MULTI-ASSET

Talking Trade Tensions, Inflation and Volatility

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Global growth has been accelerating, but there are a few potential headwinds that could cause it to stall. Three of our senior investment leaders—Ed Perks, Chris Molumphy and Stephen Dover—recently participated in a panel discussion on the potential impact of trade tensions, inflation and other issues on their radar.

Here are some highlights:

- **Ed Perks:** Generally I think we are still in a good place. We think gross domestic product (GDP) growth globally is still accelerating, especially from where we've been in this economic cycle. That's largely due to very strong growth in the United States, but also areas like Europe and Japan and emerging markets are still contributing nicely to growth. One thing we haven't seen more recently with some of the recent market volatility is a true kind of risk-off mode where US Treasuries become a haven. But I think that dynamic likely will change.
- **Stephen Dover:** For the most part, we're seeing coordinated global growth in a way we haven't ever seen before. Emerging markets continue to have very strong economic growth and I think that's very positive going forward. In regard to inflation, I think what's missing is the 10-year discussion we've had on deflation and the great fear we had about deflation. That's what the reserve banks and the economists were concerned about. If anything, I think what we're talking about with inflation is a return to normalization.
- **Chris Molumphy:** Our view is that inflation will continue to tick up, but very gradually. The primary forces that have really kept inflation muted to this point, primarily globalization and also technological innovation, are still in place and are likely to be here for a while. With respect to trade tensions, our view is that rhetoric often ends up being much more significant than underlying actions.

Tune in to our latest "Talking Markets" podcast and hear more. A transcript of the podcast follows.

Host/Richard Banks: Hello and welcome to Talking Markets with Franklin Templeton Investments: exclusive and unique insights from Franklin Templeton.

I’m your host, Richard Banks. Ahead on this episode, talking trade tensions and the potential impact on global growth. Three of our senior investment leaders—Ed Perks, Chris Molumphy, and Stephen Dover—sit down with Franklin Templeton’s Katie Klingensmith. Katie, take it away.

Katie Klingensmith: I’d like to start with you, Ed. There have been a lot of concerns lately about economic activity globally. Do you see threats to our outlook for economic growth?

Ed Perks: Yeah, we do. You know, generally I think we are still in a good place. We think GDP growth globally is still accelerating, especially from where we’ve been in this economic cycle. That’s largely due to very strong growth in the United States, but also areas like Europe and Japan and emerging markets are still contributing nicely to growth. I would say, one of the bigger concerns that we have is some of the risks that might be associated with some of the trade tensions that certainly have been coming up to the surface a bit more of late. I think it’s important to acknowledge that fears of protectionism are not new. They’ve really been with us for a period of time here in this economic expansion.

If it were to materially impact, say business or consumer confidence, that could start to actually impact economic activity. We’re not really seeing that just yet. And then, obviously if we were to get to a point where we were to see significant activity in terms of tariffs, then it’d be a much more real impact. But right now we’re in a place where we still expect a pretty robust a period of economic growth, certainly in 2018.

Katie Klingensmith: Chris, would you add any insights about the US economic outlook?

Chris Molumphy: Generally, I think we’d concur with Ed and his thoughts that the underlying fundamentals to us appear reasonably healthy; they haven’t changed dramatically from the beginning of the year. Now, these other issues that have come up with trade currently at the front of the line, geopolitical risks, are issues that are worth monitoring. We’re evaluating them on a real-time basis. With respect to trade, our view is that rhetoric often—and we’ve seen this be the case—ends up being much more significant than underlying actions. We will have to see how it plays out a bit. But bottom line is fundamentals in our view remain pretty strong, even though there are some more questions on the horizon, but, we remain pretty constructive regarding US economic growth.

Katie Klingensmith: And Stephen, when we look at our economic outlook globally, what are you and your team seeing?

Stephen Dover: We’re seeing, for the most part, coordinated growth in a way we haven’t ever seen before. We’re moving both on top-line and bottom-line growth globally. Emerging markets continue to have very strong economic growth and I think that’s very positive going forward. So in that sense it seems like a fairly benign environment. I think on the specific issue of trade, I think we’re probably more in a trade dispute than a trade war and that the underlying earnings growth that we get from the tax cut in the United States and some other countries and, in some countries, falling interest rates, probably overwhelms what may happen with trade. But if I may on trade, I think we’re at the maturing point of a huge shift that happened in the late 1980s and early 1990s when the Soviet Union broke down and in essence a lot of people became available to the free market. And as a result of that, there were labor shifts and resource shifts and that caused a great amount of deflation and a great amount of trade and that will likely continue. But the growth in trade that we have had over that 20 or 30 year period—despite any disputes—is not going to grow at the same rate, particularly those emerging-market countries that were over the last 30 years being built on trade and exports are increasingly consumption-oriented, internal-consumption oriented. So there’s a large increase in trade between those countries. And, as they have their own consumption, trade will be less important for them. I think trade is based on each country working at its competitive advantage and the competitive advantage of the West is intellectual property. And I think there are probably some legitimate disputes with particularly China about its protection of property rights. I think that’s probably the core of what this trade dispute is about.

Ed Perks: Stephen touched on something earlier in his comment that I thought was interesting and it's pretty relevant, especially as we think about economic growth in the United States as well as in Europe. An important driver for 2018—just the backdrop is extraordinarily favorable. He mentioned rising corporate revenues and profits, and how that, combined with this elevated level of confidence that we've had, really has been driving a lot of business investment. We certainly think that is an important dynamic to the acceleration in US economic growth as well as in Europe. And in Europe, obviously, it is at a different point in its economic expansion with about a two-to-three year lag of many other developed economies. So while maybe some of the manufacturing capacity that exists there is still not as tight it is in other regions, we're still seeing with the [European Commission President Jean-Claude] Juncker plan in Europe, a real opportunity to drive some growth there. So, I think we remain pretty constructive at this point that things would have to deteriorate pretty meaningfully from where we are today before trade becomes a real drag. Now there are some issues, where our expectations for growth in certain regions—Japan in particular—where maybe it's softened a bit. Some of that's due to, in our view, some of the exporters being pressured by the stronger yen. So there are some other dynamics that are affecting trade, not just the risks of tariffs being imposed.

Katie Klingensmith: Coming back to you, Chris. Given that we still see a pretty constructive outlook for US and global growth, what will that mean for inflation?

Chris Molumphy: Inflation has already started moving upward pretty gradually, but it is moving upward a bit. Not unexpected. I mean, in the United States in particular, here we are well into the 9th year—about to enter the 10th year—of this economic growth cycle, with unemployment at 4.1%. One would certainly expect some increase in inflation at this point in the cycle. The question has been why we haven't seen more of it to date. But in the last several months, we're finally seeing gradual tick up in inflation. Our view is that it likely will continue to tick up, but very gradually. You know, the primary forces that have really kept inflation muted to this point, primarily globalization and also technological innovation, are still in place and are likely to be here for a while. So we think those will continue to have a downward impact on inflation, broadly speaking. As well, the Fed [US Federal Reserve] seems to concur, its view is that inflation ticks up to 2%, but doesn't go a whole lot higher over the next several years. You know, that's just one view, but an important view in the marketplace. And you know, one we generally would agree with. Now outside the United States, as Ed points out, you know, generally speaking, they're a couple, three years behind, where the United States is in the cycle and you're seeing similar issues with inflation. It's still quite a bit more contained, whether you look at Europe or Japan, inflation is even more contained than what we see in the United States. So again, a gradual increase [in inflation], but an emphasis on gradual.

Ed Perks: I would just add to that, as the investment team in multi-asset solutions really engages all the different investment teams at Franklin Templeton, this is the million-dollar question that we're all facing. We all want to try to hone in on how much we may see inflation move and at what pace. That's something that is really dominating all of the analysis that our teams are doing.

Katie Klingensmith: And given that background, how is that impacting your bottom-up fundamental analysis, Ed?

Ed Perks: I think these macro factors, in general, are certainly becoming more relevant for our bottom-up fundamentals. And maybe just to focus in on the United States, though, right now, we're not seeing that meaningful an impact. In fact, as we get through this first-quarter earnings reporting season, the expectations are fairly high for earnings growth. I think maybe even more significantly, if we look back the last several years from where we've started, there's generally been a muting of expectations around revenue and earnings growth. We haven't seen that this time. In 2018, we've actually seen some of the expectations continue to elevate. So, the fundamental picture continues to look very positive and I think part of that may be whether we're talking about inflation or the overall level of interest rates and some of the movement up that we've seen there. Or whether we're talking about volatility, which after being extraordinarily low across a lot of asset classes, has started to certainly move up, but we would argue maybe just become a bit more normal again. And all of those things I think are fairly relevant as we think about, will it start to impact fundamentals? And that's where I think right now we're not seeing it, but we're going to be very focused on that as well.

Stephen Dover: I find it interesting we're discussing inflation because what's missing is this 10-year discussion we've had on deflation and the great fear we had about deflation. So if we look back over the last 10 years, that's what the reserve banks and the economists were concerned about. They lowered interest rates and what was the result of that? The result was to increase the price of risky assets, and it really changed how valuation metrics happened. And if anything, what we're talking about with inflation is a return to normalization. So what would that mean? That would mean that the way in which you have valuations of equities would be more normal or we would consider normal prior to 2008. It would mean that there would be more volatility in the market. So there could be a shift in how valuations happen. I think it's overall very positive for equity and earnings, but how valuations will happen might be more similar to how it was prior to 2008.

Katie Klingensmith: Chris, you've mentioned that the Fed's expectations are pretty much in keeping with what we're looking for in-house. What is your outlook for short-term rates and what will that mean for economic growth in the United States?

Chris Molumphy: As we know, the Fed takes the lead on setting short rates in the United States. They've embarked on their normalization policy for some time now. It's a gradual policy—[the US Fed] raised rates again once already this year, they forecast a couple more quarter-point increases for this year and likely three quarter-point increases for 2019. So that would move short rates (using the Fed funds as a baseline) a little over 2% come year-end 2018 and close to 3% in 2019. Our view is that this gradual normalization is probably healthy. It's important to realize while short rates are moving up, they're still quite low on a nominal basis. And in fact, the Fed talks about kind of roughly 3% as being their end game in terms of where they'll ultimately get to. So that's still a pretty, pretty healthy level. Now with respect to longer rates, that's more of a function of inflation—is impacted to some degree by short rates. But again, we think while we'll see gradual increases there, they'll be fairly muted. Now, to your point about how does this impact growth, you know, on the margin, it'll be a bit of a headwind. But again, as the market is factoring this in and to the extent it is gradual, we think it will only be on the margin a headwind. It shouldn't be a significant detriment to growth in the United States and frankly, even outside the United States.

Katie Klingensmith: Chris, where do you see us right now in the credit cycle and what do you make of some widening in credit spreads?

Chris Molumphy: Well, as I mentioned earlier, we have to be cognizant of how long this cycle has already gone on. We're, you know, almost nine years into the growth cycle. The summer, we'll head into the 10th year of a growth economic cycle. So from a credit standpoint and as credit investors, we're very much aware of where we are. We don't think cycles have gone away and we need to be thinking about when the next cycle ends and beyond that. Having said all that, we're not seeing the traditional early warning signs of credit problems, credit issues, and you virtually always see early signs of reduced credit quality. So we're spending an awful lot of time looking for that, but you know, to date haven't really seen significant changes there. So we think we have a bit more to go in this particular credit cycle. Now as you point out, we've had a little bit of a valuation backup, but this was for the most part in earlier this year in February, you know. From our viewpoint, it really mirrored the move more broadly in risk assets when the equity markets turn down, some of the credit markets followed, as well. When you look at valuations, certainly at the beginning of the year, many risk assets were pretty richly valued, shall we say. So some correction was really expected. So I think the backup is much more a function of the broad changes in valuation, changes in the risk markets, as opposed to any early warning signs of credit deterioration. So we think it's probably healthy longer term.

Ed Perks: I would add to that particularly year to date, as we've seen the volatility pick up in asset classes, particularly equities, credit really performed pretty well. There was a modest backup in spreads, but if you looked at the increase in volatility in those short windows when equity markets were fairly dislocated, we were actually quite pleased with how credit performed.

Katie Klingensmith: How do these different views 10 years into a growth cycle impact your decisions around asset allocation?

Ed Perks: Certainly the length of the economic cycle factors into our decision making, but we're looking at relative value across a lot of the asset classes. And I think maybe some of the changes we've seen is that as rates have started to move up, this desire or intent on being a bit more underweight fixed income has started to soften. Even as we look at the shorter-end of the yield curve and US Treasuries starting to have some real yield again, that starts to change the dynamic, particularly if you're thinking about other asset classes with a more normal level of volatility. One thing we haven't seen more recently with some of the pullback in markets is a true kind of risk-off mode where Treasuries become a haven. In fact, in many other days that we've had bigger declines in the equity markets, we've also seen longer-term interest rates backing up and some pressure in fixed income markets. So, I think as we continue to move higher, that dynamic likely will change. So we're becoming a little bit more interested in, and possibly even moving our kind of underweight posture and fixed income a little bit higher. We'd likely will still remain a bit more on the shorter end [of the yield] curve, a bit more biased toward credit because we continue to think the fundamental backdrop remains very supportive.

Katie Klingensmith: There's been a lot of lively discussions around the correlations between the asset classes. How do we think about the credit cycle impacting our views about equities and what are the short- and medium-term outlooks from you and your team?

Stephen Dover: I think the credit cycle is probably a bit of a canary for the equity markets. And as Chris and Ed said, we haven't seen a concern at this point, but I think we certainly would want to watch that as we're going through a paradigm shift from really worrying about deflation to a more normal market. There are players out there certainly that are probably over-levered and there will be some issues with them and that will be kind of a sign and that's what the reserve banks are concerned about and that's what we're looking at. And as we look at equities, we are looking at those that are kind of ready for the shift that we're having towards more normal.

Katie Klingensmith: Chris, it's been surprising to me—and I think to many—that there is real interest among foreign investors in the US muni [municipal bond] market. What has made this market so attractive right now?

Chris Molumphy: Initially it was surprising to us as well. I mean the municipal market is traditionally a domestic market and driven by the tax advantages to primarily individual investors. But starting really a couple of years ago, we started seeing significant demand in the municipal bond asset class from non-US buyers. And I think what it really signifies is this tremendous search for yield on a global basis that has persisted for a while and likely will continue to persist. I mean, we think about 2.75% or 3% intermediate yields as being pretty darn low in the United States. But when you move outside of the United States and whether it's Europe or Japan, you see intermediate government yields close to zero and all of a sudden the US market doesn't look all that bad. And I think that's at the core, a real driver. With respect to municipal bonds outside the United States, they look at these markets and say, wow, very high quality. Not federal-government backed, but state- and local-government backed. Oftentimes very solid fundamentally by and large and with some reasonable yield on a relative basis. So it's an interesting new source of demand we've seen over the last couple of years. And it's likely to persist, at least in the foreseeable future.

Katie Klingensmith: And Ed, I know you're working with the different investment teams and looking for solutions for clients. Obviously the search for yield that Chris mentioned is an issue across asset classes and including even just in equities.

Ed Perks: Yeah, it's certainly been a challenge. And even in this last six-month period when we've seen this more pronounced move upward in the longer-term interest rates, just thinking about some of the relative performance within equity markets now, clearly the more bond-proxy type segments of the market—and I would include utilities and real estate investment trusts in that component—maybe even preferred stocks in that component. You've seen pretty material underperformance to the broader equity market. Now, part of that dynamic has also been that growth and momentum factors have been very dominant in the equity market. And in general, if you look at the traditional tradeoff between value and growth, value tends to be a bit more income- and yield-oriented than certainly the growth segments of the equity market. So that has very much played out. As we see it continue, we do think that the secondary effects will be a bit more muted. So we're starting to kind of venture a bit more into those pockets of underperformance and looking for some opportunities for income.

Katie Klingensmith: And staying with you, Ed, it's been an interesting time as Stephen noted of synchronized global growth, maybe rising inflation concerns but still very muted inflation concerns and generally accommodative policy, both fiscal and monetary across the world. However, we've started to see quite a bit of volatility. Do you think that should really be a material concern in how we construct our portfolios and invest right now? And what is it that you see is a real risk in the short-term?

Ed Perks: We absolutely do think investors have to think about their portfolio construction along a number of different lines and it's not just diversification from an asset class or geography or sector standpoint, but it has to also be about the type of factor exposures you have in a portfolio. And I think we've just seen a little bit of that where the market started to really go through a transition in some of the factors that were really driving performance and, those that had been really underperforming starting to shift. So we certainly think that, particularly in multi-asset portfolios that have had a bias to being a bit more underweight fixed income and overweight equity, those equity components or the risk-budget assigned to that equity portion of the portfolio really will dominate the entirety of the portfolio. So I think really understanding where your risk exposures are is critical in constructing a multi-asset portfolio.

Katie Klingensmith: Chris, from a short-term volatility perspective, what are you and your team seeing?

Chris Molumphy: We're in a different environment from the beginning of this year, things have really changed. So diversification clearly is critical across fixed income and our multi-sector of fixed income portfolios.

Chris Molumphy: Also being aware of potential volatility in different asset classes. So it's something we're extremely focused on in the different portfolios. But you know, these are more kind of shorter-term risks, we think ultimately, for the most part, we tend to focus on a little bit longer-term horizon thinking about what are the primary risks ultimately to the portfolios and to the different fixed income sectors.

Katie Klingensmith: And what about in equity markets, Stephen? Where do you see the short-term risks?

Stephen Dover: Well, if we are going through a paradigm shift in going back to normalization and we've been in a risk-on situation for the last 10 years, one of the greatest beneficiaries of that of course has been the equity market. So I'm still quite positive on the earnings market from an earnings type of growth, but I think there could be some shifts in terms of how equities perform. I think analysts probably have a better opportunity going forward to differentiate between stocks because it'll be based more on individual stocks rather than the movement of the market as a whole. So I think those are some of the risks. The United States is ahead of other countries, sort of in this whole secular change. So probably there are some opportunities in some of these other countries in terms of diversifying portfolios.

Ed Perks: I think one of the potentially positive elements of particularly the equity market is that as we've seen higher volatility, as we've seen a backup in interest rates, we've also seen some multiple contraction in equities. A year ago this time, the forward 12-month earnings multiple was about 10% higher than it is today. So there has been some adjustment happening in the markets, and I think that's a pretty constructive element as well.

Stephen Dover: Yeah, to have a healthy bull market you have to have that volatility and pull back, and Ed's point is really well taken that in some sense the market's healthier now than it was a year ago.

Katie Klingensmith: It sounds like we do have quite a few drivers of short-term risk. It could be a transition to a new economic situation. How are you managing the risks?

Ed Perks: A big part of our process is trying to be somewhat tactical with our exposures, and I think the best example of that is how we've been positioned within particularly our fixed income allocations as markets adjust and change relative value and attractiveness starts to change and creates some opportunities for us. So, you know, I think that's a big part of managing the risk and also ensuring that we're taking advantage of where we think opportunities are in the markets.

Katie Klingensmith: If I can stay with you, Ed. With your overall perspective on the volatility, especially that which has been caused by the political headlines, what would you expect from the rest of this year?

Ed Perks: I think we probably should expect a bit more of the same for the rest of the year. And I do think about it less in the context of what we just experienced the last 12 to 18 months really, and think about it more from a historical perspective. I think a lot of these dynamics have played out in markets historically. Maybe one of the real negatives of having such a period of tremendously low volatility is that there were some distortions in markets and extraordinarily short-term investment horizons started to really settle in.

Stephen Dover: I think that ultimately equities are a discounted earning stream and that's really what we're trying to focus on is companies that have good quality earning streams. As we move into an environment where those companies are more differentiated, I think the opportunity to pick stocks increases. In terms of the political environment, November will be here before we know it. So there will be a lot of volatility in the United States and other countries. I don't expect that to change. I guess that's a certain amount of noise that isn't particularly useful.

Chris Molumphy: I would generally concur with Steven's point, which is we have a tendency, day-to-day, week-to-week, [to focus on] what leads the headlines or political headlines or geopolitical issues and so forth. But what we do for a living is to cut through that and focus on the fundamentals. While everyone likes to talk about and read about the politics and other related headlines, ultimately it's the fundamentals that drive financial markets, that drive financial market prices. And while these headlines can create volatility in the short run, from our perspective the fundamentals still remain pretty darn healthy as we look throughout the remainder of 2018 and frankly into 2019.

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