Notes on Global Equity Markets

PERSPECTIVE FROM THE TEMPLETON GLOBAL EQUITY GROUP

• **Market Overview:** Stocks advanced in the third quarter as the reflationary effects of rebounding commodity prices and continued central bank support overshadowed concerns about a tenuous global economy and stagnant corporate earnings.

• **Europe:** Trading at low multiples relative to depressed profits, European equities offer significant room for both earnings improvement and/or valuation re-rating, in our view.

• **Health Care:** We continue to favor companies with sound business models, solid product portfolios, attractive research and development (R&D) pipelines, and the ability to grow revenues, increase cash flows and generate high capital returns for shareholders through dividends and buybacks.

• **Energy:** Energy stocks rebounded after the Organization of the Petroleum Exporting Countries (OPEC) agreed to a preliminary framework to cut production. Oil fundamentals remain attractive to us in the intermediate-to-long term.

• **Financials:** We believe historically cheap valuations appear to adequately discount macro risks in select instances. We have consolidated our European financials exposure among firms with what we view as high operational quality and low balance sheet risk.

• **Political Landscape:** Current political dynamics represent both a threat and an opportunity for global growth. Upcoming elections in the United States and Europe could bring volatility.

• **Emerging Markets:** Cycle-adjusted price/earnings ratios (P/Es) in emerging markets are currently near a record trough. However, we believe economic growth is likely to remain below prior cycle trends. China and South Korea are chief among the Asian emerging markets offering interesting value to us.

• **Materials/Metals and Mining:** Among miners, we have found selective opportunities among low-cost precious metals producers and lowly valued industrial metals producers with special characteristics and differentiated business models that we believe are capable of weathering the expected cyclicality and volatility that we have seen in the sector.

• **Outlook:** We believe current opportunities in financial markets are both selective and highly specific to value. According to our research, valuations in the value universe remain well below average and at record discounts to many other style factors.
Market Overview
After the volatile end to the second quarter, which was marked by the Brexit vote to "Leave" the European Union, the third quarter saw stocks advance. Rebounding commodity prices and continued central bank monetary support overshadowed ongoing concerns about slow economic growth and lackluster corporate earnings. Globally, emerging markets outperformed developed markets as a weaker US dollar, a more stable China and sustained low interest rates increased investor's appetite for risk. Europe performed in line with the overall benchmark and rose more than the United States, although the United Kingdom and Italy lagged.

Europe
We are encouraged to see that both the bank conditions and economic indicators are now telling a consistent story of improvement in Europe. But, due to headline risks and uncertainties, European stocks are still cheap. If the positive economic data continue to build, we will likely see it translated meaningfully into corporate results given the high operating leverage of European companies, at which point it will begin to be reflected by rising equity prices. We think the opportunity in Europe is now, before the economic recovery gets priced in.

Health Care
After reducing a number of our health care holdings to realize profits throughout 2015, opportunities have begun to resurface in the sector more generally in 2016 amid concerns about political interference with drug pricing and US clamp downs on inversions and corporate tax strategy. We believe such fears are logical, given the political intent of a Clinton administration, but are also increasingly discounted and in our assessment generally overstated. We do, however, recognize that market sentiment and investor decision making will be reflected in near term valuation multiples until the fundamentals eventually win out and cause earnings power to be more correctly priced over time. And so we have attempted to address these political and pricing risks and concerns within our portfolios by focusing our investments on well-run, highly innovative pharmaceutical companies capable of dealing with pricing and competitive pressures on a case-by-case basis. Within health care, we continue to favor companies with sound business models, solid product portfolios, attractive R&D pipelines, and the ability to grow revenues, increase cash flows and generate high capital returns for shareholders through dividends and buybacks.

Energy
The energy sector has been one of the strongest performing sectors in the MSCI World Index year-to-date. At the end of 2014 and start of 2015, following the historic decision made by OPEC to let the markets rebalance themselves, significant value started to emerge in energy companies, according to our analysis, and many oil companies made it onto the Templeton bargain list. This value opportunity persisted through 2015 and into the start of 2016 as we found opportunities in valuations not seen since the mid-'80s, when OPEC took a similar historic decision to allow the market to rebalance itself. Given that the length and severity of the downturn was unknown, we focused on companies with the balance sheet to weather the storm and eventually win market share as weaker competitors fell by the wayside.

We are bottom up stockpickers, but, in energy, the macroeconomic environment for oil is a very important driver of the bottom-up stock fundamentals and therefore has more weight, in our analysis. Our broad thesis was, and still is, that oversupply, contrary to media reports, is not that large when compared with demand growth, oil field annual decline rates and historical periods of oversupply. We believe it is inevitable the market will rebalance itself over time as investment declines, supply normalizes downward as oil fields decline naturally and demand continues to grow modestly.

Financials
We recently conducted a comprehensive reassessment of our financials holdings, and we have implemented thoughtful changes to optimize positioning for the new reality of a slower growth, lower interest-rate environment. This exercise was similar to the one we conducted in the energy sector last year when OPEC’s initial inaction signaled a sea-change in global oil markets. Summary conclusions from our reassessment include reducing exposure to banks with vulnerable capital positions and/or major domestic operations in the United Kingdom, and increasing exposure to well-capitalized lenders with attractive market positions, improving fundamentals and sensible strategies to offset margin compression with fee- and commission-based businesses. Among investment banks and insurers, we have also prioritized capital strength and a coherent strategy for managing risk and successfully navigating a lower-for-longer interest rate environment, focusing on companies with more of a revenue stream, and those companies with overseas growth prospects. We have consolidated our financials exposure such that we are still likely to benefit from a rising interest-rate environment but are no longer dependent on one. We have reduced marginal positions, resulting in reduced overall exposure to European banks, diversified financials and insurance stocks. We remain constructive on the sector and feel that the stocks we now own represent both higher-quality businesses and higher conviction ideas from our analysts.

Deutsche Bank
We believe that the deepening troubles at German financial giant Deutsche Bank (not a Templeton holding), are a stark reminder of the anxieties still pervading the global banking system. The bank has become a flash point for investors concerned about another Lehman Brothers moment, reigniting worries about capital levels, credit quality, derivative exposures and the overall risk of systemic contagion in the banking sector. While such concerns are by no
means baseless, we would note there are significant differences between Lehman Brothers and Deutsche Bank. Lehman’s liquidity reserve in 2007 was $45 billion, compared to nearly $250 billion for Deutsche Bank today, highlighting the degree to which banks have recapitalized and strengthened liquidity in the aftermath of the global financial crisis. We also remain reasonably confident that policymakers will do everything in their power to prevent systemic contagion should the firm’s troubles worsen, with support likely coming via liquidity provision.

**Political Landscape**

Current political dynamics represent both a threat and an opportunity for global growth. On the bright side, the rising likelihood of some fiscal stimulus that could also help spur corporate investment and bolster nominal economic growth. But, should the forces of rising protectionism eventually cause higher barriers to global trade, barriers to migration and barriers to commerce, these would be clear negatives for economic growth. Voters in a democracy often respond more to perception than reality. Particularly when it comes to issues of patriotism, pride and identity, it isn’t always just about the bottom line economically.

**Emerging Markets**

Developing economies that supplied China’s growth are facing significant headwinds and headline index valuations appear very cheap, but investors need to be wary of unsustainable earnings trends and distortion to market cap weighted indexes. The watchword for us at Templeton is “select value” in emerging markets, as broad valuation levels do not yet compensate for further drops in normalized profit growth.

China and South Korea are chief among the Asian emerging markets that have been generating interesting value opportunities for us at the stock level. A distinction that is critical to establish when discussing China’s corporate sector is the difference between many private companies and the public state-owned enterprises, which is stark. While China’s state-owned enterprises have failed to deliver a single month of earnings growth since mid-2014, the country’s private industrial enterprises have, in aggregate, increased profits every month since the global financial crisis. We continue to find selective opportunities in China, primarily among lowly valued private enterprises listed on the Hong Kong exchange. South Korea, meanwhile, has a fundamentally solid and highly productive corporate sector with improving governance and shareholder policy trends trading at undemanding multiples. Overall, in emerging markets, we remain selective and focused on the fundamentals.

**Materials/Metals and Mining**

We have not been buying the metals and mining industry wholesale, but we certainly have found some selective opportunities over the past year, and our sector allocation has increased. We continue to avoid the primary producers of oversupplied, China-dependent bulk commodities, such as iron ore and coal, and certainly after the significant year-to-date rallies we have seen following better Chinese economic data.

We prefer commodities with some combination of supply constraint and demand catalyst (or at least resilience). Among miners, we have found selective opportunities among low-cost precious metals producers and lowly valued industrial metals producers with special characteristics and differentiated business models that are capable of weathering the expected cyclicality and volatility in the sector. We remain selective in our approach within the sector.

**Value Investing**

Value has significantly lagged the growth style since the financial crisis. The valuation gap between the market’s cheapest and most expensive stocks remains historically wide, and we believe the current value opportunity merits close attention by fundamental and long-term investors.

Many decades of equity market history conclusively show that, over time, value investing works. Out of the components of future total return, the correlation between starting point valuation (using the cyclically adjusted P/E) and long-term returns is statistically significant across all major markets and all major time periods. While several other factors also influence equity returns (not least of which are interest rates, earnings and dividends), we know of no other factor so highly correlated to long-term investment returns as starting-point valuation. Yet, protracted underperformance has called into question the value orthodoxy; today it’s all about safety, stability and growth…at any price.

Contrary to current popular opinion, we would argue that value stocks are well-suited for today’s market conditions. In a low rate environment, the average dividend yield of value stocks is more than double the coupon on 10-year Treasuries. In a low growth environment, value stock earnings are closer to trough than peak, suggesting greater scope for recovery than the rest of the market, which is still over-earning relative to history. Finally, at a time when financial assets overall look increasingly expensive, propped up by discount rates that approach zero, earnings and cash flow multiples in the value universe remain below their own historical average and at record discounts to factors like quality and growth.

Over time, we do expect these imbalances to correct. It has been a long road for value investors, and while it’s too early to say if we’re out of the woods yet, there are at least signs of a clearing. We are getting some positive catalysts at a time when value has still yet to meaningfully recover. And that is a good entry point for bargain hunters and keeps us very constructive on value’s prospects going forward.
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All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors. To the extent a strategy focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a strategy that invests in a wider variety of countries, regions, industries, sectors or investments.

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