FRANKLIN TEMPLETON

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The Case for Country Allocation

2019 was a "Goldilocks" year with low interest rates, stable earnings growth, and low inflation. Positive performance across many asset classes included 32% from US equity (based on the S&P 500), 22% from international equity (FTSE All World ex-US[1]), 9% from US aggregate bonds, and 18% from gold.[2] Bull markets feed on low inflation and globally, politicians appear likely to continue expansive economic policies. We are in unchartered territory, with the longest post-recession period and highest stock market level in history, and the market consensus view is to not expect a strong recovery in profits in 2020 or 2021. In our view, we'll stay on the path of a longer earnings growth rate, just not as fast as past growth.

Around the world, positive returns masked volatility throughout 2019, driven by trade tensions, natural disasters, multiple populist moves causing unrest in previously stable countries (e.g. Hong Kong, France, and Chile), and political and military showdowns (e.g., North Korea, Saudi Arabia, Israel, Syria, and parts of Africa). When an exogenous event occurs (i.e., a war or disease), we have fewer policy tools than we did in the past because interest rates have been lowered, reserve banks around the world have already expanded their balance sheets, less soft policies exist, and there is less of the ability to work together within and between countries.

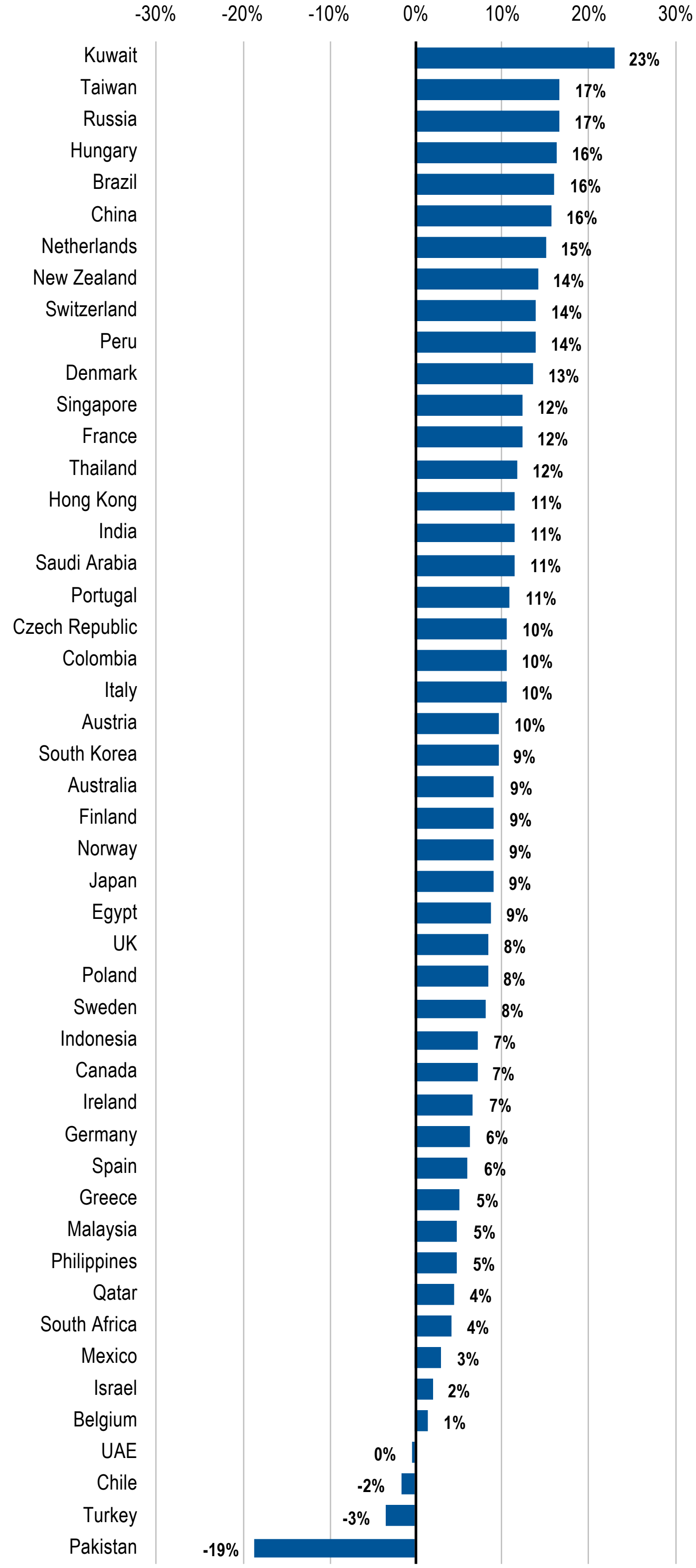
Looking at equity returns across all international markets, we observed dispersed returns and quite varied drivers of returns among the top and bottom performing countries. Investing in international markets exposes currency factors that can affect total returns depending on how the US dollar (USD) performs relative to local foreign currencies. It also shows the importance of investing in international markets as investors achieve potentially higher performance potential and increased diversification from allocating to international markets. Furthermore, each country is unique, and there are opportunities to extract higher returns when investment managers allocate to specific countries with higher outlook convictions.

Why Country Allocation is Important

- **Wide dispersion of returns among international markets**
  Wide dispersion of returns in country allocation is an opportunity and a potential tool for maximizing returns, as indicated in Exhibit 1 on the next page.

More than 40% Dispersion Between the Top and Bottom Countries

Exhibit 1: Three-year performance in USD, annualized.
As of December 31, 2019



Source: Morgan Stanley Capital International country-specific indexes, annualized 3-year returns, 2017–2019. Indexes are unmanaged, and one cannot invest directly in an index. **Past performance is not an indicator or guarantee of future performance.** Important data provider notices and terms available at www.franklintempletondatasources.com.

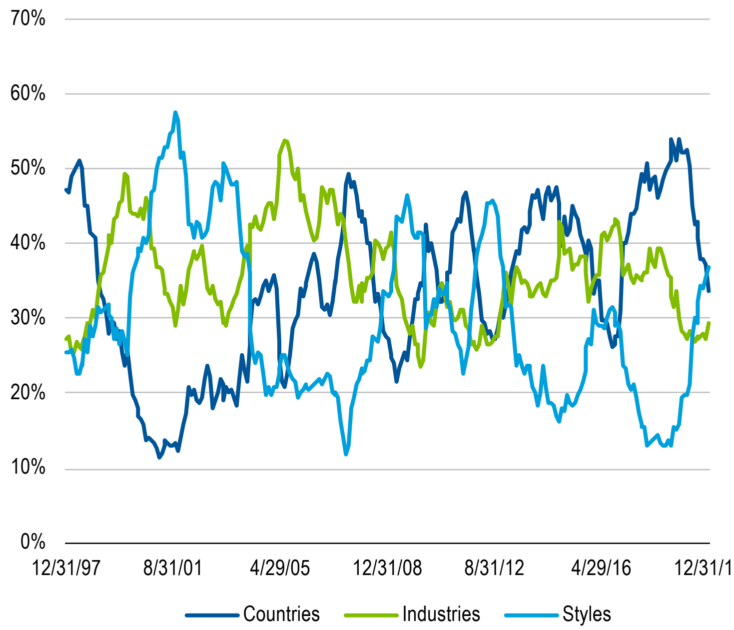
- **Country factor is a significant contributor to returns, greater in emerging markets than developed markets**

Individual and institutional investors tend to have home bias, thus they potentially miss long-term opportunities. Although economic growth is slowing, countries such as India and Indonesia are still projected to have higher growth than most of the developed world.

Total returns can be broken down into specific factors such as countries, industries, and styles, in addition to company-specific factors. As shown in Exhibit 2, despite the globalization trends, country factors continue to play a major role, especially across emerging markets. One measure to quantify the effect of country on performance is cross-sectional volatility (CSV).[3]

Despite Globalization Country Factors Still Matter

Exhibit 2: Importance of country, sector and style in explaining returns—All international markets
December 1997–December 2019



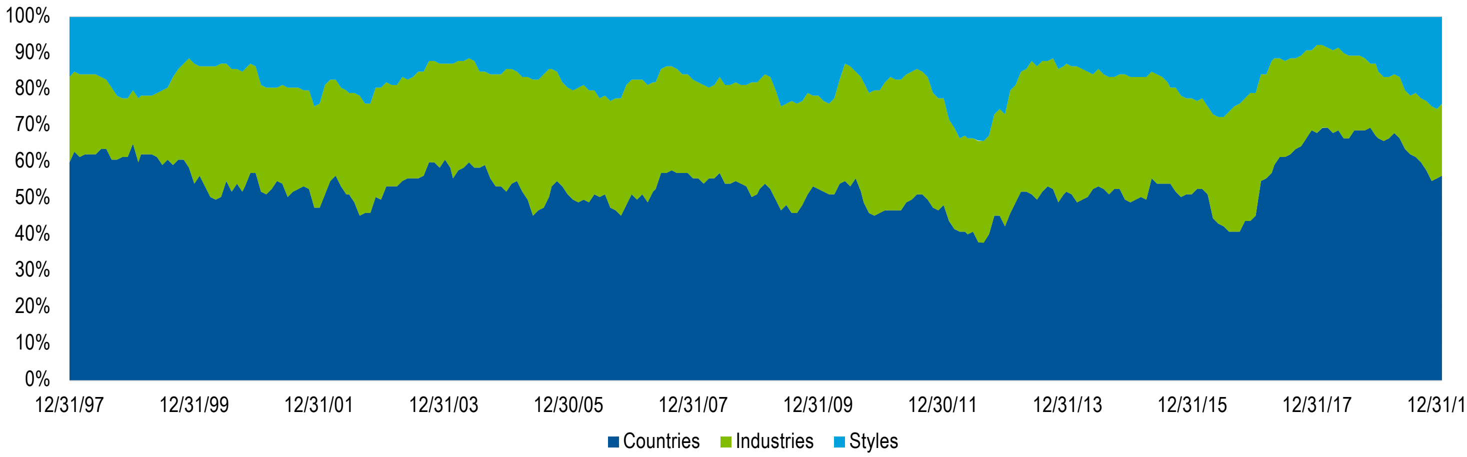
Source: MSCI All Country World Index (ACWI) Index, contribution of risk factors to cross-sectional volatility, 12/31/1997–12/31/2019. Indexes are unmanaged, and one cannot invest directly in an index. **Past performance is not an indicator or guarantee of future performance.** Important data provider notices and terms available at www.franklintempletondatasources.com.

As shown in Exhibit 3 on the next page, across emerging markets, performances were more heavily influenced by country selection when compared to industries or styles.

- **Stock market inefficiencies still exist**
  Multiple factors contribute to the pricing of global markets, including but not limited to monetary policy, a current account deficit or surplus, politics, money flows, and economic growth. Understanding and exploiting these market efficiencies could translate into higher return potential from country allocation.

Across Emerging Markets Country Factor Contributes 60% of Returns

Exhibit 3: Importance of country, sector, and style in explaining returns—All emerging markets
December 1997–December 2019



Source: MSCI Emerging Markets Index, contribution of risk factors to cross-sectional volatility, 12/31/1997–12/31/2019. Indexes are unmanaged, and one cannot invest directly in an index. **Past performance is not an indicator or a guarantee of future performance.** Important data provider notices and terms available at www.franklintempletondatasources.com.

The Impact of Country Allocation[4]

- **Broad exposure to global equity + overweight in top performing countries**
    - Investing in broad global equity in 2019 returned 27%, compared to 30% returns when adding overlays of 10% each for Russia, Switzerland, and Taiwan—adding 3 percentage points in absolute total returns, or 12% improvement from investing solely in broad global equity.

	Absolute Returns	Weight	Weighted Contributions
FTSE All World	27.3	70%	19.1
Russia	50.8	10%	5.1
Switzerland	32.2	10%	3.2
Taiwan	31.1	10%	3.1
		100%	30.5

- **Broad exposure to international emerging and developed market + overweight in top performing countries**
    - Investing in broad international equity in 2019 returned 22%, compared to the 27% returns when breaking down emerging and developed markets, and adding overlays of 10% each for Russia, Switzerland, and Taiwan—adding 5 percentage points in absolute total returns, or 23% improvement from investing solely in broad international equity.

	Absolute Returns	Weight	Weighted Contributions
FTSE EM	20.4	10%	2.0
FTSE Dev ex-US	22.3	60%	13.4
Russia	50.8	10%	5.1
Switzerland	32.2	10%	3.2
Taiwan	31.1	10%	3.1
		100%	26.9

2019 Notable Countries[5]

Six international markets' drivers of returns and performances are worth noting. Among the top and bottom performing countries:

Russia's Stellar and Sustained Recovery
Russia had one of the best performing international equity markets in 2019 with a 51% return. The primary drivers of performance were rising dividend payouts, reduced threat of US sanctions, and several strong macroeconomic improvements throughout the year.

Increasing dividend payouts drove returns higher and continued to lure investors with average dividend yields of more than 6% for the prior 12 months. The top contributor to performance was Gazprom, which makes up 15% of the index and returned 100% in 2019. Gazprom made substantial increases to its dividend payout policy and exports to countries like China, while also making sweeping changes to its board and management teams. Other top contributors, like Sberbank and Lukoil, which make up 16% and 17% of the index and returned 63% and 43% respectively, also saw large increases in their 2019 dividend payouts with even higher payouts expected in 2020.

Another major returns driver for 2019 was the reduced threat of additional US sanctions. Since its annexation of Crimea in 2014, the Russian stock market has consistently performed near the bottom of all emerging market countries and the country prioritized overcoming initial US sanctions setbacks.

To weather the setbacks of 2014, Russia raised interest rates in 2015 to 17%, withstood multiple years of double-digit inflation, and suffered a massive ruble devaluation. By year-end 2019, the country saw inflation drop to under 4%, interest rates cut to 6.25%, and appreciation of the ruble by 10% versus the USD, all pointing to signs of a sustained recovery.

Switzerland Gains from Health Care, Food, and Wellness

European equity markets performed strongly in 2019. Eurozone growth recovered—it was not bullish, but it was not bearish anymore. Rallies at the end of the year were sparked by increased trade optimism and reduced fears of a global recession. Key drivers of these sentiments were perceived improvements in US-China trade negotiations, as well as signs of a less disruptive Brexit. The European Central Bank also played a role as accommodative monetary policies kept interest rates at historic lows to drive European growth in 2019.

Up 32%, Switzerland, a perceived safe haven with minimal exposure to trade tensions and geopolitical risks, finished 2019 as a top performer among international equity markets. The Swiss index is heavily weighted in three companies: Nestle SA (20%), Roche Holding AG (14%), and Novartis AG (14%). All three companies exhibited strong returns in 2019 (37%, 35%, and 30% respectively). As a result, these three companies contributed nearly half of the Swiss equity market's total return. In 2018, Nestle, the largest food company in the world, sharpened its strategic outlook to focus on nutrition, health and wellness. In 2019, Nestle continued to invest in high growth areas like coffee, pet care, nutrition, water, and health science, resulting in the company's shares outperforming the consumer staples sector. Roche and Novartis were the highest-weighted companies in the health care sector, which was the highest-weighted sector in Switzerland. Similar to Nestle, the shares of both Roche and Novartis outperformed the broader health care sector, boosting Switzerland's return versus other international markets. Both companies made gene therapy a major focal point, an area in which medicine prices are some of the highest in the industry. Similarly, both companies made multiple acquisitions in the last half of 2019 as they attempted to bolster their future drug pipelines.

Taiwan Sets 10-Year Highs with Tech, Trade, and Tax-Savings

Taiwan was a top performing international stock market in 2019 and ended the year up 31%—its best year in a decade. While geopolitical risks dominated markets for much of 2019, trade uncertainty faded in the fourth quarter with the US and China announcing a "phase one" trade deal. This easing of trade tensions benefited many countries, including China, South Korea, and Taiwan. In addition, the Taiwan dollar strengthened 2.5% during the year and at one point crossed $30 per USD for the first time since June 2018.

Investor sentiment has rarely been this good in Taiwan. While many investors expected Taiwan to be caught up in the middle of the US-China trade dispute, Taiwan's economy and markets were aided in 2019 as local firms were incentivized to bring money back home as the new tax on repatriated funds lowered to the 8%–10% range vs. 20% for overseas earnings. The trade dispute does not appear to be a short-term event but is likely the maturation of changing globalization and we believe it will be on the investment horizon for the next five to ten years.

Generally strong performance from the technology sector boosted returns, as earnings expectations were revised upwards following solid third-quarter sales. Throughout 2019, Taiwan's technology sector was up around 50% on a weighted-average-basis, with strong foreign fund flows into large-cap stocks including TSMC (+58%), Largan (+62%), and Hon Hai (+38%). TSMC now has over 80% foreign ownership in its stock. The main drivers for the technology sector's outperformance were and continue to be the structural impact of upgrading wireless networks to 5G, the iPhone's new product cycle, and recently favorable tech commodity pricing.

Saudi Arabia Selloff and ARAMCO Initial Public Offering

Saudi Arabia, up 9%, finished 2019 as one of the worst performers among international stock markets. Up as high as 22% in May, Saudi Arabia as a whole saw negative returns for the back half of 2019. Early returns were boosted by Saudi Arabia's inclusion in both the FTSE Global Equity Index Series and MSCI All Country World Index. Both index providers brought Saudi Arabia in across multiple tranches, which led to large inflows from passive funds. However, several investors sold their positions once the tranches were complete. In June, Saudi Arabia removed the ownership cap on publicly traded companies for qualified foreign investors, encouraging further increases in foreign investment. Then in December, ARAMCO became the largest listed company in the world following an IPO that saw approximately US$25 billion invested in the Saudi oil company. In 2019 the Saudi index was weighted heavily in both financials (40%) and materials (32%). While the financial sector saw a 16% return, boosted in part by the removal of the foreign investment cap, the materials sector dragged the index down with a -6% return. Nearly half of the materials sector weight was Saudi Basic Industries Corp (SABIC), which saw a return of -16% in 2019. In March 2019, Saudi Aramco purchased a 70% stake in SABIC with the goal of boosting its future growth plans.

South Korea's Stunted Returns

Despite a return of 8% for the year, the South Korean stock market proved to be one of the bottom performers internationally in 2019. Much of the underperformance occurred in the first half of the year, driven by ongoing trade tensions with Japan, and indirectly from contentious trade relations between the United States and China. Outlooks for some sectors improved in the second half of the 2019, but not enough to place South Korea among its other emerging market peer countries.

Top performance contributors were Samsung Electronics, which returned 42%, with common and preferred lines that consisted of up to 21% of the index, as well as other information technology companies like SK Hynix Inc (6%), which returned 50%.

The bottom contributors to performance were concentrated in the health care sector, among them companies like Celltrion (2.5%), Sillajen (0.3%), and Helixmith (0.3%), which returned -17%, -81%, and -61% respectively.

At a macroeconomic level, 2019 was a mixed bag for South Korea; gross domestic product (GDP) growth of 1.8% was slightly weaker relative to its peers but the country maintained strong export levels. The cyclical nature of its economy and its close ties to other regional economies like Japan, India, and China were more influential performance drivers for the year. Uncertainty among externalities—like the US and China seeing little improvement in trade tensions, and strained relations and trade with Japan—have played a dominant role in South Korea's stunted returns for 2019.

India's GDP Growth Slows

While India's equity market rose 6% in 2019, it underperformed broad international markets and was negatively impacted by higher crude oil prices (India is a net importer), rising fiscal pressure, and concerns over slowing growth. The GDP growth rate decelerated to a multi-year low of 4.5% in the September-end quarter and was driven by the auto- and metals-related industries. Two major events that drove the markets back into positive territory during 2019 were the re-election of the Narendra Modi-led BJP government and corporate tax cuts (reduced from 30% to 22%; for new companies from 25% to 15%) in September, which resulted in Indian markets logging their highest single-day gain in almost a decade.

Despite the headwinds that India faced in 2019, foreign inflows into equities (at five-year highs) exceeded domestic activity (at three-year lows) for the first time in three years. The energy and financials sectors performed best, while the health care and utilities sectors performed worst. Within the energy sector, Bharat Petroleum performed best, closing the year up 40% due to its privatization announcement. In terms of the impact to India as a whole, Reliance Industries, the largest energy stock in the energy sector and India's equity market overall, was up 33% over the year and contributed 3.3% or just over half of the market's overall 2019 return. While absolute valuations were broadly unchanged during the year, relative valuations saw a significant correction vs. other countries. Macro data points were weak, but corporate activity was strong.

Conclusion

There are different ways to implement country allocation, from a top-down assigning of weights in the overall portfolio to each country, or a more practical way of overlaying broad market exposure with a selection of three countries with the highest convictions. Furthermore, allocating broadly to international markets based on their relative market cap size is not enough—there can be higher return potential from strategically allocating to specific countries with higher outlook convictions. Despite the strong 2019 performance of US equity markets, international markets are still a source of performance potential that should not be ignored as they can bring benefits beyond what is available in the United States and offer a source of diversification potential.

Endnotes

1. Financial Times Stock Exchange (FTSE) All World Ex-United States Index, calendar year 2019. Indexes are unmanaged, and one cannot invest directly in an index. **Past performance is not an indicator or guarantee of future performance.** Important data provider notices and terms available at www.franklintempletondatasources.com.
2. Bloomberg. As of December 2019. Important data provider notices and terms available at www.franklintempletondatasources.com.
3. CSV measures the dispersion of stock returns within an index, showing how varied the returns can be among the index's constituents. The decomposition of an index's CSV gives insight into the major factors that cause stock returns within an index to differ from one another as well as the relative magnitude of these factors. It also has the theoretical advantage of allowing comparison of country, industry and style factors on a common basis and then provide a time series for how these factors' contributions have changed over time.
4. FTSE All World Ex-United States Index, relevant FTSE country-specific, FTSE emerging market-specific, FTSE developed market-specific indexes, Bloomberg, calendar year 2019 . Indexes are unmanaged, and one cannot invest directly in an index. **Past performance is not an indicator or guarantee of future performance.** Important data provider notices and terms available at www.franklintempletondatasources.com.
5. FTSE All World Ex-United States Index, relevant FTSE country-specific, FTSE emerging market-specific, FTSE developed market-specific indexes, Bloomberg, calendar year 2019. Indexes are unmanaged, and one cannot invest directly in an index. **Past performance is not an indicator or guarantee of future performance.** Important data provider notices and terms available at www.franklintempletondatasources.com.

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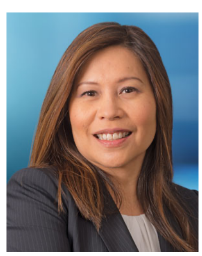

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Franklin LibertyShares ETFs

With support from members of the Global Index Portfolio Management Team

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