FRANKLIN TEMPLETON INVESTMENTS
Beyond Bulls & Bears

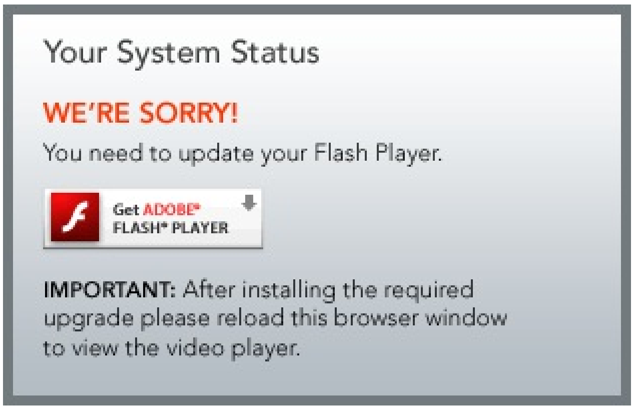
ALTERNATIVES

This Is Not 2008

February 22, 2016

Michael Hasenstab, CIO of Templeton Global Macro, says many market watchers are panicking like it's 2008 again—in the throes of financial crisis. He sees the situation a bit differently, with little reason to believe the United States is headed into a recession this year or that China is headed for a hard landing. Amid the market's sour mood, he's finding opportunities and cautions investors to look beyond short-term sentiment swings and toward longer-term fundamentals.

Watch this brief video with a summary of Michael's views on markets and economic conditions around the world.



A Vast Set of Valuation Opportunities Amid Volatility

We recognize the challenges of the current market environment. Unfortunately, global markets appear to have been negatively impacted by the continued volatility in oil prices and the recent volatility in Chinese equity markets, along with the concerns for economic conditions in China and growth across the globe. However, we believe there is a significant disconnect between the current market pessimism and the underlying global fundamentals. Markets have reacted as if conditions are worse than the 2008 global financial crisis, or the Asian financial crisis of 1997 and 1998, yet several emerging-market countries are in far better shape with larger foreign reserves and more diversified, growing economies. The risk aversion across emerging markets appears to have reached a maximum state of unwarranted pessimism, in our view, and we see a vast set of valuation opportunities amid the volatility.

Are We Headed Toward Global Deflation?

In our assessment, market fears of deflation are unwarranted. The decline in headline inflation has been driven by the collapse in oil prices, yet core inflation has been positive and stable. When the oil price effects roll off the year-over-year inflation measures, statistically we will start to see headline inflation numbers pick back up. Additionally, the US labor market is a key driver of inflation trends in the United States, which also drives inflation trends globally. By our assessment, the United States is at full employment with growing wage pressures. We do not see imminent demand-side deflationary pressures, and we just don't see any present empirical evidence of deflation. We believe the levels of underlying inflation are underappreciated by the markets, and we anticipate a growing increase in the global output gap as emerging markets recover. In our view, there are more risks to inflation moving to the upside than to the downside, yet markets appear to be pricing in deflation and downside risks. We think inflation could surprise the markets.

China and Market Volatility

Markets have overreacted to conditions in China, in our assessment, and these fear-motivated responses are driving much of the broad market sell-offs. But, it's important to separate what's happening in the stock market from what's happening in the actual economy. The Chinese stock market is relatively new and volatile with a limited number of participants; it doesn't represent the country's entire economy. The actual underlying economy is going through a rebalancing, not a collapse.

There are swaths of China's economy that are going into recession while other parts remain resilient and continue to expand. Investors in the old economy of China, such as the manufacturing and industrial sectors, certainly don't feel a 6% growth rate; they feel negative growth. While those sectors are getting a lot of headline attention, they don't reflect the overall economy. It's the consumer-driven sectors of the economy that have continued to expand and that have increasingly become a larger part of China's overall economy. Thus, growth in the service sector has largely offset contraction in the manufacturing and industrial sectors, resulting in a resilient overall growth rate for China's economy of between 6%–7%. That is certainly not a hard landing for the economy and is in fact a healthy rebalancing, in our assessment.

Additionally, the country still has several tools at its disposal to manage growth, including the resources to deploy more fiscal spending on infrastructure projects. If China were to embark on a major infrastructure or environmental project—both of which are needed—that would help support growth and cushion some of the contracting sectors. China has also faced some policy messaging challenges regarding the volatility in its stock market and its currency devaluation efforts. It appears that officials are taking steps to improve how they publicly communicate those issues and the related policy measures, which should help alleviate some of the market uncertainty.

The other challenges we've seen China face have to do with opening its capital accounts. It appears the sequencing got out of order; officials started to open the capital accounts before the domestic financial reforms were complete and before the economic rebalancing had largely taken hold. It probably needs to be the other way around: first a country gets its domestic house in order, then it goes through the rebalancing and fortifies confidence that the economy is not in a hard landing. At that point it is enabled to reform the domestic capital markets, develop the domestic bond market and ultimately open the capital accounts. It appears China is now moving in that direction as we've seen some capital account walls put in place as it works to firm up those domestic conditions. The ability to close the capital account prevents a forced run on the exchange rate, and we have confidence that China is in a good position to stabilize its currency.

Emerging Markets

Conditions right now feel a lot like they did back in 2008 and 2009, when we were buying into emerging markets that were completely out of favor with the entire investor base. In fact, recent discussions we've had with investors in Asia indicated that their least favorite asset classes are currently emerging markets and local currency markets. We feel we've reached a point of maximum pessimism on emerging markets, and those types of extreme sentiments usually indicate an opportunity. We see current similarities to what we saw in 2008 and 2009; however, there was even more uncertainty back then, in terms of the global macro outlook. In those years we were buying into the volatility across the board, including places such as South Korea, Lithuania, Latvia, Venezuela and Russia. Today, by contrast, the subset of opportunities that we find value in is a lot narrower. The magnitudes and market dislocations are similar today, but the actual investments are somewhat different; not all emerging markets are currently attractive.

We are currently focused primarily on two subsets of opportunities: 1) countries with solid fundamentals that are being priced as if they are in a crisis, such as Mexico, Malaysia, Indonesia, and the Philippines; and 2) distressed special situations that are in crisis but appear to have a clear path for exiting that crisis over the medium term, such as Brazil. We think the subsets of opportunities in emerging markets are smaller today, but that doesn't mean we are avoiding the asset class altogether. Certainly, there are several emerging markets that we are avoiding, such as Turkey, Russia, Venezuela, and South Africa, but we continue to see value in some of these other select markets where there aren't major imbalances, yet the markets have completely distorted their valuations.

The Federal Reserve (Fed) and Interest Rates

We believe the Fed risks losing credibility if it falls behind the curve in raising interest rates at a requisite pace. US labor markets remain close to full employment, economic growth is right around potential and core inflation has remained stable. These conditions would justify a normalization of interest rates. However, the Fed has been able to remain dovish because we've only recently reached full employment. The wage pressures come after reaching full employment, not before, so the Fed hasn't had those inflationary pressures to address. Concurrently, the drop in oil prices brought headline inflation down, which further reduced the imminent need to address inflation.

However, we expect wage pressures and continued strength in core inflation during the year, with a jump in headline inflation early next year as oil prices stabilize. If the Fed does not continue on its hiking path, it runs the risk of chasing inflation and losing some credibility, as well as having no mechanism to reduce rates during an eventual downturn in the business cycle. We think the Fed has a lot of credibility, but that credibility would start to erode if it does not stay ahead of the curve and continue to raise rates. In our assessment, the Fed needs to continue hiking rates this year.

Conditions in Brazil

Brazil is in the midst of a crisis that was driven by the previous pro-cyclical and overly aggressive fiscal and monetary policies during the commodity boom cycle. Those policies have now come to an end and the massive fiscal spending and credit extension has been curtailed. Additionally, interest rates were too low for too long and that has been corrected. Interest rates are now above 14%. However, the corrective fiscal discipline has yet to be put into place. We expect those corrective fiscal measures to develop with the shift in political support, and we see a path to recovery, despite the likelihood for continued volatility this year. The market has been pricing in the full brunt of the crisis; however, with bond yields around 16.5%, we believe investors are being compensated for those near-term risks as the country proceeds toward recovery over the medium term. Overall, we view the country as economically strong; it's just the policy mix that needs to be corrected.

What Will Be the Catalyst for Markets to Recover?

Markets are currently in a state of transition from a period of high commodity prices to low prices, from zero interest rates in the United States to rising rates, and from China growing at double-digit rates to moderating and rebalancing its economy. This has caused market volatility, but we believe markets have oversold the risks. We believe that when commodity prices stabilize and when the Fed continues to hike rates while China's economy appropriately moderates, markets will be in a better position to drive valuations back toward what the underlying fundamentals justify.

It's difficult to predict the exact timing of these stabilizations, but we believe we're getting closer to an inflection point on both the underlying data and valuations. In our assessment, when commodity prices find a stable range, markets will be able to recognize that the Brazilian economy does fine at these price levels. Additionally, as the Fed continues to hike rates, markets will be able to see that the rate hikes, for example, do not damage Mexico's finances because it doesn't have a lot of foreign currency reliance and its central bank is in position to raise rates in conjunction with the Fed, thus protecting against a loss in yield differential. Also, as China is able to continuously reaffirm that its economy is rebalancing with a moderation in growth but not a collapse, markets will be able to recognize that the risks are not as extreme as they have been feared to be. When we reach these stages, we believe markets will be able to more clearly see the underlying valuations and recognize that these markets were over-sold.

For a more detailed analysis of inflation as well as other 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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All investments involve risks, including possible loss of principal. 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 emerging markets involve heightened risks related to the same factors.

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