MULTI-ASSET

The Year Ahead: Will the US and Global Expansion Continue in 2018?

January 9, 2018

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January is a month of resolutions and predictions, and perhaps more often than not, both tend to be abandoned come spring. While we don't have a magic crystal ball to predict where the markets may be headed next, we do have a team of respected professionals who recently assembled to discuss whether they think last year's economic momentum could continue—and where they see potential threats on the horizon.

Ed Perks, CIO of Franklin Templeton Multi-Asset Solutions, Stephen Dover, CIO of Templeton Emerging Markets Group and Michael Hasenstab, CIO of Templeton Global Macro, are featured in our latest "Talking Markets" podcast. Tune in.

TALKING MARKETS WITH FRANKLIN TEMPLETON INVESTMENTS

Here are some highlights of the views of speakers represented in the podcast:

- Michael Hasenstab: From our global macro standpoint, things look pretty good. We don't see any huge signs of overcapacity and we need to remember expansions don't die of old age. They die because something was in a structural imbalance. What we're trying to do is think about how this all ends because it has to end at some point.
- Ed Perks: A lot of the positives that are playing out in the economy have more to do with the health of the consumer, consumer sentiment, business sentiment. That's what's really driving economic growth and driving the performance of our markets. But, I think this is a time to be relatively nimble in portfolios and have the flexibility to adapt to changes that are coming.
- Stephen Dover: I don't recall a time where people are so positive about the equity markets. I think we've had very much a risk-on trade for a very long period of time. So I have some concern about all the movement there's been towards greater risk, a lot of that being illiquid. Right now the market is priced for

a Goldilocks-type of environment. The environment's pretty benevolent though and we don't see major changes in the short term.

The full transcript of the podcast follows.

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—a start to the new year, and the big question on many of our minds is—will the US and global expansion continue?

Host/Richard Banks: Ed Perks, CIO of Franklin Templeton Multi-Asset Solutions, Stephen Dover, CIO of Templeton Emerging Markets Group and Michael Hasenstab, CIO of Templeton Global Macro, sit down with Katie Klingensmith. Katie, take it away.

Klingensmith: I think there's a lot to watch out for in the world. And a big question to get us started is when do we think that this current period of US and global expansion will end and what signs should we be looking for. Michael?

Hasenstab: I think the next couple of years from our macro standpoint look pretty good. We know we don't have any huge signs of overcapacity and we need to remember expansions don't die of old age. They die because something was in a structural imbalance. Even though we've been going on for like eight years, which is longer than almost any expansion, we haven't had the overinvestment, which is why growth has been lower. But it also takes away one of the prerequisites for a recession. I think monetary policy is going to start to tighten in the US but it's still pretty loose globally.

There is a lot of deregulation happening in the banking sector which can put more credit into the market, so I think that's a decent environment for risk. But what our team is spending the time on and what hopefully can be of value, is [by not] telling you the world is rosy; you're living in it right now you kind of feel it. That's not helpful.

What we're trying to do is think about how this all ends because it has to end at some point. I think there are a couple of things unique about this expansion. We have printed so much money. Never in the history of central banks have we printed this amount of money. That has obviously distorted the US government bond market beyond recognition. Any other part in history, if you had 3% growth and 2% interest rates, you'd have 5% 10-year [US Treasury] yields, and we struggle to get to 2.5%. So we know we're completely out of whack, and this behavior has pushed people into a lot of risky assets, increasingly illiquid, risky assets.

And so when the unwind happens, I think it's not going to be pretty. Our concern is that when the US does go into a recession at some point—we're watching the labor market, capacity markets—it could be the Fed gets behind the curve and then they have to tighten rates to get control. That trigger could be a financial-market event because asset prices are probably going to keep going higher. We don't know, but when that does happen in the US, my concern is that there are vulnerabilities in other parts of the world that could bring together the sort of perfect storm.

I think things are good now, but in terms of how we're positioning our portfolio, we're getting super liquid. We're keeping a lot of powder dry. We'll talk later about emerging markets—and there's some great little opportunities there—but it's the point in which people become comfortable and complacent that you need to be worried. When everyone's worried, you should probably be jumping in, but when everyone feels good you should probably be thinking about getting out.

Perks: You know, just to jump on Michael's comments, as he says the expansions don't die of old age. They do die occasionally because of policy mistakes, though. I think we're obviously at a pretty critical juncture at this point because the Federal Reserve has told us about their path forward in terms of raising short-term interest rates and normalizing monetary policy. They've also now laid out a pretty significant roadmap for the unwind of a lot of the QE [quantitative easing] that happened in the US.

It remains to be seen how quickly that will play out in other regions where there's been all of that money printing that Michael talked about. So while we look at a US expansion, a global economy that seems to be a bit more synchronized and has some really favorable tailwinds for the first time, at least in coordinated fashion, really since the [2008-2009] financial crisis. All that is great, but we do realize we [the expansion] are getting a bit longer and we'll start to have potential influences on markets that are the opposite of what we've had.

And clearly, the QE was meant to guide or encourage investors to move into riskier assets. I think that was a certain accomplishment of the [QE] program and as we see the opposite of—even if as the Fed reduces its balance sheet—there is a certain element of reinvestment still happening. There starts to be a growing need for other investors to step in and want to hold those assets again. I think that's our bigger concern within multi-asset solutions—just what impact does that have on longer-term rates across the US bond market, [and] I think global bond markets and then ultimately the influence that can have on equity valuations. So this is a time I think to be relatively nimble maybe in portfolios and have the flexibility to adapt to changes that are coming.

Klingensmith: There continues to be a lot of noise around the political scene here in the US. How do you view that noise and the possible impact of it?

Dover: One of the comments that I make, especially about the United States, is that it's probably a mistake to listen to the news and the politics too much because the United States is still primarily a private society. It's really primarily still driven by companies and an economy. The president has influence, but it's on a marginal amount and usually there's a lag to it. That doesn't mean presidents can't do very bad things, but I think it's probably over-emphasized what [Donald] Trump or any other president does at one point or another point. Tax policy, nominating people to the Federal Reserve, any of those things have a lag effect.

In fact, probably the irony is that a lot of those effects lag a couple of years, so you're kind of now living a little bit off whatever happened in the Obama administration. I don't know that the economy would be that much different right now if we had a different president than Trump. Now, that changes over a period of time, but when I travel that's probably the most-asked question and I'll just make the point that there's a lot going on in the US economy that has really nothing to do with the political sector.

Perks: Yeah, I think there's an element, unfortunately, there's a little bit of an element of that this is par for the course. If you look back over the last several decades, there's been an element in many of the prior administrations as well. It doesn't mean we can ignore it and we certainly have to pay a lot of attention to what's happening. But you know, I think to Stephen's point, a lot of the positives that are playing out in the economy have a lot more to do with the health of the consumer, consumer sentiment, business sentiment and that's what's really driving the economic growth and driving the performance of our markets.

Klingensmith: Stephen, How do you think about this expansion and how do we think about equity markets at this long period of increasing values?

Dover: Well, I don't recall a time where people are so—the consensus is so positive about the equity markets. I think we've had very much risk-on trade for a very long period of time. So I have some concern about all the movement there's been towards greater risk, a lot of that being illiquid.

The general environment's fairly benevolent. We have a government in the US and pretty much globally that's pretty supportive of business. Rates are low. There doesn't look to be any jump in [interest] rates in the short term, even from what we can talk about [regarding] the Federal Reserve [leadership] change, but doesn't look like there's going to be any really big changes. Earnings are growing but the markets right now are priced for sort of a perfect Goldilocks-type of environment, where it's not too, you know, —everything's just perfect. And that's the concern. Just to remind you, the Goldilocks story is the story where she goes to the house and she tests the porridge and one is too hot and one is too cold. And she finds the one that's just right and the bears come home and they love her and it's a happy-ever-after story. But in the original version the bears eat her. That's perhaps the problem that we have, the kind of thinking that everything's fine and there isn't as much caution as there used to be.

Klingensmith: What signs would you highlight for when the environment does start to sour? The porridge gets a little too cool?

Perks: It wasn't that long ago—it was only 18 months ago—that we were actually looking at markets where maybe in the US, down about 14%-15% from the prior peaks. Globally, the MSCI All Country World [Index] was down 20%.[1] We had a very different outlook just 18 months ago and I kind of find myself reflecting on that despite this, you know, daily parade of all-time or new highs in the markets. The situation was pretty different not that long ago.

So I think we have to be careful and not lose sight that there were a lot of different influences on the market. At that time, certainly it was concerns about what was playing out in the commodity markets, energy in particular, with the big catalyst there the down-move in prices. There were certainly concerns about China's growth rate and the transition in that economy, there were concerns about liquidity in financial markets, credit quality. Certainly all of that played out. A lot of people pointed to both US and I think to some extent global corporate fundamentals as being unsustainable and margins coming under pressure and the US falling into an earnings recession. There was a lot of bearish sentiment not that long ago. I think we can fall back into that pretty quickly.

Ultimately, fundamentals are showing that they're pretty strong. And companies in many respects are still pretty focused on what we would consider to be pretty positive policies for capital allocation, meaning they are selectively investing in businesses, those that didn't [pay dividends] are paying dividends to shareholders. Share buybacks are part of it, but we don't see necessarily elements of excess that have us really concerned at this point with how corporates are managing the cycle.

Dover: Picking up a little bit on that is in the equity market in real simple terms, all you're doing is discounting future cash flows. And when you have low interest rates then it makes future earnings more equal to current earnings. Right. So it increases risk in that sense. So that's one of the reasons technology companies are some of the companies that are at higher risk, and aren't making earnings now, have more value. But as interest rates start to change you put more and more value into companies that have current earnings. And if you actually look at the markets and you see markets where we've had so much growth in companies that have future earnings and not so much growth in companies that have current earnings—that could be one of the shifts in the market. I mean, we have to look at how we value.

Klingensmith: How do we invest right now? How do we think about investing in the fixed income space when [interest] rates are rising?

Perks: I think as Michael clearly touched on, the risks particularly in the very low-yield environment that exist today across the fixed income markets, the US and global, that's a very challenging situation and backdrop for fixed income investing. So I think in general we're picking select pockets where we still think there's value. That might be in select corporates where once again, the theme is more about the corporate fundamentals driving that unique investment, as opposed to broader [interest] rate moves. Now the catalyst is certainly difficult to pinpoint. We've just experienced a little bit of a back-up in longer-term interest rates in the US now and certainly from the lows in 2016 when some of that bearish sentiment still existed post-Brexit. A lot of concerns about the global economy, having pretty significant headwinds because of some of the political dynamics that we've weathered. Beyond that, it's pretty challenging, and I would say, in general, in multi-asset portfolios despite equity valuations, equity market performance, that there are more pockets for us to leverage our fundamental research and deployment in equity so we're a bit more tilted across the board that way.

Klingensmith: Are there different opportunities outside of the US right now? And how do you see emerging markets?

Dover: I had the opportunity to be in Brazil from 1997 to 2002. It's always volatile in Brazil but a particularly volatile time in Brazil during the Asian crisis which in essence went around the world and was stopped in Brazil. So the currency, the fixed currency, bust and went basically from one-to-one to four-to-one. Interest rates went from 18% to 50% and all over the place, a lot of volatility. What I really learned from that experience is you really want to focus on these companies that have a way of learning how to get themselves through this great degree of volatility. I think that the way to invest is to look for differentiation in terms of something that's overlooked or something that's idiosyncratic or something that is not correlated with everything else.

And that's why we focus on the fundamental investing**,** trying to find those individual opportunities, those companies. And because there isn't as much information about those companies, it's a way for us to add value that we can't do as well as trying to time the various markets. That said, when we look at emerging markets—and this is where Michael and I are on a lot of panels together and we've been discussing this over the last couple of years pretty strongly—is that we've just seen a lot of opportunities in those markets. Remember emerging markets are so broad. So maybe it's a third of the emerging markets that we're really talking about. And from an equity perspective, the returns of the emerging-markets portfolios over the last couple of years are much more tied to company performance, and to some degree sector performance, than they are to macroeconomic variables.

Emerging markets have changed so dramatically from what they were before, from basically being driven by exports and commodities. Now the benchmark is much more consumption and technology, and a lot of innovation. And it's exciting to see how—I've said this before—but I think, emerging markets are appropriately titled emerging because they've changed so much. So this is not your father's emerging market if you will. It's changed. And the US, to some extent, has probably been better-performing since the global financial crisis. So there's a lot of catch up in emerging markets as well and some under-valued currencies as well.

Klingensmith: How do we think about building a portfolio, especially with some of the risk scenarios we're talking about, to guard for these correlations?

Perks: Yeah, and that's certainly the experience that many investors know during the last bad bear market, the financial crisis of 2008/2009. I think there's a lot of different elements to that. I think clearly the approach that we've all somewhat touched on is how we're managing portfolios today and not taking broad market exposures that may have been more beneficial to have over the last 5-8 years as QE in the US and globally was really driving a lot of risk assets higher in uniformity. So one way to approach it is to think about portfolios. One of the things that certainly characterizes markets, US equities in particular, is how low volatility has become. How it has just settled into a level that really was not very consistent with prior experiences and to some element that is lower correlation starting to be reflected.

I look broadly across the S&P [500 Index], a breadth of 100-day, 200-day moving averages, a third of the S&P is below its 200-day moving average. Nearly half of the Nasdaq is below its 200-day moving average.[2] So there is still underlying cross-currents and much lower correlations in asset classes. I think those are very favorable for broad portfolios to be paying attention to. On the flip side, is just the reality of what kind of hedging or downside, tail-protection-type strategies portfolios need. Right now, we're in a pretty favorable environment for many portfolios to consider those because volatility is priced so cheaply so you know even in some of our more traditional strategies, we're pursuing and executing on more of those type approaches.

Klingensmith: There's a real demand for income and in this very low-rate environment that can of course be quite a complicated challenge. Do any of you have insights about how to think about that in a portfolio right now?

Hasenstab: If it's not there, don't try to make it happen. I think a lot of the traditional yield markets, the credit market, I mean they've just squeezed the value out and if you're just trying to buy, you might have to give it up for a year or two and protect your capital.

Perks: I would just add a couple of points and maybe some of this is a little more relevant for the US markets. I think that maybe the worst is behind us in terms of investing for income. We've gone through a multi-year period of very low yields and a very difficult environment for corporates that came out of it and as a result we now see, maybe we're in the early stages, but yields are clearly moving up. Globally we expect that to increase the opportunity set for income investors.

When I think about sectors across the equity market, some of the traditional yield-oriented sectors continue to perform pretty well even though we're at a stage now where we're seeing potential rising-rate pressures on that pocket. Utilities would, I think, be a great example of that in the US that have continued to generate nice returns for investors despite that kind of bond-proxy label that they've had historically. And there are underlying fundamental themes within the utility sector, a lot of that having to do around the more environmentally oriented generation and growth potential or growth opportunities within that. Rebuilding infrastructure is also an important component that's created that element for that sector. On the flip side is maybe, a sector that has fundamental headwinds like telecommunications stocks that have very high yields are among the worst-performers in the marketplace [in 2017] because they don't have that offset. So I think there are a lot of different elements that we need to think about when we're investing for yield. But generally, I think as we move forward that opportunity improves.

Klingensmith: Thank you, Stephen Dover, Michael Hasenstab, and Ed Perks.

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2. Source: The 200-day moving average is a technical analysis indicator which is used to analyze long-term price trends. It represents the average closing price of an individual security or index over a period of 200 days.

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