MULTI-ASSET

Politics, Policies and Market Resiliency

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This year has been one full of uncertainty and surprises on many fronts. While the United States has been embroiled in pre-presidential election drama and speculation about what might trigger the Federal Reserve to raise interest rates, the United Kingdom voted to

leave the European Union and multiple central banks worldwide turned to a negative interest-rate policy in an attempt to stimulate growth. While no one can predict what the future holds, we've gathered three of our investment team leaders for a roundtable discussion on developments they see likely to influence the global markets in the back half of the year, and their strategies to position for whatever comes next.

Which factors or events do you think investors should be paying attention to during the rest of the year and maybe even into 2017?

Rick Frisbie: We are wary about the potential for exogenous events. I think we will continue to watch how Brexit unfolds, but after a lot of initial global market noise, markets outside of the United Kingdom rebounded quickly. The fall and winter will be very much about Federal Reserve (Fed) watching. From Fed futures to the governors' voting "dots" as they all relate to moves away from accommodation. In our view, productivity increases are the ideal baton handoff from the current NIRP-&-ZIRP world (negative-interest-rate policy and zero-interest-rate policy), but we are just not seeing widespread signs of economic growth in developed markets.

We'll also have to see how the US election plays out from an equity market perspective. We know that US growth is grinding along and markets are not always fans of political regimes geared toward tax increases and greater income redistribution.

Michael Hasenstab: As we look toward the end of the year, we have to question whether the type of US government bond yields we have today make sense given rising inflation and the resiliency we've seen in the US economy. Our view is the rally in US Treasuries can reverse as quickly as it ran up, so our team is really avoiding that space. Second, we have concerns in the eurozone about the rise of nationalism, which questions the whole eurozone construct; the ability to form a fiscal union given all the geopolitical issues developing within Europe is incredibly problematic. So, we favor being short euro as a hedge against political risks that could continue to unfold. Additionally, the exceptional rally in the Japanese yen is stifling the economy, and it's reigniting deflationary pressures. In our view, the Japanese economy and policymakers will likely find it very difficult to deal with the yen at these inflated levels, so the massive yen rally appears tenuous to us and poised for a reversal.

Overall, we are being very selective in emerging markets. I think what will be key as we look ahead is examining each individual country's policy decisions and the political landscape–the variances will likely be massive. We think differentiation will be critical as the year progresses and into next year. You cannot treat emerging markets as uniform—that's our main message.

Ed Perks: We clearly have had a tremendous amount of global leadership from the US equity market in 2016. On a relative-value basis, looking at equities and other markets, we are very mindful of what impact Brexit will have on eurozone growth, but more broadly, as Michael alluded to, there are regions of the world where economies are much healthier than the general perception might indicate. I think that will be a key point for equity markets going into 2017, and while we remain constructive on the US market, we believe there's also an opportunity to pass the baton from the US equity market in terms of global market leadership.

Political uncertainty has clearly had an impact on global financial markets in 2016. How has it affected the views of your investment teams?

Rick Frisbie:

We see some geopolitical hotspots around the world and political issues, including a rise in populism in the United States and elsewhere that has manifested itself in the disruption of the political establishment. In the United States, we have disaffected and disenfranchised working-class voters, which have helped drive the whole political framework more toward a populist sentiment. In Europe, the pundits were initially wrong on the palpable support for Brexit in the United Kingdom, and we've seen various non-mainstream political movements and candidates picking up momentum elsewhere around the world.

We are definitely positioning to become a little more defensive. We have a saying that "when the CBOE Volatility Index[1] (VIX Index) is low it's time to go"—the VIX is often referred to as the fear index or fear gauge, and when it's at low levels, we think it could be a prudent time to move a little more out of risk assets. Currently, the VIX is trading at about 13, but the 20-year average is just above 20 or 21, so sitting at lower-than-average levels, it means many investors have become less concerned about risk and maybe a bit too complacent.

There's been a 35-year secular fixed income bull market, which is no great revelation, but people are starting to lose faith in central banks. Since the collapse of Lehman Brothers in 2008, the top 50 global central banks have cut interest rates 673 times, and negative interest-rate policy efforts haven't worked. We think many risks exist in the world, so it's a good time to be defensive. Having said that, emerging market economies in general have seen positive economic growth speeding up for the first time in four years, and we saw the stabilization of the much overdone, oversold, sharp pull-down in commodities. But from our point of view, the world is filled with dislocations, and decoupling is likely in different interest-rate regimes and different currency regimes.

After being fairly bullish overall in our multi-asset portfolios at Franklin Templeton Solutions, we have retrenched a bit and have taken more of a buckle-up attitude as we move into the fourth quarter, with the US elections and other events happening in the world.

Ed, how does your team account for political uncertainty?

Ed Perks: Rick touched on some factors to think about in terms of political uncertainty, but as I reflect on the Brexit implications and the unpredictability leading up to the vote, there was a fair amount of surprise. After some extreme post-Brexit vote volatility, the global market generally began to stabilize. I think ultimately it reinforces the reality that it is very difficult to predict the outcome of these situations. At Franklin Templeton Equity, we focus most on understanding economic conditions and the financial health and fundamentals of the individual companies in the various sectors and industries in which we are investing. As unexpected events play out, they may create dislocations, but they also may create opportunities for longer-term investors. We aim to potentially take advantage of some of those short-term dislocations.

When discussing uncertainty and unexpected events, of course the US presidential election in November is top of mind, which was touched upon. Can each of you put the upcoming presidential election into context for investors and discuss how you manage through an event like this?

Michael Hasenstab: I think what's interesting about the volatility we are seeing related to the political polarization in the United States and Europe is that it's juxtaposed against a very different dynamic happening in emerging markets. In developed markets, we have seen a rise in populism because some voters see themselves as disenfranchised, and there has been a lack of real wage growth, causing real political upheavals. In emerging markets, countries such as Brazil and Argentina that went off track in terms of unorthodox policies have returned to sort of state-planning systems; those political regimes have ended, and the countries have come back to more mainstream orthodox policies. Mexico offers another example. Aside from a couple of exceptions such as Turkey and Venezuela, by and large emerging markets have been relatively stable because, in my view, their underlying economies have been resilient despite some slowing in growth.

There are hotspots globally, and there is policy uncertainty in the United States, but again, we've been focused on the emerging market theme because we have found that economies that we used to think of as politically unstable have actually proved to be less so as they pursue more orthodox types of policies. Areas that once were thought of as highly risky and vulnerable (like Mexico, Indonesia and India) have proved to be following

what we view as a very consistent path that, I think, has benefited investors. Meanwhile, Europe has seen a rise in nationalism and populism that we think could draw into question the whole eurozone project.

Ed Perks: If there were two words to describe the situation the United States is in right now in terms of the economy and the markets, I would choose stable and resilient. The election is just a few months away, and it has been very polarizing and, at some level, is presenting some uncertainty for markets to deal with. However, I think we also have to put it in perspective. As we wrap up our second-quarter earnings season, the majority of S&P 500 companies have now reported their performance and their expectations for the future. It's kind of anecdotal, but if you listen to the calls and talk to the analysts, the US election is not in the top-five issues that companies seem most focused on. Companies are still very focused on currency trends that are impacting their business as well as on margin pressures—whether it's cost inflation through wage growth or price deflation and the compressing of margins. They are still very focused on Brexit and its potential impact on eurozone growth and their businesses in the region. But generally, the US election has fallen a bit more into the background. Ultimately, as we get closer to the election in November and certainly during third-quarter earnings season, the election will come into focus a bit more. Whatever the outcome, even if we get some volatility like we did following Brexit, I think the election will prove to be something the markets will be able to digest and move past.

Rick Frisbie: I think there are some expectations of uncertainty out there when you look at implied dollar futures out around the election, there is some expected volatility, but certainly we have lived in this kind of "TINA" world ("There Is No Alternative") to equities and that has been a big boon for them. I agree that corporate CEOs and CFOs are very focused on operating their businesses, and on the efficient use of capital. Capital expenditure (CapEx) has been fairly lethargic though in the face of pessimism around the prospects for future demand and pricing power. I think there are some expectations of uncertainty, but I completely agree with Ed that the US economy is just amazingly resilient. I think we have all waited with baited breath for a long time to see the resiliency of the emerging market economies—as Michael discussed—and it's been heartening to see that play out through real economic growth.

What's behind the market resiliency we've seen this year, and perhaps more importantly, are there risks underneath the surface?

Michael Hasenstab: At the beginning of the year, one of our strongest convictions was that, even in the midst of global uncertainty, emerging markets had been oversold. We have seen no shortage of surprise shocks and global volatility, but despite a lot of the headline noise, the fundamentals throughout most of the emerging markets were sound. The markets have shown incredible resilience, though it was clear to us the underlying fundamentals in individual countries matter. For example, in the case of Brazil, its currency (the real) is up about 20% versus the US dollar, and the 10-year government bond yield has moved from 16% at the beginning of the year to below 12% in recent days. So to us that is one of the highlights: the resilience of emerging markets within a period of volatility.

Ed Perks: To pick up on that theme, when we reflect on how we viewed global markets at the end of last year and heading into 2016, we looked at the perception versus the reality. There was a tremendous amount of turmoil in the equity markets, but the reality we saw didn't seem to justify it. About six weeks into 2016, the equity markets had seen just about the worst start to the year ever in our view—at least for the S&P 500 Index in the United States. Equity markets clearly convulsed relative to expectations at that time, but I think the reason the markets have been resilient since then is because investors had moved too far to an extreme. Many of the fears that developed early in 2016 didn't play out as anticipated. The Fed didn't raise rates in the first half of the year, and concerns about the commodity price slump seem to have eased and sowed some seeds of stability; low commodity prices have been stimulating demand in certain areas. Ultimately, I think the resilience in equity markets is due at least in part to the realization that corporate health is actually pretty strong. Companies remain pretty balanced, and many have decided to allocate their capital in ways that have benefited shareholders, including initiating or increasing dividends, and buying back shares.

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1. The CBOE Market Volatility Index measures market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Indexes are unmanaged, and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or a guarantee of future performance.

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