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The four pillars to face a world of uncertainty

FRANKLIN TEMPLETON THINKS™ GLOBAL MACRO VIEWS

FRANKLIN TEMPLETON

Global investors are facing extraordinary economic, political and financial market conditions that risk sending the world into a perilous period. In particular, we are closely watching several key areas of concern, including: (1) rising geopolitical risks and trade tensions; (2) rising populism and political polarization; (3) unrestrained deficit spending in the developed world; (4) underappreciated inflation pressures in the US; and (5) low policy rates driving investors into riskier assets and thus leading to overvaluations in many parts of the market. However, we see this as an opportunity, an opportunity to invest in potential hedges against these risks and to target building an unconstrained portfolio that is truly uncorrelated to general market risk.

There are now acute and contentious clashes over which economic and political paradigms will dominate the next generation: from capitalism to socialism, and from democracy to authoritarianism. The changing power structures between the world's largest players increases the potential for a geopolitical event, in a range of theaters from trade to military, that could disrupt financial markets. Recently elevated tensions in the Middle East and frictions between the US and China are two significant examples. Throughout history, shifts in hegemonic power have often proved very unstable to financial markets and thus merit attention.

In addition, there are an increasing number of populist governments, which, in conjunction with a global trend toward extreme polarization, have stoked greater volatility in economic policy and generally enabled undisciplined economic agendas. This populist surge has led to rising debt loads and corresponding fiscal risks across the developed world. Economic agendas are now increasingly being justified by largely untested economic theories. Whereas Keynesian or neo-Classical economic theories date back to before and around the middle of the last century, Modern Monetary Theory, which justifies printing money to fund fiscal expansion, has emerged with incredible political popularity despite a lack of rigorous theoretical or empirical foundation.

In the US, divisions among the population have surpassed any point in recent history and given rise to heightened polarization between political parties. Meanwhile, US deficit spending has deepened significantly, propelling the fiscal deficit toward an annual average of US$1.2 trillion over the next ten years (4.7% of gross domestic product [GDP])[1] and necessitating massive levels of deficit funding through US Treasuries. These deficit numbers do not even account for the costs of recent spending proposals such as the Green New Deal, student loan forgiveness or sweeping health care reform. Similarly, in Europe, nationalist parties have frayed the fabric of the eurozone, testing the political cohesion necessary to both maintain fiscal discipline today and hold the coalition together during a crisis in the future. Crucial structural concerns also remain unresolved, notably including debt sustainability and banking imbalances in Italy.

Concurrently, investors appear convinced that inflation will never be a risk in the US, yet cyclical and structural factors are undergoing significant changes that risk triggering an increase in inflation. Most notably, a move away from the free movement of capital and goods due to inward-looking policies risks increasing prices. A tight labor market, due to an extended period of economic expansion and large restrictions in both legal and illegal immigration, is driving labor shortages in many areas, resulting in a move higher in wages. These labor shortages combined with an increase in the bargaining power of labor—this past year has seen more strikes than any year since the 1980s[2]—will likely continue to reinforce these trends.

On the central bank front, the US Federal Reserve (Fed) and the European Central Bank (ECB) were discussing ways to normalize monetary policy as recently as a year ago. Today, however, both the

> "Despite extraordinary market conditions, we see an opportunity to invest in potential hedges against global risks while aiming to build a portfolio that is truly uncorrelated to general market risk."
>
> **— Michael Hasenstab, Ph.D.**

Fed and the ECB have again embraced a stance of greater monetary accommodation. Sustaining this accommodative approach prior to a realized crisis continues to push investors into riskier and less liquid investments. The world is now flush with over US$14 trillion[3] in negative-yielding bonds—securities that are designed to return less than nothing. In the US, real yields on longer-dated US Treasuries are negative, reflecting significant valuation distortions for an economy growing at full potential with full employment.

Policies that were once considered highly unconventional have become normalized, as economies become increasingly reliant on central banks to cover gaps in fiscal and economic policy. The combination of already accommodative monetary and fiscal policy limits the tools of policymakers in the next global economic slowdown.

The potential way out of the next crisis could also be inhibited by a deterioration in social cohesion. Even in this period of record low unemployment and increasing wage growth, popular frustration over heightened levels of economic inequality has significantly widened political differences. If broad economic conditions decline, it stands to reason that this sentiment would worsen, driving even more political polarization. Whether this, in turn, results in policy paralysis or in a concerted shift toward extreme economic decisions, the ability to effectively and prudently address a significant economic or market downturn will likely be severely diminished.

The four pillars of our positioning

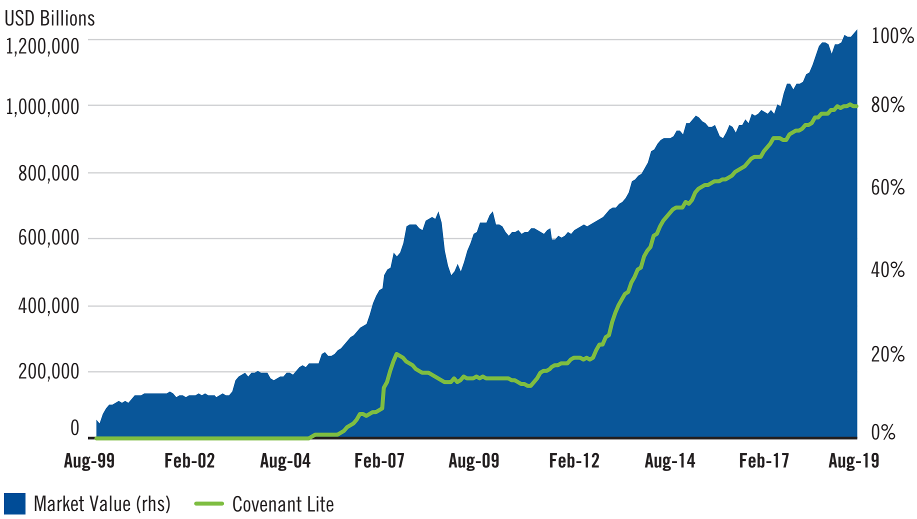
Given these factors, we are positioning our strategies around four key pillars: (1) maintaining **high liquidity** through elevated cash balances, with a focus on highly liquid assets and appropriate risk-adjusted position weights; (2) holding **long exposures to perceived safe-haven assets**, including the Japanese yen, Norwegian krone and Swedish krona; (3) maintaining **negative duration exposure to the long end of the US Treasury yield curve**; and (4) **risk-managing a select set of emerging market exposures** that appear better positioned to handle trade disruptions and potential rate shocks. Overall, we are aiming to create portfolios that can provide diversification against highly correlated risks across asset classes.

1. Maintaining high liquidity in our strategies

The combination of very accommodative central bank policy combined with a more regulated banking system has amplified credit risk in the shadow banking system. Thus there has been significant growth in US credit markets over the last decade in areas of less transparency—private issuances with limited financial disclosure and diminished debt covenants. More than half of the high-yield US corporate bond market now comes from private placements, up from around 17% before the era of quantitative easing.[4] Additionally, the levered loan market has surpassed the size of the high-yield bond market, with around 80% of its securities having light-to-nonexistent covenants and no public financial disclosures[5]. This could be cultivating conditions for the next liquidity crunch. Years of easy money have eroded discipline in the markets by favoring the borrower, thereby damaging the ability of lenders to insist on appropriate financial disclosures and stronger covenants. For every disciplined lender that passes on a non-disclosure deal, there are many more willing to step in and blindly assume the unknown risks. All of this can work as long as credit markets remain bullish, but as soon as credit conditions begin to turn, liquidity will come at an exorbitant cost.

COVENANT-LITE CREDIT DOMINATES THE LEVERAGED LOAN MARKET

Exhibit 1: Total Market Value of Levered Loans and the Percent that are "Covenant-Lite"
August 1999–August 2019



Source: Credit Suisse.

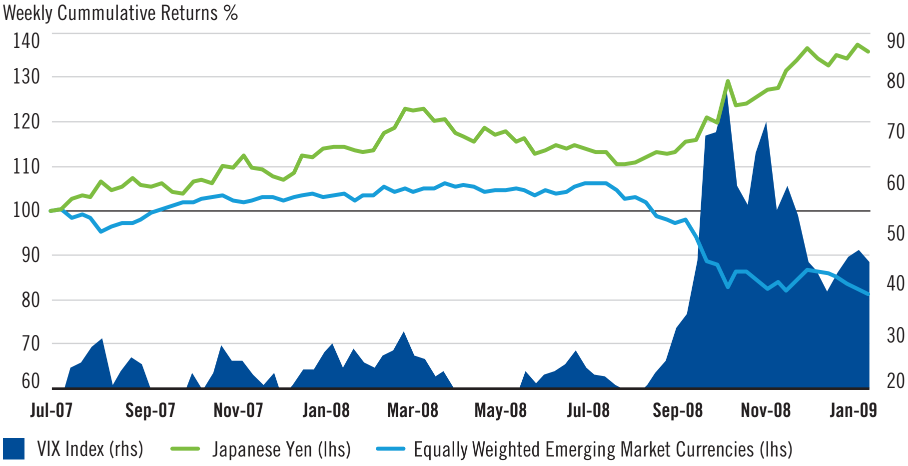
Recent spikes in US repo rates as a result of a supply/demand imbalance in short-term funding markets are a red flag for financial system liquidity risks. Such shocks also signal markets' diminished capacity to absorb such large and ongoing Treasury issuance. Strains in the repo market have been among the first financial system warning signs in prior crises, indicating that liquidity stress points might be starting to emerge.

Thus we remain wary of credit risks and liquidity risks in the global fixed income markets and are positioning our strategies accordingly. We are aiming to optimize liquidity within our portfolios by maintaining elevated levels of cash, focusing on more liquid assets and avoiding overvalued sectors, notably in credit. Instead we are focused on appropriately sizing our risk allocations in specific local-currency markets that show stronger levels of domestic liquidity. We are also targeting higher cash levels to have ample dry powder to pursue quickly developing opportunities during a market correction. Additionally, we are aiming to diversify against index-related risks given the profusion of passive strategies that own the same positions. Passive exchange-traded funds and index funds that become forced sellers of the same securities at the same time are likely to find a dearth of liquidity when they need it most.

THE JAPANESE YEN RALLIED DURING THE 2008 GLOBAL FINANCIAL CRISIS AS MANY EMERGING MARKET ASSETS DECLINED

Exhibit 2: Japanese Yen vs. Emerging Market Currencies, US Treasuries and the VIX Volatility Index

July 2007–January 2009



Source: Bloomberg. Equally weighted emerging market currencies are: Mexican peso, Colombian peso, Brazilian real, Chilean peso, Hungarian forint, Polish zloty, Russian ruble, Turkish lira, South African rand, Malaysian ringgit, Thai baht, South Korean won, Indonesian rupiah, Indian rupee. The Chicago Board Options Exchange Volatility Index, known as the VIX, is a gauge of US equity market volatility. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or guarantee of future results.**

2. Long exposures to perceived safe-haven assets

A number of global risk factors have increased, raising the need to hedge some of our foreign exchange (FX) risk exposures and counterbalance our US rate hedge. The potential for a geopolitical event appears higher than it has been in decades, given ongoing tensions among the major world powers. Additionally, populism and political polarizations are impairing policy decisions, leading to elevated risks for a significant policy error. Massive deficit spending across the developed world has also exhausted many of the resources to respond to a future financial or economic shock. The heavy reliance on monetary policy tools to cure each minor setback the economy suffers has also blunted the ability for those tools to be effective in an actual crisis. In short, there is a risk the developed world has overextended itself on both fiscal and monetary fronts, leaving risk assets highly vulnerable to a financial market event.

Thus we have increased our allocations to what have historically proved to be safe-haven assets, both for their specific underlying valuations as well as their ability to hedge against broad-based financial market risks. We have notably increased our long exposure to the Japanese yen as it shows scope to appreciate against the US dollar on softening policy divergence between the Fed and the Bank of Japan, and also based on Japan's strong external balances, which support a safe-haven status for the yen should global risk aversion deepen in the quarters ahead. We have also added long exposures to the Norwegian krone and Swedish krona as Norway and Sweden benefit from strong fiscal frameworks and current account surpluses that enable the currencies to emerge as safe havens within Europe—a role they previously served during the European debt crisis.

3. Maintaining negative duration exposure to the long end of the US Treasury yield curve

Markets continue to overvalue longer-term US Treasuries, in our opinion. Negative real yields in the US Treasury market appear highly vulnerable to a potential rate shock given rising deficit spending and rising debt. Inflation risks also remain significantly underpriced in markets, given the exceptional tightness in the labor market stemming from restrictions on immigration and breakdowns in the supply chain. Additionally, there are risks to the Fed's ability to meet very aggressive market expectations on monetary accommodation that are already priced in across the Treasury yield curve. Rising inflation could put markets in the difficult position of contending with less monetary accommodation than expected.

Thus we are positioning for curve steepening by maintaining investments in shorter duration US Treasuries combined with negative duration exposure to longer-term US Treasuries. The Fed can very effectively control short-term rates, but it cannot always control the economic and technical pressures on the longer end of the curve. We think investors need to diversify against the rate risks loaded in across the asset classes. We are structuring our strategies to be uncorrelated to the interest-rate risks that investors have embedded throughout their portfolios.

4. Risk-managing a select set of emerging market exposures

Finally, we continue to see value in specific emerging markets, but we have focused on sizing and hedging our positions for individual risks. We have generally been reducing the overall risk in the emerging market sleeves in our strategies while continuing to aim at isolating the specific alpha components through various hedges. For example, we've maintained exposures to local-currency bonds in India, but have fully hedged the Indian rupee and moderately reduced the years of duration in the position. For other countries, such as Brazil, we've largely maintained exposure while increasing our net-negative position in the Australian dollar as a proxy hedge to certain risks embedded in holding local currency Brazilian Bonds. The net-negative Australian dollar exposure intends to hedge broad emerging market beta risk across our strategies, as the currency shows strong positive correlation with emerging market currencies due to shared risk factors, such as linkages to China's economy and commodity markets.

While we have become more cautious on the broad outlook for emerging markets as a whole, we continue to see scope for additional valuation strength in specific countries in certain alpha sources. These opportunities vary highly between countries and across risk exposures. We see a number of higher-yielding local markets that we expect to outperform the core fixed income markets in the quarters ahead.

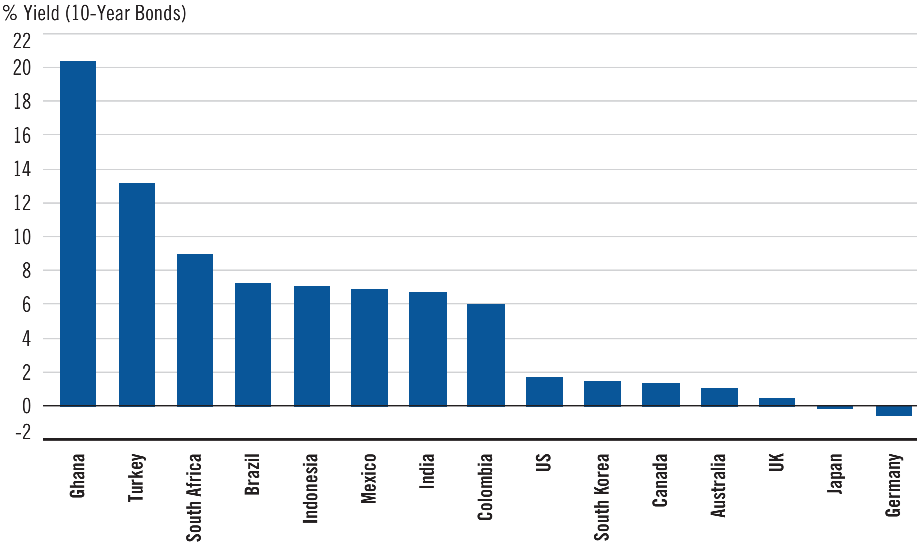
US TREASURY YIELDS ARE ABNORMALLY SUPPRESSED, REMAINING WELL BELOW NOMINAL GDP

Exhibit 3: US 10-Year Treasury Yield and Nominal GDP Growth
June 1981–June 2019

Source: Bloomberg.

HIGHER YIELDS AVAILABLE IN SELECT EMERGING MARKETS

Exhibit 4: 10-Year Sovereign Local-Currency Bond Yields
As of September 30, 2019



Source: Bloomberg.

Conclusion

Investors are currently faced with a growing number of unprecedented challenges that necessitate equally unique solutions. Investment strategies that may have worked well over the last decade are not as likely to be effective in the next one, in our view. We think investors need to prepare for today's challenges by building portfolios that can provide true diversification against highly correlated risks present across many asset classes.