PERSPECTIVES

PODCAST: Making Sense of Recent Market Action

January 15, 2019


Edward D. Perks, CFA
Executive Vice President,
Chief Investment Officer,
Franklin Templeton Multi-Asset Solutions


Sonal Desai, Ph.D.
Executive Vice President
Chief Investment Officer
Franklin Templeton Fixed Income


Stephen H. Dover, CFA
Executive Vice President,
Head of Equities

After a turbulent end to 2018, early January brought some relief for equity investors, but there certainly are no shortage of uncertainties about the year ahead. Three of our senior investment leaders recently participated in panel discussion about what they see affecting investor sentiment, how they think changes in monetary policy are influencing market action and why they don't see a US recession this year.

Tune in to our latest "Talking Markets" podcast and hear more from Franklin Templeton Fixed Income Group CIO Sonal Desai, our Head of Equities Stephen Dover and Franklin Templeton Multi-Asset Solutions CIO Ed Perks.

TALKING MARKETS WITH FRANKLIN TEMPLETON INVESTMENTS

Key Takeaways:

- When we look at recent market action, there are a number of things we think have driven market moves, and certainly at the forefront is the removal of monetary policy accommodations.
- We think it's likely the US dollar is not going to appreciate as much as it has the last couple of years. That gives opportunity in emerging markets, and particularly in companies that aren't as well-known to investors.
- The world seems to be thinking about a US recession but if you look at what's happening to the underlying fundamentals in the US economy, they are still pretty strong. The US labor market is strong and wages have been rising.

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, there is a lot on investors' minds around the world right now, and on this episode, three of Franklin Templeton's senior investment leaders break down the key factors driving market movements, how they view economic conditions and where they see investment opportunities. Stephen Dover, head of Equities; Sonal Desai, chief investment officer, Franklin Templeton Fixed Income Group and Ed Perks, chief investment officer, Franklin Templeton Multi-Asset Solutions, give their perspective. Katie Klingensmith leads our conversation, Katie?

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, there is a lot on investors' minds around the world right now, and on this episode, three of Franklin Templeton's senior investment leaders break down the key factors driving market movements, how they view economic conditions and where they see investment opportunities. Stephen Dover, head of Equities; Sonal Desai, chief investment officer, Franklin Templeton Fixed Income Group and Ed Perks, chief investment officer, Franklin Templeton Multi-Asset Solutions, give their perspective. Katie Klingensmith leads our conversation, Katie?

Katie Klingensmith: Thank you Richard. Let's start with what's been a lot of movement in the markets of late. Ed, how do you view what's been happening?

Ed Perks: I think when we look at some of the recent market actions, really there are a number of things that really kind of come to mind that we think have driven a lot of the movements we've seen in markets, and certainly maybe at the forefront of that is some of the quantitative tightening. So the removal of the monetary policy accommodations that have been so important for much of this expansion, really coming out of the financial crisis [of 2008-2009]. And certainly, markets are adapting to that reality; 2018 really put that at the forefront because the Federal Reserve was also normalizing interest-rate policy and we saw a number of increases in short-term [interest] rates. That, kind of combined with that quantitative tightening, did affect an overall rise in interest rates in the US economy. And that certainly raised, I think, some concerns in the market around the durability of the expansion, the continuation of the expansion that we're in. When we look beyond that, maybe a little less tangible, but things that have really impacted investor sentiment, certainly some of the political dysfunction that we're seeing and the transition, certainly, the House of Representatives over to Democrats, the [US government] shutdown that we saw at the end of 2018 that continues to this date. But when we really look beyond those things, we see some positive fundamentals still as a backdrop for the overall market. While rates have risen, they're still at relatively low levels and at levels that we think will not impede economic activity. We also have a backdrop for the consumer that remains quite healthy. The consumer balance sheet remains in very good shape. Even looking at certain segments of the economy, like energy, that have seen a substantial decrease in energy prices that can actually over time benefit the consumer, benefit the economy. So while we do see certainly some slowing in growth in the US economy, I think it's important to realize we do still expect there to be growth.

Katie Klingensmith: Sonal, what are your thoughts on economic conditions right now, and do you see that the Fed's interest rate hikes are really going to be slowing down?

Sonal Desai: I think market expectations for the end of the economic cycle are highly overstated right now. If you look at what's happening to the underlying fundamentals in the US economy, they're still pretty strong. I do think that, you know, this year we will see some moderation of that 3%-style steady growth of 2018—maybe some moderation—but it's moderation to a point which is still above potential. This is really important. Maybe the Fed [Federal Reserve] doesn't raise three times or four times as we might have anticipated perhaps several months ago. Maybe it raises twice, but the assumption that the Fed will not raise, I think is misguided.

Katie Klingensmith: Stephen, as you focus on equity markets, how are you factoring in monetary policy?

Stephen Dover: We've been living in a great stimulative experience over the last 10 years as we've had monetary easing around the world. Now we're going to the second part of that experience. As we move towards monetary tightening, we don't know exactly how that's going to work out and that is the biggest uncertainty and the biggest factor we have to look forward to in 2019, but probably for the next few years, the low rates that we have had over the last 10 years have to some extent distorted how equities are valued and made companies with long-term earnings cheaper relative to companies that have consistent stable earnings. As interest rates rise, we are likely to see an increase in the value of those companies that have more stable earnings and that's the type of companies, in general, we're moving toward. This will be the great experiment where we see the big monetary banks moving the baton from their monetary stimulus over to the real economy.

Katie Klingensmith: As you look for opportunities, how do you consider the success of US companies last year?

Stephen Dover: 2018 was a fantastic year for earnings growth—particularly in the United States—and that was partly because of the great tailwind of tax cuts, regulatory changes and fiscal stimulus, which is not going to repeat itself in 2019. We think corporate earnings are likely going to grow roughly 8% over this next year. Good, but not as good as 2018. A good underlying effect for the market, but not what we had in 2018. Perhaps what's going to be interesting is that US earnings were so much higher in 2018—the US market outperformed foreign markets—we think that's less likely to happen this next year as the US doesn't have a stimulus that's so different from other countries.

Katie Klingensmith: One of the countries that continues to be a focus is China—and the ongoing trade issues with the US. Do you see any resolution in sight there?

Stephen Dover: I think it's important to understand that trade with China isn't just about trade, but it's really a much bigger, more complicated geopolitical issue. It's likely that there will be some resolution to this trade issue within the next few months. China has local economic problems and has every desire to try to resolve this. That doesn't mean that we won't have ongoing issues, but likely in the short term there'll be some resolution and that would be really positive for equity markets and we would expect a step up in positive reaction.

Katie Klingensmith: If there is a resolution, sometime in the near future, Sonal, would you still have more longer-term concerns?

Sonal Desai: Our view on China has become somewhat more pessimistic than we've had historically. It isn't to say that we're anticipating a rapid downturn in China. That's not it. We're not talking about a hard landing this year. Will we see growth ease closer to something like 6%? Probably. That's probably healthy. Our bigger concern though is if we do get that external shock—when we get a recession in the US. I think the number of silver bullets that China has left to fire is dramatically lower than at any other time in the last decade and that's something which we should all be concerned about. In terms of how much China can increase its credit to try and shore up growth, that's problematic. I think that these are factors which definitely weigh in terms of risks to the outlook more globally. The global outlook is a little bit more at risk from China today than it was say two or three years ago.

Katie Klingensmith: You mentioned a recession in the US, but you don't view it as coming this year.

Sonal Desai: The entire world seems to be thinking about a recession in the US. I don't think there's going to be a recession. We have a strong labor market, we have wages going up, essentially, firms' pricing power is going to go up.

Katie Klingensmith: What about inflation, do we need to see higher inflation in the US to expect long end rates to move up?

Sonal Desai: I would say no, actually. That is going to come almost independently on the back of the very strong underlying economy, I think that you are going to see higher US Treasuries. I do think we will have somewhat higher inflation, but we're not talking not massively higher inflation.

Katie Klingensmith: Speaking of higher US Treasuries—the 10-year Treasury yield topped 3.2% in November, and then really quickly dropped to as low as 2.55%. What's your current view on long-term US rates?

Sonal Desai: I would actually say that, you know, when we were at 3.20% [Treasury yields] markets had absorbed 3.20%. This economy, these markets can take higher Treasury rates. We had a period of panic, we had dislocations. So if I look at these two periods and say, where do I expect Treasuries to go back, it's definitely in the direction of 3.20%, if not higher. And the big thing here is it's not a reason to panic. We will get periods of volatility in the year going forward. I think that's the only given over here, but the most important thing here is not to panic. It's okay because this is what active management is here for, to try and take advantage of these periods.

Katie Klingensmith: Ed, what have you observed with the return of market volatility and some of the dramatic market movements we've recently experienced?

Ed Perks: Clearly there's been a normalization of some of the volatility, and I think prior to 2018, there was a backdrop that suppressed volatility. And a lot of that had to do with the monetary policy that was in place to support the economy. As it has normalized, and, and we've seen now markets in many ways behave more in line with how they have historically, you add these other elements that have questioned the durability of this economic expansion. and we've seen real movements in markets. And I think from an active manager standpoint, there are really two things that stand out for me. One is when you have such large movements in broad asset classes—we at times, last year, saw substantial increases in interest rates affecting different parts of the fixed income market, but then the end of the year, we saw substantial downdraft in equity prices—that naturally gives us a tremendous opportunity to think about relative value between different asset classes and how we want to position to pursue our longer-term investment objectives. But additionally, when we look specifically within asset classes, particularly with the volatility that we saw in markets to end the year, it was a very, kind of, broad-brush moment when the markets, as a whole—across sectors, across companies, within sectors—really being impacted, very broadly by this downdraft. That's a great opportunity for active managers to really apply the fundamental research that we have, to look for very specific opportunities, and identify those companies that we think, are really now, kind of, in many respects kind of on sale because of something that's happening in the broader market.

Katie Klingensmith: What about the government shutdown in the US—how does it impact the economy and markets?

Ed Perks: Our view on the current government shutdown is that in the short run, it really creates more of a deferral of economic activity. So some of the drag effect we may be experiencing once there is a resolution, in large part, we expect that to come back. I think importantly though, one of the real elements of the shutdown is that it does create some uncertainty in markets and that may be contributing to some of the volatility that we've been seeing. Long term, if the government shutdown were to remain in place, then we do think there could be a real impact—on whether it be consumer or corporate sentiment and optimism—that ultimately can lead to reduced economic activity.

Katie Klingensmith: Stephen, you mentioned earlier you're not expecting a repeat of last year with US markets outperforming foreign markets. With that said, where do you see opportunities in emerging markets?

Stephen Dover: We think it's likely the US dollar is not going to appreciate as much as it has the last couple of years. That gives opportunity in emerging markets. Emerging markets, in general, have less debt than a lot of the developed markets, making them potentially more stable. Specifically, we think there are going to be opportunities in countries such as Brazil, which has a new president and a new Congress that is likely to move towards fiscal stimulus, tax stimulus as well as a better regulatory environment.

Katie Klingensmith: What about China—we've talked about the challenges there, but do you also see opportunities?

Stephen Dover: China could provide a lot of opportunity in 2019 in both the local A-Share Market, as well as the overseas China market. If the trade issues are resolved with China—between China and the United States—that's likely to be very positive for the equity market. China also will have a larger portion in the global indexes which will just naturally increase and add more flow into the Chinese equities. So we see opportunity there.

Katie Klingensmith: Let's go to the Middle East, and I know you're closely tracking opportunities in Saudi Arabia.

Stephen Dover: Saudi Arabia will go from not being in the emerging-markets index to being included at about 3% of the emerging-markets indexes. These are companies that aren't very well known by most investors, and as a person who's visited Saudi Arabia many times, it's an opportunity for active investors to really get to know those companies and add value.

Katie Klingensmith: Sounds like you think a lot of potential with companies there. Let's end on a country you think could really surprise this year.

Stephen Dover: The Ugly Duckling of 2018 was Turkey, and it perhaps will turn into a swan in 2019. It was one of the worst-performing markets in 2018, and now, I think has the opportunity for a turnaround in 2019, as that country goes through closer relationships with the United States so there's less political turmoil and there are regulatory changes and stimulative changes within that country.

Katie Klingensmith: Stephen Dover, Ed Perks, and Sonal Desai—thank you for joining us.

Host/Richard Banks: And thank you for listening. If you've enjoyed these insights, and would like to hear more, check out our archive of previous episodes and subscribe on iTunes, Google Play, or just about any other major podcast provider. So, until next time when we uncover more on the ground insights from our investment professionals, goodbye!

To hear even more insights from our investment leaders, visit our Global Investment Outlook web page.

To get insights from Franklin Templeton delivered to your inbox, subscribe to the Beyond Bulls & Bears blog.

For timely investing tidbits, follow us on Twitter @FTI_US and on LinkedIn.

The comments, opinions and analyses expressed herein should not be considered recommendations to invest in any security or to adopt any investment strategy. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice. The material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy.

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.

What Are the Risks?

All investments involve risks, including possible loss of principal.

Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors or general market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds adjust to a rise in interest rates, the share price may decline. Interest-rate movements may affect the share price and yield. Treasuries, if held to maturity, offer a fixed rate of return and fixed principal value; their interest payments and principal are guaranteed.

Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging market countries involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Such investments could experience significant price volatility in any given year.