ALTERNATIVES

Hasenstab Sees Once-in-a-Multi-Decade Opportunities

October 6, 2015

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While short-term market gyrations can be painful for investors' portfolios at times, Michael Hasenstab of Templeton Global Macro is patiently plotting his strategy for longer-term market shifts. He says recent investor panic has created some once-in-a-multi-decade opportunities for fixed income investors, particularly in some beleaguered emerging markets.

Two Distinct Market Periods in 2015

Market activity in 2015 can be divided into two distinct parts: what occurred in the first part of the year up through the end of June; and what we have seen since the end of June to the present. In the first part of the year, market activity was very much aligned with what we have been positioned for; our Templeton Global Bond Fund and Templeton Global Total Return Fund were short the euro and yen, both of which continued to weaken, and we were short US Treasuries, which underperformed during that period. Those events were good for the funds and provided opportunities to hold and accumulate positions in select emerging markets that had experienced currency depreciations of anywhere from 10%–15%.

At the end of June, markets then entered a period of panic and massive risk aversion triggered by economic concerns in China. Many emerging market currencies depreciated another 10%–15%, while the yen and the euro remained largely flat, acting as perceived safe havens. Concurrently, US Treasuries appreciated. The combination of these events was a perfect storm against the funds as our short US Treasury duration[1] and long emerging market currency exposures[2] detracted from performance. But what encourages us is that many emerging market currencies are now in many cases 15%–30% undervalued, in our assessment, and we were able to use this period of volatility to continue to buy these really distressed assets. We saw specific valuations reach levels that are not only a once-in-a-decade opportunity, but what we believe to be rare multi-decade opportunities to capture extraordinary longer-term investment potential.

Positioning for Rising US Interest Rates

We don't think that this recent period of complete panic is likely to continue. We think the greater risk is the sensitivity of financial markets to a rise in interest rates. Thus, we want to be positioned for interest rates to go higher (specifically US Treasuries) and have a negative correlation[3] to the bond market as well as other risk assets that could be affected by higher interest rates.

We think the big tragedy in a lot of investors' portfolios will be the belief that the correlations of the last 30 years will hold—namely inverse correlations of equities and bonds. But when they don't—when we potentially get a falling bond market and a falling equity market—people's portfolios may not be well positioned. We haven't seen that scenario for the last 30 years, but that doesn't mean it can't happen. We are now in extraordinary times; we've never had monetary policy distort Treasury markets to the current extent, so we have to think a little bit differently. What worked for the last 30 years might not work for the next five years. Therefore, we have to be pro-active and create a portfolio that has these different characteristics and that has the potential to be uncorrelated to rising interest rates.

Three Areas of Investment Opportunity Ahead

We are currently focused on three main areas of investment potential: 1) the profound value opportunities in specific emerging markets, 2) short US Treasuries in a rising-rate environment and 3) the flexibility of management within the currency markets to be long and short. These three broad sources of investment return really excite us about the opportunity set for the next couple years.

First, right now we are buying select emerging markets at multi-decade and/or all-time low valuations. We can buy the Mexican peso at the weakest level it has been in the history of Mexico. Similarly, the Malaysian ringgit and the Indonesian rupiah are at levels we have not seen since the Asian financial crisis in 1998. On a valuation basis, these are not just once-in-a-decade, but multi-decade opportunities to buy what we believe to be very cheap assets. Certainly, not all emerging markets have good value. We are not buying everything. We're not investing in countries such as Turkey or South Africa, for example. But, there are a handful of countries that are being caught up in the current market turmoil that we think are the diamonds in the rough—multi-decade opportunities, or for some of these countries, once-in-their-history—opportunities.

Second, we are positioning our funds to aim at a negative correlation to US Treasuries. We view one of the biggest risks over the next five years to be rising US interest rates. In our assessment, the strength of the US economy justifies higher rates and we think inflation is underpriced in the Treasury yield curve. For the last 30 years, most investors made money from declining rates; we think over the next five years you want to make money from rising rates. Thus, our strategy is positioned to be short US Treasury duration.

Third, we believe it's important to have a highly flexible strategy that can directionally position across the currency markets. One of the most attractive aspects of the currency markets is there is generally always something undervalued; things are usually never in perfect alignment. Thus, an investor can allocate in opposing directions; for example, going long the US dollar or short the US dollar. Currently, we have the flexibility to be long the US dollar against short positioning of the yen, the euro, and the Australian dollar. At the same time, we can also short the US dollar against long positions in currencies that we view as undervalued, such as the Mexican peso. Those positions could completely flip around in a couple of years if we see valuations adjust, so the flexibility to move to where

value resides in the currency markets is an opportunity set that we believe never runs out. By contrast, other security markets often depend on where they are in an investment cycle. Taken together, we see vast opportunity sets for the upcoming years.

So in conclusion, it is our view that currently, there are attractive value opportunities in many emerging markets. Second, being short US Treasuries in a rising-rate environment. And, third, the flexibility within currency markets to be long/short. Those are the three areas that really excite us about the opportunity set over the next couple of years.

For a more detailed analysis of markets around the world, read "Global Macro Shifts," a research-based briefing on global economies featuring the analysis and views of Dr. Michael Hasenstab and senior members of Templeton Global Macro. Dr. Hasenstab and his team manage Templeton's global bond strategies, including unconstrained fixed income, currency and global macro. This economic team, trained in some of the leading universities in the world, integrates global macroeconomic analysis with in-depth country research to help identify long-term imbalances that translate to investment opportunities.

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What Are the Risks?

Templeton Global Bond Fund

All investments involve risks, including possible loss of principal. Currency rates may fluctuate significantly over short periods of time, and can reduce returns. Derivatives, including currency management strategies, involve costs and can create economic leverage in the portfolio, which may result in significant volatility and cause the fund to participate in losses (as well as enable gains) on an amount that exceeds the fund's initial investment. The fund may not achieve the anticipated benefits, and may realize losses when a counterparty fails to perform as promised. The markets for particular securities or types of securities are or may become relatively illiquid. Reduced liquidity will have an adverse impact on the security's value and on the fund's ability to sell such securities when necessary to meet the fund's liquidity needs or in response to a specific market event. Foreign securities involve special risks, including currency fluctuations and economic and political uncertainties. Investments in emerging markets involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size and lesser liquidity. Investments in lower-rated bonds include higher risk of default and loss of principal. Changes in interest rates will affect the value of the fund's portfolio and its share price and yield. Bond prices generally move in the opposite direction of interest rates. As the prices of bonds in the fund adjust to a rise in interest rates, the fund's share price may decline. The fund is also non-diversified, which involves the risk of greater price fluctuation than a more diversified portfolio. Changes in the financial strength of a bond issuer or in a bond's credit rating may affect its value. These and other risk considerations are discussed in the fund's prospectus.

Templeton Global Total Return Fund

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Investors should carefully consider a fund's investment goals, risks, charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at (800) DIAL BEN/342-5236, or visit franklintempleton.com. Please carefully read a prospectus before you invest or send money.

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1. Duration represents a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. Duration is expressed as a number of years. As of August 31, 2015, duration of Templeton Global Bond Fund was 0.03; duration of Templeton Global Total Return Fund was 0.66. Figures reflect certain derivatives held in the portfolio (or their underlying reference assets).

2. As of August 31, 2015, geographic breakdown for Templeton Global Bond Fund: Asia – 34.92%, Europe/Africa – 25.41%; short-term cash and cash equivalents – 22.42%; Americas – 16.49%; other – 0.47%; supranational – 0.29%. Geographic breakdown for Templeton Global Total Return Fund: South Korea – 13.85%; short-term cash and cash equivalents – 12.26%; Mexico – 11.71%; Hungary – 5.44%; Malaysia – 5.3%; Uruguay – 5.13%; Brazil – 4.67%; Indonesia – 4%; Serbia – 3.84%; other – 33.9%. Figures reflect

certain derivatives held in the portfolio (or their underlying reference assets) and may not total 100% or may be negative due to rounding, use of derivatives, unsettled trades or other factors.

3. Correlation measures the degree to which two investments move in tandem. Correlation will range between 1 (perfect positive correlation, where two items historically have moved in the same direction) and -1 (perfect negative correlation, where two items historically have moved in opposite directions).

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