Real assets could be the alternative
In this issue

In broad terms, the global economy is slowing, trade tensions dominate investor sentiment and inflation is subdued. A broad-based rally in global equities since the start of the year has extended a notable divergence against the less optimistic views being reflected in government bond markets and expressed by those central bankers who have pivoted from the planned normalization of monetary policy to offering additional stimulus.

Market disappointment over the delivery of rate cuts could renew pressure on equities. The alternative scenario, where growth continues to disappoint, might lead to additional rate cuts, but this is hardly an optimistic outcome for stocks.

**Major themes driving our views**

- **Slower global growth a rising concern**
  Growth is slowing as contagion from manufacturing threatens resilience in the services sector. Trade disputes are only a symptom of broader tension between the United States and China. With profit margins having peaked, this is likely to present an ongoing headwind for business investment intentions.

- **Subdued inflation across economies**
  Inflation expectations remain close to historical lows, and various central banks are struggling to engineer a revival. Corporate fundamentals generally remain relatively strong despite the moderation in global growth. At the same time, the ability of corporations to pass costs on to consumers appears limited, increasing pressure on margins.

- **Approaching the limits of monetary policy effectiveness**
  The global economy is slowing, and policymakers may be reaching the limits of conventional monetary policy. Various markets and their participants appear to be discounting different degrees of support from central banks, some of whom are constrained in their ability to act decisively. Any failure to manage these expectations could result in a loss of confidence among investors.

**Practical positioning**

- **Nimble management required**
  Over recent quarters, we have highlighted a return to long-run levels of market volatility rather than the muted levels seen for much of the past 10 years. This indicates that we have entered a new volatility regime. We have taken a more cautious stance on risk assets and believe the challenges that current markets present will require nimble management.

- **Real assets could be the alternative**
  Market-based expectations for inflation, derived from the yields of nominal and real return bonds, have fallen sharply. In an uncertain environment, holding a diversifying asset such as US Treasury Inflation-Protected Securities (TIPS) might enhance return potential and lower portfolio volatility.

- **Alternative assets that aren’t really alternative enough**
  Other alternative assets such as real estate might show uncorrelated return potential. However, listed alternatives such as real estate investment trusts (REITs) would be more vulnerable in a correction due to their equity-like characteristics. We retain a less optimistic view of commodities, despite their potential diversification benefits.
Major themes driving our views

Slower global growth a rising concern
The global economy continues to show downward momentum, with many of the themes discussed in our Allocation Views over the past year remaining pertinent. Trade in goods has been the transmission mechanism for declining sentiment; the big question remains whether contagion from manufacturing threatens the more resilient services sector.

Stress in the traded goods sector of the economy has been broader based than just the flows directly impacted by tariffs imposed by the United States, or the retaliatory measures enacted by China. Indeed, threats to expand the theater of this trade dispute continue to pose a direct threat to European automakers. This hit to confidence has already started to impact manufacturing employment, and with factory orders in Germany showing little sign of a rebound (see Exhibit 1), the risks to growth remain skewed to the downside.

However, it is the seeming intractability of the conflict between the United States and China that has become a bigger concern. We view trade disputes as only one symptom of broader tensions between an incumbent global power and its challenger for supremacy.

The political pressure on US President Donald Trump to secure a deal may see some progress in coming months. He likely has at least one eye on his forthcoming re-election campaign. However, the hardened rhetoric that Chinese officials have adopted more recently suggests that President Xi Jinping is willing to take a longer view of this conflict. For now, his Chinese counterpart appears to have more levers to pull than President Trump.

Taking a broader perspective of the major economies, the United States remains better placed than some in Europe. However, both regions show high levels of employment, and the relative confidence of consumers remains intact. This provides some cause for optimism.

While we continue to see few signs of late-cycle imbalances that typically foretell recession, and the probability of recession remains moderate, the risks are rising. The deeper the trade slowdown and the longer it persists, the harder it is to see the global economy escaping some form of contagion. Our dominant theme remains “Slower Global Growth Is a Rising Concern.”

Subdued inflation across economies
Subdued inflation expectations remain the main concern of key central banks. At this late stage in the business cycle it is unusual to see such limited pass-through from tight labor markets to higher wages and ultimately broad measures of inflation (see Exhibit 2). When combined with the headwinds facing global growth, an inability to generate the targeted level of inflation starts to feed concerns that inflation expectations might become “un-anchored.”

It is well observed that inflation expectations are a large determinant of actual inflation, through the actions of wage bargaining and company pricing power. Survey measures of longer-term inflation expectations in the United States remain close to historical lows, matching levels last seen in late 2016 (see Exhibit 3). As a result, it is unsurprising to see the US Federal Reserve’s (Fed’s) continued focus on this issue.

Corporate fundamentals have remained relatively strong, despite the moderation in global growth. With labor markets tight in many economies, wage inflation has been picking up to some extent. However, the ability to pass this cost on to consumers appears limited. After a long period of expansion, profit margins have peaked and are likely to slow the pace of earnings growth.
Real assets could be the alternative

Together with cyclical drivers of inflation that are weakening, commodity price declines since the middle of 2018 have put pressure on headline measures of inflation. Underlying disinflationary forces from demographics, technology and globalization have not been reversed, although some of their impact might be offset by growing protectionism and the impact of populism. However, on balance our analysis leads us to continue to reflect a theme of “Subdued Inflation Across Economies.”

Approaching the limits of monetary policy effectiveness

Policymakers are facing a challenging few months. Investors’ expectations, in broad terms, appear to be discounting continued interest-rate cuts from the Fed, which are being mirrored in a range of developed and emerging economies. However, given the low levels of current official rates, many central banks may be running out of ammunition. Growing concern that conventional policy measures are nearing the end of their effectiveness puts more pressure on alternative policy measures and leaves investors worrying about policy impotence. This is reflected in our theme “Approaching the Limits of Monetary Policy Effectiveness.”

In Europe, heightened fears of recession have prompted calls for fiscal policy to be used to complement monetary policy. Although Christine Lagard, incoming president of the European Central Bank (ECB) supports policy coordination, we do not underestimate the challenge of making progress in this area. The ECB may struggle to achieve the political consensus required for an early adoption of these measures until a deeper slowdown raises the fears of a renewed crisis in the eurozone.

At the same time, stock market resilience in the face of slower global growth appears to reflect ample liquidity more than corporate earnings expectations. We are concerned that central bankers will collectively fail to meet the full extent of market expectations. When combined with political pressure on the Fed and the complex interaction between trade rhetoric, market sentiment and monetary policy, we would not be surprised to see continued sharp moves in asset prices.
Nimble management required

Over recent quarters, we have highlighted continued divergence between various financial markets and the global economy. Although we recognized the longer-term return potential for stocks, we continued to point to shorter-term concerns that have tempered our enthusiasm. A return to long-run levels of market volatility since early 2018, rather than the muted levels seen for much of the past 10 years, indicates that we have entered a new volatility regime.

The decline in bond yields that accompanied the prospect of tariff increases makes the next move even harder for the Fed. Markets now appear to anticipate a succession of rate cuts through year-end, at least in part to offset the impact of trade concerns, as well as any hit to market confidence. Increasingly, it looks like the Fed is being pushed toward actions that it is less able to justify on the basis of its dual mandate of stable prices and maximum employment. This has driven an inversion of the US Treasury yield curve, as the 10-year note’s yield fell below that of Treasury bills (see Exhibit 4). Such a development is often a signal for impending recession, though we maintain a somewhat more constructive view of the US economy.

Against a backdrop of slower growth, global equities as a whole are not cheap, in our analysis. Any market disappointment over the Fed’s delivery of potential rate cuts might hurt market stability. Having taken a more cautious stance on risk assets in the first half of the year, we continue to believe navigating the challenges 2019 presents will require nimble management.

Real assets could be the alternative

By a significant margin, energy has been the most important factor driving consumer prices over recent years. The cost of a barrel of oil rebounded strongly and then corrected again. Despite its relatively modest weight in the overall Consumer Price Index (CPI), oil has accounted for a large part of the volatility in headline CPI inflation. That energy is considerably more volatile than most other components of CPI is not new or surprising. Indeed, this is why central bankers and market watchers tend to look at underlying “core” inflation, which is the headline reading minus the volatile food and energy segments.

Although we may have an interest in core inflation from a macroeconomic perspective, headline inflation increases have a direct impact on the return from certain real assets. Inflation-linked bonds’ capital value and income stream rise in direct proportion to the increase in the headline CPI (or other price index that certain countries’ bonds follow), delivering explicit inflation protection. Today, unless oil prices rebound, the rate of headline inflation is likely to continue slowing during the next few months. Similarly, an increase in prices that comes about because of import tariffs may have an immediate impact on inflation. However, the longer-term impact (on a sustained basis) is dependent on changes to consumer behavior. For now, longer-term inflation expectations remain relatively well anchored.

In contrast, market-based expectations for inflation, derived from the yields of nominal and real return bonds, have fallen sharply. These so-called breakeven inflation rates (where the prospective return on nominal and real-return bonds are equal) have responded directly to recent commodity price declines. Looking more deeply, the level of breakeven inflation over the five-year period starting five years from now (5-year/5-year forward rate) has also fallen (see Exhibit 5). This largely reflects a re-rating of nominal bond yields and a decline in the risk premium for inflation uncertainty.
Some further modest decrease in this market-based measure of long-term inflation rates could occur, but to see it move appreciably lower would require consumer expectations to become less well anchored. Such an event would likely be a catalyst for an acceleration in the pace of monetary easing by the world’s leading central banks and may see broader market changes—weaker stock markets or, in the longer term, higher bond yields. It is this combination of “shocks” that provides the environment where holding a diversifying asset such as TIPS might enhance return potential and lower portfolio volatility.

Management of risk profile—duration considerations

How would we take exposure to inflation protection? If we buy inflation linked bonds out of our short-term bond holdings, we will take additional exposure to the level of interest rates (duration1 or interest-rate risk as well as the term premium seen in longer-dated yields). This might help to diversify against equity risk. However, we may not wish to add further to this exposure given historically subdued yield levels.

If instead we sell other bonds to fund this position, we would be reducing exposure to the defensive component of a multi-asset portfolio and not adding to overall duration. However, in our analysis, the overall portfolio would be more correlated to equity markets and more cyclical in nature, which runs counter to our defensive posture overall. Any reduction in overall diversification needs to be considered in deciding how to fund an investment in inflation linked bonds.

Alternative assets that aren’t really alternative enough

We anticipate that certain other alternative assets might show uncorrelated return potential. Real estate is widely viewed as providing some protection against a general rise in inflation. However, as global growth slows, this would impact the ability of tenants to continue to cover rent and risks falling occupancy rates. Similarly, any rise in bond yields could put pressure on property valuations through the current relatively subdued yield.

While directly held property might weather this storm, and even potentially benefit from a modest rise in inflation, listed alternatives such as REITs would be more vulnerable to a correction due to their equity-like characteristics, in our analysis.

Broad commodity prices typically perform well in the latter stages of a business cycle, but they have been weak over the past year. They would benefit from any increased demand, driven by a renewed capital investment cycle. Commodities often see prices rise as a result of supply constraints, but this has been offset by demand concerns as China rebalances its economy toward domestic consumption. We retain a less optimistic view of real assets such as commodities, despite their potential diversification benefits.2

More specifically, certain commodities may offer alternative diversification benefits. Precious metals such as gold may not follow the same trend as industrial metals or broad commodities (see Exhibit 5).

COMMODITY CYCLES ARE NOT PERFECTLY CORRELATED

Exhibit 5: Growth Comparison Between Industrial Metals, Gold and Commodities
January 2002–August 2019

Index Value

0 100 200 300 400 500 600 700 800

Jan-02 Nov-03 Sep-05 Jul-07 May-09 Mar-11 Jan-13 Nov-14 Sep-16 Aug-19

Industrial Metals Spot Index Agriculture Spot Index Precious Metals Spot Index Energy Spot Index

Sources: Franklin Templeton Capital Market Insights Group, Bloomberg, Macrobond.
At times of financial market or geopolitical stress, they can offer perceived safe-haven benefits and are viewed as a hedge against the debasement of fiat currencies. Our analysis of the drivers of precious metals shows that they would tend to fare better if the US dollar were to depreciate. Also, as an asset that generates no income, they compete better in a falling interest-rate environment (see Exhibit 6). Currently, we find the specific attractions of gold somewhat more compelling than those of commodities more broadly.

**GOLD PRICES RISE AS US TREASURY YIELDS FALL**

*Exhibit 6: Price of Gold vs. 2 Year Treasury*

January 2015–August 2019

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**Endnotes**

1. Duration is a measure of the sensitivity of the price of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years.

2. Diversification does not guarantee profit or protect against risk of loss.

3. Fiat currency is money that is not backed by a physical commodity. Most modern paper currencies, such as the US dollar and euro, are fiat money. They are issued by a government, which guarantees the validity of that currency for use in economic trade.
We see global growth trending lower, coupled with subdued inflation. As a result, we have started to scale back our conviction in riskier assets. However, given modest economic imbalances, we do not see a high probability of recession. Our view reflects reasons for concern over the diverging expectations across markets but is not overly bearish.

Global equities are still supported by corporate earnings, but profits margins have peaked. Concerns remain regarding growth momentum and capital investment plans. We are carefully monitoring the potential for renewed market volatility and have moved to reflect these concerns in a more cautious stance.

Slower global growth and the prospects for easier monetary policy contrast with long-term valuations that have remained expensive, reflecting low term premiums. Some widening of corporate bond spreads is likely as growth slows and financial conditions tighten. We have moved to a truly neutral view of bonds, at the asset allocation level, reflecting the balance between reasons for optimism and valuation concerns.

The inflation that was feared, as the economic cycle entered its later stages, has not appeared. 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.

Cash yields remain attractive to us, with short-term US Treasury bill yields reflecting greater supply and previous monetary policy normalization. Cash is no longer a significant drag on portfolio yield, boosting its attractions to us generally.
### Allocation Tier

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<tr>
<th>Asset class</th>
<th>Conviction</th>
<th>Our viewpoint</th>
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<tr>
<td>Equity Regions</td>
<td></td>
<td>Despite ongoing trade tensions, US growth remains stronger than in other developed markets, although earnings have dipped. The market’s attention will likely focus on valuations, pressure on margins and whether Fed rate cuts meet market expectations.</td>
</tr>
<tr>
<td>United States</td>
<td></td>
<td>We see modest opportunities in Canada, with earnings growth expectations providing some room for positive surprises, but commodities are a headwind. Canadian banks remain burdened by the 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 has slowed as global trade concerns and weaker manufacturing activity have led to negative sentiment. The ECB looks likely to deliver renewed stimulus, and we see banks acting as a drag. However, our views reflect the market discounting of these conditions, and we are cautious rather than bearish at this time.</td>
</tr>
<tr>
<td>United Kingdom</td>
<td></td>
<td>UK economic uncertainty has been driven by domestic political tension and uncertainty over Brexit. However, this defensive market appears historically cheap, corporate profits remain high, and we retain a truly neutral view.</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td>Equity valuations, particularly on a price-to-book value basis, have remained attractive to us relative to other markets. However, declining global growth and a late-cycle environment are typically unfavorable for companies with higher operational leverage and for the Japanese market. 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 Australian and Hong Kong banks persist. The region is vulnerable due to linkages to China as demand slows. However, at valuations we regard as attractive, we are not bearish, though we see reasons for concern.</td>
</tr>
<tr>
<td>Emerging ex China</td>
<td></td>
<td>The slower growth environment highlights emerging markets’ idiosyncratic risks and underlying cyclical. However, valuations remain attractive to us relative to developed market peers. Easier Fed policy could support local currencies. We see a balance of growth concerns and optimism regarding the longer-term attractions of emerging markets.</td>
</tr>
<tr>
<td>China</td>
<td></td>
<td>China’s equity market has rebounded on stimulus measures, and the economy has stabilized. However, the risk of an escalating trade war has intensified, and the rhetoric has hardened. Further support from fiscal or monetary measures may be required. Although valuations remain attractive to us, we see reasons for caution and have taken a truly neutral view of this market.</td>
</tr>
<tr>
<td>Fixed Income Sectors</td>
<td></td>
<td>The Fed has continued to shift its stance from patience and a data-dependent response function to cutting interest rates as an insurance against heightened uncertainties. Although further cuts are likely, they may not meet market expectations, and we remain concerned about stretched valuations and supply dynamics. We see a balance of reasons for concern and optimism.</td>
</tr>
<tr>
<td>US Treasuries</td>
<td></td>
<td>Valuations appear full in the eurozone, where term premiums are the lowest among government bonds. However, with subdued growth, the ECB has moved to open the way for further stimulus, including asset purchases. We maintain a cautious stance in line with other developed market bonds but are not bearish.</td>
</tr>
<tr>
<td>Eurozone Government Bonds</td>
<td></td>
<td>Canada is vulnerable to global trade concerns and oil price volatility hitting business confidence. Expectations for the Bank of Canada lag those for the Fed, but risks suggest rate cuts. We have moved from a cautious position in line with other developed market bonds and have taken a more constructive stance, reflecting reasons for optimism.</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 its policy will remain stimulative for an “extended period” and indicated it will act “without hesitation” to ease further, if required.</td>
</tr>
</tbody>
</table>
## ALLOCATION TIER

<table>
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<tr>
<th>Asset Class</th>
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<tr>
<td><strong>Fixed Income</strong></td>
<td></td>
<td><strong>Sectors continued</strong></td>
</tr>
<tr>
<td>High Yield</td>
<td>- CONFIDENCE + CONFIDENCE</td>
<td>The business cycle is entering its later stages, leading us to adopt 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. Bank loans have suffered persistent outflows as the Fed has moved to cut rates, and they are potentially vulnerable due to the relaxation of covenants. Overall, we are moving to reflect greater reasons for caution but are not yet bearish.</td>
</tr>
<tr>
<td>Investment Grade</td>
<td>- CONFIDENCE + CONFIDENCE</td>
<td>The investment-grade sector remains supported by strong corporate fundamentals; however, leverage is high, and technical conditions may prove challenging. Some widening of yield spreads is likely as growth slows and financial conditions tighten, but yields remain attractive to us in a global context.</td>
</tr>
<tr>
<td>EM Debt</td>
<td>- CONFIDENCE + CONFIDENCE</td>
<td>We regard emerging market bond valuations as fair among local- and hard-currency bonds. Exchange rate risks in local-currency bonds are mitigated by dovish global central bank policy and may prompt a continued search for yield among investors. As a result, we have moved to reflect a more optimistic outlook. However, with continued fears over protectionism and geopolitics, selective positioning is important, in our view.</td>
</tr>
<tr>
<td><strong>Alternative Assets</strong></td>
<td>- CONFIDENCE + CONFIDENCE</td>
<td><strong>Inflation-Linked Bonds</strong></td>
</tr>
<tr>
<td></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. However, we maintain a neutral view of assets that benefit directly from rising prices, such as inflation-linked bonds.</td>
</tr>
<tr>
<td>Commoditys</td>
<td>- CONFIDENCE + CONFIDENCE</td>
<td>A deceleration of economic growth creates a less supportive environment for broad commodities. We believe that stimulus measures in China are likely to be focused on supporting domestic consumers rather than financing major infrastructure projects, amid commodity price declines. With inflation pressures remaining subdued, we continue to hold a more cautious view.</td>
</tr>
</tbody>
</table>

## WHAT ARE THE RISKS?

**All investments involve risks, including possible loss of principal.** The positioning of a specific portfolio may differ from the information presented herein due to various factors, including, but not limited to, allocations from the core portfolio and specific investment objectives, guidelines, strategy and restrictions of a portfolio. There is no assurance any forecast, projection or estimate will be realized. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, 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. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Derivatives, including currency management strategies, involve costs and can create economic leverage in a portfolio which may result in significant volatility and cause the portfolio to participate in losses (as well as enable gains) on an amount that exceeds the portfolio's initial investment. A strategy may not achieve the anticipated benefits, and may realize losses, when a counterparty fails to perform as promised. Currency rates may fluctuate significantly over short periods of time and can reduce returns. Investing in the natural resources sector involves special risks, including increased susceptibility to adverse economic and regulatory developments affecting the sector—prices of such securities can be volatile, particularly over the short term. Real estate securities involve special risks, such as declines in the value of real estate and increased susceptibility to adverse economic or regulatory developments affecting the sector. Investments in REITs involve additional risks; since REITs typically are invested in a limited number of projects or in a particular market segment, they are more susceptible to adverse developments affecting a single project or market segment than more broadly diversified investments.
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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.

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