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PODCAST: Market Resilience: Strength in Numbers

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Concerns about where the financial markets are heading are at the forefront of many investors' minds. The risks of a US or global recession this year continue to persist amid slowing global growth, trade tensions and worries about potential geopolitical shocks. Recognizing uncertainties, central banks globally—including the US Federal Reserve—have turned a bit more dovish, causing markets to price out US interest-rate hikes in 2019.

Our senior investment leaders see a different story unfolding. In this roundtable discussion, they outline why they think some market observers are misguided and where they see opportunities today.

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, Templeton Global Macro CIO Michael Hasenstab and Franklin Templeton Multi-Asset Solutions CIO Ed Perks. For even more insights, visit our Global Investment Outlook web site.

TALKING MARKETS WITH FRANKLIN TEMPLETON INVESTMENTS

Key market and economic topics:

- "It seems like currently there is near-complete consensus the United States is going to hit a recession within 18 months or so, but I find it difficult to determine what is going to cause it. The US labor market is strong and the Fed is dovish. I don't see what the triggering mechanism for a recession would be right now." – Sonal Desai
- "The last 10 years of monetary policy has increased asset class correlations. As monetary policy normalizes, I think the differences between asset classes and company correlations will matter more. This means stock selection will add more value to the investment process. If markets tilt in favor of value, it will lead to a new set of companies leading the markets." – Stephen Dover
- **"**US Treasury yields should go higher for many reasons: growing fiscal deficits, rising inflationary pressures, strong US growth and fewer foreign buyers. When that happens, we will likely get another interest-rate-led shock to broad assets. We think investors need to prepare for that risk." – Michael Hasenstab
- **"**I think fundamentals remain a pretty favorable backdrop as long as global GDP sustains itself. But we have a lot of transition happening in the markets, and I think it's incumbent upon us to ensure that we can react to opportunities that markets are inevitably going to give us as volatility increases." – Ed Perks

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: our latest edition of Franklin Templeton's Global Investment Outlook. Despite slowing growth in the US economy, hear why our investment leaders think a recession is not likely near term, and how they're viewing economic conditions in Asia and Europe.

Plus, the impact of a dovish pivot by the US Federal Reserve and a breakdown of monetary policy around the world. And, hear how orthodox policy is driving opportunity in some emerging markets.

Discussing it all is Michael Hasenstab, Chief Investment Officer, Templeton Global Macro, 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. And leading the conversation is Katie Klingensmith. Katie, take it away.

Katie Klingensmith: Thank you, Richard. And thank you Stephen, Sonal, Michael and Ed for joining us. There have been quite mixed signals about global economic activity. Michael, can you kick us off with your outlook?

Michael Hasenstab: I think, in fact, there have been some recent signals that maybe—particularly in the US—economic activity will be bottoming and we are starting to see some normalization. I think there has been too much bearishness, this view that the US is about enter a recession, or is in a recession, I think that is overstated. However, I do think there are some growing concerns fundamentally about long-term sustainability—this idea of massive reckless deficit spending, the populist politics that lead to uncoordinated and often volatile economic agendas—I think, put a more fundamental concern longer term. But in the short term, US economic activity certainly driven by a very strong labor market, supportive consumption, I think that at least gives us some comfort in the very short term.

Sonal Desai: I would say the very short term because there seems to be now complete consensus that we are going to hit a recession in the US by the end of this year or in 18 months. And what I find a little bit more tricky to figure out, in that time horizon, is what is going to cause that recession? Because we do have those strong labor markets, we don't have, by any means, a hawkish Fed—the Fed is very dovish. [High] Energy prices—another leading culprit—not around. Financial stability and asset-price bubbles, that's what we are looking at.

Ed Perks: You think back to the fourth quarter 2018—both in equity and in credit—that was a pretty big dislocation. And this recovery, I think, has a lot to do with the pivot that the Fed made. Clearly, they are dovish and markets took a reprieve from that and we have seen the rally so far in 2019.

Stephen Dover: It's interesting sitting here because a quarter ago, the market was saying, "we are likely to go into recession, Fed's going to raise rates, China trade deal," algorithms were unwinding with all these hedge funds and then we have had this big bounce back which seem to be a little bit too pessimistic, and perhaps now it's a little bit too optimistic.

Michael Hasenstab: I think one of the concerns I have, though, again going into that longer-term view, is that that recovery and risk assets was the Fed being told to be dovish and flipping their view perceivably, like overnight. And you can do that a couple of times, but at some point, the credibility of the institution is at stake and with the very tight labor market, that's good for consumption and growth short term. Clearly, the wage price inflation is now coming through and that's good, to some extent. It's solving some of these inequalities, but at some point, it will be inflationary. And if you have a Fed that is being directed to be dovish in the face of inflation, that draws into question its institutional strength and that to us is a medium-term concern.

Stephen Dover: Well, from an equity manager point of view, it almost looks like the Fed has three objectives—inflation, wage growth and not letting the market fall too much. This is the issue, is that there is, in essence, been a "put."

Sonal Desai: And I think that "put" though, it goes way back. It started with Greenspan [Alan Greenspan, former Chair of the Federal Reserve of the United States] and it's always been alive and well, and I think it's really interesting. What you just said Stephen, about it being the equity market, I think that's completely true because fixed income markets, we saw US Treasury sell off. The Fed did not respond to US Treasuries, it responded to the equity market. I would actually say that that's pretty dangerous. The Fed should not be targeting the equity market and there hasn't been any very good example of a central bank targeting asset prices and doing it successfully in a way that didn't hurt.

Michael Hasenstab: Well that goes back to the issue of your multiple targets. And I think that is a problem around the world, is that when you have populist, divided populations and governments and institutions are failing, the one institution that's been tasked with solving everything, is the central bank. The central bank can't solve income inequality, target inflation and target growth. It's just too many objectives. So, I think it goes to the fundamental issue that the breakdown of broader institutions, maybe isn't a problem when growth is good, but our concern comes in the crisis response later. I mean we think back to the global financial crisis [2007-2008], you had coordinated responses between China, US, Japan, Europe, they are barely talking now.

Stephen Dover: Right, and China doesn't have the ability to come in like it did last time.

Katie Klingensmith: If we look at further out in the US what are you expecting? Would you expect that the growth will continue?

Sonal Desai: Right now, I think you need something to happen to push the US off its growth path. It's not that we are talking about 3.5% or 4% growth, that's not it. It's just that you need the bursting of a bubble, you need something to shock the US into a recession.

Sonal Desai: I don't see what the triggering mechanism for that recession. Right now, we don't see it.

Katie Klingensmith: What about globally, Michael?

Michael Hasenstab: I mean, I think you have clearly seen a moderation in China, but our view there is, they have such incredible control over the economy, over their capital flows, that a domestically led collapse is pretty unlikely. Things in Europe have been turning down. Some emerging markets have begun to stabilize a little bit, but, they have been a little bit weaker. But we don't see this massive downgrade of global growth, as long as the US can remain this anchor.

Stephen Dover: I think China is probably one of the better examples for the economy. It's not the stock market, right? The fastest growing economy over the last 20 or 30 years, but not the best-performing stock market. And right now that's particularly true because there are other factors going on in China. One of those being that the China market, which has been kept out of the global indexes, is now being included, and it's going to be included to such a degree that it's upwards of half of the emerging market index. So, if I were to look at a place on the equity side right now, I would look at China and some of the changes that are going on and separate that from the economic news that China is slowing down a bit.

Katie Klingensmith: Would anyone like to comment on interest-rate policy?

Michael Hasenstab: Well, I think it's this issue of being led by the Fed that there's a lot of central banks in the developed world that are probably behind the curve. And I think mostly the US. And I think that is a concern. I wouldn't say the US is becoming an emerging market, but some of the behavior on fiscal policy, on monetary policy are things that we have only usually seen in emerging markets.

Sonal Desai: And I would say just talking a little bit about central bank policy, turning our eyes to Europe for a bit, there's been a lot of noise about the European slowdown. And I would note that it's slowing down, sure, the eurozone is slowing down to probably around 1.5% to this year, but this is still substantially above European potential GDP [Gross Domestic Product] growth. So it's certainly not a global slowdown led by Europe. Very rarely, apart from when we saw the eurozone debt crisis, has Europe really been at the forefront of the global move in any direction so to speak, and a very easy ECB [European Central Bank] for sure.

Stephen Dover: So some of that slowdown in Europe is Germany—Germany is very much tied to China growth—so when there is some clarity on tariffs and what's going on in China, that could help Germany particularly in European growth.

And secondly, obviously there's just a lot of, for equity investors, concern about Brexit and we don't know what's going to happen, we can't predict it—but, we'll know better in the next month or so and I think some clarity will help the markets.

Ed Perks: And then just to bring it back to the US. I think we have already touched on interest-rate policy in the US and how the market movements in the last six months have been heavily influenced by that interest-rate policy and I think if growth sustains itself, particularly with asset markets performing pretty strongly year to date, I think that's a natural challenge that's being set up or event that we are going to have to deal with.

Stephen Dover: So Ed, what are you seeing in credit markets, what are you seeing even like going forward in terms of how companies are going to finance themselves?

Ed Perks: Companies still have a lot of access to capital markets and rates that they are issuing long-term corporate debt at is still very reasonable—higher than where they were, but still very low for corporate—so we don't see much of a challenge there. I think in the more speculative parts of markets, we have seen some challenges in the floating rate loan market, a lot of kind of excessive type of borrowing, maybe, was happening in that pocket of the market that I think corrected a bit meaningfully at the end of the 2018 and has also kind of not rebounded as quickly, still seeing some outflows from that segment of the market. So we expect companies, generally, to remain pretty diligent about their maturity schedules and their overall level of borrowing.

Stephen Dover: So, kind of connected to that is stock buybacks and companies either financing for buybacks or using their tax gain. I mean, last year we saw almost a trillion dollars in buybacks, heavily in the technology area. So a lot of the support for the public market over these last few years has been buybacks and there is some political pressure on that.

Ed Perks: I think there, the key is, look, are companies borrowing to buy back stock, or in the case of most tech companies, tremendous cash balances, as well, on balance sheets.

Stephen Dover: And the other thing with the tech companies is a lot of that is really just compensation, right? That money is going out in terms of stock options or compensation to employees.

Katie Klingensmith: It sounds like we can expect that stock markets may still have some upside and credit markets may still have some upside with economic growth, even if not as positive as last year, still pretty constructive?

Ed Perks: Yeah, I think fundamentals remain a pretty favorable backdrop. I mean, as long as this global GDP outlook kind of sustains itself. I am not convinced that markets are comfortable with the concept of further rate tightening and a further upward movement in rates. You know, if we go back the last 18-24 months, when we have seen rates make that move up, particularly on the longer end of the curve, adjusting to those short-term interest-rate increases that the Fed was executing the last two years, that's when we have had those kind of bouts of volatility in equity markets. So I think that is something that still remains to be seen, if markets can get comfortable with the normalization of rates.

Katie Klingensmith: Right, and difficult to invest when rising interest rates is affecting many different asset classes.

Michael Hasenstab: I think it's getting more important than ever, and October of last year really taught us that investors need to separate out beta from idiosyncratic alpha ideas. And to think that rates going higher will never happen again, I think is not only just wishful thinking, but complacency. And so, our view is that we will get another period where, because of decent economic activity and gradually rising inflation, we get that move in higher rates and beta won't perform particularly well and it will really separate out those investors who are identifying unique special company, country situations versus just broad index risk and I think when all markets rise in such a quick snap back, people forget about October. I mean, it was such a traumatic event, but it's never even talked about. People view it as one-off, never happen again. We think actually, probably it will happen again, people should use this time to be ready for it.

Sonal Desai: I tend to agree with Michael that we will see more Fed action because the Fed actually ultimately has to want higher rates when they eventually get to the next recession. I would say that periods of volatility absolutely have to be expected. It's for us to try and navigate those periods, but they are going to happen.

Ed Perks: I think that a lot of those points are actually kind of good news, right? Idiosyncratic alpha, that's what active managers want markets to be driven by, not by broad beta in asset classes. And then I think volatility management, we have to be and have clients increasingly expecting that—controlling that volatility in our portfolios is a key element of what we're doing.

Stephen Dover: And this last 10 years of monetary policy has, in essence, increased its correlation of a lot of asset classes, certainly within equity and tilted growth versus value. So as that normalizes, there's likely to be more idiosyncratic differences between companies in the equity market.

Katie Klingensmith: So higher volatility, in general, it sounds like we are expecting that. Sonal, you also mentioned that we need a trigger to actually get the end of this period of US and global growth. I think a lot of folks are worried about political risk right now. Do we see political risks right now in the horizon that really concern us from an investment perspective?

Michael Hasenstab: Sonal laughing might have just answered that question.

Sonal Desai: I would just say that, you know, if you take at face value what is coming out from both parties in the US right now, you should be concerned, very concerned. Either if you are talking about the complete rollback of corporate tax cuts which had an enormously positive impact on the US regardless of what you think about the rest of the measures, that's one side of it. The other side of it, this trade policy which we can talk about, I think trade policy is fascinating in and of itself. Almost separate from politics because if, as globally is anticipated and wished for, you do get a democratic administration, the one area which probably will get even worse is trade policy which is this populism which Michael alluded to earlier which does give medium-term concerns, right?

Stephen Dover: But there is this dichotomy with the trade talks. That this idea that they want to reduce the trade deficit, but at the same time increase the fiscal deficit. So as a country, if we are going to lever ourselves, if we are going to borrow all this money, we are borrowing from foreigners, so we are going to have trade deficits. Putting tariffs, one way or another, isn't going to stop—it might reallocate the trade deficit, but it's not going to stop the trade deficit. Fourth quarter of last year, we had the highest trade deficit ever.

Michael Hasenstab: I mean, I just find sitting here amazing that the only country that has passed a bipartisan budget of meaningful change that will run a surplus over the next couple of years is Argentina. The only country that will embark upon landmark social security pension reform is Brazil. So this populism that Sonal described in the US, I think is a huge issue, but it is happening globally.

Stephen Dover: But you have made this point several times about Latin America. They are ahead of us in the sense that they went through the populism and it kind of had a short-term positive effect and then it completely blew up.

Michael Hasenstab: It failed, yeah.

Stephen Dover: And I'd never heard of [modern] monetary theory, the idea that spending absolutely doesn't matter, but now it's in the mainstream in terms of what's being discussed.

Sonal Desai: No, not mainstream. We won't agree to it being the mainstream.

Katie Klingensmith: Let's go back to trade politics as they currently stand, Michael, do you think that the conflict, for example in the US and China, really threatens growth in either of those countries?

Michael Hasenstab: So the immediate impact, if you add up all the tariffs that could potentially happen, and you flow that through to GDP, is, I think, I wouldn't say trivial, but it's very manageable. To me, the bigger concern is what drove these trade conflicts. It's a frustration of populations that don't want internationalization. They want to turn inward, which means trade is just one of the symptoms of I think a very difficult political dynamic in the US or in other countries that will manifest itself in fiscal deficits. It will manifest itself in some places through authoritarian control, it will manifest itself in trade conflict, so this is just the beginning of what I think is a decade-long shift towards very unorthodox economic policies and that to me is the bigger worry.

Sonal Desai: Yeah, and I would just add to that, there's been a lot more talk than action on trade. So since Trump came into power, we have been hearing about the trade war, the war actually never took place. It's been fought out in the press, but, in fact, there has been very little outcome. I think it's far more important to actually consider those other areas of populism where trade is just one small piece of anti-globalization, it's across-the-board, immigration policy. Every policy you look at, there is this inward-looking nature to what's going on and not just in the US, Europe is very close to that.

Stephen Dover: I think the issue with China, it's really a geopolitical issue that trade is a part of. And I agree, that the whole trade is overemphasized in the press. And I just want to reiterate, my view is that as investors—particularly equity investors—looking forward, you really have to look at China in a way that, in the past, maybe you looked at Europe or something else as not part of emerging markets, but its own area that probably will make some sense to look at and be invested in over the longer period of time.

Katie Klingensmith: You mentioned before that we have to get used to quite a bit of volatility. Is political risk something that you think you can actively manage in a portfolio or is it a separate conversation?

Ed Perks: You know, I think it's a challenge. And just to be clear, I think a lot of the volatility that we have been seeing more recently, we would characterize as a return to more normal volatility in markets, after a period of really prolonged depressed volatility because of monetary policy and other factors. But I think in the US, we have been a bit surprised just how quickly post mid-term elections, we have clearly launched ourselves into the 2020 presidential cycle. Look, that's going to be a dominant theme in the media until the election.

So, I think that does present some challenges. I think a good example we have already seen a lot of attention, say on health care, on drug pricing, as being a key theme of this election cycle. So I think, fundamentally, you have to think about, maybe not so much what that does to actual results from these companies, but I think certainly, the multiple that the market that investors might afford those equities can certainly move around quite substantially.

Stephen Dover: Although, it has been surprising, given all the political turmoil, how little the market has paid attention to what's happened. I mean, that to me could be a shock. At some point, the market kind of decides that what's going on politically is important, but it hasn't happened at this point.

Katie Klingensmith: It sounds like there is a lot of different factors influencing the economy and how we invest in 2019. If I can just ask each of you for a sense of what you are most expecting and what you are most concerned about in your spaces in your outlook for 2019?

Sonal Desai: I would say it's complacency. There is an enormous amount of complacency. The idea is the Fed gave us a "get out of jail for free card" forever. The very fact that within days of Powell's turnaround, markets not only priced out all rate hikes, actually, the next rate move being priced is a rate cut next year. I think that, for me, is always very frightening. We talk about the increase in volatility, but clearly there is a not enough if the markets are still not pricing what I think is a very real possibility of additional rate hikes on the back of what's happening in the economy. So I'd say that's where my greatest concern would be.

Michael Hasenstab: I completely share that and I think rates will have to go higher for fiscal reasons, inflationary reasons, growth reasons, lack of buyer reasons. When that happens, we will get another shock—interest-rate-led shock—to broad assets and again investors have to hedge that risk. And one way to do it is by negatively correlated assets to that, the other way is idiosyncratic unique situations, there needs to be more of that.

And that applies broadly to emerging markets. We don't even use the term emerging markets anymore within our group because there is no emerging markets. There is such variance between countries, you can only talk about specific countries. So I think variation with that higher volatility is going to go up. So our outlook is actually quite, ironically—there is a negative feeling about some of the state of the world, but for active managers this is actually a very fertile area to take advantage of.

Stephen Dover: I think from the equity point of view, equity investors have been thinking, in my opinion, a bit too much about the Fed and looking at the Fed in this sort of Fed put. Traditionally, equity investors need to look at earnings and they need to look at the ratio of those earnings. And I think that this last 10 years of monetary policy have really made a lot of investors more macro investors, rather than micro investors and not really looking at the differences in stocks. And just like Michael's talking about, the differences in markets, it's really true in the equity market, as well. And in emerging markets, I have said this now a few times, but I think that they are so different and there are so many different opportunities and the one thing I would look at in separate now is China. And I think there are some opportunities there, not just because of the economy and the growth, but because how the market is being looked at really changes.

Ed Perks: You know, I think the multi-asset portfolios really blend a lot of these themes that we have been hearing about. I think if there is one statement that I can make that reflects how we are thinking about our portfolios, and this is true kind of generally, but I think more so today, it's how do we prepare for what's next because we do have a lot of this transition happening in markets and I think it's incumbent upon us to ensure that we can react to opportunities that markets are inevitably going to give us with the volatility.

Katie Klingensmith: Thank you all of you for your insights.

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