FRANKLIN TEMPLETON

October 2024

Franklin Templeton Investment Solutions

Allocation Views

Holding safe harbor

Summary

Interest-rate cuts from the US Federal Reserve (Fed) are typically supportive for risk assets in an environment of constructive macro fundamentals. However, elevated equity valuations and uncertainty around near-term forecasts curtail our optimism somewhat. As a result, we retain our neutral allocation stance into October, as we wait for more compelling opportunities to add risk.

Deteriorating corporate earnings growth expectations lead us to reduce US equity holdings, adding back to economies with brighter growth prospects, while weak economic growth impacts our view on Japan. Elsewhere, stimulus bolsters our position on China, while lower yields diminish the return potential from US Treasuries, in our view, influencing a preference for other developed market government bonds.

Macro themes driving our views

Growth remains relatively constructive

- Leading economic indicators suggest positive, albeit slowing, global growth.
- Global growth reflects strength in the services sector, but manufacturing remains sluggish.
- 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.

Divergent policy outcomes

- Western central banks have started cutting rates.
- Globally, we expect policy easing to influence a greater divergence of outcomes.
- Inflation progress allows policymakers leeway to implement easier monetary policy, offering greater potential downside protection for markets.

Portfolio positioning themes

Balance of risks across assets

- A constructive macro environment is typically associated with strong markets.
- Extended sentiment has moderated, but equity risk premiums remain low, particularly given seasonal uncertainty.
- Policy changes may help to offset growth and inflation surprises and moderate recession risks.

A changing equity landscape

- Weaker earnings growth momentum in the United States influences a reallocation across developed market equities.
- Recent stimulus measures inform our neutral view on China, while emerging markets (EMs) ex-China remain a preferred cyclical region.
- UK equities offer a defensive complement to cyclical EM exposure, while we downgrade Japan amid weak macro conditions.

Less attractive yields for bonds

- Lower yields diminish the return potential from global fixed income, supporting our neutral duration preference in government bonds.
- Market expectations around the depth and duration of some policy easing cycles are excessive, in our view.
- Relatively healthy financial conditions support optimism toward high-yield corporate bonds, which we prefer over investment-grade issues.

Macro themes driving our views

September will be remembered as the month in which the US Federal Reserve (Fed) finally decided to cut interest rates.

It was March 2022 when the Fed began its policy tightening cycle, in response to pandemic-related inflationary pressures. Two-and-a-half years later, the central bank has concluded that its battle against inflation has made sufficient progress, lowering the federal funds rate by 50 basis points from its highest level since 2001. The markets had already priced in the move, but it does appear to be supporting equities amid an environment of broadly constructive macro fundamentals.

Separately from Fed intervention, the macro environment has improved somewhat during the last month, as leading indicators of growth remain supportive, even as global growth slows toward trend. Major economies have also made significant progress on disinflation, to the extent that most other large central banks have already begun to ease monetary policy to support economic growth.

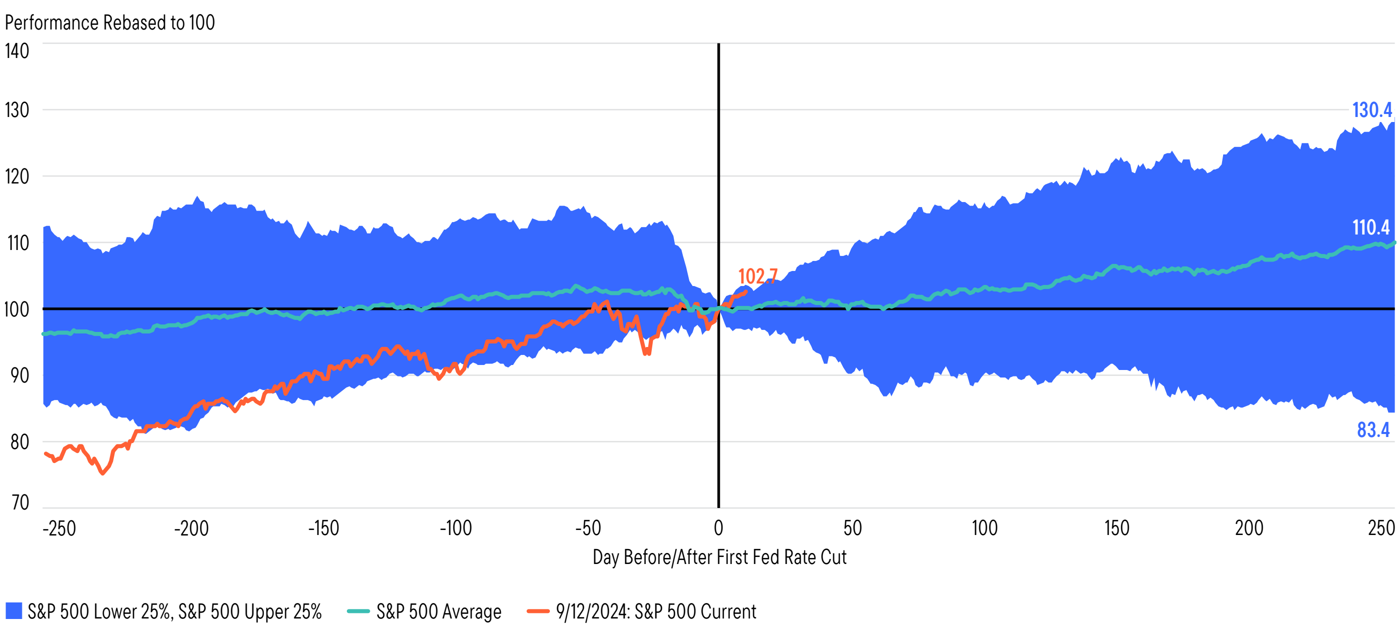
Additionally, policy support should allay concerns around labor-market weakness and cyclicality, notably in the manufacturing sector, which continues to lag services. Global purchasing managers' index (PMI) data indicate that the services sector continues to expand, whereas manufacturing PMIs have been contracting for the past two months. Similarly, although US nonfarm payrolls rose modestly in August by 142,000, the headline figure concealed divergent fortunes for individual sectors. Employment in the manufacturing sector fell by 24,000, while the number of leisure and hospitality positions rose by 46,000.

Against this background, we hold a broadly optimistic view of risk assets, despite elevated equity valuations, as we draw support from the Fed's dovish pivot. Our analysis suggests that US equities have rallied by an average of 18.9% across a 12-month period on the five recent occasions that the Fed has eased into a non-recessionary environment. Clearly, these are very strong returns, but a few considerations quell our optimism. First, US equity markets have already rallied 36% over the past year. Second, the average returns we have seen previously (18.9%) mask a low sample size and a large degree of variability. Third, while we believe the United States will avoid an imminent recession, we maintain humility in our market and macro forecasts, especially given the likelihood of increased volatility as we draw closer to the presidential election in early November.

Macro Conditions Impact the Effect of Policy Easing on Equities

Exhibit 1: Range of US Equity Returns Following Historic Interest-Rate Cuts

Analysis Period: 1971–Current



Sources: Fed, S&P Global, US Treasury, Macrobond. As of September 2024. 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 or a guarantee of future results.** Important data provider notices and terms are available at www.franklintempletondatasources.com.

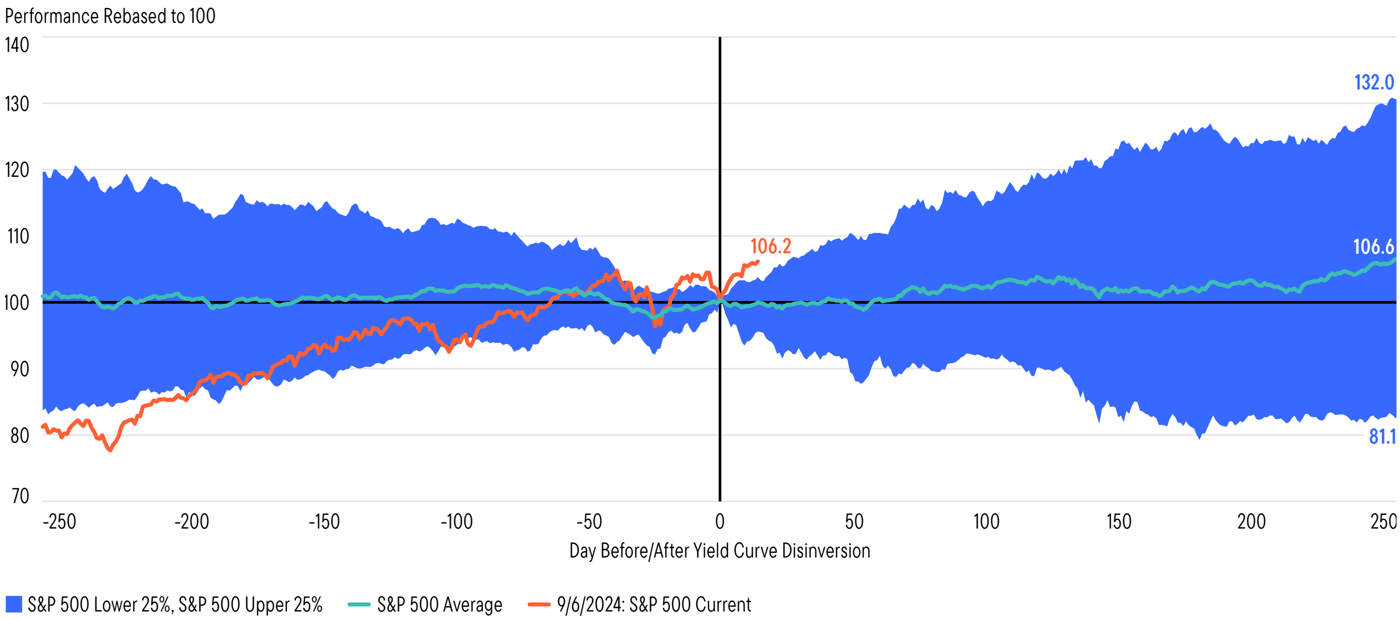
September was also the month that the US Treasury yield curve (2yr-10yr) decisively disinverted, affected by elevated expectations around future interest cuts. This signal has historically been viewed as bearish for risk assets, given its tendency to foreshadow recession, but we find no clear causal link to economic weakness. This finding is reinforced by the fact that a positive inflation backdrop is one of the key reasons the Fed has begun cutting interest rates. Past periods of disinversion have resulted in a wide dispersion of outcomes, like our analysis on rate cuts, and we do not view it as a negative catalyst for markets in this instance, despite other market participants suggesting so.

As a result of this analysis, we are retaining our neutral allocation to risk assets this month, particularly given the strong recent performance of global equities, which leads us to believe the potential for further upside is limited in the near term. We instead opt to hold our portfolios in what we consider "safe harbor" as we wait for compelling opportunities to add risk.

Disinversion is Not Always a Negative Catalyst for Markets

Exhibit 2: Range of US Equity Returns Following Historic US Treasury Yield Curve Disinversion

Analysis Period: 1966–Current



Sources: Fed, S&P Global, US Treasury, Macrobond. As of September 2024. Indexes are unmanaged and one cannot invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms are available at www.franklintempletondatasources.com.

Portfolio positioning themes

Having articulated our positive view on the macro environment, we caveat that with a reminder that risks are balanced across assets. Equity risk premiums remain low in the current uncertain environment, while US recession risks persist, despite a favorable mix of policy and macro trends.

The diversified approach we are taking to regional allocations amid a changing equity landscape is evidence of our caution. We are reducing our optimism toward US equities, moving to a neutral position amid weaker corporate earnings growth expectations. The gentle slowdown in US economic growth suggests to us that growth in corporate earnings will also decelerate, reverting to more trend-like levels.

We have also moderated our positive outlook on EM equities, despite positive corporate fundamentals in the region. This is largely due to a more uncertain macro environment where leading indicators for both manufacturing and growth are weakening. For example, semiconductor sales have been strong recently, bolstering economies such as Taiwan and South Korea, but leading indicators around future sales growth in this sector have begun to plateau. Elsewhere, we downgrade our view on Japanese equities, as the country is dealing with weak growth alongside inflationary pressures that may result in tighter monetary policy and a stronger yen, in our view.

Reducing our allocation to equities in these regions, particularly the United States, has allowed us to increase exposure to certain developed economies that we believe have brighter growth prospects, notably the United Kingdom and Canada. We are upgrading our view on UK equities this month, moving to an optimistic outlook as the economy shows signs of recovery. Leading indicators of sentiment and growth are positive in the United Kingdom, while inflation is falling. The country also offers a defensive element to our equity portfolio, given its largest sectors are utilities, consumer staples, health care and real estate. This sector array complements our preference for EM equities, which are broadly cyclical in nature.

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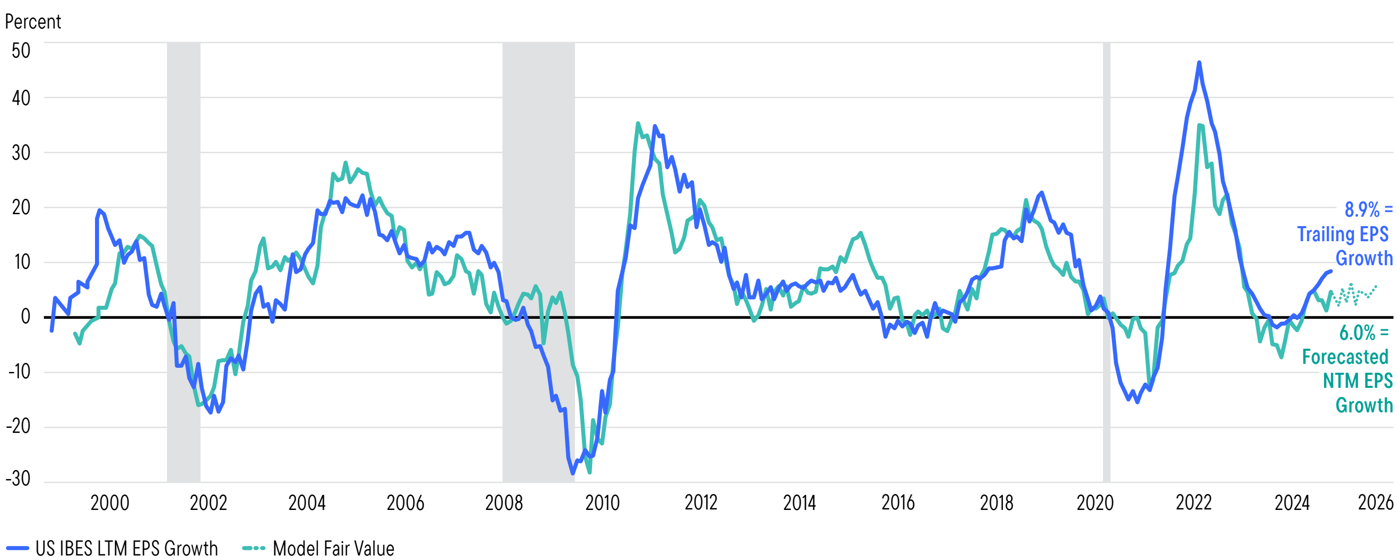
US Corporate Earnings Growth is Expected to Slow

Exhibit 3: Trailing US Earnings Growth (EPS) vs. Fair Value

As of September 27, 2024



Sources: ISM, TCB, US Treasury, Fed, BLS, Chicago Fed, Kansas City Fed, Macrobond, Franklin Templeton Investment Solutions. F=Forecast. As of September 27, 2024. **Past performance is not an indicator or a guarantee of future results.** There is no assurance that any estimate, forecast or projection will be realized. Important data provider notices and terms are available at www.franklintempletondatasources.com.

We view credit valuations as rich amid tight spreads, but financial conditions in credit markets have improved, with lower leverage (debt to enterprise value), subdued volatility and better market access and liquidity.

We also see a positive macro environment in Canada, driven by a sharp fall in inflation that has allowed the Bank of Canada to rapidly ease monetary policy and offer support to an interest-rate-sensitive economy. This aggressively dovish approach contrasts with the policies of other major central banks but has had a positive impact on business confidence. Despite this, we remain neutral toward Canadian equities, as consumer spending continues to be restrained by high mortgage rates.

We have decided to retain a neutral view on China, despite weakening domestic consumer demand and a precarious property sector. The market-friendly range of fiscal and monetary stimulus measures unveiled by the Politburo and the People's Bank of China in late September should stabilize Chinese equities, in our view. The lowering of all key policy interest rates, alongside stimulus measures specifically targeting the housing sector and stock market liquidity, are particularly welcome. However, policymakers will need to demonstrate more ambition to persuade us to become optimistic on this market.

Elsewhere, we feel that lower yields have diminished the return potential from global fixed income, supporting our neutral duration preference in government bonds. US Treasury valuations seem too high when set against a background of excessive market expectations for further rate cuts from the Fed. We wouldn't expect US Treasury prices to move significantly higher, unless the labor market collapsed, which is unlikely in our view. Instead, we hold a preference for eurozone, UK and Canadian government bonds, which we believe are better value at present.

We view credit valuations as rich amid tight spreads, but financial conditions in credit markets have improved, with lower leverage (debt to enterprise value), subdued volatility and better market access and liquidity.

We hold a preference for high-yield issues, as the excess return available over US Treasuries appears attractive and should offset any modest spread widening linked to macro uncertainty. We remain neutral on EM debt, but we prefer local-currency sovereign bonds, as the commencement of the Fed's easing cycle has increased the likelihood of lower interest rates in some major EM countries.

Allocation settings views—October 2024

Pendulum settings reflect cross-asset-class views

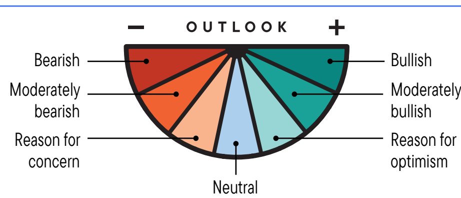
Risk tier

Asset class	Conviction	Our viewpoint
Risk off/on		• Global growth remains relatively constructive, supported by positive leading indicators. • We maintain a neutral stance toward riskier assets. • Risks are focused on market and macro-driven factors, including yield-curve dynamics, elevated valuations in equities 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 earning power and continued corporate resilience. • We retain a neutral view of global equities on elevated tech earnings expectations and positioning, which remains somewhat stretched.
Bonds		• Yields are less attractive, in our assessment, and may already discount policy easing. • Corporate bond spreads remain tight 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 in recent months, taking overall portfolio effective duration to roughly neutral.
Alternatives		• We see structural attractiveness 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. • Policy rates have declined from their peaks, but do not yet 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 are also optimistic about improved market breadth driven by a cyclical rotation.
- However, we have moderated our constructive view, reflecting slowing earnings growth expectations relative to other markets. Elevated stock market valuations and extreme earnings expectations for artificial intelligence companies also inform our more cautious approach.

Canada

- Falling inflation has allowed the Bank of Canada to implement multiple interest-rate cuts in support of economic growth.
- The improving macro environment has had a positive impact on business confidence, although consumer spending remains restrained by high mortgage rates.
- As a result, we have improved our outlook this month, adopting a neutral stance.

Europe ex United Kingdom

- Easier monetary policy from the ECB and Swiss National Bank is supporting the economy, as is stabilizing business confidence.
- 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

- Leading indicators of sentiment and manufacturing activity are positive in the United Kingdom, while inflation is falling.
- A low weighting to technology and significant foreign currency earnings offset a generally high dividend yield.
- In this context, we improve our view on this market, favoring its defensive sector composition as a complement to our cyclical exposure.

Japan

- Leading macro indicators suggest that growth is weakening in Japan.
- The country is also dealing with inflationary pressures that may result in tighter monetary policy and a stronger yen, negatively impacting exporters.
- Against this background, we downgrade our view on Japanese equities, favoring other countries in the region.

Pacific ex 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 but have trimmed our underweight position.

Emerging ex China

- Stronger long-term growth opportunities are offsetting emerging markets' weaker current earnings.
- The Asia region should benefit from strong semiconductor demand, but leading indicators around future sales growth in the sector have begun to plateau.
- As a result, our conviction in this position has diminished further, and we have moderated the constructive view of emerging markets into October.

Allocation tier

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

China

- Property market risks and weak domestic demand are holding back China's economy, despite a broad package of stimulus measures from the Politburo and the People's Bank of China.
- 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

US Treasuries

- The Fed has finally begun its rate-cutting cycle, but the market appears to be fully pricing in these changes.
- 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 tightening up our curve positioning.

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 in recent months, amid falling yields.

Canada Government Bonds

- The Bank of Canada moved aggressively to address inflation and has now implemented multiple interest-rate cuts.
- The economy is sensitive to changes in interest rates, which have skewed yields lower than those of peers.
- Lower yields have influenced the decision to moderate our constructive view recently, in line with other international bonds.

Allocation tier

Asset class	Conviction	Our viewpoint
Japan Government Bonds		• The Bank of Japan has moved away from negative interest rates but maintained its relatively 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 retain our neutral outlook.
Investment Grade		• 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.
High Yield and Loans		• Corporate earnings have supported the fundamental attractiveness of lower-rated fixed income, including loans. • We retain a confident stance toward high-yield bonds, despite narrow spreads, encouraged by improving financial conditions and low leverage. • Reflecting likely cuts in cash rates, we have recently eliminated a tilt toward loans, which benefited from higher yields.
Emerging Market Debt		• Emerging market corporate fundamentals have been 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.

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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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.

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