PERSPECTIVES

Global Investment Outlook: How Much Further Can Global Growth Fly?

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A number of market headwinds—including trade tensions, rising interest rates and a general fear the long-running US economic expansion may be facing fatigue—have cast a shadow over the markets in the first half of the year. Nonetheless, US economic growth managed to hit a four-year high in the second quarter, and the US equity market marched along to what many regard as its longest bull run in post-WWII history.

Templeton Global Macro CIO Michael Hasenstab, Franklin Templeton Fixed Income Group CIO Chris Molumphy and Franklin Templeton's Head of Equities Stephen Dover weigh in on whether synchronized global growth can continue, why worries about trade wars may be overblown and why opportunities for investors may be more idiosyncratic or divergent moving forward.

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Key Takeaways:

- Generally, we expect positive global economic growth to continue for the near term, led by the United States and supported by continued profit and earnings growth.
- We believe growth has peaked in Europe and is decelerating, while economic data in Japan continues to look soft. The US economy is benefiting from stimulus measures, including a reduction in regulations as well as tax cuts.
- The case can be made for continued strength in emerging markets, on the heels of favorable demographics and technological advancements. While some emerging markets have been experiencing significant challenges, broadly we think many emerging markets should be fundamentally stable and offer opportunity for selective investors.
- China continues to de-leverage the shadow banking sector, which we believe has positive long-term implications. We will probably see more of a US and China tit-for-tat trade dispute, as opposed to a full-out trade war. Our baseline is it probably increases volatility but doesn't impact fundamentals much.
- We think market skepticism is healthy, as it balances out overexuberance in the market. And what worked

in the last decade probably is not necessarily going to work going forward. We think it's about applying research to find opportunities best suited for growth in the current market conditions.

You can also read the full outlook online with even more views from our investment professionals.

Host/Richard Banks: Hello and welcome to Talking Markets with Franklin Templeton Investments: exclusive and unique insights from Franklin Templeton. I'm your host, Richard Banks.

Ahead on this episode—Franklin Templeton's latest Global Investment Outlook, with a focus on continued global growth.

To talk about it all: three of our senior investment leaders—Dr. Michael Hasenstab, Chris Molumphy and Stephen Dover—join Franklin Templeton's Katie Klingensmith. We hope you enjoy their conversation.

Katie Klingensmith: Let's jump right in and talk about global growth, which still seems to be quite synchronized and high. US growth rates came in at a four-year high at 4.1% for the second quarter of 2018. To get started, Stephen, could you tell us what you see as the primary drivers for US growth?

Stephen Dover: Well, there is an incredible amount of stimulus in the US economy now. Reduction in regulations, obviously the tax cut. There is fiscal stimulus, and we are coming out of a very long recession, so I think there's a lot of earnings growth. In fact, earnings grew 25% year-on-year this last recorded quarter, which is the biggest growth we have had since the financial crisis started.[1] I think what's encouraging is there seems to be a lot of investment driving some of this growth. Now, it's primarily in technology and in a few industries, but there is investment, rather than just being so dependent on the consumer as we were in the past. But it's definitely one of the most unloved bull markets that we have ever had.

Katie Klingensmith: Michael, where do you see us right now in the growth cycle?

Michael Hasenstab: I think the US is definitely going to lead the pack. What we are seeing outside of the US in the major economies is a bit less. We are seeing growth peaked in Europe and is decelerating; it's not a collapse, but it's decelerating. Arguably, Japan is kind of still squishy, and you have had some of the major emerging markets have run into some pretty big headwinds.

Katie Klingensmith: Chris, where do you see us in the US credit cycle?

Chris Molumphy: Clearly, we are pretty far along in the economic cycle, hence the credit cycle. You mentioned 4%, that's likely unsustainable. But even if we normalize 2.5% to 3%, that's a pretty solid pace of growth in the US, and—Stephen alluded to a number of factors driving this, as did Michael—but at its core, too, we have some pretty good underlying fundamentals with the consumer being quite healthy, with respect to savings rates, even confidence—just recently record-high confidence—and health of the consumer, combined with the very solid corporate sector. So that bodes well for the foreseeable future from a fundamental standpoint.

Now having said that, the question I get quite a bit is, what about corporate credit? Where are we in the cycle? We seem to be pretty long in the tooth, corporate credit is by and large expensive on a historical basis—which I wouldn't disagree with—but our view is despite that, we think we have some legs in the credit cycle.

Fundamentals remain very good. The nice thing about the credit cycle in the corporate arena is if you're doing your due diligence, if you're staying on top of your credit work, you typically get lead indicators of credit deterioration. So far, we really haven't seen that on a widespread basis, we are watching awful carefully, but our sense is, we have some legs to the corporate credit cycle. So, we are bullish on the shorter-term basis, but we are clearly aware of where we are in the cycle and watching out for those initial signs.

Katie Klingensmith: Is your concern also reflecting what you expect from Fed policy?

Chris Molumphy: In the United States, we are currently a little under 2% in the Fed funds rate. It's very likely we are going to have a 25-basis-point increase at the end of September, and there is a real possibility we get another 25 basis points at the end of the year in December. I think the key is that we are moving toward a more neutral rate. The Federal Reserve tells us the neutral rate is roughly 2.75% to 3%, that's a level where you are balancing the risk of inflation and economic growth. But in our view, that's a pretty healthy place to be. Quite frankly, with the US economy having momentum, that's the time when the Fed should be raising rates. It should be getting up to that neutral rate, so it has some ammunition for the next cycle. So, we would like to see rates get up to that level.

The last point I would make on Fed rates is there is a bit of a disconnect as we look out into 2019 and beyond with respect to the Fed versus the market. The Fed, on the one hand, is saying we likely will have to raise rates all the way up to 3% and beyond to slow down the economy. Where the market says, 'okay we see you getting rates up a bit this year, but maybe only a little bit more next year and peaking out at 2.50% to 2.75%,' so there is that disconnect. Ultimately it will be data dependent, but we think it's a healthy sign to get that Fed funds rate up a bit.

Katie Klingensmith: Michael, what are you looking for from the Fed?

Michael Hasenstab: What we are looking for is the next change. The fact that the labor market is getting tighter, the Fed is unwinding its balance sheet, and there is just a lot of complacency, I think, in the Treasury market to move back to something, as Chris was saying, it's not exceptionally tight, but just normal, consistent with this activity, and we are not there.

Katie Klingensmith: And how does that stack up to the monetary policy stances of other major central banks?

Michael Hasenstab: Mexico, for example, has done, you know, what a central bank should do: buy insurance. They have hiked rates, so that if and when there is a shock, they have an ability to react. And I think you have seen a few emerging markets, when faced with a shock, be responsible. ECB [European Central Bank], BOJ [Bank of Japan], obviously very dovish, but there are pockets in emerging markets where we have seen them actually lead the pack. And I think that's a lot of what's behind currency performance in emerging markets. If a country's policymakers lead, then there is protection. In Turkey's case, the theory was that high rates caused inflation, so they kept rates low, which obviously created a problem. It's a lot more variant, but there are pockets of emerging markets that we think have been very responsible.

Stephen Dover: I think it's one of the ironies, in many ways, emerging markets are more responsible than developed. Just a quick point on how, what Michael is talking about, affects equity markets. This monetary policy needs very low rates. All assets are, in essence, a discount of future earning streams, but particularly stocks and the variability of that. So, the lower interest rates are, the more your future earnings are more valuable, and that's a really great environment, particularly for growth stocks. And as rates come up, and as those discounts change, it's probably going to be an environment that's probably a little bit better for more traditional companies.

Katie Klingensmith: Transitioning a bit from monetary policy to fiscal policy, the Trump administration successfully implemented tax reform and there has been other fiscal stimulus. How do you think fiscal stimulus is affecting the outlook for the US right now, Michael?

Michael Hasenstab: I think fiscal stimulus at the margin is a positive. I think the tax reform is probably more significant because that has allowed companies to finally get some clarity and make investment decisions. And I think the most important has actually been, in terms of growth, deregulation. And that deregulation is really also the trigger for investment growth,

Katie Klingensmith: Stephen, how does this, the regulatory and fiscal changes, affect your outlook for companies?

Stephen Dover: Yeah, I guess when you look in the equity market, those companies whose tax rates were cut the most have had the biggest earnings impact. They tend to be smaller and tend to be more domestic companies, so it's helped those domestic companies. And as I mentioned earlier there's been some movement towards more capital spending. Changing the regulatory environment and having more certainty is clearly very stimulative. I think in the business community, they are very positive on the outlook going forward.

Katie Klingensmith: And Chris, in your world have the fundamentals improved?

Chris Molumphy: I think they certainly have in the corporate sector, and some of this is in fact sustainable. Michael points out deregulation, it's an issue that hasn't got as much press. But frankly, it's probably had as much of a positive impact on the corporate sector broadly over the past couple of years. With respect to tax reform, it was really all about corporate tax reform, Personal taxes made a lot of the headlines, but it was about corporate tax reform and putting the US on an equal playing field globally. Because frankly, prior to that, we just were not competitive from a corporate tax standpoint. So that's been beneficial, and that will be sustainable.

Stephen Dover: Two quick points, I think the old tax law favored importers over exporters. It's definitely, again, a more equal playing field, and all those earnings that are overseas can come back to the United States as well. And we have seen that in some acquisition, certainly some stock buybacks and some more investments.

Katie Klingensmith: Taking us back to the international stage, Michael, I know that you have been receiving quite a few questions about if we're in the midst of a trade war, what a trade war even means. What do you make of the current tension in international trade conversations?

Michael Hasenstab: I would say it's more of a tit-for-tat trade dispute, as opposed to a full-out trade war. I mean, the real risk would be something between the US and China. That's obviously the highest probability, but I still put it at a low probability at this point. So far, every action the US has made, China has responded pretty much in just a measured equal reaction, so we haven't seen this huge escalation. It is true that the US has, only behind Australia, the second lowest import tariffs in the world. So probably what you are going to see is US tariffs go higher, US goods prices go higher and some of the tariffs in a place like Korea come lower and their goods prices go lower.

Katie Klingensmith: And Chris, do you have any expectations for how this trade tension might play out?

Chris Molumphy: Well, I would just point out it's noteworthy that the risk markets, and equities in particular, have, while a little bit more volatility, by and large have looked past that. In other words, agreeing with Michael's assessment that it's probably going to be more of a back-and-forth. But fundamentally, the likelihood is probably for no significant impacts on global growth.

Certainly, when you look at the non-China countries, as Michael points out, Mexico, Canada, and then Europe, hopefully, we're in the early stages of resolving some of those. China is probably the big issue because it's not just a trade issue, but it's intellectual property rights and all these other more involved things. That may well take a while and as well, we are looking at these tail-risks because you never know exactly what's going play out, but our baseline is that it probably increases volatility but doesn't impact fundamentals all that much.

Katie Klingensmith: Stephen, are there any investment opportunities that can emerge from these trade conversations?

Stephen Dover: Yes, I think there are, particularly because perhaps there is too much fear around these. So we are a global company, I personally am a globalist, I'm very pro free trade, but we have to acknowledge that it's not as simple as trade, that there are a lot of political issues, foreign policy and even defense issues involved in this—particularly with China. Just to give you an idea how important trade is, trade has grown about 1.5x GDP over the last 20 years, or so.[2] It's actually the single most, if you were to have one factor, the single most important factor for global GDP growth.

And the US has led trade since World War II and, as part of that, as Michael said, you know, we have been willing to have a little bit lower tariffs than others because we have led the world into this and, I think, probably, it's time to relook at some of those trade deals. China is one of those countries where, when it was starting to emerge, had a lot of very favorable trade deals. But China doesn't need that in the same way anymore, and China has a lot of very big projects that are quite competitive with developed world—and I say developed because it isn't US it impacts Japan and Europe even more than it impacts the US. So, I think, ultimately, reform is probably going to be good for China; it will be more stable.

Katie Klingensmith: Michael, would you like to add anything from an investment perspective about the trade tensions?

Michael Hasenstab: I think the biggest one has been Mexico, where it has been affected adversely and this latest resolution that they've kind of come to an understanding, I think, tells us that, there is a way through this by just updating the treaties as opposed to tearing them up. And the irony is that most of the terms that are going to be put in the new NAFTA [North American Free Trade Agreement] were basically TPP [Trans-Pacific Partnership] which [US President] Trump wanted to get rid of, but now is going to accept, but under the terms of NAFTA. So, I think Mexico is an encouraging case study that, there is a lot of bluster, and then at the end there's a reasonable solution.

Katie Klingensmith: We have been talking about how the biggest trade conflict could potentially be between the US and China. Let's talk about what's going on in China. And Stephen, if I could come to you and ask about your outlook for economic activity in China?

Stephen Dover: I think you shouldn't underplay China at this point. I mean, the end of China has been called for for a long period of time. I think we have to be a little bit more cautious. There are two huge initiatives that China is working on right now that I think are worth knowing about. The first is the "Made in China" campaign, the 2025 China campaign, and that is really China trying to be a leader in a lot of different industries, most of them technology industries, and also—perhaps not surprising—in environmental industries.

The second thing is China's "Belt and Road" Initiative, which is a little confusing because the road is actually seaways, but it's really an initiative to expand the infrastructure that China has across all of the countries that at least touch China and then all the way into Europe. It's a multi-trillion-dollar capital initiative not dissimilar to the Marshall plan, but very much in China's interest, and that's going to be very stimulative to those countries outside of China. I think there's a lot of opportunity there.

Katie Klingensmith: Michael, do you see material risks to the Chinese growth trajectory?

Michael Hasenstab: I think in the short term, no. They could take over the banks, recapitalize the banks if there were problems there, and the government has a lot of leverage and control. However, in and of itself, I think the longer-term risk is that the country becomes increasingly reliant on government-organized plans—and throughout history, those have tended to not be sustainable and they have crowded out the private sector. I think those are the longer-term questions, but in the short term I think all the analysis that they are about to go into a credit crisis is wrong because the government has so much control, so many levers and it's a closed economy. If anything is open, they have the ability to close it.

Katie Klingensmith: Michael, you mentioned early on that the policy mix and opportunities in individual emerging markets varies quite a bit. Can you give us your highlights about the trajectory for emerging market economies?

Michael Hasenstab: We think that Asia is pretty stable. Latin America is more of a turnaround story in that where policies were really bad, they are now either getting better or trying to get better. There are probably more alpha opportunities in Latin America. Africa is really idiosyncratic, country by country, and the variance is quite high. And then Central and Eastern Europe, we're a bit more concerned that policies that used to be very credible, very orthodox, are now moving 180 degrees in the other direction. You have had a takeover of the press or the judiciary system in some countries that used to be really the leaders in market-based democracies, and so I think that that could be a concern, and their linkages in with issues in Europe are a concern.

Katie Klingensmith: Michael, you mentioned that some emerging markets would be dependent on what goes on in Europe and mentioned the ECB before. What do you think is the trajectory right now economically and politically in the European Union?

Michael Hasenstab: I think economically, it's a moderate deterioration. I think politically, you know, you have seen a pretty big spike in Italian yields over the course of the year, reflective of a very populist and fragmented regime. And I think that's the pressure that Europe is going to have to face. Populism leads to and is often tied with nationalism and tends to look inward, but the eurozone politically only works if countries are integrated and act as a common community.

I think the exact reverse is happening. Now, as long as economic activity is okay, and there's no real big shock, the political system is not tested, but the question will be in the next economic downturn—or If there is a shock in Italy, or an immigration shock, or something—will Europe, as a community, come together like they did in 2011, or will countries decide to sort of shut their borders and turn inward?

Katie Klingensmith: And Stephen, in spite of these economic and political headwinds potentially in Europe, do you still see opportunities to invest there?

Stephen Dover: In Europe, there's a very big difference between the economies and the stocks. So, where companies are listed, and where their economic exposure is, are quite different. We see a lot of opportunities in those type of companies. I think that probably our worry has also been Italy, and to some degree, Turkey—not necessarily economically, but Turkey has been the stop for the immigration. There is an agreement between particularly Germany, the EU, and Turkey to stop immigration and, if that were to turn bad, I think they could have an increase in immigration problems in Europe again.

Katie Klingensmith: Alright, to wrap us up, US equity markets have been hitting new highs, but it seems that many investors are quite concerned about investment opportunities and the global outlook. There has been more volatility, even with many asset classes doing well. Chris, I will start with you, do you think that investors need to be preparing for more volatility and potentially downside?

Chris Molumphy: We think it's healthy that there is a lot of skepticism out there. As soon as you lose that skepticism, that's when you have to really start worrying, and that's usually the beginning of the end, as it were. But we are not seeing that. In the US, we are now in the 10th year of a growth cycle. The longest growth cycle we have had in the US since World War II is 10 years. So clearly in the back of our mind, we are going to be in unchartered waters, likely, pretty soon. But the fundamentals in the near- and even intermediate-term look pretty good. So that's what we are focusing on. We have a pretty positive outlook, and we think the skepticism is actually healthy. Near term, you put those together and that's pretty good for financial markets.

Katie Klingensmith: Stephen?

Stephen Dover: I think it'd probably not be the best time to really pull in your risk exposure. You might not want to focus on the more risky companies and be a little bit more conservative, but I think that it's very hard to predict a pullback. The equity markets are becoming much more efficient. Trading friction has dropped, the ETFs and the movement in passive have made the markets more efficient in some ways. So, I think the long-term return for stocks could actually be at least what it has been in the last hundred years and maybe even slightly better. So, I'm still quite positive, in general, on the equity markets.

Katie Klingensmith: And Michael?

Michael Hasenstab: We have been focusing more on idiosyncratic alpha opportunities and not just getting this broad market beta. I think it's pretty hard to argue that broad market beta is cheap. In fact, it's probably pretty expensive, and so the danger is obviously a lot of index or passive investing. You are kind of getting that index beta without focusing on the smaller subset of alpha. Now, there is risk in that, because it's more concentrated, and it's idiosyncratic, but I think that's where we see the value. I think the other thing investors should look on is, look for uncorrelated assets. When there's a drop in the equity market, what happened to your other positions? Or a drop in the bond market, what happens to your positions? If they are all moving in the same way when you have a shock, that's not a very effective portfolio construction. And what worked in the last decade probably is not going to work going forward. I think it's idiosyncratic, isolated alpha and trying to hedge out the broad market beta.

Stephen Dover: I think you make a really interesting point saying that beta is actually expensive right now because there is such a focus on trying to keep beta cheap with ETFs or passive, and focusing on the fee, but if you are in the wrong beta, it's really, really expensive.

Katie Klingensmith: Thank you very much for your time and perspectives Dr. Michael Hasenstab, Stephen Dover and Chris Molumphy.

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1. Sources: Franklin Templeton Capital Market Insights Group, S&P, Dow Jones, Bloomberg. See www.franklintempletondatasources.com for additional data provider information.

2. Source: World Trade Organization, "Strong trade growth in 2018 rests on policy choices," April 12, 2018.

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