September 2024

Franklin Templeton Investment Solutions

Allocation Views

Staying in the saddle

Summary

A healthy market correction in early August reset sentiment and positioning to more neutral levels and stabilized equity markets. However, potential volatility linked to the upcoming US election, alongside seasonality concerns, tempers our enthusiasm and informs our neutral allocation to risk assets.

Given the uncertain environment, equity risk premiums remain low, in our view, although a cyclical rotation does offer potential investment opportunities. Elsewhere, falling global bond yields influence a reduction in duration across our fixed income portfolio amid diminished returns. Against this background, we choose to "stay in the saddle" from an investment perspective and await better opportunities to add risk.

Macro themes driving our views

Growth remains relatively constructive

- Leading economic indicators suggest positive, albeit slowing, global growth.
- Global growth is stronger in services whereas manufacturing remains sluggish.
- Market volatility is not likely to lead to slower growth by itself, as labor market dynamics remain key across regions.

Inflation risks are more balanced

- Significant progress has been made, although it has been bumpy, and inflation is still above targeted levels.
- Elevated services inflation is normalizing alongside labor markets.
- Core goods inflation has already normalized, but higher freight costs may offset this.

Divergent policy cycles

- More central banks are likely to start cutting rates soon, but with a greater divergence of outcomes likely.
- Inflation progress allows policymakers some leeway to balance growth and inflation objectives.
- Central banks remain cautious and will seek data that confirms disinflation before acting.

Portfolio positioning themes

Balance of risks across assets

- A constructive macro environment is typically associated with strong markets, supporting a tilt toward riskier assets.
- Extended sentiment and positioning have moderated, but equity risk premiums remain low, particularly given seasonal uncertainty.
- Policy changes may offset growth and inflation surprises, suggesting the collective mix is more supportive.

A changing equity landscape

- US equity earning growth is rising and breadth is improving.
- Diminished conviction on the growth outlook for Europe ex-UK stocks, but more positive on UK equities due to an improving macro backdrop.
- Emerging markets ex China remain our preferred region, notably Asian economies, amid strong semiconductor demand.
- We continue to find Canada and Pacific ex Japan less appealing due to relatively weak macro and corporate fundamentals.

Less attractive yields for bonds

- Lower yields diminish the return potential from global bonds, influencing a further reduction in our duration preference among government issues.
- Easing cycles are likely to continue for Western economies, although we find market expectations to be excessive in some cases.
- Sustained growth supports some optimism toward riskier assets such as high-yield corporate bonds, which we prefer to investment-grade issues.
- We see value in elevated levels of real yields, balanced by caution around ongoing market volatility.

Macro themes driving our views

August proved dramatic for global markets, as the month began with a sharp drawdown influenced by weak US jobs data and overextended sentiment. The pullback was then amplified by volatility control managers selling down equity positions and a rapid unwinding of the Japanese yen carry trade.

The moves validated fears we voiced in last month's *Allocation Views* about extreme concentration and narrow equity market leadership, as the drawdown became systemic, rippling out across international markets and sending intraday volatility to levels not seen since the COVID-19 pandemic in early 2020. However, by mid-month, most equity markets had fully recovered those losses, suggesting the volatility was mostly a function of extreme positioning, rather than economic fundamentals.

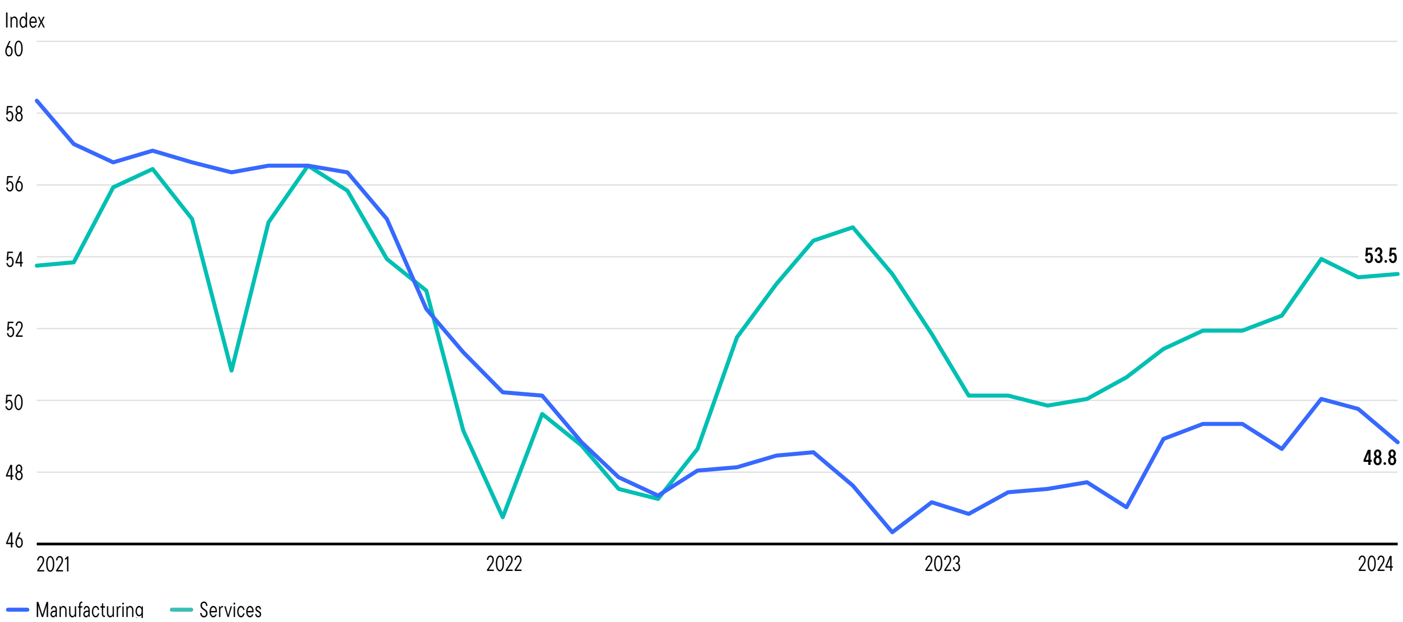
The reset could be characterized as a healthy correction, given many sentiment and positioning indicators moved back to more neutral levels, removing froth from markets and offering some short-term clarity. Analyzing the market without the white noise of investor exuberance shows us that the economic fundamentals of growth, inflation and monetary policy are all relatively supportive. However, other factors such as seasonality and the upcoming US election temper our enthusiasm and lead us to maintain a neutral allocation to risk assets.

Global growth trends continue to play a central role in our allocation decisions as we consider the implications for risk assets. In our analysis, **growth is slowing, but remains relatively constructive**, as weak manufacturing activity is balanced in most regions by a more robust services sector. Leading indicators of global growth have ticked up somewhat in the last month, while US corporate earnings breadth has also improved. In addition, we believe some well-publicized recession triggers, such as the Sahm Rule[1] on unemployment, are overstating weakness in the US economy.

Balancing Act: Robust Global Services Activity is Offsetting a Weaker Manufacturing Sector

Exhibit 1: Global Growth PMIs: Manufacturing vs. Services

As of August 2024



Sources: S&P Global, Macrobond. PMIs = Purchasing Managers Indexes. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms are available at www.franklintempletondatasources.com.

Inflation continues to trend downwards in most developed markets, aided by softer labor conditions and an outsized disinflationary impulse from certain inputs such as used car prices and airline fares. Wage pressures have also eased in the United States and Europe in recent months, illustrated by a material weakening of negotiated pay rises for eurozone workers in the second quarter, following five quarters of increases above 4%. However, we have previously emphasized how hard it can be to get inflation back to target levels, and that sentiment hasn't changed. While core inflation is declining in most regions, some leading indicators, such as global supply-chain measures, have stabilized in the last month, suggesting the path to normalization may not be smooth. With these considerations in mind, we retain our cautious outlook as **inflation risks appear more balanced.**

The improving outlook for inflation, alongside weakening jobs data, has encouraged several major central banks to begin cutting interest rates. Indeed, the Bank of Canada lowered rates for a second time in August, while the European Central Bank (ECB) and Bank of England have also reduced borrowing costs. The recent market volatility has firmed up expectations that the US Federal Reserve (Fed) will cut imminently, fueling perceptions that the United States is lagging other developed economies on policy normalization. We find those expectations to be somewhat excessive, as markets are pricing in more than 200 basis points of cuts during the next 12 months. However, it does illustrate how **divergent these policy cycles** are likely to be, as the frequency and depth of cuts differ between central banks, dependent on available disinflation data. That is before we acknowledge that interest rates in Japan may rise further, despite the recent strength of the yen and its impact on exporters.

A Dovish Fed? Rate-Cutting Expectations Appear Excessive

Exhibit 2: Market-Implied Change in Policy Rate Over the Next Year

As of August 2024

Sources: Bloomberg, Macrobond. There is no assurance that any estimate, forecast or projection will be realized. Important data provider notices and terms available at www.franklintempletondatasources.com.

Portfolio positioning themes

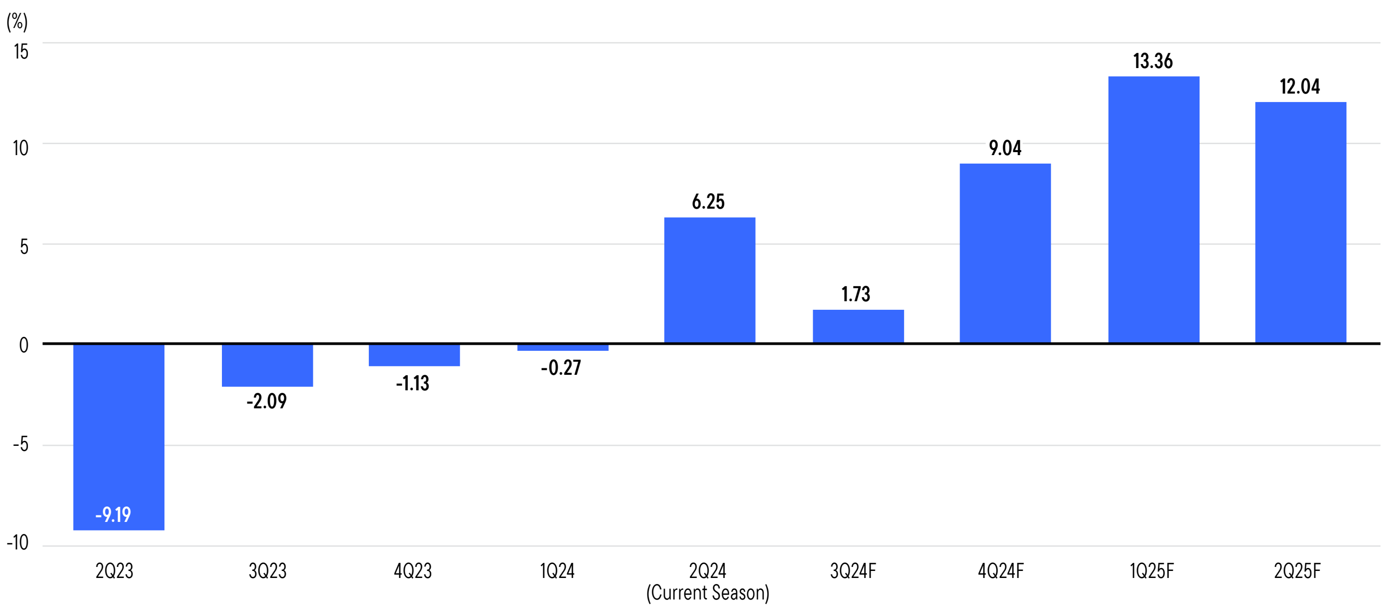
A constructive macro environment and the moderation of previously overextended sentiment and positioning supports our broadly optimistic view of equities. Added to this, the potential for further monetary policy easing, particularly from the Fed, should offset slowing growth. However, we feel equity risk premiums remain low, especially given the uncertain environment. September is traditionally the weakest month of the year for equities, while the unpredictability of the upcoming US election will add to instability and fuel ongoing volatility in markets. As a result, we believe **risks remain balanced across assets.**

While risks remain, the **equity landscape is changing** and offering up new opportunities to investors. Large-cap technology stocks have led the market rally during the last year, but a recent rotation into more cyclical sectors has improved market breadth and bolstered corporate earnings. The S&P 500 Index has gained 9.3% (year-on-year), up from 7.8% three months ago and -4.5% 12 months ago. In comparison, when we exclude "Magnificent Seven"[2] stocks, the S&P 500 Index has risen 6.1% (year-on-year), compared to 0% just three months ago and -9.1% a year ago.

Earnings Growth is No Longer Reserved for the Magnificent Seven

Exhibit 3: S&P 500 ex Mag Seven EPS Growth

As of August 29, 2024



Source: Bloomberg. F = Forecast, EPS = Earnings per share. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator of future results.** There is no assurance that any estimate, forecast or projection will be realized.

US stocks look healthier, but we hold a slightly diminished conviction toward European markets amid persistent economic weakness. Purchasing Managers' Index data released by S&P Global in August shows that the eurozone's manufacturing sector started the third quarter of 2024 with a steep reduction in new orders, impacting output and employment.

Elsewhere, we are no longer cautious on UK equities amid an improving economic backdrop, although weak macro and corporate fundamentals moderate our enthusiasm for Canada and the Pacific ex-Japan region. We continue to prefer emerging markets (ex China), particularly the Asia region, which should benefit from strengthening semiconductor demand and a buoyant Indian economy. In contrast, headwinds in China seem likely to persist despite recent policy announcements.

Rate-cutting cycles have been accompanied by a broad drop in global bond yields, influencing our decision to further reduce the duration of our fixed income allocation amid diminished return potential. We still appreciate the defensive characteristics of developed market government bonds, but we have trimmed our overweight positions in Europe, the United Kingdom and Canada. Elsewhere, we are adding back to the front end of the US Treasury curve, in anticipation of imminent interest-rate cuts from the Fed. In contrast, we have moved closer to a neutral position on Japanese sovereign issues, improving our outlook even as the Bank of Japan (BoJ) normalizes monetary policy in the face of rising inflation expectations.

As yields on sovereign bonds become less attractive, we retain optimism towards high-yield credit, encouraged by sustained growth and improved earnings breadth. Given healthy fundamentals and sustainable corporate leverage, we are attracted by the opportunity to lock in higher real yields as inflation subsides. We are less enthusiastic on investment-grade credit, given lower all-in yields resulting from the recent rates rally.

Allocation settings views—September 2024

Pendulum settings reflect cross-asset-class views

Risk tier

Asset class | **Conviction** | **Our viewpoint**

Risk off/on

- Global growth remains relatively constructive in the developed world as leading indicators suggest continued expansion.
- We maintain a neutral stance toward riskier assets.
- Risks are focused on elevated valuations in equities, seasonality and election uncertainty.

High level allocation tier

Equities

- Improving earnings expectations support the outlook for global equities despite localized margin pressures.
- Longer-term equity fundamentals favor regions with proven earnings power and continued corporate resilience.
- We retain a neutral view of global equities on elevated tech earnings expectations and positioning, which remain somewhat stretched.

Bonds

- Yields are less attractive, in our assessment, and may already largely discount likely policy easing.
- Corporate bond spreads remain low but offer adequate compensation for default risk given the macro backdrop.
- We hold a neutral view of bonds overall relative to stocks but have moderated our long-duration preference, taking overall portfolio effective duration to roughly neutral.

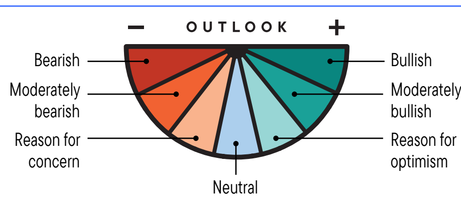
Alternatives

- We see structural attractions in naturally diversifying alternatives, such as private assets.
- Continuing changes to usage and demand present headwinds to real estate.
- We have maintained a neutral view overall, consistent with our longer-term structural allocation.

Cash

- Defensive features of cash are complemented by attractive yields for short-term US Treasury bills.
- Peak policy rates are still available and no longer present a drag on portfolio yield.
- Cash has appeal as a means of diversification, but we maintain a neutral view at this time.

Understanding the pendulum graphic



Arrows represent any change since the last month end.

Allocation tier

Asset class	Conviction	Our viewpoint

Equity regions: Pendulum settings relative to equity asset class broadly

United States

- Strong current economic activity and robust corporate fundamentals support the outlook for US equities.
- We retain a more constructive view on the prospects for ongoing earnings growth over the next year, particularly given greater breadth driven by a cyclical rotation.
- However, our tilt toward this market is minimal relative to other regions, reflecting elevated stock market valuations and extreme earnings expectation for artificial intelligence companies.

Canada

- Growth in Canada faces headwinds from past central bank rate hikes, though cuts have now begun.
- Banking stocks remain under pressure, even with what we consider to be attractive valuations.
- We retain a moderately cautious stance on this market despite global cyclical improvement, amid weak corporate fundamentals.

Europe ex United Kingdom

- Easier monetary policy from the ECB and Swiss National Bank, and stabilizing business confidence, support the economy.
- However, we hold diminished confidence in corporate earnings troughing, as the lagged effect of wage increases pass through to profit margins. Purchasing managers' index data also suggest weakness in the region's manufacturing sector.
- As a result, we retain a neutral outlook toward these markets.

United Kingdom

- UK economic prospects remain uncertain despite a pickup in business investment and an improving economic backdrop.
- A low weighting to technology and significant foreign currency earnings offset a generally high dividend yield.
- We retain our neutral view, reflecting what is typically a market with defensive sector composition.

Japan

- Overall, this region is vulnerable due to tensions in relations with China.
- A sticky decline for inflation in Australia and still-elevated interest rates may impact consumers.
- We retain our cautious stance on these markets, where valuations are less appealing.

Pacific ex Japan

- Overall, this region remains vulnerable due to tensions in relations with China.
- Persistent inflation in Australia and elevated interest rates may impact consumers.
- We hold a more cautious stance on these markets, following divergence relative to weak China equity markets.

Emerging ex China

- Stronger long-term growth opportunities are offsetting emerging markets' weaker current earnings.
- Developed-market demand should boost growth, which is not discounted in valuations, while the Asia region should benefit from strengthening semiconductor demand and a buoyant Indian economy.
- However, conviction in this view has diminished somewhat, and we have moderated the constructive view of emerging markets in recent months.

Allocation tier

Asset class	Conviction	Our viewpoint
China		• Property market risks are holding back China's economy, despite recent policy measures from the Third Plenum. • Trade disputes remain unresolved and are a symptom of broader tensions as geopolitical stresses persist. • We retain a neutral stance to reflect growth risks and lower earnings expectations, despite the valuation attractions of this market.

Fixed income sectors: Pendulum settings relative to fixed income asset class broadly

Asset class	Conviction	Our viewpoint
US Treasuries		• The Fed is likely to start cutting its policy rate later this year, but the market now fully anticipates these moves. • Once rate cuts start, we anticipate lower US Treasury yields in a year's time but hold greater conviction in other markets. • We have reduced duration sensitivity to US interest rates by adding back to the front end of the curve, funded from the long end, in anticipation of rate cuts.
Inflation-Linked Bonds		• The level of inflation discounted in inflation-linked securities fairly reflects anticipated longer-term inflation. • Tight monetary policy reduces the value of these assets' potential risk-mitigating role within a portfolio. • We have maintained a neutral view of assets that benefit from rising prices, such as inflation-linked bonds.
Eurozone Government Bonds		• The ECB has started to cut from peak rate levels, even with inflation currently above target. • Given still-weak demand growth in the European economy, the future path of rates is likely to head lower. • We have trimmed our overweight to bonds in this region, as yields have fallen, but maintain a constructive stance.
UK Government Bonds		• The UK economy is recovering, having been in recession last year, and inflation risks are moderating. • Bank of England policy will likely continue to restrict activity, even as rates are cut. • We believe the pace of cuts may be faster than anticipated, but we have trimmed our overweight to Gilts, amid falling yields.
Canada Government Bonds		• The Bank of Canada moved aggressively to address inflation and has now started to cut rates. • The economy is sensitive to changes in interest rates, which have skewed yields lower than those of its peers. • Lower yields have influenced the decision to moderate our constructive view this month, in line with other international bonds.

Allocation tier

<table>
<tr><th>Asset class</th><th>Conviction</th><th>Our viewpoint</th></tr>
<tr><td>Japan Government Bonds</td><td>
</td><td>

- The BoJ has moved away from negative interest rates but maintained its easy monetary policy stance.
- Reducing purchases of government bonds in the months ahead is a likely step toward policy normalization.
- Further monetary policy tightening is largely anticipated, despite a strong Japanese yen, so we have improved our outlook toward this market.

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<tr><td>Investment Grade</td><td>
</td><td>

- The investment-grade sector has benefited from earnings levels that make high debt loads more sustainable.
- At recent elevated yields, this market was more attractive to some investors, driving yield spreads lower.
- We retain a slightly cautious bias in higher-quality credit, preferring government bonds' defensive features.

</td></tr>
<tr><td>High Yield</td><td>
</td><td>

- Corporate earnings have supported the fundamental attractions of lower-rated fixed income, including loans.
- We continue to build a more confident stance toward high-yield bonds, despite narrow spreads.
- Reflecting likely cuts in cash rates, we eliminated a tilt toward loans, which have benefited from higher yields.

</td></tr>
<tr><td>Emerging Market Debt</td><td>
</td><td>

- Emerging market fundamentals are improving and should benefit from a benign global environment.
- We remain marginally constructive toward local-currency bonds as domestic monetary policy has further to ease.
- We remain neutral on emerging market bonds overall but are more cautious on China's local bonds.

</td></tr>
</table>

Allocation Views

At **Franklin Templeton Investment Solutions (FTIS)**, we translate a wide variety of investor goals into portfolios powered by Franklin Templeton's best thinking around the globe. We serve a variety of institutional clients, ranging from sovereign wealth funds to public and private pension plans in addition to retail multi-asset clients around the world.

The hallmark of our approach is a central forum—the Investment Strategy and Research Committee (ISRC)—which generates a top-down view across asset classes and regions. Furthermore, it connects and synthesizes the bottom-up sector and regional insights of the global investment teams at Franklin Templeton. The ISRC also calibrates firmwide views with original analysis from our dedicated teams, which include both fundamental and quantitative research professionals.

FTIS actively engages with clients in an ongoing, collaborative partnership, to understand each client's particular needs and then to draw from our extensive global resources and capabilities to meet those goals. These portfolios are built, managed and monitored in the framework established by the ISRC, and undergo rigorous tests under multiple scenarios and market regimes.

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Endnotes

1. The Sahm Rule identifies signals related to the start of a recession when the three-month moving average of the national unemployment rate (U3) rises by 0.50 percentage points or more relative to its low during the previous 12 months.
2. Alphabet (parent company of Google), Amazon, Apple, Meta (formerly Facebook), Microsoft, Nvidia and Tesla were dubbed the Magnificent Seven for their strong performance and resulting increased index concentration in recent years.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal.

Equity securities are subject to price fluctuation and possible loss of principal.

Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. **Low-rated, high-yield bonds** are subject to greater price volatility, illiquidity and possibility of default.

The allocation of assets among different strategies, asset classes and investments may not prove beneficial or produce the desired results. To the extent a strategy invests in companies in **a specific country or region**, it may experience greater volatility than a strategy that is more broadly diversified geographically.

Commodity-related investments are subject to additional risks such as commodity index volatility, investor speculation, interest rates, weather, tax and regulatory developments.

International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. The government's participation in the economy is still high and, therefore, **investments in China** will be subject to larger regulatory risk levels compared to many other countries.

Investing in privately held companies presents certain challenges and involves incremental risks as opposed to investments in public companies, such as dealing with the lack of available information about these companies as well as their general lack of liquidity.

Active management does not ensure gains or protect against market declines. Diversification does not guarantee a profit or protect against a loss.

Notes

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