DECEMBER 2019

2020 appears tilted to the downside

FRANKLIN TEMPLETON THINKS™ | ALLOCATION VIEWS

FRANKLIN TEMPLETON

In this issue

The themes we discuss at our Annual Investment Symposium guide our research process. Over a longer-term horizon, we believe global stocks have greater performance potential than global bonds, supported by continued growth and moderate inflation. With government bond term-premia remaining below historical averages, we see a lower performance potential from government bonds.

We recognize that our longer-term outlook will not be reached along a smooth path and we continue to point to shorter-term concerns that have tempered our enthusiasm for riskier assets. We retain a modestly lower conviction on global equities, but we are not overly bearish.

Major themes driving our views

- **Slower global growth remains a concern**
  Growth momentum is negative, but the consumer remains resilient. Trade disputes are only a symptom of broader, potentially longer-term, tension between the United States and China. With profit margins having peaked, this is likely to present an ongoing headwind for business investment intentions.

- **Subdued inflation across economies**
  Inflation expectations remain close to historical lows, and various central banks are struggling to engineer a revival. A deficit in demand is likely to be the key driver of disinflation. The ability of corporations to pass costs on to consumers appears limited, increasing pressure on profit margins.

- **Approaching the limits of monetary policy effectiveness**
  In the longer-term, policymakers may be reaching the limits of conventional monetary policy. Major central banks are reviewing their mandates, which could result in more symmetrical inflation targets. We question whether the political will exists to increase the role of fiscal policy.

Practical positioning

- **Nimble management required**
  Over recent quarters, we have highlighted a return to long-run levels of market volatility rather than the muted levels seen for much of the past 10 years. This indicates that we have entered a new volatility regime. We continue to believe navigating the challenges in the year ahead will require nimble management.

- **Bond valuations are also stretched**
  In a multi-asset portfolio, we seek assets that provide the potential for diversification. Bonds traditionally fulfill that role. Global bonds exhibit low term-premia and modest credit spreads for investment grade corporates. However, slower growth and subdued inflation balances this in our neutral overall view of the asset class.

- **Opportunities and threats in emerging markets**
  In a world where equity return potential is mainly driven by the growth of earnings, higher growth rates should favor emerging market stocks in the longer term. Valuations remain attractive to us relative to developed market peers, but we see this balanced by global growth uncertainty as reason for caution.

Major themes driving our views

Thoughts for 2020 and beyond

Financial markets spent most of 2019 torn between signs that the current expansion is mature and optimism that policymakers stand ready to sustain growth in the years to come. As we look forward to the coming year, we retain a modestly cautious position, balancing the evident risks that lie ahead with the longer-term return potential of riskier and higher-yielding investments.

The slowdown in global trade that has been the dominant economic theme this past year may be showing signs of stabilization and investors are prepared to look favorably on the signs of détente in the US-China trade negotiations. Progress toward a trade deal, and whether it might be delivered before year-end, appears less certain but also an ever-changing feature of the investment landscape. We observe the evolving situation with interest but remain unconvinced on its near-term impact on growth.

However, when we look to 2020 as a whole, we continue to view the balance of risks to global growth as being skewed to the downside, even as the worst fears of slowdown may have eased. Germany narrowly avoided a technical recession by posting the most modest of quarterly growth rates in the third quarter, after contracting in the previous period. This superficially good news might be viewed as easing the pressure to deliver additional fiscal stimulus in one of the eurozone countries with the greatest flexibility to do so. At the same time, the cumulative hit to confidence is gradually impacting the broader economy, and with factory orders remaining in a continued steady decline (see Exhibit 1), the headwinds remain evident.

Longer-term drivers of growth

At our Annual Investment Symposium in November, we debated the longer-term themes that impact our analysis of the global economy. This saw the Multi-Asset Solutions team engage in collaborative dialogue with senior leaders and CIOs from across Franklin Templeton's wide range of asset class specialists.

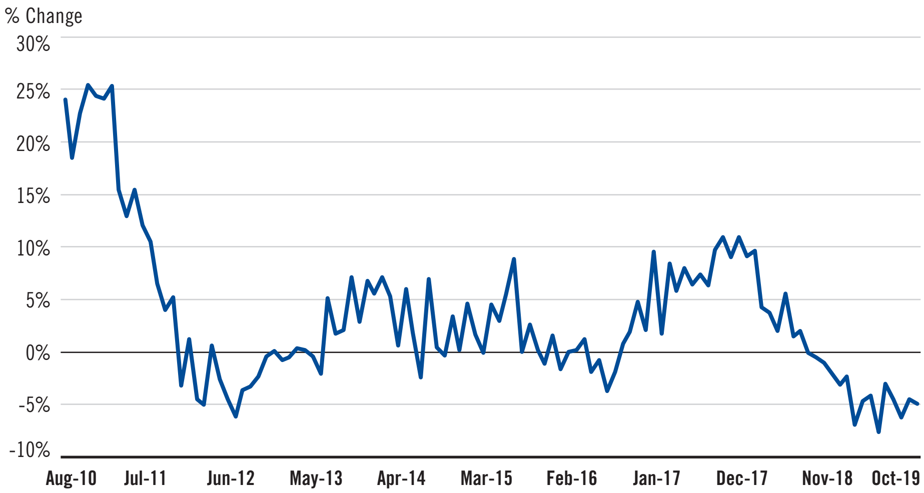
This year, our focus was on populism, debt levels and policy response in the next downturn. We noted that growth has disappointed this cycle, failing to deliver the broad increase in prosperity seen in earlier decades, compounding the rise of inequality. How policymakers respond to populism, and pressures such as climate change, will determine the long-term trajectory of absolute growth and relative prosperity.

The topics we discussed are complex and overlapping but help us understand the underlying dynamics that will drive macroeconomic outcomes over a longer investment horizon. Continued modest growth likely reflects the impact of deleveraging that has been felt globally initially in certain economies (Japan, exacerbated by adverse demographics) and, most significantly, specific sectors (US households). China's deleveraging will likely perpetuate this dynamic moving forward.

However, we expect continued global growth and moderate inflation over the long-term. With relatively few imbalances, and ongoing central bank stimulus measures, the global economy is less likely to see extreme swings in output. We continue to see only a moderate risk of a US recession in the next 12 months. For now, our proprietary indicators of growth momentum, in both developed and emerging markets, remain negative and the risks going into 2020 appear skewed to the downside. Our dominant investment theme is fundamentally unchanged as **"Slower global growth remains a concern."**

ORDERS REMAIN DEPRESSED IN GERMANY

Exhibit 1: Germany, new manufacturing orders (year-over-year change)
August 2010–October 2019



Sources: Franklin Templeton Capital Market Insights Group, German Federal Statistical Office (Statistisches Bundesamt), Macrobond.

Inflation expectations are modest

We also focused on themes that color our outlook for inflation. The structural disinflationary forces that led to the great moderation have not disappeared, but their continued influence is being questioned. For example, the "Great Power" tensions evident in the rise of China may divert the steady march of technological progress and globalization.

In the very long term, demographics will likely exacerbate the disinflationary impulse. This risks a downward shift in inflation expectations ("Japanification") that may be reversed only by seemingly extreme policy actions. However, policy actions can influence the impact of secular trends, such as population dynamics. Decisions over immigration regimes and measures to expand female participation can help offset the impact of a declining workforce.

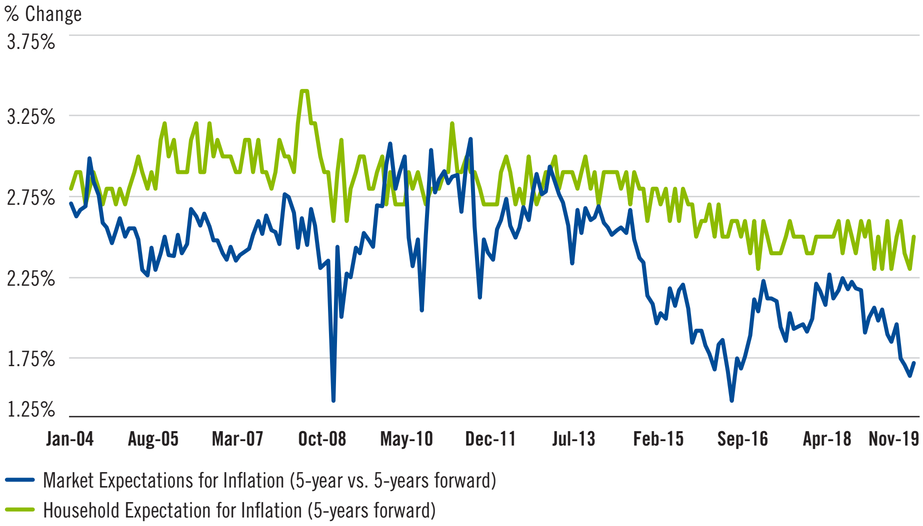
Market-based measures of inflation expectations, derived from the yields of nominal and real-return bonds, have declined sharply this year. These so-called breakeven inflation rates (where the prospective return on nominal- and real-return bonds are equal) have responded directly to headline inflation and commodity prices. Looking more deeply, the level of breakeven inflation over the five-year period starting five years from now (5-year/5-year forward rate) has remained depressed (see Exhibit 2). This may largely reflect a decline in the risk premium for inflation uncertainty, as government bond yields have fallen.

For now, we view the primary driver of inflation to be changes in demand. As a result, the headwinds for global growth are anticipated to cap inflation.

INFLATION EXPECTATIONS REMAIN SUBDUED

Exhibit 2: Market vs. household expectations for inflation

January 2004–November 2019



Sources: Franklin Templeton Capital Market Insights Group, Bloomberg, FactSet, Macrobond, University of Michigan, St. Louis Fed. There is no assurance that any estimate, forecast or projection will be realized.

This effect has been felt broadly, including in emerging markets, reinforcing our theme that sees **"Subdued inflation across economies."**

Policy response in the year ahead

Among the themes that we debated was the likely policy response during the next recession. As we noted above, this probably isn't a question for 2020. However, it is already helping to frame central banks' thoughts about their mandates. Both the US Federal Reserve (Fed) and the European Central Bank (ECB) are engaged in reviews that could result in more symmetrical inflation targets.

Likewise, our discussion on the theme of populism showed a greater emphasis on the quality and distribution of growth rather than its level. Political and social imperatives such as environmental protection will require fiscal spending to be achieved, offsetting private sector deleveraging.

Some central banks, notably the ECB, are increasingly supportive of more active fiscal policy to engineer these outcomes. However, we continue to question whether the political will exists to adopt such measures in the year ahead, or whether they can be delivered without a deeper slowdown and the fear of a renewed crisis in the eurozone.

Having paused its sequence of rate cuts in October, the Fed remains acutely aware of the need to be seen to stand ready to buy a little more "insurance" if necessary. Fed Chairman Jerome Powell indicated that the bar to further rate cuts had moved higher. But the bar to rate hikes was even higher still. Our outlook for asset markets remains more uncertain than usual due to the inherent tension between the need for stimulus and the fear encapsulated in our final major theme that we may be **"Approaching the limits of monetary policy effectiveness."**

Practical positioning

Nimble management required

We incorporate the longer-term themes that we discussed at our Annual Investment Symposium into our research process, helping to set the direction for our portfolios and the benchmarks that we agree with clients.

Over this longer-term horizon, we believe global stocks have greater performance potential than global bonds, supported by continued growth. Within bonds and equities, we believe there is stronger return potential for emerging markets. And with short-term interest rates and government bond term-premia remaining below historical averages, we see a lower performance potential from government bonds.

However, in managing portfolios today, we also need to reflect more immediate economic concerns and the dynamics that drive shorter-term market moves. Uncertainty over policy response and its efficacy leaves the outlook more clouded than usual. As we proceed towards the latter part of an unusually long economic expansion in the United States, we need to recognize that our longer-term outlook will not be reached along a smooth path. Markets are understandably focused on the probability that a recession might occur in the next few years.

Although we acknowledge the longer-term return potential for stocks, and believe that they will earn their equity risk premium over time, we continue to point to shorter-term concerns that have tempered our enthusiasm. Against a backdrop of slower growth, global equities as a whole are not cheap, in our analysis. The cumulative effect of ongoing trade tensions leaves us concerned about investment and hiring plans, and we struggle to see catalysts for much stronger activity in a growing number of economies.

Having scaled back our cautious stance on risk assets last month, we retain a modestly lower conviction on global equities. Our view reflects the balance between longer-term attractions and some reasons for concern over valuations and diverging expectations across markets, but we are not overly bearish. We continue to believe that navigating the challenges the year ahead will require nimble management.

Bond valuations are also stretched

One of the most striking features of our longer-term analysis is that the return potential from global bonds, especially government bonds, is depressed. This largely reflects the fact that current yields are at historical lows. However, we note that depressed yields likely reflect demographics and demand for matching assets, which are likely to persist. This shows up in the "term premium," the difference between the current bond yield and the average level for short-term interest rates over the life of the bond (see Exhibit 3).

In a multi-asset portfolio, we need to hold assets that provide the potential for diversification. Bonds traditionally fulfill that role. Global bonds—especially high credit quality and long-duration issues—appear vulnerable to us due to low term-premia and modest credit spreads for investment-grade corporate issues. However, slower growth and subdued inflation balance this in our neutral overall view of the asset class.

The yield curve inversions that occurred this year have left a bearish signal about the prospects for recession in the year or two ahead. Whether this occurs is an open question, and many investors point to reasons why it might

US TREASURY YIELDS REMAIN EXPENSIVE

Exhibit 3: 10-year US Treasury term premium

January 2008–November 2019

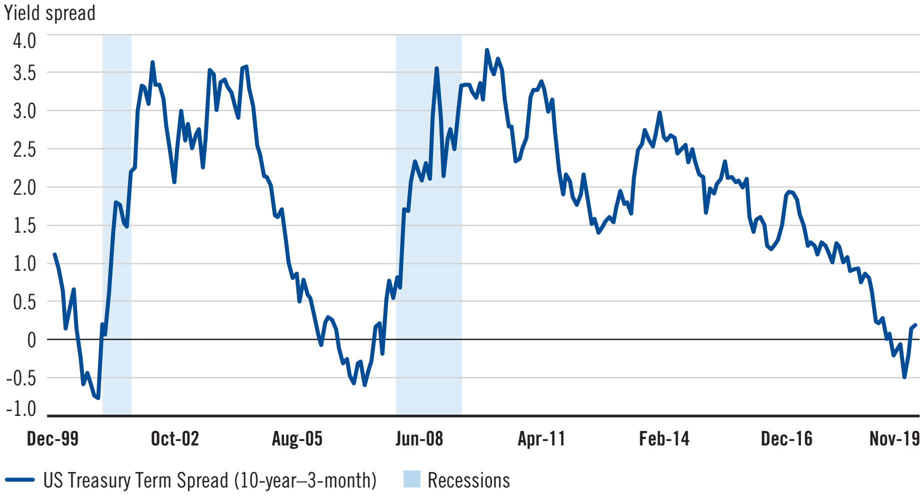
Sources: Franklin Templeton Capital Market Insights Group, Federal Reserve Bank of New York, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

be "different this time," but the response of central banks will probably be key (see Exhibit 4). In part, we believe it is this bias towards cutting interest rates, even from the low levels already reached, that argues for a relatively evenly balanced portfolio of bonds and stocks at this time.

PREFERENCE FOR LONGER-DATED ASSETS DROVE YIELD CURVE INVERSION

Exhibit 4: 10-year Treasury bond yield less 3-month Treasury bill yield

December 1999–November 2019



Sources: Franklin Templeton Capital Market Insights Group, Federal Reserve, NBER (National Bureau of Economic Research) Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

Opportunities and threats in emerging markets

In both stocks and bonds, we believe the longer-term performance potential in emerging markets will exceed that of developed markets. This has been a persistent result of our analysis but one that has been tempered in its application to portfolios in the recent past.

Emerging economies have demonstrated a much higher growth potential, notably in China and India. As these countries grow to comprise a larger part of the global economy and contribute a still larger share of global growth, we believe the structural tailwind is likely to persist over the very long term. In a world where the growth of earnings mainly drives equity return potential, we believe this should favor the return potential for emerging market stocks.

The range of starting points of various economies, and the manifold forms of populism that are already being seen, may present opportunities for active managers to take advantage of the growing dispersion of outcomes.

We believe strongly in the attractions of emerging markets as a venue for active management. Indeed, we would always start with a presumption towards active management in this area.

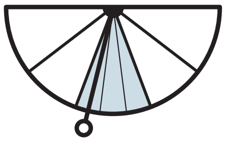
However, in the current environment of global trade uncertainty and with a less favorable outlook for commodities, we have scaled back our conviction on emerging market equities. Valuations remain attractive to us relative to developed market peers, but we see this balanced by reasons for caution.

We do, however, retain a more optimistic view of local-currency emerging market bonds, especially in comparison to the opportunities available in lower-rated corporate credit in the developed world.

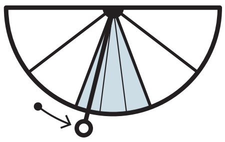
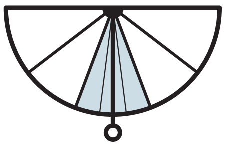
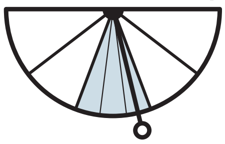
More generally, we continue to believe a return to long-run levels of volatility since early 2018, rather than the muted levels seen for much of the past 10 years, indicates that we have entered a new volatility regime. Such an environment may present headwinds for emerging market investments, and tempers our enthusiasm, despite longer-term attractions.

Allocation settings—December 2019

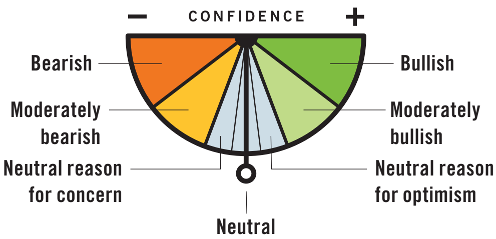
RISK TIER

Asset class	Conviction	Our viewpoint
Risk off/on		We see global growth trending lower, coupled with subdued inflation. However, given modest economic imbalances, we do not see a high probability of recession. As a result, we are only moderately defensive toward riskier assets. Our view continues to reflect some reasons for concern over the diverging expectations across markets but is not overly bearish.

HIGH LEVEL ALLOCATION TIER

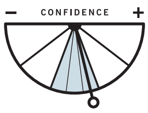
Asset class	Conviction	Our viewpoint
Equities		Corporate earnings still support global equities, but profit margins have peaked. Concerns remain about growth momentum and capital investment plans. We are carefully monitoring the potential for renewed market volatility, but these concerns are offset for now by supportive liquidity conditions and are reflected in a less cautious stance.
Bonds		Slower global growth and the prospects for easier monetary policy contrast with long-term valuations that have remained expensive, reflecting low term premiums. Some widening of corporate bond spreads is likely as growth slows and financial conditions tighten. We retain a truly neutral view of bonds at the asset allocation level, reflecting the balance between reasons for optimism and valuation concerns.
Alternatives		The inflation that was feared as the economic cycle entered its later stages has not appeared. We see better prospects in naturally diversifying assets. We hold a neutral view, reflecting the balance between reasons for optimism and market-driven concerns that we continue to monitor.
Cash		Cash yields remain attractive to us, with short-term US Treasury bill yields reflecting greater supply and previous monetary policy normalization. Cash is no longer a significant drag on portfolio yield, boosting its attractions to us generally.

Understanding the pendulum graphic



Arrows represent any change since the last quarter end.

ALLOCATION TIER

Asset class	Conviction	Our viewpoint
Equity regions United States		Despite global headwinds, US growth remains stronger than in other developed markets, although earnings have dipped. The market's attention will likely focus on valuations, pressure on margins and whether US Federal Reserve (Fed) interest-rate cuts are effective in stimulating demand.
Canada		We see modest opportunities in Canada, with earnings growth expectations providing some room for positive surprises, but commodities are a headwind. Canadian banks remain burdened by domestic housing concerns and low net interest margins. We are not especially bearish, though we see reasons for caution.
Europe ex UK		Economic activity has slowed as global trade concerns and weaker manufacturing activity have led to negative sentiment. The ECB has made efforts to offset the effect of lower rates, but we see banks remaining a drag. However, our views reflect the market discounting of these conditions, and we are cautious rather than bearish.
United Kingdom		Domestic political tension and uncertainty over Brexit have driven UK economic uncertainty. However, this defensive market appears historically cheap, corporate profits remain high, and we retain a truly neutral view.
Japan		Equity valuations, particularly on a price-to-book value basis, have been attractive relative to other markets. However, declining global growth and a late-cycle environment are typically unfavorable for companies with higher operational leverage and for the Japanese market. We retain a lower level of conviction in this market.
Pacific ex Japan		With banks and related financial companies representing heavier weights in the region, concerns about Australian and Hong Kong banks persist. The region is vulnerable due to local tensions in Hong Kong and linkages to China. However, at valuations we regard as attractive, we are not bearish, though we see reasons for concern.
Emerging ex China		The slower growth environment highlights emerging markets' idiosyncratic risks and underlying cyclicality. However, valuations remain attractive to us relative to developed market peers and particularly supportive for local currencies. We see a balance of growth concerns and optimism regarding the longer-term attractions of emerging markets.
China		China's equity market has rebounded on measured stimulus, but the economy is still slowing. Trade disputes are only a symptom of broader tensions, even as a partial deal seems more likely. Further support from fiscal or monetary measures may be required. Although valuations remain attractive to us, we see reasons for caution and have taken a truly neutral view of this market.
Fixed income sectors US Treasuries		The Fed has cut interest rates as an insurance against heightened uncertainties. Further cuts are now less likely, and the Fed is not ready to signal a full easing cycle, but remains biased to cut if needed. We remain concerned by stretched valuations and supply dynamics but see reasons for optimism.
Eurozone Government Bonds		Valuations appear full in the eurozone, where term premiums are the lowest among government bonds. However, with deteriorating growth, the ECB has moved to provide further stimulus, including asset purchases. We maintain a cautious stance in line with other developed market bonds, but are not bearish.
Canada Government Bonds		Canada is vulnerable to global trade concerns and oil-price volatility hitting business confidence. Expectations for the Bank of Canada lag those for the Fed, but risks support interest-rate cuts. We have moved from a cautious position in line with other developed market bonds and have taken a more constructive stance, reflecting reasons for optimism.

ALLOCATION TIER

Asset class	Conviction	Our viewpoint
Fixed income sectors *continued* Japan Government Bonds		The Bank of Japan has maintained its monetary policy stance, which targets low 10-year government bond yields. It has also provided guidance that its policy will remain stimulative for an “extended period” and indicated it would act “without hesitation” to ease further, if required.
High Yield		The business cycle is entering its later stages, leading us to adopt a more cautious stance on the outlook for lower-rated fixed income sectors such as high yield. Default rates appear to be rising toward historical averages. Bank loans have seen outflows, and they are potentially vulnerable due to the relaxation of covenants. Overall, we have moved to reflect a tactical preference away from riskier assets.
Investment Grade		The investment-grade sector remains supported by strong corporate fundamentals; however, leverage is high, and technical conditions may prove challenging. Some widening of yield spreads is likely as growth slows and financial conditions tighten, but yields remain attractive to us in a global context.
EM Debt		We regard emerging market bond valuations as fair among local- and hard-currency bonds. Dovish global central bank policy and real yields that remain higher than historic averages mitigate exchange-rate risks in local-currency bonds. As a result, we retain a more optimistic outlook. However, with continued fears over protectionism and geopolitics, we think selective positioning is important.
Alternative assets Inflation-Linked Bonds		The inflation that was expected—and feared—as the economic cycle entered its later stages has not appeared, and the level of inflation discounted in inflation-linked securities remains subdued. However, we maintain a neutral view of assets that benefit directly from rising prices, such as inflation-linked bonds.
Commodities		A deceleration of economic growth creates a less supportive environment for broad commodities. We believe that amid commodity price declines, stimulus measures in China are likely to be focused on supporting domestic consumers rather than financing major infrastructure projects. With inflation pressures remaining subdued, we continue to hold a more cautious view.

Franklin Templeton Thinks: Allocation Views

Our research process monitors a consistent set of objective indicators and screens them to identify signals that help our analysts to make better recommendations. By doing this we aim to filter out the daily noise to reveal the underlying trend.

Our macro-economic research group aims to challenge the consensus forecasts for growth and inflation by digging deeper into the data. Just as important, we aim not to be swayed unduly by topics that are dominating current market debate.

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