FRANKLIN TEMPLETON INVESTMENTS
Beyond Bulls & Bears

EQUITY

Stock-Market Value Hunting—and a Potential Post-Election Outcome

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Value-oriented strategies had been out of favor for the past couple of years, but seem to have turned a corner in recent months. Tucker Scott, executive vice president and portfolio manager, Templeton Global Equity Group, shares where he and his value-oriented team are finding bargains around the world today—and offers an interesting take on an outcome from upcoming elections around the globe many investors may not be considering. He highlights energy, metals and emerging-market stocks—all of which have been good performers this year—as areas that he thinks still offer potential for investors today.

Still Bargains in Emerging Markets

When looking at various countries or regions where we invest, we believe emerging markets represent a disproportionate share of bargains today after several years of underperformance relative to developed markets. We think South Korea, for example, probably represents the cheapest market of its size in the world. Samsung Electronics has had a good year so far, even considering its recent troubles with the Galaxy Note 7 smartphone. The stock still trades at seven times earnings (ex-its cash), which is low, so we continue to think it is an undervalued, high-quality growth opportunity.[1] South Korean banks also look very undervalued to us, and we don't see any obvious risk factor that would justify their shares trading at such low levels. So we see potential there as well.

South Korea and Japan have much in common in terms of their export focus and the kinds of industries both nations excel at, but we think valuations in South Korea are far more attractive right now. Japan has been reaching what we consider to be a fair-value type of range, but we still don't consider valuations there cheap enough yet to offer wholesale opportunity. We also see some macro issues within Japan's economy that give us pause, along with corporate governance structure and measures of profitability.

Meanwhile, China has clearly been out of favor, but we think there are some really interesting opportunities there, mainly in the growth sectors. We are not interested in China's banking sector, commodity-oriented companies or traditional state-owned enterprises. Instead, we are focusing on growth sectors that are trading with value multiples. Those areas include solar, Internet, health care, telecommunications and household goods.

European Banks: Still Some Bargains

Initially, there was a knee-jerk type of selloff across the European financials sector following the Brexit vote in June, but the sector has recovered since then. I think cooler heads have prevailed, and many of those stocks have moved back up over the course of the last two months.

When we look at the European financials, we see a sector that is currently very out of favor, though admittedly there are some real risk factors. When we look at this sector, at banks in France, in the United Kingdom, in the Netherlands, for example, we think their capital appears generally adequate. That's the first question we want to know in regard to European banks: whether they need to raise capital. The second question is, assuming the macro environment stabilizes, what is a normalized level of return on equity (ROE) for the banks? The European banks are generally paying out dividends now, and their capital has been rebuilt. While, admittedly, there are some risks, we think investors are being more than compensated by lowly valuations. Just after the Brexit vote, for example, European banks traded down to around half of tangible book value, roughly where they bottomed in 2009 and 2012.

Energy: Getting Back into Balance

The energy sector had been a source of market underperformance for the past couple of years, but has been experiencing strong performance so far in 2016. We look at oil in a similar fashion as other industrial commodities, and for us it essentially comes down to traditional demand and supply analysis. When we examine supply and demand, we see a pretty attractive longer-term outlook. Unlike most other industrial commodities, oil is consumed and acts more like a consumer staple. The demand for oil is highly inelastic; it doesn't grow very fast. Instead, demand tends to increase very steadily, typically 1%–2% per annum, so we see a stable and defensive demand profile.

But what's really different about oil is the supply side. In this case, we think it's best to think about the natural decline rate, and oil has a very high natural decline rate. When prices are low and capital expenditures are cut back, existing wells are pumped out and there is no drilling of new wells. When a well is pumped out and depleted, overall supply falls naturally. We believe that is what is taking place right now.

The oil rig count in North America has declined more than 70% from where it was two years ago and that has fed into North American production, which is falling at about a 10%–12% annualized rate.[2] That type of dynamic should bring the price of oil back into balance in relatively short order, because the market is not too oversupplied. In our estimation, the market is currently about 1% oversupplied, which means supply is running about 1% ahead of demand. As I mentioned, with North American energy supply falling, we think some balance should be restored around the end of this year or maybe early next year. Recent news that the Organization of the Petroleum Exporting Countries (OPEC) had agreed to a framework could help the market rebalance, and perhaps more importantly, restore confidence among generalist investors in the energy sector as we suspect that OPEC's recent intransigence has been a big deterrent for portfolio investment.

That leads into determining a possible price outlook. When oil is in an oversupplied market, the price tends to drop well below what a normalized price should be. The price typically falls into line with marginal producers' operating costs. Currently, operating costs for the higher-end North American shale producers are around $35–$40 per barrel, and that's where the price of oil seemed to find a bottom at the beginning of this year.

Then we start looking ahead and think about how new supplies will come to a market that appears to be balanced or in shortage. Instead of looking at operating costs, we start examining total cost, including the capital cost, which is very high for the oil business. So it's not a $35–$40 per-barrel price we would consider when there is a balanced market or a market in shortage; we would need to consider the full cost of drilling a new well and replacing or increasing supply. Thinking in those terms, we believe the normalized price for oil should converge somewhere between $60–$75 per barrel, and those levels should be high enough to incentivize the new investment we think will be needed going forward.

One fly in the ointment is that inventories are currently higher than normal in North America, which may slow oil's price rise a bit in terms of reaching that convergence range. So next year, oil might not go straight up to $60–$75 a barrel—it might spend more time in the fifties—but when we look at the stock perspective, we reckon most oil-sector stocks are pricing in around $50 for oil, still shy of a full recovery. When we look at shares of companies in the oil services sector in particular, which tend to be much more exposed to the commodity price and move with a closer correlation to it, they haven't done all that well yet. So, we still think there's more potential upside in that part of the energy complex.

Mining for Opportunities in Metals

It’s important to look at where precious metals prices were trading at the beginning of the year. Both silver and gold had been declining for the better part of five years and were very much out of favor. So not only were the commodity prices low, but valuations of many of the sector’s stocks were also at secular lows. This year we experienced a double-whammy where gold and silver prices rebounded some 30%–40% year-to-date, and the valuation discount on sector stocks disappeared.

Although the valuation discount has disappeared, we think the underlying outlook for both metals looks positive in terms of the macro environment today. At some point, I think people will return to these metals as legacy monetary assets to preserve wealth, and we are seeing that trend already starting. I think that’s part of the story for the price rebound we’ve seen this year, but we think there is potentially further room to run.

We’ve also been finding isolated opportunities among diversified miners in recent quarters. For example, Swiss-based miner and commodities trader Glencore[3] was the type of classic contrarian call we favor. The stock was deeply unloved, even distressed, with high debt levels, an opaque trading business and exposure to China-dependent commodities like coal and copper had driven the stock some 85% below its 2011 initial public offering price. Glencore’s bonds were trading at 60 cents on the dollar, and some Wall Street analysts were predicting the equity could go to zero. It was a scary moment, but we attempted a calm analysis of the facts. We noted that Glencore’s commodity mix, with the notable absence of iron ore, was less China-exposed than its diversified peers, argued that its trading business was an asset not a liability, and concluded that management would likely be able to deleverage the balance sheet by selling assets, reining in working capital and cutting costs. We felt the situation was manageable and that the market’s overreaction amounted to what the late Sir John Templeton famously identified as the best buying opportunity: the moment of maximum pessimism. Financial results have supported our thesis thus far; Glencore continues to progress with balance sheet restructuring and portfolio optimization, while also benefiting from a more recent rally in the price of key commodities like zinc, nickel and gold.

A Shifting Global Political Landscape

As we look out over the next 12 to 18 months, the global political landscape is probably the most important factor we see likely to influence the markets. We have the US election this fall, but we also have major elections coming up for specifically France and Germany next year, which are the core of the eurozone.

Elections ahead of us around the world are important, but I think one thing which hasn't happened in a long time that seems likely to change is the passing of the baton from monetary policy to fiscal policy. When we look, for example, in the United States, both candidates are speaking about large infrastructure programs. Japan seems to have gone down this road tentatively, but at some point will likely move even farther toward a large fiscal deficit type of policy, in our view. This shift could be reflationary.

Right now, the global fixed income markets are priced for deflation; clearly, there is a deflationary psychology that pervades most markets. Even in the equity markets, we find a real fear of deflation and many people are hugging the most defensive stocks and bidding them up to very expensive levels. I think what could come out of left field would be some very aggressive fiscal policy, which could put to work some of the underutilized assets that exist not only in the developed world but also in the emerging world. We may see that translate into a much stronger recovery, both in real terms and in nominal terms than I think people are looking for. That could be very good, obviously, for commodity producers, that could be very good for industrials, and it could also be very good for banks in the sense of normalizing interest rates and having a stronger economy taking credit losses back down.

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What Are the Risks?

Templeton Foreign Fund

All investments involve risks, including possible loss of principal. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors. In addition, smaller-company stocks have historically experienced more price volatility than larger-company stocks, especially over the short term. To the extent the fund focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a fund that invests in a wider variety of countries, regions, industries, sectors or investments. Derivatives, including currency management strategies, involve costs and can create economic leverage in the portfolio which may result in significant volatility and cause the fund to participate in losses (as well as enable gains) on an amount that exceeds the fund's initial investment. The fund may not achieve the anticipated benefits, and may realize losses when a counterparty fails to perform as promised.

These and other risk considerations are discussed in the fund's prospectus.

Investors should carefully consider a fund's investment goals, risks, sales charges and expenses before investing. Download a prospectus, which contains this and other information. Please carefully read a prospectus before you invest or send money.

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1. As of 9/30/16, Samsung Electronics Co., Ltd. represented 4.73% of Templeton Foreign Fund. Holdings are subject to change without notice .

2. Sources: Bloomberg, Baker Hughes, US Energy Information Administration, data as of October 2016.

3. As of 9/30/2016, Glencore PLC represented 1.51% of total net assets of Templeton Foreign Fund. Holdings are subject to change without notice.

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