Are there realistic alternatives to stocks?
Major themes driving our views

• Significant headwinds to global growth
  The coronavirus has pushed the global economy into a deep recession, though growth momentum is stabilizing. Risks to the recovery are tilted to the downside due to fears about a second wave of infection. Political uncertainty contributes to the outlook remaining less clear than usual and presents an ongoing headwind for business investment intentions.

• Subdued inflation across economies
  We believe that changes in inflation are driven mainly by demand, but expectations have already fallen to historical lows. While it is premature to call an end to globalized production, its influence might moderate as a result of onshoring.

• Dovish bias to policy
  In responding to the current virus crisis, policymakers remain accommodative and will do whatever it takes. Emergency measures have exceeded consensus expectations, but the easy wins may already have been delivered, while the need for fiscal policy coordination is increasing.

Practical positioning

• Government bonds remain expensive
  In a multi-asset portfolio, we seek assets that provide the potential for diversification. Bonds traditionally fulfill that role. Global bonds—especially long-duration issues—appear vulnerable due to low term premia. However, slower growth and subdued inflation balance this, leaving us only modestly defensive in our overall levels of conviction.

• Corporate bonds are more attractive to us
  The yield spread on corporate bonds is somewhat higher than average, reflecting market concerns over the economic environment. The attractions of corporate bonds lie in this modest additional yield and some potential diversification benefits from government bonds, but not as a long-term return generating alternative to stocks.

• Emerging market bonds
  Emerging market investments can be a very attractive addition to a broadly diversified portfolio. However, we always believe that a selective approach is particularly appropriate in these less-developed markets. However, right now, emerging market bonds do not represent compelling alternatives to stocks, in our view.
Major themes driving our views

Global growth needs some support

One of the phrases we hear most often today is “TINA: There Is No Alternative.” It is used regularly to explain why otherwise rational investors seem to be blind to risks in a particular investment or asset class. But, reflecting on the last few months, perhaps it is equally applicable to the policy imperatives of governments in the major economies.

Last month we talked in Allocation Views of the need to hold the course. Specifically, we highlighted the ongoing commitment of central bankers to do “whatever it takes” and of calls for the coordination of monetary and fiscal policy that have become a new normal. We also worried about whether the political will to deliver might ease with the passing of peak pandemic.

During May, some of these fears were put to rest. Emmanuel Macron, president of France, and his German counterpart, Chancellor Angela Merkel, took the lead in driving forward a coordinated European Union (EU) response to the COVID-19 crisis. Where previous French proposals for closer coordination were met with a cool response in Berlin, the two leaders demonstrated a new-found common purpose. The proposed recovery fund, offering significant levels of support in the form of grants, rather than loans, is a notable step toward greater fiscal cooperation. Funding some part of this through the issuance of joint liability bonds would be ground-breaking. Why is it happening now? Perhaps the answer is TINA.

Similarly, at home in Germany, Merkel is facing up to the reality of this current crisis. Even in one of the less severely hit economies, rising unemployment and concerns over business investment intentions require dramatic action.

Temporary reductions in VAT (consumption tax) may help to offset natural caution when it comes to spending decisions. Infrastructure investment will be accelerated to offset any retrenchment by businesses. But, by committing a further €130 billion to stimulus measures, Germany’s government is reflecting the need to make use of the fiscal headroom provided by previous frugality. Again, perhaps there is no alternative. In showing a willingness to share some part of that fiscal strength with countries less well placed than itself, Germany highlights the strength of the European project…or perhaps its vulnerability to current events.

The past few weeks have seen the initial publication of data that confirms the depth of the recession that the global economy is already experiencing. It is notable that financial markets have become inured to these releases. Previously, analysts would pore over the details and investors might respond to movements in the second decimal place of key indicators. Today, extraordinary data is often ignored. This is perhaps an indication of some form of post-traumatic stress disorder. It boils down to saying, “We know we are in a hole; its depth is irrelevant.” Despite a heightened level of uncertainty, we believe that expectations have largely caught up with the true depth of economic damage that had been suffered. However, the pace of recovery remains more uncertain than usual.

When we look at indicators of future activity, the outlook has not cleared. A year ago, we were entering a deepening trade war between the United States and China. This prompted us to monitor data such as new export orders, which had been falling sharply. They typically foretell the level of trade activity in the following three to six months. The weakness in orders that started last year has still not abated, and relations between Washington and Beijing are again a concern. As a result, we expect a continued period of trade weakness into the second half of this year, notably in China and its regional trading partners. Japan has suffered a sharp deterioration in exports, and a closely watched indicator of new orders for industrial machinery has continued to decline (Exhibit 1). This only emphasizes the importance of supporting domestic consumers through this period of adjustment.
The compressed nature of the slowdown may result in a rapid rebound. Historical relationships may not hold. But, reflecting the balance of issues noted above, we see policy makers having no alternative but to continue their support. The next question we ask is “for how long?” Like them, we are focused on the potential for the risks around the recovery to be skewed to the downside. As a result, this leaves us with a relatively cautious view, encapsulated in our theme that sees “Significant Headwinds to Global Growth.”

Inflation is a two-way pull

Global central banks are struggling to revive inflation expectations, which have been depressed by the current economic shock. We believe that inflation expectations form part of a feedback loop that helps determine actual inflation, through the actions of wage bargaining and company pricing power. Fear of a downward spiral, as expectations become “un-anchored,” is the number one concern of monetary policymakers. However, even as current headline inflation is being undermined by broad-based commodity price declines (Exhibit 2), some market commentators are becoming worried about the risks of resurgent inflation down the road. These concerns tend to focus on deglobalization rolling back the disinflationary benefits of optimized supply chains. Anecdotal evidence supports the idea that some outsourced production will be brought back onshore, aiding resilience of supply, but at a cost. Equally, national security reasons might drive other changes in procurement. However, we do not see a wholesale reconfiguration of supply chains, given the lead times and costs involved in doing so. Profit maximizing forces remain strong, and it is premature, in our opinion, to call an end to globalized production.

We continue to believe that inflation will be driven mainly by changes in demand. Recent supply shocks may have lowered productive capacity, but the deceleration in global activity that we saw in 2019, and the further interruption to growth that is occurring now, will be much more powerful. This effect has been felt broadly, including in emerging markets, reinforcing our theme that sees “Subdued Inflation Across Economies.”

Policymakers response is “whatever it takes”

The US Federal Reserve (Fed) is emphasizing the need for further fiscal stimulus while continuing to buy US Treasury and mortgage-backed securities in whatever amounts are needed to support market functioning. It promises to do so until the United States is well on track to attaining the Fed’s inflation and employment goals, and will roll out additional lending programs if necessary. All the major central banks share similar concerns over the outlook and have acted accordingly (see Exhibit 3 on next page). Perhaps they see no alternative.

The extreme illiquidity and volatility conditions seen in March have continued to moderate. Market expectations of further policy easing, if needed, are embedded within them. We continue to believe that policymakers will offer ample support to limit the pain associated with the hard stop that many economies have experienced. This is reflected in our final theme of a “Dovish Bias to Policy.”

Indeed, such emergency measures have exceeded consensus expectations so far, but the easy wins have been delivered. It is easier to promise to do “whatever it takes” when you are in the teeth of the storm. As the immediate crisis passes, helping to rebuild damaged economies will require continued support. However, it may well be that the low-hanging fruit has already been picked.

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**COMMODITY PRICES HIT HEADLINE INFLATION**

Exhibit 2: US Consumer Price Index (CPI) inflation vs. Core CPI, year-over-year change

October 2008–April 2020

Year-over-year change (%)

<table>
<thead>
<tr>
<th>CPI Core</th>
<th>Headline</th>
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<tbody>
<tr>
<td>Oct '08</td>
<td>Apr '09</td>
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<tr>
<td>Oct '09</td>
<td>Oct '10</td>
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<tr>
<td>Oct '11</td>
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<td>Oct '15</td>
<td>Oct '16</td>
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<td>Oct '17</td>
<td>Oct '18</td>
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<tr>
<td>Oct '19</td>
<td>Apr '20</td>
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</tbody>
</table>

CENTRAL BANKS AROUND THE WORLD ARE PROVIDING MONETARY STIMULUS IN 2020

Exhibit 3: Countries providing monetary stimulus in 2020
As of May 31, 2020

Countries Reducing Policy Rates

Argentina  Chile  Finland  India  Latvia  Namibia  Poland  South Korea  United Arab Emirates
Australia  China  France  Indonesia  Lithuania  Netherlands  Portugal  Spain  United Kingdom
Austria  Colombia  Germany  Ireland  Luxembourg  New Zealand  Qatar  Sweden  United States
Belgium  Croatia  Ghana  Israel  Malawi  Nigeria  Romania  Taiwan  Vietnam
Botswana  Czech Republic  Greece  Italy  Malaysia  Norway  Russia  Thailand  Zimbabwe
Brazil  Denmark  Hong Kong  Japan  Mauritius  Pakistan  Slovakia  Turkey
Bulgaria  Egypt  Hungary  Kenya  Mexico  Peru  Slovenia  Uganda
Canada  Estonia  Iceland  Kuwait  Mongolia  Philippines  South Africa  Ukraine

Source: Franklin Templeton Capital Market Insights Group, Bloomberg.
Are bonds the alternative?

Our investment approach continues to look through the shorter-term noise and retain a clarity of focus. We believe it is important to maintain diversified portfolios, particularly in times of increasing investment uncertainty. We also need to recognize that our longer-term outlook may not be reached along a smooth path, and that the current environment is more uncertain than usual.

It is these basic elements of our multi-asset approach that necessitate us looking for alternatives to the long-term attractions of stocks. Traditionally, government and corporate bonds have provided a measure of diversification from the higher volatility that stocks usually bring.

Today, some might argue that bonds are too expensive to offer diversification.

Government bonds remain expensive

After more than three decades of a broad bull market in bonds, it is hardly surprising that many investors express the view that government bonds are expensive. This largely reflects the fact that current yields are close to historical lows. However, we note that depressed yields also reflect demographics and demand for matching assets, which are likely to persist. This shows up in the “term premium,” the difference between the current bond yield and the anticipated average level for short-term interest rates over the life of the bond (Exhibit 4).

As a result, global bonds—especially high credit quality and long-duration issues—appear vulnerable due to low term premia. However, slower growth and subdued inflation balance this in our overall view of the asset class, leaving us only modestly defensive in our overall levels of conviction. However, they do not come close to matching the anticipated return from stocks, and currently it is only for their residual risk reducing characteristics that they justify a place in a longer-term portfolio.

We continue to hold a neutral view on the return potential from real assets such as inflation-linked bonds (Treasury Inflation-Protected Securities [TIPS]) despite their having become cheaper. We will write more extensively in coming months about the potential for these and other alternative asset classes.

Corporate bonds are more attractive to us

Bonds issued by companies in developed markets provide an additional yield on top of that offered by similar maturity government bonds. They typically trade at a positive spread to so-called risk-free yields. This additional yield reflects the increased risk from these lower-rated assets. However, in the long term, the yield spread typically over-compensates for the default-loss experience.

Today, the yield spread on corporate bonds is somewhat higher than average, reflecting market concerns over the economic environment. Central banks have offered direct liquidity support to companies and are signaling that they will provide a back-stop to this market. As a result, the extra yield has dropped and is not as high is typical in the depths of a recession, let alone one as severe as the current COVID-19 crisis.

The prospects for lower-rated, so-called high-yield bonds, are also bolstered by central bank support. But in this case, the inability of the likes of the Fed to protect the solvency of companies makes a rise in defaults highly probable. In our opinion, the most attractive balance of risk and reward is found in higher-rated investment-grade corporate bonds. This is reflected in us maintaining a moderately constructive view on this segment of the corporate bond market.
However, the concerns about depressed government bond yields extend to the higher-quality parts of the corporate bond market. If government bond yields rise sharply, prices of most high-quality bonds will drop, even though investment-grade bonds would likely prove to have a lower sensitivity to this move. The attractions of corporate bonds probably lie in offering a modest additional yield and some potential diversification benefits from government bonds, but not as a long-term return generating alternative to stocks.

**Emerging market bonds**
The conclusions that we shared in Allocation Views in December 2019, focusing on the longer-term outlook, noted that “within both bonds and equities, we continue to forecast stronger return potential for emerging markets.” For now, the headwinds to growth that the current crisis presents have tempered our enthusiasm for these markets.

Specifically, for emerging market bonds, the risk of broad-based pressures leading to individual countries struggling to repay their hard-currency debt has increased. As an asset class these countries have improved their resilience to contagion from their peers. But they do not compensate adequately for the risk of even a few isolated defaults, in our analysis. For bonds issued in the country’s own currency (local-currency emerging market debt), the level of yield is insufficient to offset the inherent risk of currency devaluation.

Emerging market investments can be a very attractive addition to a broadly diversified portfolio. However, we always believe that a selective approach is particularly appropriate in these less-developed markets. However, right now, emerging market bonds do not represent compelling alternatives to stocks in our view.

**Perhaps there is no alternative to stocks**
As we focus on the longer-term return potential for stocks, and believe that they should earn their equity risk premium over time, we continue to balance this with shorter-term concerns that have tempered our enthusiasm. We maintain a modestly higher conviction toward global equities than bonds, reflecting relatively more attractive valuations over the longer term. In broad terms, bonds have become more highly valued and equity prospects have improved relative to them, but we do not view them as cheap in a historical context (Exhibit 5.)
Are there realistic alternatives to stocks?

In broad terms, corporate earnings will dip, and eventual economic recovery will be needed to support global equities, as profit margins have peaked. Concerns remain about downside risk to capital investment plans that reflect general uncertainty. However, we anticipate an easing of market volatility and supportive liquidity conditions to offset these concerns. And we think longer-term prospects have improved, which is reflected in our more optimistic bias.

Weak global growth, and a bias toward easier monetary policy, contrast with long-term valuations that have become more expensive, reflecting low term premiums. Further widening of corporate bond spreads may occur as growth slows and financial conditions tighten. We maintain a more cautious view of bonds at the asset-allocation level, reflecting valuation concerns.

The inflation that was feared as the economic cycle entered its later stages has not appeared, and commodity price declines will weigh on headline inflation. We see better prospects in naturally diversifying assets. We hold a neutral view, reflecting the balance between reasons for optimism and market-driven concerns that we continue to monitor.

The defensive features of cash remain attractive to us, despite its drag on portfolio yield. Short-term US Treasury bill yields reflect falling policy rates rather than greater supply. Cash has attractions as a means of diversification from low-yielding government bonds.

Understanding the pendulum graphic

Arrows represent any change since the last quarter end.
## Allocation Tier

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Conviction</th>
<th>Our viewpoint</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity regions</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td></td>
<td>Despite significant headwinds, trend US growth remains stronger than in other developed markets, and technology exposure sustains the market opportunity. The market’s attention will likely focus on valuations, the 2020 presidential election cycle, and whether Fed policy programs are effective in stimulating demand.</td>
</tr>
<tr>
<td>Canada</td>
<td></td>
<td>We see modest opportunities in Canada, with earnings growth slowing and commodities a notable headwind. Canadian banks remain burdened by domestic housing concerns and low net interest margins. We are not especially bearish, though we see reasons for caution.</td>
</tr>
<tr>
<td>Europe ex UK</td>
<td></td>
<td>Economic activity had stabilized before recent virus concerns, but weak manufacturing sentiment persists. The ECB has made efforts to offset the effect of lower rates, but we see banks remaining a drag. We maintain a more cautious view, which reflects a lower outlook for earnings, and valuations that remain expensive relative to history.</td>
</tr>
<tr>
<td>United Kingdom</td>
<td></td>
<td>Domestic political tensions have eased, but uncertainties over Brexit and UK economic prospects remain. Earnings per share were improving prior to the spread of the coronavirus. This defensive market appears historically cheap, so long as corporate profits are not too severely impacted. We reflect these opportunities in a more constructive view on this market, tempered by caution over remaining uncertainties.</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td>Equity valuations, particularly on a price-to-book-value basis, have been attractive relative to other markets, in our view. However, weaker economic activity following a consumption tax rise and growth vulnerabilities due to COVID-19 are unfavorable for the Japanese market. Earnings per share and return on equity are weakening relative to peers. We retain a lower level of conviction in this market.</td>
</tr>
<tr>
<td>Pacific ex Japan</td>
<td></td>
<td>With banks and related financial companies representing heavier weights in the region, concerns about banks in Australia and Hong Kong persist. The region is vulnerable due to local tensions in Hong Kong and subdued global trade flows. However, at valuations we regard as supportive, we are not bearish, though we see reasons for concern.</td>
</tr>
<tr>
<td>Emerging ex China</td>
<td></td>
<td>Risks to global growth highlight emerging markets’ idiosyncratic risks and underlying cyclicality. However, valuations remain attractive to us relative to developed market peers, and return on equity is improving. We see a balance of near-term growth concerns and optimism regarding the longer-term structural attractions of emerging markets.</td>
</tr>
<tr>
<td>China</td>
<td></td>
<td>China’s economy faces a longer-term impact from COVID-19, weak global demand and heightened geopolitical tensions. Further support from fiscal or monetary measures may be required. Trade disputes remain unresolved in the longer term and are a symptom of broader tensions. Although valuations remain attractive to us, we see reasons for caution and maintain a neutral view of this market.</td>
</tr>
<tr>
<td><strong>Fixed income sectors</strong></td>
<td></td>
<td></td>
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<tr>
<td>US Treasuries</td>
<td></td>
<td>The Fed has delivered a sequence of interest-rate cuts in response to the coronavirus threat, easing toward zero. However, the Fed remains biased to provide more stimulus as needed and to maintain a stable US Treasury yield curve as it moves beyond the crisis response phase. Stretched valuations and supply dynamics balance slower growth and subdued inflation expectations, and we maintain a broadly neutral position.</td>
</tr>
<tr>
<td>Eurozone Government Bonds</td>
<td></td>
<td>Valuations appear full in the eurozone, where term premiums are the lowest among government bonds. However, in response to growth concerns, the ECB will continue to provide stimulus, including additional asset purchases. European yields have followed US equivalents, but to a more muted extent, and we maintain a cautious stance and neutral position.</td>
</tr>
<tr>
<td>UK Government Bonds</td>
<td></td>
<td>Continued uncertainty over Brexit was weighing on sentiment before the virus threat increased, and weak productivity growth was holding back activity. The Bank of England has cut interest rates to their lower bound but remains biased to provide more stimulus as required. We remain broadly neutral overall, in line with other developed markets.</td>
</tr>
<tr>
<td>Asset class</td>
<td>Conviction</td>
<td>Our viewpoint</td>
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<tr>
<td><strong>Fixed income sectors</strong></td>
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<td><strong>continued</strong></td>
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<tr>
<td>Canada Government Bonds</td>
<td></td>
<td>Canada is vulnerable to a hit in business confidence from oil-price volatility. Expectations for the Bank of Canada mirror those for the Fed. Canada has seen bond yields fall, but they now broadly match those in the United States. We maintain a broadly neutral view overall, in line with other developed markets.</td>
</tr>
<tr>
<td>Japan Government Bonds</td>
<td></td>
<td>The Bank of Japan has maintained its monetary policy stance, which targets low 10-year government bond yields. It has also provided guidance that policy will remain stimulative for an “extended period” but seems less likely to ease in the near term, with fiscal policy taking a larger role in providing stimulus. Low sensitivity to global yields is likely to continue.</td>
</tr>
<tr>
<td>Investment Grade</td>
<td></td>
<td>The investment-grade sector has weakened on coronavirus concerns, reflecting deteriorating corporate liquidity and high leverage. Yield spreads had widened dramatically, as the market has focused on the risk of rising defaults. However, Fed support has calmed markets significantly. Renewed widening of yield spreads is possible as growth slows and financial conditions tighten, but valuations have become more attractive to us in a global context. As such we have moved to a more constructive view.</td>
</tr>
<tr>
<td>High Yield</td>
<td></td>
<td>Pressure on energy companies and fears of recession lead us to maintain a more cautious stance on the outlook for lower-rated fixed income sectors such as high yield. Default rates appear to be rising toward historical averages. Overall, we maintain a tactical preference away from these riskier assets, while Fed support is more focused on investment-grade issuers. Longer term, we have adopted a somewhat more constructive view on this market, tempered by caution over remaining fundamental uncertainties.</td>
</tr>
<tr>
<td>Emerging Market Debt</td>
<td></td>
<td>We regard emerging market bond valuations as fair among local- and hard-currency bonds, but fundamental pressures due to global economic weakness offset these. Concerns over exchange-rate risks in local-currency bonds remain prominent. With continued fears regarding global growth, we maintain a more cautious view on these markets, and we continue to think selective positioning is important.</td>
</tr>
<tr>
<td><strong>Alternative assets</strong></td>
<td></td>
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</tr>
<tr>
<td>Inflation-Linked Bonds</td>
<td></td>
<td>The inflation that was expected—and feared—as the economic cycle entered its later stages has not appeared, and the level of inflation discounted in inflation-linked securities has fallen sharply. We believe that these expectations may start to normalize, even as overall inflation remains subdued. However, we maintain a broadly neutral view of assets that benefit directly from rising prices, such as inflation-linked bonds.</td>
</tr>
<tr>
<td>Commodities</td>
<td></td>
<td>Risks to economic growth create a less supportive environment for broad commodities. We believe that fiscal stimulus measures are likely to be focused on supporting consumers and preserving jobs rather than on major projects. However, prices had fallen dramatically, which balanced inflation pressures remaining subdued, and saw us move to a neutral overall view.</td>
</tr>
<tr>
<td>Risk Premia</td>
<td></td>
<td>In an environment of slower growth but ample liquidity, we see mixed prospects across asset classes and in market-neutral or naturally diversifying assets. We hold a neutral view of risk premia, reflecting a balance between concerns over the reversal of established trends and the prospect of valuations becoming more attractive.</td>
</tr>
</tbody>
</table>
Franklin Templeton Thinks: Allocation Views

Our research process monitors a consistent set of objective indicators and screens them to identify signals that help our analysts to make better recommendations. By doing this we aim to filter out the daily noise to reveal the underlying trend.

Our macro-economic research group aims to challenge the consensus forecasts for growth and inflation by digging deeper into the data. Just as important, we aim not to be swayed unduly by topics that are dominating current market debate.

Editorial review

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Participation in this committee may change periodically and without notice.
Notes
Notes
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