PERSPECTIVES

PODCAST: Midyear Outlook: Reining in Risk

July 1, 2019

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Equity markets continued to march higher in the first half of 2019, despite trade uncertainties and recessionary fears. An abrupt change to a more dovish stance among central bankers has recently provided fresh tinder to the equity fire. But does a looser policy stance signal there are cracks in the global economy's foundation?

Our senior investment leaders share their views on investing in uncertain times and how their outlooks have changed from earlier this year. They weigh in on market divergence, whether there is simply too much focus on the US Federal Reserve, where they see pockets of opportunity and how they are looking to play defense.

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Discussion topics within:

- Market and data disconnects
- The Fed effect
- Shifts in global growth
- Finding defensible space

Podcast Transcript

Host/Richard Banks: Hello and welcome to Talking Markets with Franklin Templeton, I'm your host, Richard Banks.

Ahead on this episode, our senior investment leaders discuss their view on investing in uncertain times and how their outlooks must adjust as a result.

Sonal Desai, Chief Investment Officer, Franklin Templeton Fixed Income, Stephen Dover, Head of Equities, and Ed Perks, Chief Investment Officer, Franklin Templeton Multi-Asset Solutions, weigh in on market divergence, the intense focus on the US Federal Reserve (Fed), the ongoing impact of trade tensions, and the slowing of global growth. Ed begins the conversation.

Ed Perks: You know, when I think about what we have experienced so far in 2019, what really stands out to me is the, kind of, cross- currents that we are seeing in markets and maybe an extreme way of saying that would be we have a real disconnect or disagreement happening between markets. And as a result, from a multi-asset perspective, we have actually reined in risk a little bit and certainly the most obvious way to do that in a multi-asset portfolio is to pull back a little bit on equities.

So maybe to explore that a little bit and to kind of give the rationale for what we are seeing, you know, clearly from an economic standpoint, a little bit of a deceleration globally, certainly, but more so in the US of late and that's something that does have us a bit concerned about exactly where it's going. Is that a function of the series of [interest] rate hikes that we experienced in 2017 and 2018 having that standard, kind of more lagged effect, of effecting economic activity? Or is it a function of the slowdown being a bit more pronounced globally? And the real issue that we are dealing with, I think, today and that's really starting to impact how we want to position portfolios, is the uncertainty that's now gripping markets.

Sonal Desai: But you know, I would say we have to distinguish between real risks and financial market risks. Because to me, going back to what you were saying, Ed, I have seen a deceleration for sure. But if I look around the world and I look at each of the major blocs so to speak, and if I look at the euro area, I look at emerging markets, I look at the US, yes there has been a deceleration, but still above potential.

So if I look at global growth, I think it's almost premature to assume that growth is slowing. On the other hand, the way central banks are reacting, in particular the Fed, that worries me because, you know, as soon as we are in a position where we are right now, where markets react more positively to bad economic data, it means that they are acting on the Fed, not on data and that, for me, that's a worry.

Stephen Dover: Yes, I totally agree, that as the person responsible for equity to have, so many of my questions have been around what the Fed is going to do rather than earnings or companies or the traditional way we look at it.

Ed Perks: I think we would all agree that we prefer that the Fed not act simply to appease markets. We prefer the Fed to act because there is further tangible deceleration in economic activity or we see trade tensions escalate to a point where that would be implied for the second half of the year into 2020.

Stephen Dover: On the equity market side, obviously, we'd prefer the equity market to go up because of earnings growth, not because of expansion, because the more you have P/E [price/earnings] expansion, the more sensitive you are to interest rates. It's the inverse of interest rates.

Ed Perks: So that brings us almost equity market valuations, which is the other element of this because while there is still earnings growth and maybe we are just decelerating to this longer term trend growth or potential growth from an elevated level of growth, certainly in the US because of fiscal stimulus. But let's say we are decelerating to that, equity markets do have this little bit of a challenge because growth was so boosted artificially in 2018 that we have tougher comps for the next couple of quarters. So that's why we have pivoted and we are certainly not full on recommending a more defensive tilt, but it's just incrementally we have moved to that direction from say where we were at the early part of the year because of the performance of some of the riskier assets in the markets.

Sonal Desai: I would say, you know, moving a little bit to the Fed for a moment and just looking at what they have done, I think that I would read Jay Powell as a pretty cautious guy and I cannot believe that the Fed is comfortable with the kind of rally we have seen based on markets pricing in of massive quantities of rate cuts. You know, I think that the Fed has probably, clearly, I believe the Fed should have been a lot more preemptive in terms of rate or rate hikes than it has been so far. Having said that, the type of rallies we have seen, I cannot believe from a financial stability perspective make the Fed comfortable.

The markets right now are looking at trade and you could get a big change in trade in the second half of the year, and you know, this could be a shock. But keep in mind, the first cut of trade, in terms of tariffs, it's on prices. You know, uncertainty, absolutely, that's going to be a problem, that's going to come from politics, that's going to come from trade. I have gone on record as calling the trade war a phony war essentially and, we have been waiting for this war to explode. It hasn't happened yet.

Stephen Dover: I think the first thing to understand about trade and I think, probably we understand it, is that when you set a tariff on another country that isn't a tax on the other country, that's a tax on the American consumer. So I think, let's just be straight about that. It doesn't mean it doesn't hurt the other country, but it means it increases prices in most cases.

Ed Perks: Or erodes profit margins.

Stephen Dover: Or erodes profit margins, and that's the second thing.

Sonal Desai: So this is the sequential element and this is a discussion we are having a lot on our team right now, right? Profit margins, absolutely the first round. But to me, there's a little petri dish out there, which is washing machines. You know, let's think about washing machines for a moment, right? We have had washing machines, those tariffs have been in place for a year and a half, so what actually happened. And I've seen a lot of analysis. Guess what, prices increased. But what I found was really interesting, was prices increased on all washing machines and people continue to buy them, which to me argues a certain element of pricing power. Second round would be people maybe go out and invest more, American producers invest more in factories, I don't know, you guys know, but maybe that's, eventually, or demand goes down.

Stephen Dover: I think that's the point and that's where we are. If you actually look at the statistics and say, well, how much do these tariffs affect trade, it's very small, de minimis really. But it's the uncertainty happened to have a talk with a friend who works for a manufacturer that manufactured in China. So they moved their manufacturing to Mexico just before these tariffs. I mean, business doesn't know what to do, so the magnifying effect on business, the uncertainty is the concern. What is best for the equity market is some level of certainty. So we went into this scenario two years ago where we [the United States] lowered business taxes, we lowered regulation, we were the most positive environment for equity markets that we could have had. And then we have kind of taken some pretty big steps back because now they [businesses] don't know where to invest, we are looking at a really big change and how we might have to change the entire manufacturing circle. I mean, this is a big deal. And I think that at first with the China tariffs and even with the Mexican tariffs, there was a little bit of, you know, we are going to, this is all going to be over within three months, we don't really need to make any changes. And at this point, we just don't know. Right?

Ed Perks: The theme of some of this conversation is that the potential for disruption is high.

Sonal Desai: Yes, absolutely, full agreement.

Stephen Dover: Yeah.

Ed Perks: Whether it be equity, you know, corporate fundamentals, markets and, and I think we are seeing that. So I think as it relates to portfolios that we manage, thinking about this, how do you have some flexibility, some means of handling a higher level of volatility that we are seeing in markets? I mean, just recall the downdraft we just experienced in May flipped on its head by some very obvious statements out of the Fed about taking necessary or appropriate actions, if needed, and the market rallies substantially.

Stephen Dover: Absolutely.

Sonal Desai: I also think that, you know, in terms of tightening monetary conditions, we shouldn't focus simply on the rate hikes. So yes, there have been a lot of rate hikes. But if I look at the size of the Fed's balance sheet, it's still well over $4 trillion. And you know, I always point out that, you know, that is the asset side of the Fed's balance sheet. The liability side of it is essentially sitting as excess reserves. So you know, so in a sense, we have got a lot of contingent liquidity, which is out there available, if you will. So you can have, you know, increases in interest rates, but still have fairly liberal credit, as we have noticed and as we have noted. So these are some of the reasons that I feel that yes, we are seeing a softening, but definitely not enough for me to think that we are getting ready for that tipping point. You know, another very frequent rationale or reason for recessions, historically, has been an overexuberant economy, lots of inflation than an over-tightening Fed. Well, we haven't seen the inflation, but I think we'll probably see more, but we certainly won't see an over tightening Fed. This has to be one of the most dovish Feds out there.

Ed Perks: Maybe just pivot to the global economic outlook, we have seen now negative rates again in Japan, in Germany, still a lot of uncertainty around Brexit. So I'm just curious where we think those major economic regions are, maybe specifically what kind of opportunity for stimulus, incremental stimulus, because in many cases we didn't see those central banks move the same way the Fed did in the US.

Sonal Desai: I'm not a part of the camp which thinks that the euro area is necessarily going to go the way of Japan. Japan still remains the only country in the world, in the developed world and presumably also the emerging market universe, which has actually seen deflation. So, let's start there and start off that. I don't think that the euro area is going towards deflation. I do worry about the euro area a fair deal, but it's not an imminent worry, it's an ongoing issue. In particular, we have had very easy monetary policy clearly from the ECB [European Central Bank]. The ECB is essentially what I would consider the only adult in the eurozone room, so therefore the ECB is responsible for preventing another eurozone debt crisis. The reason I even raised this is that there are definite issues at play with Italy and it's just people have not wanted to think about it, it's been much more comfortable to not worry about what's happening in the euro area.

This is populism at its best or worst and it's social populism. My big concern with social populism, and I'm calling it social because it's really very focused on immigration in the case of Italy and many countries in Europe, but there's this huge tendency for social populism to drift towards economic populism and we are seeing that in the case of widening budget deficits, which they can't have given their debt problems.

Ed Perks: With sovereign markets now at negative yields, corporate credit markets very low yields, certainly relative to other US credit assets. Stephen, I'm interested in the equity outlook in Europe in particular, because I think as you look at many of the large companies, multinationals maybe a bit more dependent upon global trade.

Stephen Dover: Sort of our thesis on Europe has been, so many European companies are global, and so you have to look at them as global companies, you have to really look at where their income comes from, but you are right, if there's a slowdown in global growth, that's going to be hard on those companies. We are looking at the UK and I think that if you look at the UK as an equity market, it looks like a reasonable market and certainly outperform versus anybody's predictions, but you have this hangover of Brexit that we just really don't know how that's going to turn out, but that's a place where we actually think there's opportunity, but there's also some downside risk there.

Germany, its economy is actually very tied to China. So, you have to look at the whole global picture in Germany, it's struggling right now. We are worried about the populist side and this is where we have had this conversation, our entire conversation has said there are these idiosyncratic risks out there that we really can't predict. And I think what you need to do is to kind of look at a scenario of what might happen if something, one of the idiosyncratic risks happen. And so we would look at the UK, for example, and say, probably at this point it probably makes some sense to invest in that, there might be more upside than downside at this point.

Europe, from an economic point of view, we don't think it's going into recession, but it isn't booming either. However, from an equity point of view, there might be some value there because it is relatively cheaper than the United States.

Sonal Desai: And I'd say, actually, looking at Europe, it's one of those situations where really, I think, if we just look at the eurozone as a single entity, there can be errors—let's put it that way.

Stephen Dover: Yes, absolutely.

Sonal Desai: If I look at Spain, for example, Spain has done all the right things. They certainly didn't let their crisis go to waste. I would say Spain is very much one of our preferred spaces to be invested in and I think this would probably get reflected even on the corporate side, with respect to Spain, and Italy unsurprisingly is one of the places which gives us the most concerns. I look at Germany and it's a combination to some extent, to me, of concerns about populism, the weakness of [Chancellor] Angela Merkel in the current environment in Germany for almost the entire post-eurozone debt crisis environment, the post-GFC [Global Financial Crisis] environment, Angela Merkel really drove most of the positive results in terms of diffusing the crisis in Europe and she doesn't have that authority anymore and it's not clear that anybody else is going to step in and they will have it.

Stephen Dover: But there is no clear leader.

Sonal Desai: There is no clear leader.

Stephen Dover: From an equity point of view, it's very hard to find companies that are local, unless you are looking at really small-cap companies. So, I agree with you that it's very different by country, but in terms of as an equity investor, it's very hard to invest that way. And I would just say that's a mistake I think some investors who just do a country investing, make a country's stock market very, very rarely represents a country's economy.

Sonal Desai: I would agree on that. So you know talking about emerging markets, more broadly, it's more along the lines of what we have said about Europe, it's country by country. There are countries where populism makes it extremely difficult to be all-in invested and there are other countries which are definitely improving stories. So, I would say that right now it's much harder to just talk about complete asset classes or complete regions as being positive on a region or negative on a region, it's really a country-by-country piece. I would note, I think it's still too early to get really concerned in a big way about global growth, it is decelerating, but regionally I am worried about places like China.

Ed Perks: It becomes a very difficult time for investors, right, because some of the base economic theory or practice that historically has led markets in cycles is taking a bit of a backseat to things that become very difficult to analyze, predict, prepare for. So I think we have to think deeply about that and ultimately, take actions in portfolios that, once again, back to that "How can we manage in a kind of flexible way that lets us be tactical?" Whether it's market movements at an asset-class level, at a geography, under or outperformance basis or you know, simply these sharp movements that we see volatility spikes happening in markets.

Stephen Dover: Ed, Can you talk just a little bit about how you see the debt changing over these last few years and what your concerns are around that?

Ed Perks: Yes. There has been a narrative and I think the market ran with it a bit more than it needed to, where we have seen increased levels of nonfinancial corporate debt, in particular. I think the thing that's given us a bit more comfort is that, well one, we have had a really favorable backdrop. The economy has been growing, corporate fundamentals have been solid, profit margins have been at record highs, cash balances on corporate balance sheets have been extreme.

Stephen Dover: Rates are incredibly low.

Ed Perks: And that's the final.

Just looking at the absolute level of debt doesn't capture the whole picture. When you think about all these other factors, when you think about the cost of debt, the interest burden that's put on corporate income statements, it's minimal. It's manageable. And that's given us, I think, a lot more comfort that there are opportunities within the debt portion of the capital stack. That said, you know, we are now in this position where those markets have priced themselves off of long-term interest rates.

Ed Perks: So I think at some level, where we sit today, we certainly think about markets in the second half of 2019 and even leading into next year as having maybe a bit different risk reward profile, right?

Sonal Desai: Absolutely.

Ed Perks: So I think we have to just make those adjustments. We know periods of elevated volatility will be with us and we have to, at some point, be realistic about the potential rewards that we will get by investing in these different asset classes. So that's, I think, the broader backdrop for how we are approaching it. And then, to be tactical, to have that opportunity to be flexible in our mandates that's something that we are really emphasizing.

Sonal Desai: And I think that that actually does come, always, it does bring it back to the idea of being active and being able to not just buy the market, because I think increasingly there isn't a single market that I'd want to just buy. It's a pretty scary time to be looking at some of these markets, if you are just going to go out and buy the entire thing. Because I think just on that issue, picking up on what you were saying, Ed, I'm also thinking, when we think about spread sectors, if you believe like I do that the underlying asset, which is [US] Treasuries, is vastly overvalued, your absolute return in terms of how much you are being rewarded carry that risk just starts looking very unattractive. Not in spread terms, but the absolute amount.

Ed Perks: And we have seen, you know, points in times where maybe we have been less favorable on the direction of Treasuries, that benchmark, but the feeling that fundamentals could support spread compression offsetting that, I wouldn't say we are in that position today. So I think that there's been a broader ripple through into the spread markets based upon what rates have done.

Sonal Desai: I think, this is a time if you're looking at the corporate sector to start thinking in terms of keeping your duration[1] short, taking your carry and really focusing on being paid back because it's always important, but I feel it has never been more important to keep that duration short. So, if necessary, you essentially get cashed out.

Ed Perks: That might not be a bad way to kind of frame this part of the conversation, as focusing on duration, because you actually really were rewarded to have duration these last six months, in particular seven months. You know, at this point, to continue to have duration seems less interesting and a pivot away from that.

Sonal Desai: I would say that is very much the way I would see it, you know, in a sense, really focusing a lot on making sure that you are not getting locked into positions which are going to be adversely affected by the overvaluation that, certainly, all of us see of the underlying, I think at this point.

Stephen Dover: We always talk about duration in bond markets, but equity markets have duration, as well. So you can bring in duration by moving more towards dividend stocks and that type of thing, so you should look about that in the equity market. One of the concerns I have about the question of allocation is there is sort of this presumption that people have a pool of money or pension or something, but I think a lot of our listeners are actually accumulators, right? They are actually making their biggest investment is really their income stream and their ability to invest over the next, whatever it is, 20 or 30 years. And I think in that market, if you look out long term, and I have a bias here, but I think equity looks like it'll perform over a period of time so I wouldn't stop your accumulation in the markets at this point. So you know, if the question is, are we saying you should move to cash and get out of the markets, that historically has been with a very few exceptions has been a really, really bad move. So I think you continue your systematic investing and perhaps you shorten your duration.

Sonal Desai: And yeah, so you stay. Somewhat, like I said, it's a different definition of being defensive, perhaps, than most people have. But to me, at these valuations, being defensive means actually being short duration, but not being entirely in cash, especially against a backdrop where you don't see a crisis as imminent, you just want to make sure that you are in a position of having the flexibility to be nimble the way you are in the event that you get to that position.

Stephen Dover: Being defensive within the investment categories as opposed to taking it off the table.

Ed Perks: And it certainly aides in the liquidity of a portfolio.

Sonal Desai: Yes, it does. And I think that that is important to have that ability.

Richard Banks: That's it for this edition of Talking Markets with Franklin Templeton, thanks to our contributors. If you've enjoyed their 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 insights from our on the ground investment professionals, goodbye.

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1. Duration is 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.