Monetary Policy across the Globe
Weighing the Opportunities and Risks in Equity and Fixed Income
Pockets of Opportunity in Emerging Markets
Perspective on the United Kingdom’s Recent Election
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.

FEATURED SENIOR INVESTMENT LEADERS

Christopher J. Molumphy, CFA, Chief Investment Officer, Franklin Templeton Fixed Income Group®

Chris is executive vice president and chief investment officer of Franklin Templeton Fixed Income Group, a global fixed income platform that includes the Municipal, High Yield, Investment Grade, Global, Money Market and Floating Rate groups. He is also a member of Franklin Resources’ executive committee, an 11-member group responsible for shaping the company’s overall strategy.

Stephen H. Dover, CFA, Head of Equities

Stephen is head of equities for Franklin Templeton. In this role, he focuses on global oversight and administration of the company’s equity investment business including Franklin Equity Group, Templeton Global Equity Group, Franklin Mutual Series and Franklin U.S. Value. He is also the CIO for Templeton Emerging Markets Group, Templeton Private Equity Partners, and the head of the equity teams of Franklin Local Asset Management.

Edward D. Perks, CFA, Chief Investment Officer, Franklin Templeton Multi-Asset Solutions

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Michael Hasenstab, Ph.D., Chief Investment Officer, Templeton Global Macro

Michael is executive vice president and chief investment officer for Templeton Global Macro, which conducts in-depth global macroeconomic analysis covering thematic topics, regional and country analysis, and interest rate, currency and sovereign credit market outlooks. Templeton Global Macro offers global, unconstrained investment strategies through a variety of investment vehicles ranging from retail mutual funds to unregistered, privately offered hedge funds. Dr. Hasenstab is economic advisor to the CEO of Franklin Resources, Inc., providing his perspective and insight through the lens of Templeton Global Macro. In addition, he is a member of Franklin Resources’ executive committee.

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This document summarizes the video content from our panel discussion.
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Monetary Policy across the Globe

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.
-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.

– Michael Hasenstab
Weighing the Opportunities and Risks in Equity and Fixed Income

Q: From an investor’s point of view, what are the implications of this interest-rate environment for US fixed income sectors?

CHRIS MOLUMPHY:
US interest rates have generally remained pretty suppressed over the past couple of years and we’ve been in a risk-on type of market. The 10-year US Treasury yield has remained very low on a historical basis, and rate-sensitive market sectors have performed well. Given a search for yield not only in the United States but globally, risk-on credit sectors of various types have surged over the past couple of years. We have seen a rally in corporates including high-yield, leveraged loans and in emerging-market debt.

Looking forward, we think interest rates should remain reasonably low in the near-to-intermediate term. Some observers say the corporate market or other credit sectors appear overvalued and could be set up for a correction. That may be the case, but using high-yield corporates as an example, fundamentals still appear pretty robust, in our view. If we look at past economic cycles, the corporate sector in general has remained reasonably strong as the economy has continued to grow.

If the US economy holds up—which we think it should—fundamentals for corporate credit should hold up and valuations could remain at relatively rich levels as investors continue to search for yield globally.

10-Year US Treasury Yields
January 30, 1980–May 31, 2017

Source: Bloomberg, US Federal Reserve. Treasuries, if held to maturity, offer a fixed rate of return and fixed principal value; their interest payments and principal are guaranteed.
Q: Thinking about equities, what opportunities and risks are you seeing across developed markets?

STEPHEN DOVER:
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, as Michael alluded to, 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 funds realize the potential risks they are taking. We believe that we can add value in diversifying a portfolio better to help reduce these risks versus a traditional cap-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 have 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 I look across the asset classes—equities in particular as Stephen touched on—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. That may not be the case today but going forward certainly I think can be more relevant. As I think back on the last five years in particular, Michael mentioned the post-financial crisis trade that existed and maybe supported a lot of different asset classes and we largely feel like that trade is done.
Volatility has been subdued in recent quarters across both equities and fixed income. What’s your view on market volatility going forward and how do you see it potentially impacting returns?

**ED PERKS:**
The CBOE Volatility Index (VIX)² has recently dropped below 10 and has been hitting record lows on nearly a daily basis. I think at some level we have to put this in perspective. Often dubbed the “fear index,” the VIX is a very short-term gauge of expectations for equity market volatility. The VIX (quoted in percentage points) aims to predict price movement in the S&P 500 Index over a 30-day period. VIX levels below 20 generally reflect low volatility, and thus higher investor confidence.

What stands out to me though is just how broad-based the decline in volatility has been across various asset classes. Over the past six months or so, US equities, European equities, Asian equities and even emerging-market equities are now realizing volatility at or very close to the lowest decile of the prior 10-year period.

Shifting to fixed income, we have seen some bouts of volatility more recently. But generally across the globe, in sovereign bonds and across corporates and high yield, we also are seeing very low levels of realized volatility. Markets have gotten through some pretty significant periods of uncertainty in the last several years. Whether concerns about China, commodity prices, Brexit in the United Kingdom, the US election or some recent geopolitical hotspots and conflicts, the markets have been able to get through these challenges.

Tying in what Michael stated, in addition to accommodative central bank policies, we have seen concerted fiscal policy efforts in many countries to support economic growth. While that stimulative response may come with implications down the road, right now one of the things I think it is broadly doing for markets is reducing the likelihood of recession globally, and that also drives down market volatility.

The phrase “lower for longer” can be true for volatility as well, but one should be careful not to assume it is smooth sailing ahead. We may be in a period of relative subdued volatility, but ultimately as the economic expansion or business cycle ages—particularly in the United States—pressures will bubble up that could lead us to enter a more normal or elevated period of volatility. I think investors need to be mindful that periods of low volatility support equity valuations generally, but in many asset classes, low volatility can also mean slightly lower returns.
Pockets of Opportunity in Emerging Markets

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. It’s an exciting area with good value opportunities, but again, we have to be very selective.

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. “

– Michael Hasenstab
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.

Michael and I have had discussions over the past year about our optimism for emerging markets, and we have a number of reasons for feeling optimistic.

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.

The other point I would like to make about emerging markets is that they are changing. I think an investor has to look at what constitutes these countries and the companies in them today. By and large, emerging-market countries used to be much more dependent on exporting and much more dependent on commodities than they are today. Now, they are much more dependent on consumption, and there are many more opportunities on the technology side.

If you look at most benchmark emerging-market indexes, they are heavily overweight government-controlled companies and on export and commodity-oriented companies. But we see a lot of opportunities outside these areas, in the more consumer-driven and technology sectors, and are excited about the potential we see as these economies and markets continue to grow and evolve.

"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."

– Stephen Dover
**Featured Perspective on the United Kingdom’s Recent Election**

THERESA MAY’S SHOCK DEFEAT THREATENS FURTHER VOLATILITY

David Zahn, CFA, FRM  
Head of European Fixed Income  
Senior Vice President, Portfolio Manager  
Franklin Templeton Fixed Income Group

Theresa May’s gamble didn’t pay off. She had hoped that a resounding election victory and an increased majority in the House of Commons would give her a mandate to pursue her own political agenda and, in particular, strengthen her hand in negotiations to secure the United Kingdom’s withdrawal from the European Union (EU).

But those plans are in tatters and instead, slightly less than a year after the country voted to leave the EU, the United Kingdom has been plunged into further political uncertainty.

We expect the pound to plummet and gilt yields to decline as investors embark on a so-called flight to safety. Overall, we think so-called risky assets, such as equities, are likely to underperform.

Even though the Conservatives remain nominally in power in the United Kingdom, for many investors the prospect of an unstable minority government paints a picture of a government not in complete control during a period in which the United Kingdom needs its most focused administration for 70 years.

More Scrutiny on Brexit Strategy

Instead of securing an easier passage for any Brexit deal, as May had hoped, this result increases the likelihood of Members of Parliament (MPs) more aggressively scrutinizing the Brexit progress. It also raises the possibility of Parliament rejecting an unpopular deal.

In our view, that result would significantly tie the hands of UK negotiators. MPs would be more likely to demand more transparency on the UK side of the negotiations, which will be a boon to the EU negotiators. This is likely to make the prospect of a deal that is beneficial to the United Kingdom tougher to achieve.

The Clock Is Ticking

The harder it is for the UK government to negotiate, the more likely we anticipate a “hard Brexit” scenario to be, leaving the United Kingdom without a deal to replace the current European trade agreements.

That outcome would likely result in the pound selling off further and UK bond prices surging. And although that prospect might seem some time off, yet, it’s worth remembering that the clock has already started ticking, and there are only 20 months left. We’re four months into the Brexit process and have officially accomplished nothing as yet.

Worryingly for the UK authorities, this election result is likely to play into the hands of the EU’s Brexit negotiators. They will see the UK doesn’t have a strong leader to negotiate with and could be emboldened to take a tougher line.

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