PERSPECTIVES

Uncharted Terrain: Today's Global Market Drivers

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Despite some uncertainties, economic improvements in developed and emerging markets have supported a positive mood across both equity and fixed income this year. However, with some geopolitical risks on the horizon and historically low volatility in equities in particular, many investors are wondering whether the tide may turn. Against this backdrop, Franklin Templeton's senior investment leaders discuss where they see opportunities and risks ahead.

Monetary Policy across the Globe

Q: In the United States, we have started to see the Federal Reserve (Fed) move up the path of interest-rate normalization, but some might argue that it's taking longer than expected. What's driving this and do you see a shift in the pace of policy going forward?

Chris Molumphy: We think the Fed is certainly taking longer than expected to normalize rates and longer than the Fed has operated historically. If we look back to the last tightening cycle— admittedly more than a decade ago—the Fed moved its benchmark short-term interest rate from 1% to over 5%, so a more than 4% move in roughly two years, hiking virtually at every meeting.

Looking at the current tightening cycle, the Fed started moving its benchmark rate up a year and a half ago, and today it is less than 1% higher. So it's a considerably different situation.

A couple of things are different about this cycle. One is the pace of economic growth. US gross domestic product (GDP) has been growing at roughly 2% per year for the majority of this current cycle, and we are coming up on eight years into the growth cycle. That's a pretty low pace of growth and different than in the past.

The other difference is inflation. Inflation has been very slow to pick up, even with unemployment currently at 4.3%. Inflation is running pretty low with both core metrics showing inflation still at sub-2%.

What's interesting is that there is a divergence between what the Fed says it plans to do going forward and what the market believes it will actually do.

The Fed has been communicating it would tighten rates roughly three times per year over the next several years. Meanwhile, the market is projecting about two rate hikes in total this year.

Q: Thinking globally, what central bank policy shifts might we expect to see from developed markets outside of the United States?

Michael Hasenstab: What was an unprecedented experiment in terms of money printing has now become fairly normal throughout most of the developed world.

I was recently in Japan, which has faced very different problems than the United States. While the US economy has begun to normalize in the years following the global financial crisis, Japan is nowhere close to that. It can't reach its inflation target, growth is still anemic, and policymakers have thrown all the monetary stimulus they can at the economy.

Those efforts haven't fully succeeded in pulling Japan out of the rut it has been in for decades.

Incredibly accommodative monetary policy alone just hasn't generated the results some politicians would like. I think probably the next shift in Japan—and this also applies to both the United States as well as Europe—is a shift to fiscal policy despite large deficits in these countries.

In Europe, I think some sort of fiscal discipline and fiscal rules has held the eurozone together thus far. The wave of populist movements in Europe today would like to throw those out, and we will likely see more aggressive fiscal policy to complement monetary policy that's already quite accommodative. And the United States has already been talking about more expansive fiscal policy.

I think it's a pretty dangerous recipe when you have very aggressive monetary policy and throw very aggressive fiscal policy on top of that. I think we need to be cognizant that we are in uncharted territory here.

Weighing the Opportunities and Risks

Q: Thinking about equities, what opportunities and risks are you seeing across developed markets?

Stephen Dover: The environment for equities globally right now appears rather benign and positive, which we haven't seen in a long time. Globally, we see GDP growing and corporate profits growing. The US is growing and we see green shoots of opportunity in Europe.

The backdrop seems to be quite positive for equities in general. One concern we have relates to fiscal stimulus. An expectation of greater US fiscal stimulus certainly has contributed to the market's positive short-term performance.

However, we see some potential negative long-term challenges on the horizon for equities, which speaks to the value we think active management can bring.

I'm not sure many investors in passive index funds realize the potential risks they are taking. We believe that we can add value in seeking to diversify a portfolio better to help reduce these risks versus a traditional capitalization-weighted index-type strategy.[1]

Q: It sounds like there are a lot of potential and very interesting investment opportunities across equities and fixed income. From a multi-asset class perspective, how should one think about asset allocation? Are there trends in asset correlations or relative valuations that investors should consider?

Ed Perks: One of the things that we are seeing is that the dispersion across different markets within the same asset class and within given sectors of an asset class has been fairly low but show some signs of starting to rise.

On the flipside, the correlations that have been so high these last five years across asset classes and within asset classes are showing a tendency to start declining.

Reflecting back on the past five years, we think the environment was supportive for passive investing, but going forward, we think active investing will be critical to navigating the uncertainties we know exist.

As we look across the asset classes, we have seen tremendous performance in US equities. And when we look more broadly around the globe today, we see an improving fundamental outlook and a relative valuation benefit potentially existing. I wouldn't say we aren't finding opportunities in the United States, but it's a broadening opportunity set. I think that's something that is very relevant for asset allocation today for many investors.

Now as we see the broader fixed income markets adjust to potentially higher interest rates over time, that opportunity set may also broaden for us.

Pockets of Opportunity in Emerging Markets

Q: Let's shift our focus to emerging markets. We have certainly seen a nice rebound in the asset class as a whole over the past year. Going forward, do you think emerging markets will likely maintain their strong run, and what risks should investors be mindful of?

Michael Hasenstab: Emerging markets have been an exciting area for us. While the Fed, the European Central Bank and the Bank of Japan have been artificially suppressing interest rates for an extended period, emerging-market local currency bonds have been among the most unloved asset classes for the last three years despite offering much higher yields.

There were fears that rising US interest rates would trigger an exodus, so the capital left before the Fed even started to tighten.

However, this created incredible valuation opportunities. We saw local currency markets at levels we hadn't seen since the global financial crisis, or the Asian financial crisis or the Mexican peso crisis (the tequila crisis) in the mid-90s.

The question for us is whether the fundamentals are actually worse today in some of these emerging-market countries than they were during those prior crisis periods.

We spent several years visiting these countries to analyze for ourselves whether the market's assessment was right or wrong about the situation.

In some cases, I would agree the market was right. There are some emerging markets we think are incredibly vulnerable, such as Venezuela or Turkey.

We like to be contrarian, but we are not going to be contrarian just for the sake of being contrarian. We have stayed away from a number of countries where we simply see too much risk.

On the flip side, we believe other markets including India, Indonesia, Brazil, Argentina and Colombia are either in the midst of a huge turnaround from populist policies to more orthodox policies, or have healthier fundamentals than the market would indicate.

We think there are good opportunities with a deliberate approach to investing in emerging markets.

We have to be very selective even if it means being a bit more concentrated in particular countries.

Q: What do you see as the most interesting investment themes in emerging-market equities, considering near-term or medium-term volatility and also what risks might we see?

Stephen Dover: Emerging markets are volatile. That is just the story of emerging markets. They have been volatile in the past and they will be in the future.

However, that is also a reason we see a lot of opportunity in emerging markets. The question is whether you will be compensated on a risk-adjusted basis for that volatility. Very recently, we have seen volatility flare up in Qatar and in Brazil.

Having many years of experience in emerging markets, one thing I've learned is how prepared for volatility businesses located in emerging markets are. That's why we think it's so important to be on the ground and really look at the businesses themselves and see how they can face the volatility in their countries.

From my perspective on the equity side, we have recently seen a turnaround in GDP growth in most of these emerging-market countries (again with some notable exceptions), with profit growth following.

Emerging markets have generally underperformed developed markets in the past few years, but as we see an increase in corporate profit growth, we think there is an opportunity for real catch up with the developed markets. We have seen that occurring year-to-date and I think that catching up should likely continue.

For more detailed commentary, download our topic paper, "Uncharted Terrain: Today's Global Market Drivers"

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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 prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. High yields reflect the higher credit risk associated with these lower-rated securities and, in some cases, the lower market prices for these instruments. 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.

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 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.

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1. Diversification does not guarantee a profit nor protect against risk of loss.