PERSPECTIVES

Distortion, Divergence and Diversification: 2019 Global Investment Outlook

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Volatility has plagued equity markets globally in 2018—most notably emerging markets and US equity markets. As the US economic expansion officially crossed the nine-year mark in 2018, many investors started to wonder when the cycle would change—and what the catalyst might be. Our senior investment leaders see plenty of reasons to be optimistic about the year ahead, but recognize investment opportunities may be more divergent, with some previously overlooked countries or asset classes potentially taking the spotlight.

Following is a summary of each of their views. *For more detail on the team's views, check out our Global Investment Outlook website.*

Addressing Desynchronized Global Economic Growth and Late-Cycle Volatility

Edward D. Perks, CFA
Chief Investment Officer
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The global economy holds the potential to maintain solid momentum in 2019, in our view, underpinned by the strength of US fundamentals and demand. Volatility returned to global financial markets in 2018 as the narrative around synchronized global growth became more pessimistic.

However, growth trends remain broadly positive and desynchronization might not be the headwind that markets may have feared at times. Of keen interest to us is how countries' economic divergences and policy differences will ultimately be reconciled, given their prospective impacts on trade, currencies and the normalization of monetary policy in the advanced world.

We see few signs of emerging-market volatility affecting other markets as yet, and believe the widening relative performance dispersion between markets we witnessed throughout most of 2018 may be sustained. Consequently, we see little reason for the leading central banks to deviate significantly from the monetary policy trajectories they have currently laid out. In the United States, the current combination of above-trend growth, benign inflation and near-full employment could continue for some time, in our view. We believe the prospects for a US recession are still several quarters away.

As we head toward 2019, we recognize there are reasonably full valuations in certain parts of both the equity and fixed income markets, and while favorable corporate fundamentals remain in place, we have become incrementally more cautious. We have grown concerned about elevated government debt levels (focused on some major eurozone countries, Japan, the United States, China and other emerging markets).

Inflation remains moderate globally; however, we are mindful of the risks of increasing inflation.

Thus, while equities and fixed income typically remain the largest asset class exposures in our multi-asset portfolios, we also hold a constructive view of real assets, including commodities. We favor assets that typically perform well during the latter stages of a business cycle or offer explicit inflation protection such as inflation-linked bonds. Additionally, alternative assets could provide diversification against potential weakness in stocks and bonds if an unexpected uptick in inflation occurs.

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> Ed Perks, Franklin Templeton Multi-Asset Solutions CIO

Looking Across the Globe for "Unloved" Markets

Stephen Dover
Head of Equities
Franklin Templeton Investments

The year ahead looks to be one of restrained global equity market performance. As the benefits of substantial fiscal stimulus from US tax cuts and greater public spending wane, US earnings and the broader global economy may have a hard time keeping pace with 2018 levels.

However, we see opportunities outside the United States as earnings and economic disparities with the United States narrow. We also believe equity valuations in non-US markets remain attractive relative to the United States. Additionally, we expect companies with low debt and high, strong cash generation to do well as economic and earnings growth moderates.

With interest rates rising and political issues a concern, the quality of earnings along with valuations will be an increasingly important investment consideration.

Many non-US markets have been undervalued relative to the United States for the past few years, in our assessment, due to the strong US corporate earnings performance. Europe, for instance, has not seen as robust growth, giving European corporations an easier hurdle to clear in 2019. Meanwhile, the Japanese market, which has seen decent earnings growth, could benefit from any signs of a more durable pickup in inflation.

The main challenge for European markets may be the increased political uncertainty that looms in 2019. We think the continued rise in populism, not just in Europe but globally, is slowly chipping away at some of the economic and political institutions that have been the bedrock of many market-based economies.

We see opportunities beginning to emerge in many unloved areas of the global equity markets. While headline rhetoric about the trade war's impact on the Chinese economy has made many investors wary of Chinese equities, we believe growth in China is driven more by domestic consumption than trade these days.

Latin America also offers new promise. The election of Jair Bolsonaro as Brazil's new president suggests to us a return to more orthodox economic policies, despite some of his more extreme political rhetoric.

In general, the underlying fundamentals in emerging markets look positive to us and valuations have been falling back to levels that historically have proven attractive to us.

> *"Over the longer term, we continue to see tremendous opportunities in disruptive companies. Major US and Chinese technology companies are innovating and have become a more important part of the global economic and political landscape. We believe the question for investors now is how much value to assign to this growth."*
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> Stephen Dover, Head of Equities

US Treasuries Are Facing a Perfect Storm of Rate Pressures

Michael Hasenstab, Ph.D.
Chief Investment Officer
Templeton Global Macro

A decade after the global financial crisis peaked in 2008, financial markets have only just begun to correct the asset price distortions that were created by the US Federal Reserve's (Fed's) massive quantitative easing (QE) program. QE was originally deployed to stabilize financial markets during the crisis, but instead of being a limited intervention to restore markets over a few years, it expanded and became an ongoing endeavor. It succeeded in pushing down bond yields and pushing up asset prices, steering many investors toward riskier assets while also keeping the costs of capital artificially suppressed. But continuous QE also led to ongoing price distortions in bonds and equities, while incentivizing leverage and rewarding complacency among investors who appeared to view persistently low yields and the Fed's "buyer of last resort" role as a permanent arrangement.

However, those conditions are neither normal nor permanent, in our view, and we expect the reversal of QE to have significant impacts on bond and equity markets alike in the upcoming year.

Just this past fall (October 2018), we saw bond and equity markets in the US decline concurrently as rates rose. That may seem anomalous, but because bonds and equities were equally propped up by Fed intervention, they have been equally vulnerable to the opposite effect as Fed policy unwinds. These are the types of valuation corrections we expect to see as the artificial effects of prolonged monetary accommodation are dismantled.

Investors that are not prepared for concurrent price corrections in US Treasuries (USTs) and other asset classes in 2019 may be exposed to unintended risks.

Three key factors are lining up to drive UST yields higher, in our assessment: increased borrowing needs from the US government, a decline in UST buying from the Fed and foreign governments, and rising inflationary pressures. The first storm on the horizon is the growing fiscal deficit. Increased spending from the Trump administration, along with tax cuts, and ongoing mandatory spending are projected to drive the fiscal deficit toward 5% of GDP (gross domestic product), in our analysis. That increases the already high borrowing needs of the government.

The second storm is the diminished official buying demand, both domestically from the Fed as it unwinds QE, as well as externally from foreign governments. This leaves a large funding gap that will need to be filled by price-sensitive investors, who would need to roughly triple their current levels of buying to fill the void. Less buying volume and more supply volume means yields need to rise to find new clearing levels.

Those two dynamics alone would probably be enough to drive yields higher. But a third storm is brewing in the form of inflation. Wage pressures have been rising on exceptional strength in the US labor market, along with a lack of skilled and unskilled labor in certain sectors. The labor pools have been further constrained by restrictions on both legal and illegal immigration from the Trump administration.

Additionally, late-cycle fiscal stimulus, deregulation and tax cuts have added fuel to an already strong economy.

Taken together, all of the aforementioned factors form a perfect storm of rate pressures that we expect to drive UST yields higher in the upcoming year.

> *"Overall, we think it's important to recognize that the state of the world that investors have become accustomed to for the last decade is not going to continue indefinitely. In 2019, we expect US Treasury yields to rise and various asset classes to endure price corrections as monetary accommodation unwinds."*
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> Michael Hasenstab, Templeton Global Macro CIO

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