



FRANKLIN TEMPLETON
INVESTMENTS

WILL THE ROAR OF MARKET TENSIONS TAME GLOBAL GROWTH?

GLOBAL INVESTMENT OUTLOOK
Q2 2018 VIEWS



The first quarter of 2018 started like a lamb but went out like a lion as long-dormant volatility began to roar. Inflation fears, trade tensions and geopolitical risks contributed to market turbulence, leaving many investors wondering whether these issues will put a damper on global growth—and end the US market’s nine-year bull run. Franklin Templeton’s senior investment leaders weigh in.

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US, China and Beyond: The Impact of Trade on Global Growth



There are a lot of concerns right now about economic activity globally. Do you see threats to the outlook?

ED PERKS:

Despite some recent challenges, gross domestic product (GDP) growth globally is still accelerating in a coordinated fashion. While the fundamental backdrop looks good to us overall, recent trade tensions, which are part of a protectionist trend, represent one of the bigger risks or concerns we see. I think it's important to acknowledge that fears of protectionism are not new and have been with us in many parts of the world during the current economic expansion.

Many of the risks we see today are not yet having a material impact on business or consumer confidence, or on economic activity. Expanded tariffs could impact economic activity going forward, but for now, the global economy remains in a period of robust growth.

Rising revenues and corporate profits are an important driver of economic growth. The elevated level of confidence that we've seen in the outlook for corporates has been driving a lot of business investment, which in turn has played an important part in the acceleration in US and European economic growth. Europe is certainly at a different stage of its economic expansion, with about a two to three year lag of certain other developed economies, such as the United States. We think European Commission President Jean-Claude Juncker's plan in Europe represents a real opportunity to drive some additional growth across the continent.

In our view, the trade situation would have to deteriorate pretty meaningfully before trade becomes a real economic drag. There are also some other issues impacting trade besides the risk of tariffs—for example the impact of a stronger yen on exporters.

CHRIS MOLUMPY:

Generally, we would agree that underlying global economic fundamentals appear reasonably healthy and that has not changed dramatically from the beginning of the year. We are continuously monitoring the recent issues that have come up in regard to trade and geopolitical risks. With respect to trade, we would note that often the political rhetoric ends up being much more significant than the actual actions. We will have to see how this all plays out, but we remain positive regarding the outlook for global growth.

MICHAEL HASENSTAB:

Trade restrictions, if enacted, would likely add to existing inflation. US consumers benefited from cheaper goods for decades—trade restrictions would shift the current benefits that consumers enjoy in the form of cheaper goods to benefiting a narrow sector of manufacturers. At this stage, the risks of a full-scale retaliatory trade war appear contained, but an escalating trade conflict that affects global growth remains a risk. On the whole, we don't see trade coming to a standstill or the global economy toppling into a recession. We still have a positive outlook for US

growth and the global economy for 2018, but we're continuing to watch for potential economic disruptions.

STEPHEN DOVER:

For the most part, the global economy is experiencing coordinated growth in a way we haven't seen in a long time. We've seen companies experiencing both top-line and bottom-line growth across the globe. Emerging markets in general have seen strong economic growth—outpacing that of developed markets over the past year—and I think that's very positive and likely to continue going forward.

On the issue of trade, I think we're probably more in a trade dispute situation than a trade war right now. In our view, the underlying earnings growth we anticipate from the US tax cuts this year and going forward, along with falling interest rates in some countries, are likely to be bigger near-term influences than trade.

I think the global economy is at the maturing point of a huge shift that happened in the late 1980s and early '90s when the Soviet Union broke apart. In essence, millions of people became available to the free market. There were shifts in labor and resources that caused a great amount of deflation and a great amount of trade.

While some of those labor and resource shifts continue to occur, the growth in trade we saw over the 20–30 year period since

then is not likely to continue at the same pace, as many emerging-market economies that were built on trade and export-oriented models are shifting to more internal consumption-oriented models.

Trade is based on each country working at its competitive advantage. The competitive advantage of the West, I think, is intellectual property. There probably are some legitimate disputes about the protection of intellectual property rights, which I think is probably at the core of what this recent US-China trade dispute is about.

MANRAJ SEKHON:

In our view, a trade war is in no one's interests. It would be damaging to the United States, it would be damaging to

China, and it would be damaging to many other markets. While there has been a lot of political posturing, we don't expect to see an all-out trade war. Stepping back a bit, it is an interesting time right now in terms of the leadership of the United States and China. With Chinese President Xi Jinping able to retain power for another decade, investors will be watching how China continues to pursue its policy agenda and exert its influence around the world.

In terms of growth, as Stephen noted, emerging markets have been outpacing developed markets, and we see many reasons why that should continue to be the case. There are many drivers of growth in emerging markets. There are domestic drivers, there are global drivers, and there

are technological drivers. There has been a mass penetration of new products and services, including financial services, telecommunications and health care. In the past, emerging-market growth cycles were closely tied to that of developed markets, but I think we are seeing more decoupling there.

When you think about which economies are likely to be the largest in the world in the next 10, 15 or 20 years, we think emerging markets are likely to be at or near the top of the list. That would likely include countries like China, India, Indonesia, Brazil and others.

Inflation: Is It a Real Threat?



Given what appears to be a pretty positive outlook for US and global growth, what will that mean for inflation?

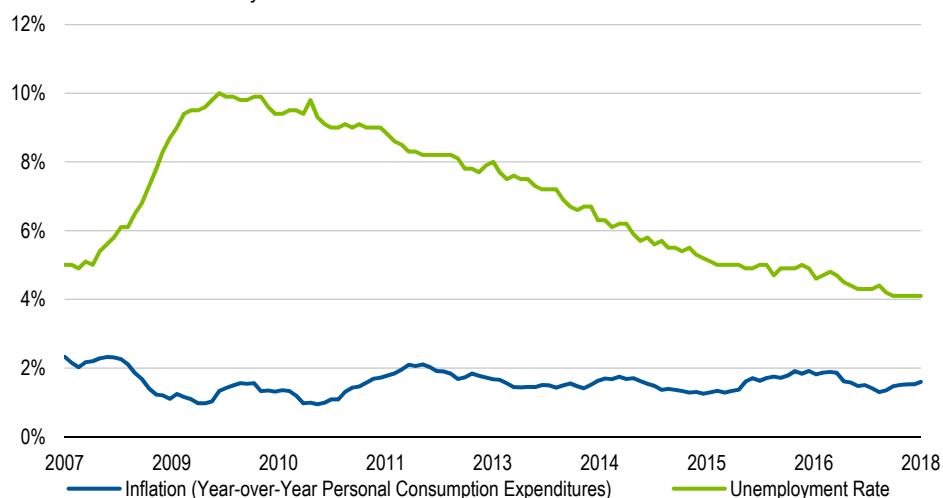
CHRIS MOLUMPBY:

We are starting to see signs of inflation in a number of markets, but that is not unexpected. The United States is in the ninth year of its current economic growth cycle, and with the unemployment rate at 4.1% (as of February 2018), one would certainly expect some increase in inflation at this point in the cycle. Many observers are questioning why we haven't seen even stronger inflation to date. Our view is that inflation likely will continue to tick up, but the increase is likely to be very gradual. The primary forces that have kept inflation muted—primarily globalization and technological innovation—are still in place and should likely continue to have a restraining influence.

Inflation Has Been Muted Despite a Strong Labor Market

US Personal Consumption Expenditures and US Unemployment Rate

December 2007–February 2018



Source: Bloomberg, as of 2/28/18.

The US Federal Reserve (Fed) seems to agree with that view, as its inflation projection (based on personal consumption expenditures) is expected to slowly move up to 2.0% in 2019. The Fed doesn't expect inflation to move up much more than that over the next several years. That's just one view, but it is an important view in the marketplace and one we generally agree with. In Europe and Japan, inflation is even more contained.

The Fed takes the lead on setting short-term interest rates in the United States, and it embarked on a gradual normalization policy some time ago. The Fed raised its benchmark interest rate in March, its sixth rate hike since December 2015. The Fed forecasts two more quarter-point increases for this year and likely three quarter-point increases in 2019, moving the Fed funds rate up to close to 3% in 2019. Our view is that this gradual policy normalization is probably healthy. It's important to realize while short rates are moving up, they're still quite low on a nominal basis. The Fed has conveyed that roughly 3% would likely be its "end game" in terms of rate hikes, which we think is a reasonable level. With respect to longer-term interest rates, that's more of a function of inflation—although impacted to some degree by short rates.

On the margin, rising US rates could be a bit of a headwind to economic growth. But the market is factoring this in and to the extent it is gradual, we think it will only be a minor gust and shouldn't be a significant detriment to global growth.

ED PERKS:

I would add that from the Multi-Asset Solutions perspective, this topic of inflation is the million-dollar question our team has been pondering and has dominated a lot of our analysis. Focusing on the United States, we are not seeing inflation as a meaningful factor.

The expectations for corporate earnings growth were fairly high as we moved into the first-quarter reporting season. We would have expected a muting in expectations at this point of the cycle, but we've actually seen some of the expectations continue to rise. So the fundamental picture still looks positive. We would argue some of the recent market volatility we have seen tied to worries about inflation or interest rates represents a return to a more normal level of volatility after being extraordinarily low for a long time.

STEPHEN DOVER:

I think one point that may be missing or forgotten is the discussion the markets had on deflation not all that long ago, and the great fear about it that lasted a long time. If we look back over the last 10 years, that was what global central banks and many economists were concerned about. So monetary policymakers lowered interest rates. What was the result? To increase the price of risk assets. That phenomenon dramatically changed valuation metrics. I think what we're talking about with inflation today is actually a return to normalization—along with normalization in valuations and in volatility to the dynamics we saw perhaps prior to 2008.

MICHAEL HASENSTAB:

We're anticipating rising inflation in the United States. Wage pressures have picked up in specific pockets of the economy and we expect those pressures to accelerate, given the exceptional strength in the labor market. Policy constraints on immigration have also been pressuring wages higher in specific labor sectors. Financial deregulation also has the potential to accelerate credit activity, stimulate investment and accelerate the velocity of money, which would further drive inflation.

MANRAJ SEKHON:

Our view from an emerging-market perspective is that the developed markets' views on interest rates and inflation will ultimately have an effect on risk premia for emerging markets, and that is one of the risks on the horizon.

“Our view is that inflation likely will continue to tick up, but the increase is likely to be very gradual. The primary forces that have kept inflation muted—primarily globalization and technological innovation—are still in place and should likely continue to have a restraining influence.”

– Chris Molumphy

A Look at the Credit Cycle and the Investment Case



What is your outlook in terms of the US credit cycle?

CHRIS MOLUMPBY:

As credit investors, we certainly are very much aware of where we are in the cycle. We do need to be thinking about when the cycle ends and beyond. Having said that, we are not seeing the traditional early warning signs of credit problems or issues that might indicate a shift. So we think this particular credit cycle still has legs.

When you look at valuations, certainly at the beginning of the year, many risk assets were pretty richly valued. So some type of correction was certainly not unexpected

and in our view, not representative of warning signs of credit deterioration.

ED PERKS:

I would note that as we have seen volatility pickup this year in equities, credit actually has performed pretty well. Certainly the length of the economic cycle factors into our decision-making, but we focus on relative value across asset classes broadly.

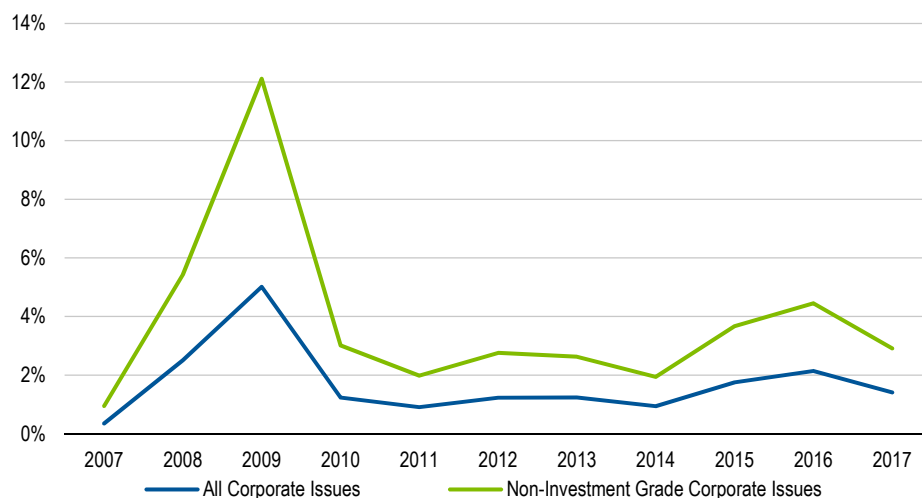
As US Treasuries start to have some real yield again, it starts to change the dynamic for investors, particularly considering other

asset classes with a more normal level of volatility. One thing we haven't seen amid the recent market volatility is a true "risk-off" mode where Treasuries become a safe haven for investors. In fact, on days this year where equities have made some of their bigger declines, fixed income markets have also faced some pressure. But I think that dynamic likely will change, and our team is becoming a little more interested in fixed income than we had been previously. We still will likely focus a bit more on the shorter end of the yield curve, but we are a bit more biased toward credit currently because we continue to think the fundamental backdrop remains very supportive.

Corporate Default Rate Remains Well below Pre-Financial Crisis Level

Default Rate of All Corporate and Non-Investment Grade Corporate Issues

2007–2017



Source: Moody's, Moody's Annual Default Report, as of 12/31/17.

STEPHEN DOVER:

For equity markets, I think the credit cycle is probably a bit of a canary in a coal mine. While our team has not seen it as a concern at this point, I think we certainly have to be on alert as we go through a paradigm shift from worrying about deflation to a more normal type of inflationary environment. There are certainly some over-levered players out there and there will likely be some issues that crop up, which will be a sign to us the cycle may be shifting.

The Hunt for Income and Yield

Q: There has been a search for yield across the globe and across asset classes. How are you thinking about it from a portfolio perspective?

CHRIS MOLUMPHY:

One trend that we have seen is foreign interest in the US municipal bond market, which has traditionally been a domestic market driven by the potential tax advantages to primarily individual investors. But a few years ago, we started to see significant demand for the asset class from non-US buyers. I think it really embodies this tremendous search for yield on a global basis that has persisted for a while and likely will continue to persist. Intermediate US Treasury yields of 2.75% or 3% are pretty low to US investors, but in Europe or Japan, intermediate government yields remain close to zero. And all of a sudden, the US market doesn't look all that bad. And as investors look at muni bonds, they generally see very high quality offerings with solid fundamentals and attractive yields. While munis are not backed by the federal government, they are backed by state and local governments, which appeals to many investors.

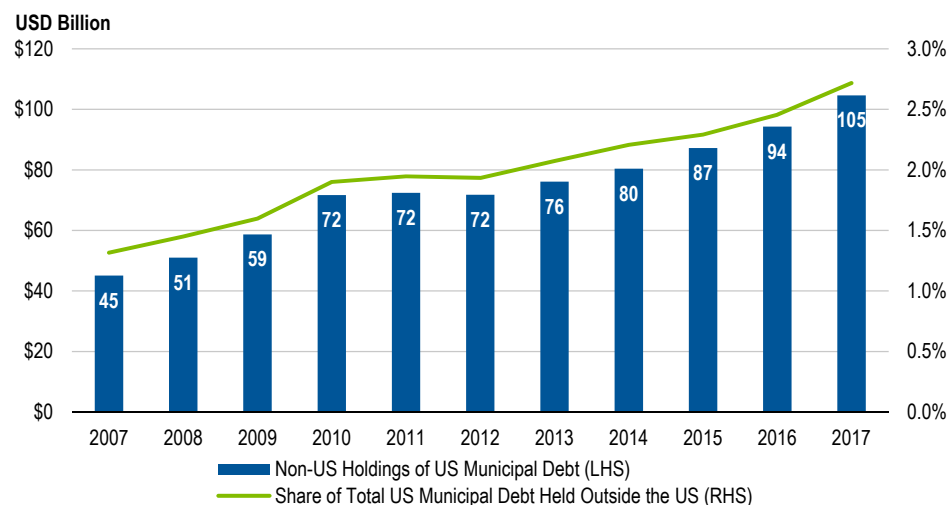
ED PERKS:

Finding yield and income certainly has been a challenge for many investors. In the last six months, as we have seen a more pronounced rise in longer-term interest rates, equities that are thought of as bond-proxy type segments of the market, such as utilities and real-estate investment trusts, have underperformed the broader equity market.

Non-US Investors Have Turned to the US Municipal Market...

Non-US Holdings of US Municipal Debt (Billions) and Share of Total US Municipal Debt Held Outside the US (%)

2007–2017

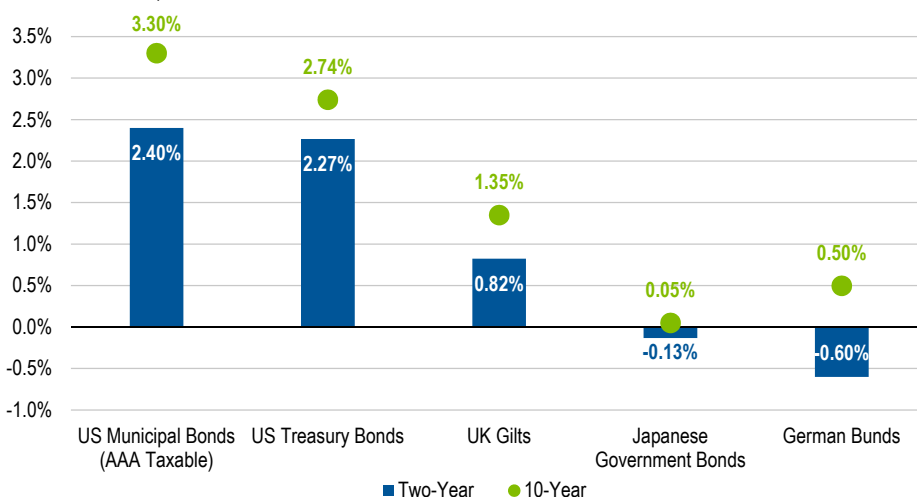


Source: US Federal Reserve, as of 12/31/17.

...In Search of Higher Yields

Yields of Select US Municipal and Global Government Bonds

As of March 31, 2018



Source: Thomson Reuters for AAA taxable municipal bond yields; Bloomberg for government bond yields.

A Buying Opportunity for Value Stocks?

Price Levels of MSCI All Country World Growth Index vs. MSCI All Country World Value Index

December 1998–March 2018



Source: FactSet, as of 3/31/18. Values above 1 represent outperformance of growth stocks; values under 1 represent outperformance of value stocks. Indexes are unmanaged and one cannot invest directly in an index.

We have also seen a preference toward growth and momentum stocks. If you look at the traditional tradeoff between value and growth, value generally tends to be a bit more income- and yield- oriented than growth. On the equity side, our team is venturing out a bit more into those pockets of underperformance and looking for some opportunities for income.

We think about portfolio construction along a number of different lines—not just diversification from an asset-class, geography or sector standpoint, but also

the type of factor exposures in a portfolio. Some of the factors driving performance seem to be shifting, so I think really understanding where your risk exposures are is critical in constructing a multi-asset portfolio.

MICHAEL HASENSTAB:

We've been preferring higher yields available in specific emerging markets over the lower yields across much of the developed markets. Emerging markets with low rate environments, or large structural imbalances and economic soft spots could

be vulnerable to rate hikes in the United States. But countries with healthier balances and relatively higher yields should be in a stronger position to absorb rate shifts of 100 basis points or more. Brazil has around a 9.7% yield on its local-currency 10-year bonds, Mexico around 7.3% and Indonesia around 6.6%. Countries with this type of yield advantage over US Treasuries should fare better than the lower-yielding markets as the Fed tightens policy.

Coping with Volatility

Q: How should investors think about market volatility, and, what do you expect from the rest of this year?

ED PERKS:

I think investors probably should expect a bit more of the same for the rest of the year and I would encourage investors to think about the situation from a historical perspective, not just the past 12–18 months. One of the real negatives of having a lengthy period of tremendously low volatility is that it created some market distortions and caused many investors to have extraordinarily short-term investment horizons.

STEPHEN DOVER:

Ultimately, equities represent a discounted earning stream, and we are focused on companies that have good quality earning streams. As we move into an environment where the growth rates of companies are more differentiated, I think the opportunities for stockpickers increase. In terms of the political environment, I think there will likely be a lot of volatility in the United States and other countries ahead, particularly those facing elections this year. I think most investors should not focus too much on that sort of noise and instead focus on underlying market fundamentals, which remain healthy.

CHRIS MOLUMPHY:

I would generally concur that the pundits often talk about the day-to-day, week-to-week headlines, political, geopolitical or otherwise. But as long-term investors, we have to cut through that and focus on the longer-term fundamentals that ultimately drive markets.

We are clearly in a different environment today than we were at the beginning of this year, so we think diversification is important, whether it's across fixed income or across different asset classes.

MANRAJ SEKHON:

Volatility is a given in emerging markets because of the changing nature of investors' risk appetite. Investors should recognize the drivers of emerging-market growth have changed, and there has been a lot of change taking place in many of these economies. When you look at prior crisis periods, what had resulted was a desire for reform. So we saw emerging markets embark on reforms on many levels. Debt at all levels—consumer, corporate and sovereign—was reined in. Debt levels in many emerging markets are more attractive than in developed markets, in our view, and they have built up more robust levels of foreign reserves. Emerging-market economies have also embarked on fiscal and regulatory reform. I think investors have started to recognize this improvement and are recognizing the sustainability of growth. Of course, that doesn't mean we won't still see market volatility. We see volatility as an opportunity to pick up shares of companies we think can weather the storms, at more attractive valuations.

“ I think there will likely be a lot of volatility in the United States and other countries ahead, particularly those facing elections this year. I think most investors should not focus too much on that sort of noise and instead focus on underlying market fundamentals, which remain healthy. ”

– Stephen Dover

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