PERSPECTIVES

Will the Roar of Market Tensions Tame Global Growth?

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The first quarter of 2018 started out like a lamb but went out like a lion as long-dormant volatility began to roar. Issues like inflation fears, trade tensions and geopolitical risks contributed to market turbulence, leaving many investors wondering whether these issues will put a damper on global growth—and end the US market's nine-year bull run. Three of Franklin Templeton's senior investment leaders—Stephen Dover, Christopher Molumphy and Ed Perks—weigh in.

For more detailed market insights from these individuals and others at Franklin Templeton, visit our Global Investment Outlook Second-Quarter 2018 hub page.

United States, China and Beyond: The Impact of Trade on Global Growth

Ed Perks: Despite some recent challenges, gross domestic product (GDP) growth globally is still accelerating in a coordinated fashion. While the fundamental backdrop looks good to us overall, recent trade tensions, which are part of a protectionist trend, represent one of the bigger risks or concerns we see. I think it's important to acknowledge that fears of protectionism are not new and have been with us in many parts of the world during the current economic expansion. If it were to materially impact business or consumer confidence, then we could see an impact on economic activity. But right now, we're in a place where we still expect a pretty robust a period of economic growth, certainly in 2018.

Chris Molumphy: Generally, we would agree that underlying global economic fundamentals appear reasonably healthy, and that has not changed dramatically from the beginning of the year. We are continuously monitoring the recent issues that have come up in regard to trade and geopolitical risks. With respect to trade, we would note that often the political rhetoric ends up being much more significant than the actual actions. We will have to see how this all plays out, but we remain positive regarding the outlook for global growth.

Stephen Dover: For the most part, the global economy is experiencing coordinated growth in a way we haven't seen in a long time. We've seen companies experiencing both top-line and bottom-line growth across the globe. Emerging markets in general have seen strong economic growth—outpacing that of developed markets over the past year—and I think that's very positive and likely to continue going forward. On the issue of trade, I think we're probably more in a trade dispute situation than a trade war right now. In our view, the underlying earnings growth we anticipate from the US tax cuts this year and going forward, along with falling interest rates in some countries, are likely to be bigger near-term influences than trade.

Inflation: Is It a Real Threat?

Chris Molumphy: We are starting to see signs of inflation in a number of markets, but that is not unexpected. The United States is in the 9th year of its current economic growth cycle, and with the unemployment rate at 4.1% (as of March 2018), one would certainly expect some increase in inflation at this point in the cycle. Many observers are questioning why we haven't seen even stronger inflation to date. Our view is that inflation likely will continue to tick up, but the increase is likely to be very gradual. The primary forces that have kept inflation muted—primarily globalization and technological innovation—are still in place and should likely continue to have a restraining influence.

Ed Perks: I would add that from the Multi-Asset Solutions perspective, this topic of inflation is the million-dollar question our team has been pondering and has dominated a lot of our analysis. Focusing on the United States, we are not seeing inflation as a meaningful factor.

The expectations for corporate earnings growth were fairly high as we moved into the first-quarter reporting season. We would have expected a muting in expectations at this point of the cycle, but we've actually seen some of the expectations continue to rise. So the fundamental picture still looks positive. We would argue some of the recent market volatility we have seen tied to worries about inflation or interest rates represents a return to a more normal level of volatility after being extraordinarily low for a long time.

Stephen Dover: I think one point that may be missing or forgotten is the discussion the markets had on deflation not all that long ago, and the great fear about it that lasted a long time. If we look back over the last 10 years, that was what global central banks and many economists were concerned about. So monetary policymakers lowered interest rates. What was the result? To increase the price of risky assets. That phenomenon dramatically changed valuation metrics. I think what we're talking about with inflation today is actually a return to normalization—along with normalization in valuations and in volatility to the dynamics we saw perhaps prior to 2008.

Chris Molumphy: As credit investors, we certainly are very much aware of where we are in the cycle. We do need to be thinking about when the cycle ends and beyond. Having said that, we are not seeing the traditional early warning signs of credit problems or issues that might indicate a shift. So we think this particular credit cycle still has legs.

Ed Perks: I would note that as we have seen volatility pickup this year in equities, credit actually has performed pretty well. Certainly the length of the economic cycle factors into our decision-making, but we focus on relative value across asset classes broadly.

The Hunt for Income and Yield

Ed Perks: Finding yield and income certainly has been a challenge for many investors. In the last six months, as we have seen a more pronounced rise in longer-term interest rates, equities that are thought of as bond-proxy type segments of the market, such as utilities and real-estate investment trusts, have underperformed the broader equity market.

We have also seen a preference toward growth and momentum stocks. If you look at the traditional tradeoff between value and growth, value generally tends to be a bit more income- and yield-oriented than growth. On the equity side, our team is venturing out a bit more into those pockets of underperformance and looking for some opportunities for income.

Chris Molumphy: One trend that we have seen is foreign interest in the US municipal bond market, which has traditionally been a domestic market driven by the potential tax advantages to primarily individual investors. But a few years ago, we started to see significant demand for the asset class from non-US buyers. I think it really embodies this tremendous search for yield on a global basis that has persisted for a while and likely will continue to persist. Intermediate US Treasury yields of 2.75% or 3% are pretty low to US investors, but in Europe or Japan, intermediate government yields remain close to zero. And all of a sudden, the US market doesn't look all that bad. And I think as investors look at muni bonds, they generally see very high-quality offerings with solid fundamentals and attractive yields. While munis are not backed by the federal government, they are backed by state and local governments, which appeals to many investors.

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