL ECONOMIC PERSPECTIVE

SEPTEMBER 14, 2009

PERSPECTIVES FROM THE FRANKLIN TEMPLETON FIXED INCOME GROUP®

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BEN BERNANKE SET FOR NEW FOUR-YEAR TERM

In late August, President Barack Obama announced his intention to appoint Ben Bernanke as chairman of the Federal Reserve for a second four-year term starting next January—a move that most investors appeared to approve for several reasons. First, his reappointment removes the disruption and uncertainty that would be associated with a new appointee. Second, some credit Mr. Bernanke with saving the U.S. financial industry in one form or another, with the notable exception of Lehman Brothers. President Obama praised Bernanke for tackling "a financial system on the verge of collapse with calm and wisdom, with bold action and out-of-the-box thinking that has helped put the brakes on our economic free fall." Third, as the financial industry nurses its wounds after its worst crisis since the 1930s, it seems to some observers that Bernanke has struck a relatively conciliatory tone in the sometimes angry debate about tightening bank regulations to minimize the risk of another crisis.

While many laud Mr. Bernanke's decisiveness, pragmatism and creativity in dealing with the financial crisis, some people fault the Bernanke-led Federal Reserve for failing to spot problems early on relating to banks' exposure to collateralized debt obligations (CDO) and mortgage-backed derivatives. Critics also point out that Bernanke served on the Fed's Board of Governors when Alan Greenspan was chairman earlier this decade, and the Greenspan-era Fed has been increasingly vilified in some circles for setting the stage for the loose credit conditions and lax lending standards that led to the financial market crisis in 2008. However, the central banker's academic research work on the Great Depression also adds to his credibility. At this year's annual Jackson Hole meeting of central bankers in late August, Mr. Bernanke reflected on the last twelve months and noted, "As severe as the economic impact has been…the outcome could have been decidedly worse. Unlike in the 1930s when policy was largely passive…during the past year monetary, fiscal and financial policies around the world have been aggressive and complementary."

Mr. Bernanke faces a number of daunting economic and regulatory challenges as he enters a second term. The Fed has been handed a substantial increase in power through its administration of multiple new credit and liquidity programs designed to aid specific sectors of the American economy. The Fed's role as "lender of last resort" during various crises in the past year has left it with a huge asset stockpile, as it accumulated loans, securities and other assets on its balance sheet. The Fed said its balance sheet more than doubled to $2.08 trillion, year to date through September 2, 2009. The loosening of monetary conditions that lies behind this balance-sheet expansion increases the risk of a future inflation surge in the economy. President Obama has also made wide-ranging proposals to give the Fed new powers in managing systemic risk, but many lawmakers are uneasy about the prospect of an unelected body putting taxpayer money at risk. In fact, some legislators are calling for greater control over the Fed's actions, which could potentially diminish the central bank's independence.

On the U.S. economic front, signs of improving fundamentals are likely to pose important questions for the Fed. Some observers continue to doubt the sustainability of the

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nascent recovery, given weak consumer demand and ongoing deleveraging. It may therefore be too early to talk about an "exit strategy" from the Fed's current ultra-loose monetary policy. Nonetheless, the Fed will need to raise interest rates and tighten credit at some stage—without throttling economic recovery—to avoid inflation and the formation of fresh asset bubbles. As President Obama said when announcing Mr. Bernanke's reappointment, "…we cannot go back to an economy based on overleveraged banks, inflated profits and maxed-out credit cards."

MIXED SIGNALS FROM THE U.S. HOUSING MARKET

U.S. GDP is generally anticipated to show a resumption of growth in the third quarter, although some question the quality of any expansion. For many, the growth spurt is likely to be due to temporary stimulus measures such as the "cash for clunkers" program and an inevitable turn in the inventory cycle. The need to replenish run-down inventories would explain recent upturns in purchasing manager indexes and surveys of manufacturing activity. Only time will tell if the present incipient upturn lasts. The Fed's Beige Book survey, released on September 9, said that the outlook for economic activity remained "cautiously positive" in most regions, but at the Jackson Hole meeting, Mr. Bernanke himself left open the possibility that growth could sag again after picking up in the second half of this year.

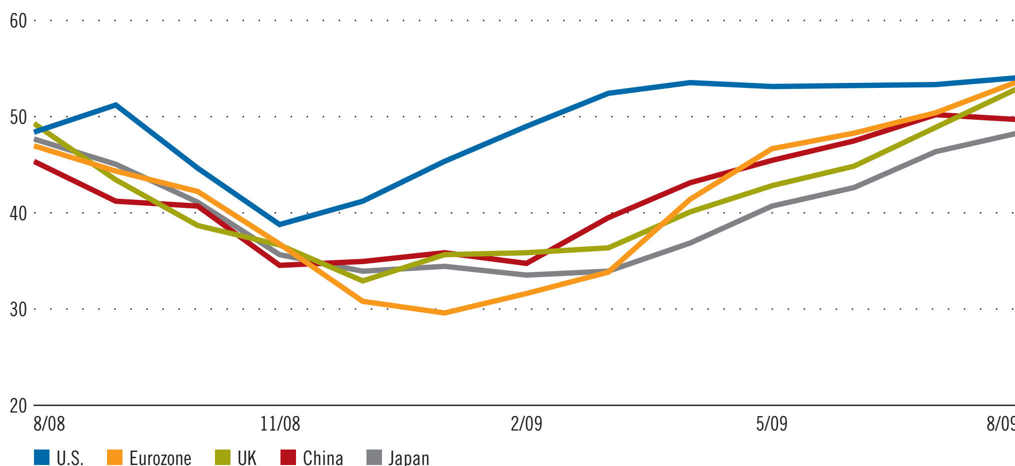
At least one important part of the U.S. economy, housing, appears to be showing some early signs of bottoming out. For example, construction of single-family homes rose in July for the fifth straight month, and forecasters widely expect that residential construction may have ceased to be a drag on U.S. growth during the third quarter for the first time in 14 quarters. Deutsche Bank, for example, expects residential investment in the GDP accounts to be flat in the third quarter, compared to -29.3% in the second quarter. July also saw a record surge in home sales, with the National Association of Realtors (NAR) announcing a 7.2% rise in existing home sales over the previous month. NAR data also showed that pending home sales climbed to the highest level in more than two years during July.

Yet the economic turnaround remains tentative and somewhat dependent on government intervention. In addition to ongoing Fed-led efforts to keep mortgage rates low, first-time home buyers benefited from a $8,000 tax credit. However, this program is due to expire by December 1, 2009. Many of the recent sales have also been due to foreclosures, which continued to rise together with mortgage defaults. Distressed property sales and high inventories pushed down the median price for an existing home by over 15% year-over-year as of July end, according to NAR. Finally, it is important to stress the strong seasonality of home prices in the U.S. Increases in home prices typically seen in the first two quarters of a given year typically fade in the third. Such seasonality should not be confused with strong fundamental housing demand.

The S&P/Case Shiller Index of home prices in 20 major U.S. cities showed prices rising for the second straight month in June, but even the producers of this index cautioned against reading too much into such apparent momentum. While tax credits and lower mortgage rates have helped first-time buyers at the lower end of the market as well as investors with cash, the same has not been true for existing owners, particularly those of higher-priced properties.

More generally, a recent Zillow.com survey from August 11, 2009 found that close to one quarter of U.S. home owners owe more than the value of their homes, and the survey estimated the figure could rise to over 30% by mid-2010. There is a risk that such high negative equity rates could exacerbate foreclosures before the housing market fully stabilizes. Notices of default, auction or repossession totaled 2.3 million in the first seven months of this year, according to RealtyTrac, suggesting that U.S. housing and the U.S. economy are both still far from full recovery.

Purchasing Manager Indexes (Manufacturing)
August 31, 2008–August 31, 2009



Source: U.S. Institute for Supply Management, Markit Economics, Markit/nomura (Japan), China Federation of Logistics.

BANKS CONTINUE TO FALTER

Those U.S. banks that accepted government support earlier this year have been clamoring to repay and thereby rid themselves of associated restrictions. Additionally, conditions within the interbank lending markets appeared to be normalizing for big banks, thus easing their liquidity

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concerns and increasing the chances of credit becoming progressively more available to the broader economy.

Nevertheless, concerns remain regarding the U.S. banking industry, particularly for second-tier banks. Such banks are less able to withstand the negative effects on their mortgage debt portfolios stemming from an increase in foreclosures, which were above 300,000 for six straight months between February and August 2009, according to RealyTrac. The rise in negative equity and unemployment is likely to increase the banks' pain. Another worry for second-tier banks is the number of U.S. prime borrowers behind on their home loan payments, which has also risen sharply, according to a Standard & Poor's survey.[1] In turn, such developments have implications for the valuations of residential mortgage-backed securities held by banks.

Commercial loans and commercial mortgage-backed securities (CMBS) present another daunting challenge for American banks. Delinquencies in the U.S. commercial mortgage sector have risen exponentially in the past year, prompting the Federal Reserve to step in. In August, the Fed extended the life of a facility to support asset-backed securities, including CMBS. However, until we find out whether such intervention will work, banks are exposed to the inability of property owner-clients to roll over their loans.

The Federal Deposit Insurance Corporation (FDIC) announced in late August that 82 banks had failed in the U.S. so far this year. Among the latest to fail, as of the time of this writing, were Colonial BancGroup of Alabama, a lender with $25 billion in assets, and Texas-based Guaranty Bank, with over $13 billion in assets, which Spain's BBVA agreed to rescue via a U.S. subsidiary with U.S. government support. Meanwhile, the FDIC said its list of "problem banks" had risen to 416 by the end of June, the highest level in 15 years. Total assets held by this group of troubled institutions rose to nearly $300 billion at the end of June, compared to $200 billion three months before, due to increases in the number of "problem banks" as well as problem loans.

At its quarterly press conference on August 27, the FDIC highlighted the rising loan-loss provisions on bank balance sheets, most of which were related to conventional retail and commercial loans as well as complex mortgage-related assets and residential loans. Provisions at U.S. banks are expected to remain elevated for quite a while. Given the FDIC's chairman, Sheila Bair, warning that "cleaning up balance sheets is a painful process that takes time," the capacity and willingness of the banks to lend to consumers and businesses is likely to remain subdued despite improvements in the interbank markets. At the same time, recognition of banks' need to repair balance sheets could be one important element in determining how long the Fed is willing to wait before embarking on monetary tightening.

EUROPEAN OUTLOOK

European economies, particularly those of larger countries, would seem to have reached a turning point. The quarter-over-quarter contraction in the eurozone as a whole was just 0.1% in the second quarter, allowing a number of forecasters to revise upward their expectations for the rest of the year. In early September, the Organization for Economic Cooperation and Development (OECD) said it expected the eurozone economy to contract by "only" 3.9% for 2009 as a whole, compared to an earlier estimate of 4.8%.

Some European countries have been faring better than others. Germany and France actually returned to positive economic growth territory in the second quarter, both recording quarter-over-quarter growth of 0.3% in the three months ended June 2009. The hope is that France and Germany will set the pace for other European economies that remain mired in recession such as Spain, which contracted by 1% in the second quarter compared to the first, and Italy, which fell by 0.5% over the same time period.

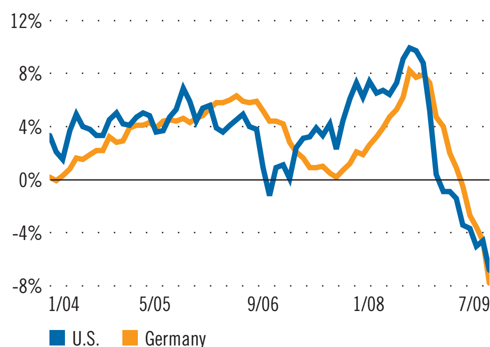
The turnaround in the eurozone's two most important countries was palpable in other statistics and surveys as well. Optimism has grown among businesses thanks to an increase in net exports, while declines in energy and food prices, plus government incentives to spend, have started to make consumers more upbeat. Germany's purchasing managers' index indicated that recovery has gathered momentum, jumping from 49 in July to 54.2 in August, with expansion in both the manufacturing and services components of the index —a performance replicated in other European countries. However, unemployment continued to rise across the 27-nation European Union—albeit at a slowing rate—while unemployment in Germany actually fell unexpectedly for the second consecutive month in August.

In the UK, the Bank of England is cautiously optimistic about the future. Despite a quarter-over-quarter GDP decline of 0.7% in the second quarter, the BOE's governor, Mervyn King, said that output had likely stabilized and expressed his confidence that the economy would pick up as the year progresses, although "recovery could be slow and protracted." Home prices in the UK rose in August for the second month in a row. The purchasing managers' index has also been climbing, and retail sales have increased. Even the UK financial sector claims growth in its business could soon resume after three years of contraction. A report commissioned by the City of London suggested that the UK's financial sector could grow by over 2% a year from 2011 to 2013.

1. Standard & Poor's Market, Credit and Risk Strategies (MCRS) Group survey, August 4, 2009.

However, doubts are already being raised about the sustainability of even this most tentative of recoveries. The recent improvement in France and Germany owed much to stopgap stimulus measures and inventory drawdowns. In France, a 2.5% fall in net imports in the second quarter and a rise in government consumption were not seen as particularly reassuring indicators of sustainable growth. Germany's recent job statistics concealed the massive government subsidies being provided to employers to keep workers on their payrolls, while the president of the Bundesbank, Axel Weber, has been keen to dispel any illusion that the financial crisis has ended. Both the French and German economies have also been boosted by generous car scrappage programs, the effect of which is set to fade. German producer price inflation fell at its fastest rate in 60 years in July, indicating that there was still massive excess capacity in the German economy. Just as importantly, demand in much of southern and central Europe remained in the doldrums, leaving Germany dangerously dependent on exports to countries outside Europe, while structural impediments continued to thwart any sustained improvement in domestic consumer demand.

Producer Price Inflation in Germany and the U.S.
January 31, 2004–July 31, 2009



Source: U.S. Bureau of Labor Statistics, German Federal Statistics Office, August 2009.

Mixed signals about the extent and sustainability of a pick-up in economic prospects have some wondering what the European Central Bank's (ECB) next move might be. Nonetheless, the bank's main interest rate is widely expected to remain at the current 1% level until well into next year. While waiting for a clearer picture to emerge, the ECB has continued to work earnestly to encourage banks to lend again. Indeed, there is evidence that confidence in the interbank markets has been boosted by the vast amount of liquidity that the ECB and other central banks in Europe have pumped into the financial system.

The ECB pushed €442 billion in fixed-rate one-year-loans into the markets in June and is planning further refinancing operations for late September and mid-December. Along with low official rates, this injection of funds has triggered a dramatic fall in money-market rates and boosted hopes for a revival in bank lending, which is critical for economic recovery. Generous liquidity has also been provided to the interbank market through the Bank of England's quantitative easing program.

At its governing council meeting on September 3, the ECB held interest rates steady at a record low of 1% as expected, but in response to liquidity injections, benchmark interbank lending rates for the U.S. dollar, euro and UK sterling have continued to slide, recently hitting record lows. Indeed, by September 9, the key three-month Euribor rate, traditionally the main gauge of interbank euro lending, had fallen to 0.75%.

The ECB's July survey of bank lending showed that eurozone banks tightened lending standards in the second quarter —their eighth consecutive quarter of tightening. However, observers say growing reassurance on the interbank markets has prompted banks to lend further out, with some nascent signs that European banks are willing to lend more for longer durations than since the collapse of Lehman Brothers in September 2008.

WHAT ARE THE RISKS?

Bond funds are subject to the same interest rate, inflation and credit risks associated with the underlying bonds held by the fund. Global bond risks include currency fluctuations and political uncertainty. Risk considerations are discussed in the appropriate fund prospectus.

IMPORTANT LEGAL INFORMATION

Because market and economic conditions are subject to rapid change, the analysis and opinions provided are valid only as of September 14, 2009. An assessment of a particular country, market, security, investment or strategy may change without notice and is not intended as an investment recommendation nor does it constitute investment advice. Statements of fact are from sources considered reliable, but no representation or warranty is made as to their completeness or accuracy.

Your clients should carefully consider a fund's investment goals, risks, charges and expenses before investing. They should read the prospectus carefully before they invest or send money. To obtain a prospectus, which contains this and other information, please call Sales and Marketing Services at (800) 223-2141.

U.S. MACROECONOMIC DATA

FINAL OUTPUT

Gross Domestic Product (GDP)[1]	Q1:09	Q2:09		
Q/Q ar (%)	-6.4	-1.0		

ECONOMIC INPUTS

CONSUMPTION/FINAL DEMAND

Income/Savings[1]	APR 09	MAY 09	JUN 09	JUL 09
Consumer Spending, Y/Y (%)	-1.9	-2.0	-1.9	-1.6
Personal Income, Y/Y (%)	-2.0	-2.2	-3.2	-2.4
Savings Rate (%)	4.5	6.0	4.5	4.2
Employment	**MAY 09**	**JUN 09**	**JUL 09**	**AUG 09**
Unemployment Rate (%)[2]	9.4	9.5	9.4	9.7
Participation Rate (%)[2]	65.9	65.7	65.5	65.5
Non-Farm Payrolls (in thousands)[2]	-303	-463	-276	-216
Jobless Claims, 4 wk average (in thousands)[3]	632	616	557	571
Housing[4]	**APR 09**	**MAY 09**	**JUN 09**	**JUL 09**
Existing Home Sales (in millions)	4.66	4.72	4.89	5.24
Y/Y Change (%)	-3.9	-4.6	-0.2	5.0

INVESTMENT

Corporate Earnings[5]	Q1:09	Q2:09	3Q(E)	4Q(E)
Earnings, Y/Y (%)	-23.2	-23.0	-22.2	61.2
Production & Utilization[6]	**APR 09**	**MAY 09**	**JUN 09**	**JUL 09**
Industrial Production, Y/Y (%)	-12.6	-13.4	-13.5	-13.1
Capacity Utilization (%)	69	68.3	68.1	68.5
Non-Residential Fixed Investment[1]	**Q3:08**	**Q4:08**	**Q1:09**	**Q2:09**
Y/Y (%)	0.9	-6.0	-17.4	-20.0

INFLATION & PRODUCTIVITY

Inflation Indicators	APR 09	MAY 09	JUN 09	JUL 09
Personal Consumption Expenditure (PCE), Y/Y (%)[1]	0.1	-0.3	-0.4	-0.8
Core PCE, Y/Y (%)[1]	1.7	1.6	1.5	1.4
Consumer Price Index (CPI), Y/Y (%)[1]	-0.7	-1.3	-1.4	-2.1
Core CPI, Y/Y (%)[2]	1.9	1.8	1.7	1.5
Producer Price Index (PPI), Y/Y (%)[2]	-3.7	-5.0	-4.6	-6.8
Core Produce Prices, Y/Y (%)[2]	3.4	3.0	3.3	2.6
Productivity[2]	**3Q:08**	**4Q:08**	**1Q:09**	**2Q:09**
Productivity, Q/Q ar (%)	-0.1	0.8	0.3	6.6
Unit Labor Costs, Q/Q ar (%)	4.6	2.0	-5.0	-5.9

FINANCIAL MARKETS

Valuation	JUL 09	AUG 09	SEPT (E)	OCT (E)
P/E S&P 500[5]	17.04	18.84		
Fed Funds Rate	0–0.25[6]	0–0.25[6]	0.175[7]	0.18[7]

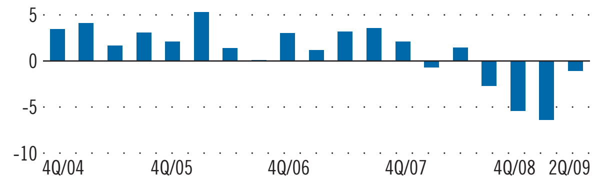
BALANCE OF PAYMENTS

U.S. Monthly Trade Deficit[1,8]	MAR 09	APR 09	MAY 09	JUN 09
(in USD billion)	-28.5	-28.8	-26.0	-27.0
U.S. Current Account Deficit[1]	**Q2:08**	**Q3:08**	**Q4:08**	**Q1:09**
Quarterly (in USD billion)	-187.7	-184.2	-154.9	-101.5
Annualized (% GDP)	-5.2	-5.1	-4.3	-2.9

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

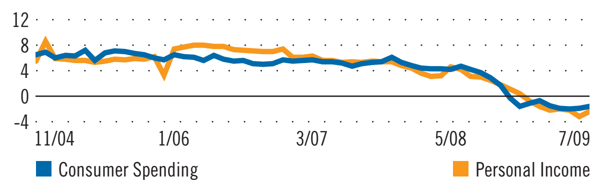
1. Source: Bureau of Economic Analysis.
2. Source: Bureau of Labor Statistics.
3. Source: Department of Labor.
4. Source: Copyright National Association of REALTORS®. Reprinted with permission.
5. Source: Bloomberg. Corporate Earnings represented by Bloomberg's calculation of the earnings of S&P 500 Index components.
6. Source: Federal Reserve.
7. Source: Chicago Board of Trade (30-Day Federal Funds Futures Rate), as of 8/31/09.
8. Source: U.S. Census Bureau.

GROSS DOMESTIC PRODUCT (GDP), Q/Q AR (%)



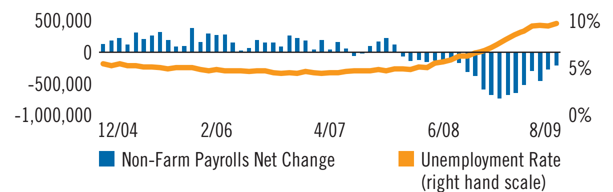
Source: Bureau of Economic Analysis, June 2009.

PERSONAL INCOME & EXPENDITURES, Y/Y (%)



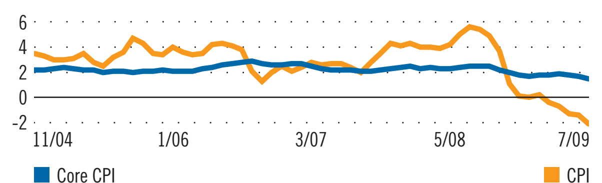
Sources: U.S. Department of Commerce and Bureau of Economic Analysis, June 2009.

NON-FARM PAYROLLS & UNEMPLOYMENT RATE



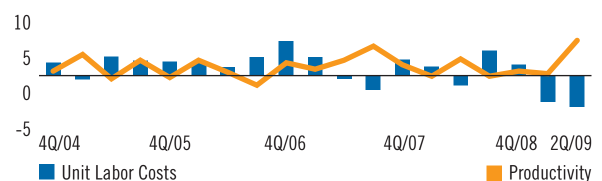
Source: Bureau of Labor Statistics. All figures seasonally adjusted. July 2009.

CONSUMER PRICE INDEX, Y/Y (%)



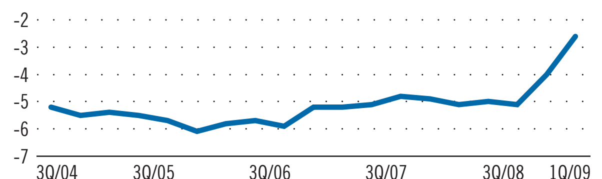
Source: Bureau of Labor Statistics, June 2009.

PRODUCTIVITY & UNIT LABOR COSTS, Q/Q AR (%)



Source: Bureau of Labor Statistics, June 2009.

U.S. ANNUALIZED TRADE DEFICIT, % GDP



Sources: U.S. Department of Commerce and Bureau of Economic Analysis, March 2009.

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