Taking solace from the longer outlook

FRANKLIN TEMPLETON THINKS™ | ALLOCATION VIEWS

DECEMBER 2018

Is growth divergence a concern?
How big a risk is inflation?

Tempered by shorter-term considerations

Allocation settings

FRANKLIN TEMPLETON INVESTMENTS

In this Issue

Every year, when we publish longer-term capital market expectations, it is always interesting to reflect on how our views evolve over different time horizons. Today, with increased market volatility, divergent economic performance and looming trade wars, can we take solace in a constructive longer-term outlook?

Our Capital Market Expectations (CME) are designed to provide annualized return expectations over a seven-year horizon, which approximates the average length of a US business cycle.[1] This length of horizon is especially relevant as we proceed toward the latter part of an unusually long economic expansion in the United States. Are we able to look through the risk of a cyclical correction in the intervening years? How are our conviction levels impacted by these risks?

Major themes driving our views

Is growth divergence a concern?

- Market concern focuses on a desynchronization of global growth and a less positive outlook than in the early part of 2018. However, key measures of the health of the business cycle remain supportive of a continued period of sustained growth.

How big a risk is inflation?

- Our central assumption is that inflation pressures will remain subdued, despite being in the later stages of the business cycle where inflation typically rises. However, the risks to wage growth, and to consensus inflation expectations, are skewed to the upside.

Practical positioning

Tempered by shorter-term considerations

- We remain confident about growth staying strong enough to support risk assets over a longer-term horizon. However, investors' concerns that a pause is close enough at hand to justify reducing risk, tempers our enthusiasm for stocks in the shorter-term.

- A return to long-run levels of market volatility, rather than the lower levels seen for much of the past ten years, indicates a new volatility regime. As we review our current conviction levels, we tilt toward a more cautious outlook.

- We favor assets that offer explicit inflation protection such as inflation-linked bonds (TIPS). These alternative assets could provide diversification against any weakness in stocks and bonds because of an unexpected uptick in inflation.

- As the global liquidity environment evolves, we expect to feel more confident in expressing our longer-term conviction in emerging-market investments. However, we maintain a modestly lower conviction in emerging-market stocks for now.

1. Since 1945, the National Bureau of Economic Research has defined 11 US business cycles, with an average duration of 69.5 months.

Major themes driving our views

Is growth divergence a concern?

Over recent months, we have observed a growing market concern about the desynchronization of global growth, which has been reflected in a widening relative performance dispersion between markets. The extent of emerging market underperformance during the last six months is notable, but not unprecedented (see Exhibit A).

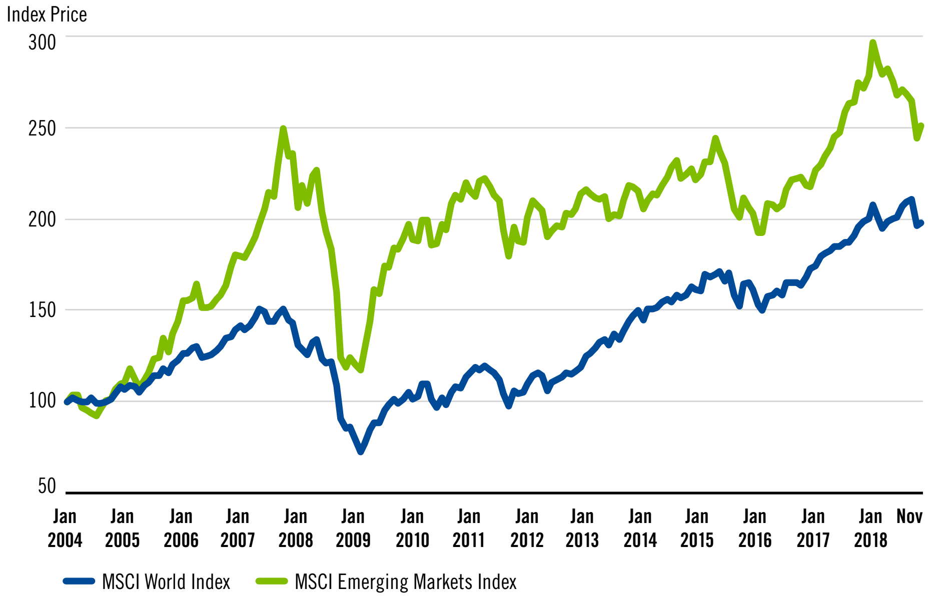
Fears of continued trade conflict have seen largely idiosyncratic concerns in emerging markets broaden out into a more extensive market decline. Political risks are an ever-present concern, but at times of broader uncertainty can act as a driver of investor caution. Indeed, sentiment has been dented more recently. However, as the continued impact of previous fiscal stimulus works through the economy, we may see the United States continue to behave as an oasis of relative calm and increasingly elusive economic growth.

China has recently taken proactive steps to support its economy, lowering bank reserve ratios and promising tax cuts. This action could be viewed as affirming the growth divergence as real and worthy of attention. But if the divergence is no longer in question, focus should turn to how does it narrow? Do we expect growth in the United States to fade as well, or the rest of the world to revive?

Looking at our score-card of global growth indicators, we see a less positive outlook than was the case in 2017 or the early part of 2018. Global trade is slowing. However, our key measures of the health of the US business cycle

DIVERGENT EQUITY MARKET PERFORMANCE

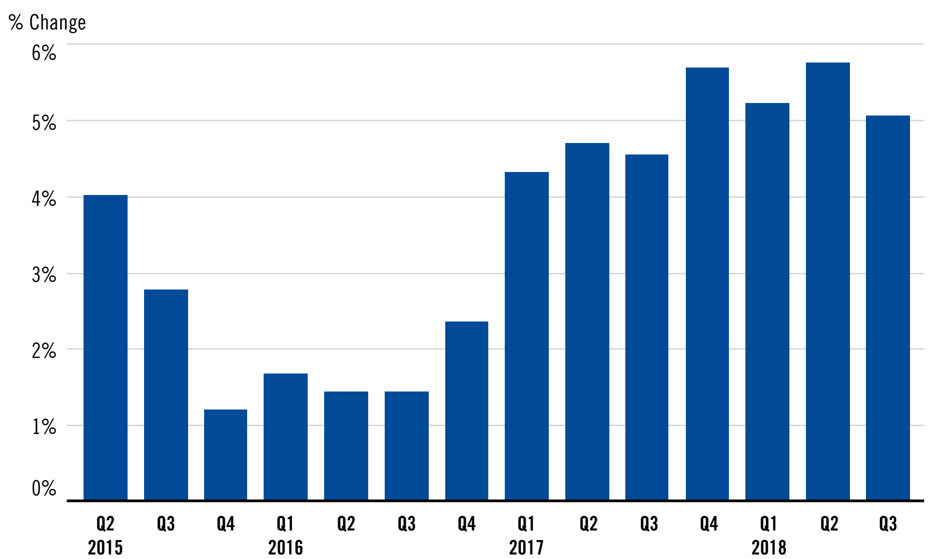
Exhibit A: MSCI World Index vs. MSCI Emerging Markets Total Return Index
As of November 30, 2018



Source: Franklin Templeton Capital Market Insights Group, MSCI, FactSet. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI. Important data provider notices and terms available at www.franklintempletondatasources.com.

CAPITAL EXPENDITURE SUPPORTS GROWTH

Exhibit B: U.S. Fixed Investment, YOY Change
As of September 30, 2018



Source: Franklin Templeton Capital Market Insights Group, FactSet, US Bureau of Economic Analysis. Important data provider notices and terms available at www.franklintempletondatasources.com.

remain supportive of a continued period of sustained growth. Profitability may be close to a peak, but we view capital expenditure as likely to support productivity and sustain growth in earnings (see Exhibit B). Capital expenditure would have beneficial impacts globally, not just in the United States. In that case, at some point, we believe the markets that have fared worst would have a strong likelihood of catching up.

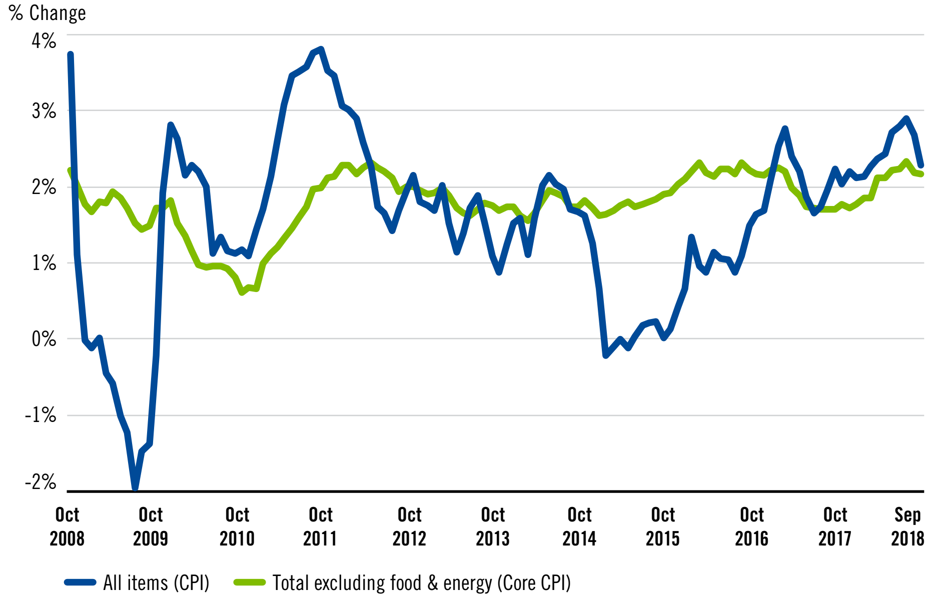
How big a risk is inflation?

We are at the point of the business cycle where inflation typically rises. Many economies are operating close to capacity and labor markets are tight. Specifically, the threat of an escalating trade war would likely be inflationary. But, how big a risk is inflation, and could it derail the constructive business cycle environment that we continue to foresee?

The drivers of inflation are complex and for now quite well balanced. Subdued inflation in recent years has been explained in terms of globalization. However, even as the fears of deflation have faded, this trend has continued to prevent core traded goods prices from rising. US core inflation has remained subdued, even as food, energy and service prices have moved higher (see Exhibit C). The impact has been global and has persisted throughout this business cycle. These disinflationary forces remain but have been masked by stimulus measures which have boosted activity and stoked-up demand for commodities, helping to extinguish the last fears of deflation in Europe and Japan (see Exhibit D). As a result, our central assumption is that inflation pressures will remain subdued.

CORE INFLATION REMAINS SUBDUED

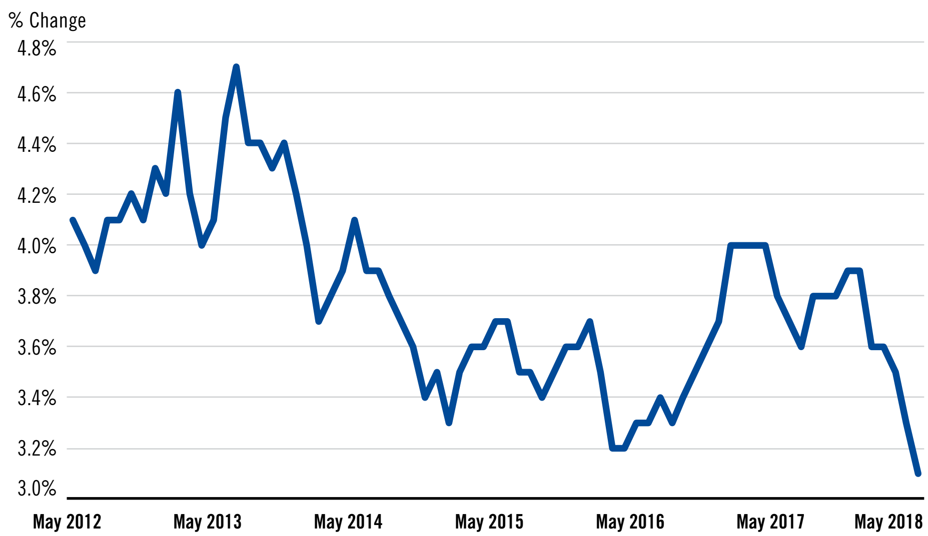
Exhibit C: U.S. Consumer Price Index (CPI) vs. U.S. Core CPI, YOY Change
As of September 28, 2018



Source: Franklin Templeton Capital Market Insights Group, FactSet, Bureau of Labor Statistics. Important data provider notices and terms available at www.franklintempletondatasources.com.

SIGNS OF GLOBALIZATION AS A DISINFLATIONARY FORCE

Exhibit D: IMF World Consumer Price Index (CPI), YOY Change
As of May 31, 2018



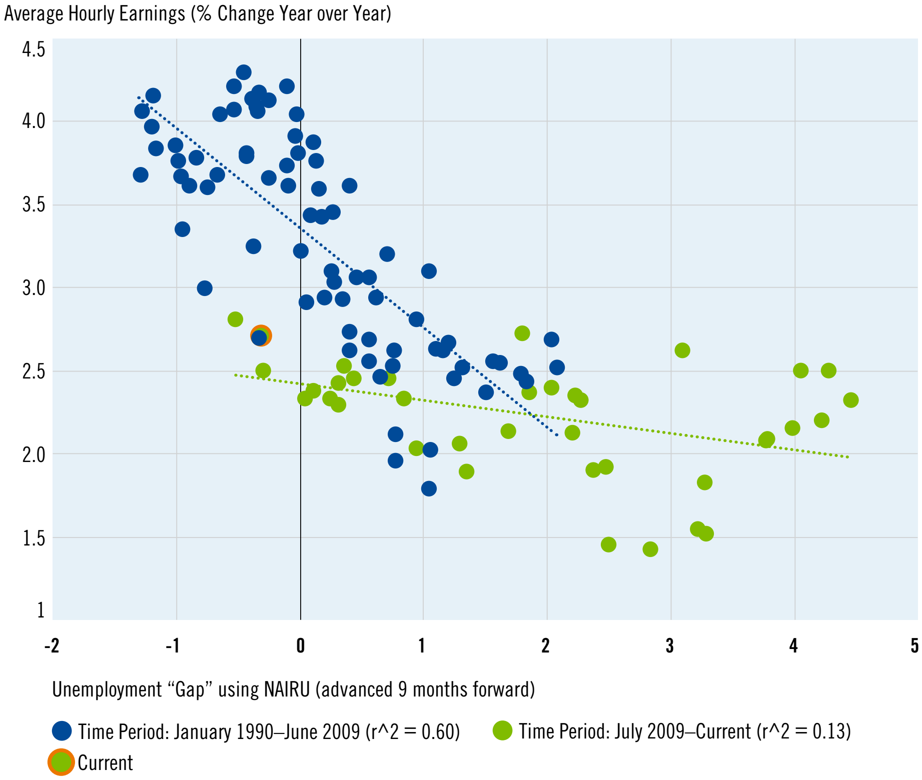
Source: Franklin Templeton Capital Market Insights Group, Bloomberg, International Monetary Fund. Important data provider notices and terms available at www.franklintempletondatasources.com.

Increased isolationism would roll back the benefits of globalization. An escalating trade war and associated tariffs would likely be inflationary, at least in the first instance. As a result, we see risks as being tilted more clearly to the upside, in our analysis. With certain economies operating close to their potential, the risk of modest wage gains accelerating is mounting. The relationship between the level of US unemployment and the rate of wage inflation (the Phillips curve) appears to have changed (see Exhibit E). The flatter profile that is evident in recent years could justify the subdued impact of a tight labor market on wages and inflation. However, it might only be temporary and any snap-back to previous trends could destabilize the finely-balanced inflation picture.

Despite full employment labor has not yet seen a real-terms acceleration in wages. Does this reflect structurally low productivity growth and a lack of bargaining power by workers? If workers are able to gain the upper hand, will companies have the pricing power to recover the cost of higher wages, or will margins take a hit? If we are at peak profitability, what does this mean for the near-term return potential from stocks in the United States and globally? At this stage we don't know how this factor develops but the risk to wage growth, and to consensus inflation expectations, are skewed to the upside.

CHANGING NATURE OF THE PHILLIPS CURVE

Exhibit E: Unemployment Rate minus NAIRU* vs. Change in Average Hourly Earnings
As of September 30, 2018



Source: Franklin Templeton Capital Market Insights Group, U.S. Bureau of Labor Statistics, U.S. Congressional Budget Office.

*Non-Inflation Accelerating Rate of Unemployment

Tempered by shorter-term considerations

This section provides a near-term perspective to complement our annual Capital Market Expectations which summarized our longer-term outlook as follows:

We believe global stocks have greater performance potential than global bonds, supported by continued global growth. Within both bonds and equities, we continue to forecast stronger return potential for emerging markets, over a seven-year investment horizon. With short-term interest rates and government bond term-premia remaining below historical averages, we see a lower performance potential from government bonds.

Our current levels of conviction reflect these longer-term views but must be tempered by shorter-term considerations. As we proceed toward the latter part of an unusually long economic expansion in the United States, are we able to look through the risk of a cyclical correction in the intervening years?

1. Stocks for the longer-term?
Our underlying assumption in the CME forecasts is that global growth, though muted, and perhaps increasingly desynchronized, will persist. With moderate inflation, few imbalances, and remaining signs of a late-stage favorable cyclical environment, the global economy is less likely to see extreme swings in output. However, when we come to analyze the appropriate level of conviction for global stocks we must consider some wider issues.

At a time when markets have been more volatile and are increasingly concerned about the risks of recession, we remain confident about growth staying strong enough to support risk assets over a longer-term horizon but are carefully monitoring conditions. However, at some point investors may become concerned that a pause in growth is close enough at hand to justify reducing risk, even if just on a tactical basis. This concern tempers our enthusiasm for stocks in the shorter-term.

In addition, profit margins have been strong and with earnings growth especially in the US continuing to benefit from fiscal stimulus, market expectations for earnings may be closer to their peak. As stimulus measures fade and comparisons with previous-year numbers become harder targets to beat, investor sentiment is likely to become more fragile. At some point most of the good news may be viewed as being discounted in the market price.

2. Volatility set to remain higher?
Global central banks are exiting from quantitative easing programs and shrinking their balance sheets. This may see the repression of market volatility of recent years come to an end—perhaps we've already seen a preview of this in October and November. In our CME we assume a return to long-run levels of market volatility rather than the lower levels seen for much of the past 10 years, as we enter a new volatility regime.

We do not believe that the latest market sell-off is large enough to influence the longer-term economic outlook. But, it may have some lasting impact on the level of risk that investors are willing to sustain and cause some repositioning of portfolios. The more interesting assessment over the coming months will be to see whether the mood of other investors shifts from buying on the dips to a preference to reduce growth exposure on any recovery. Investor psychology may be informative.

As we review our current conviction levels, we tilt toward a more cautious outlook. We are drawn toward strategies that help to protect against a rise in volatility or a change in investor behavior more broadly.

3. Are bonds at risk from an inflation surprise?
With short term interest rates still at subdued levels and global central banks set on a course to normalize policy, the headwinds for bonds are clear. However, with divergent economic growth and fears of a growing trade war impacting investors' behavior, we have taken a somewhat more positive view of Europe ex-UK bonds at this time.

Our growth and business cycle indicators suggest we are in an environment where inflation typically rises.

We believe that any rise will be modest but that the risks are skewed to the upside. To reflect this, we hold a constructive view of real assets, including commodities. We favor assets that have typically performed well during the latter stages of a business cycle and especially those that offer explicit inflation protection such as inflation-linked bonds (TIPS). These alternative assets could provide diversification against any weakness in stocks and bonds because of an unexpected uptick in inflation.

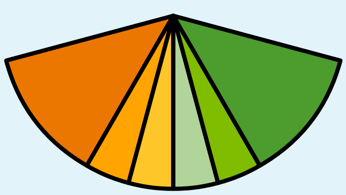
4. When will the headwinds for emerging markets turn?

The longer-term arguments in favor of emerging-market investments over their developed-market peers mainly center on the productivity gains from development and higher rates of GDP growth. These are intrinsically secular arguments. However, we also recognize that the developing economies tend to face a higher base level of volatility and are susceptible to bouts of contagion. Foreign investors are prone to panic as concerns over the sustainability of emerging market's financing arrangements, sensitivity to interest rate changes globally or the strength of the US dollar play out. We are currently in one of these periods which warrants caution.

As the global liquidity environment evolves, we expect to feel more confident in expressing our longer-term conviction in emerging-market investments. However, we maintain a modestly lower conviction in emerging-market stocks for now. Overall, we maintain neutral view of equities and toward growth assets more generally.

Pendulums Explained

In the next section-Allocation settings-we are presenting a new graphical representation of our allocation views and the extent of conviction being expressed.



The central two segments of these pendulum charts both represent a neutral overall conviction toward the asset in question. We have split it into two segments to represent nuanced views. On the left, "reasons for concern, but not bearish" and on the right "reasons for optimism, but not bullish". These can indicate a direction of travel or underlying longer-term view. For truly neutral views, we highlight both segments.

Where we hold a stronger conviction, we "light-up" more of the segments, working out from the mid-line to the left or right respectively. Two segments for moderate conviction, all three for full conviction. We show arrows (below the pendulum) to show changes from a month ago. This representation supports a clearer representation of our views and is less prone to ambiguity about how strong a view is being shown.

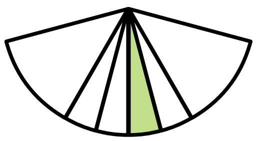
We show our views in three allocation tiers—working down from a top tier that reflects "risk-on" or "risk-off". Secondly, the top-level allocation, equities, bonds, alternatives and cash along with the rationale for each position. In the third tier, we highlight global, regional or sector preferences, aiming show those where we have a view. This last tier will evolve appropriately over time but is unlikely to have many neutral views.

Allocation settings—December 2018

To better understand the graphical representation of our allocation views refer to the "Pendulums explained" description on the previous page.

RISK TIER

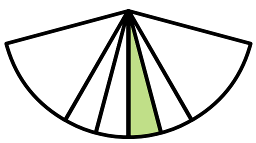
Risk Off/On



We anticipate continued, but muted, desynchronized global growth and moderate inflation. With few imbalances, and remaining signs of a late-stage favourable cyclical environment, less likely to see extreme swings in output. Growth remains strong enough to support risk assets over a longer-term horizon, but we are carefully monitoring conditions.

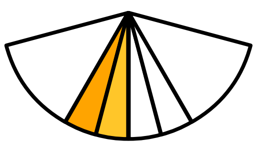
HIGH LEVEL ALLOCATION TIER

Equities



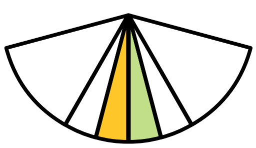
Global growth still supported by corporate earnings and strong profit margins, although we are monitoring growth momentum as we are seeing more desynchronization throughout the world. Monetary policy becoming less accommodative. We are carefully monitoring inflation and the potential for increased market volatility.

Bonds



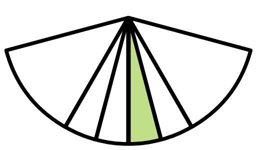
Ongoing global growth and risks of inflation heading higher leads us to prefer lower exposure to government bonds and duration. Long-term valuations have remained expensive despite the rise in yields, reflecting low term premiums. However, the continued effects of fiscal measures are supportive of corporate bonds and bank loans have been looking more attractive to us given less duration risk.

Alternatives

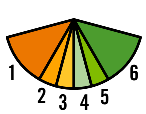


Within a balanced view of alternative assets, we prefer those that have historically performed well late in the economic cycle, such as real assets, including commodities. We hold a stronger conviction on those that benefit directly from rising prices, such as inflation-linked bonds.

Cash

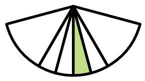
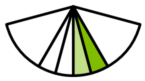
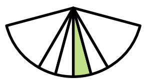
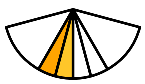
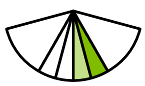
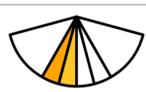
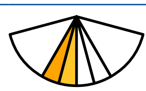
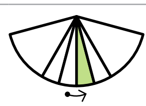
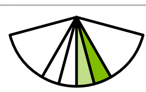
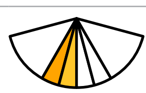


Cash yields have increased, with short-term US Treasury bill yields reflecting greater supply and gradual monetary policy normalization. Cash is no longer a significant drag on portfolio yield, boosting its attractions generally.



These scores are on a scale of 1 to 6, with 3/4 being neutral. Arrows represent month over month change.
No arrow = no change from previous.

ALLOCATION TIER

Asset Class	Conviction	Our Viewpoint
Equity Regions Developed		The positive economic growth story in developed markets, led by the United States, remains intact despite increasing divergence around the world. Corporate fundamentals are currently on par with historical norms, with above-average margins and return-on-equity ratios.
United States		Despite elevated geopolitical headlines and trade tensions, growth fundamentals continue to be positive, with tax reforms still providing a tailwind for earnings and margins. With increased volatility and lower valuations, the market's attention will focus on both corporate earnings growth and the US Federal Reserve's (Fed's) hiking cycle.
Canada		We see select opportunities within Canada, with financials benefiting from a rising interest-rate environment. Conclusion of trade negotiations removes a notable headwind and is a positive.
Europe Ex UK		Economic activity has disappointed as declining global trade and domestic activity led to negative sentiment. With the European Central Bank not yet close to embarking on a rate hiking cycle, we see the banks acting as a drag along with populism concerns over Italy.
Japan		Equity market valuations, particularly on a price-to-book value basis, have remained attractive to us relative to other markets. Corporate fundamentals have remained quite conservative, with forward earnings growth expectations at significantly lower levels than peers.
Emerging		In general, emerging markets have seen profit margins peak and corporate earnings revisions turn negative. Risk of an escalating trade war continue. Fed policy normalization present headwinds but return-on-equity ratios remain stable.
Fixed Income Sectors US Treasuries		Although yields have increased, the Federal Open Market Committee has indicated that they will continue to raise rates beyond neutral. Additionally, we are concerned about decreased support from global central banks and supply-demand dynamics. We prefer short duration exposure.
Eurozone Government Bonds		Valuations have appeared full in the eurozone, where term premiums are the lowest among government bonds. However, rate hikes remain a distant prospect, boosting hedged yields, and Italy's budget announcement has increased tension with the European Union.
High Yield		While valuations have been tight, the economic backdrop remains supportive of riskier fixed income sectors such as high yield. We believe bank loans can be an attractive complement to high yield, given less sensitivity to Fed rate hikes, but are also vulnerable due to a relaxation of covenants.
EM Debt		Poor sentiment in the asset class following idiosyncratic events in Turkey and Argentina has seen valuations improve. Although many countries are better prepared to withstand sector headwinds, fears of contagion remain. Selective positioning is important, in our view, as some countries are more exposed to the rising cost of capital.

WHAT ARE THE RISKS?

Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in developing markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size, lesser liquidity and lack of established legal, political, business, and social frameworks to support securities markets. Such investments could experience significant price volatility in any given year. Derivatives, including currency management strategies, involve costs and can create economic leverage in a portfolio, which may result in significant volatility and cause the portfolio to participate in losses (as well as enable gains) on an amount that exceeds the portfolio's initial investment. Investing in the natural resources sector involves special risks, including increased susceptibility to adverse economic and regulatory developments affecting the sector—prices of such securities can be volatile, particularly over the short term. Some strategies, such as hedge fund and private equity strategies, are available only to pre-qualified investors, may be speculative and involve a high degree of risk. An investor could lose all or a substantial amount of his or her investment in such strategies. Real estate securities involve special risks, such as declines in the value of real estate and increased susceptibility to adverse economic or regulatory developments affecting the sector.

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