FRANKLIN TEMPLETON INVESTMENTS

30 March 2016

Beyond Bulls & Bears Bulletin

INSIGHT FROM FRANKLIN TEMPLETON INVESTMENTS MANAGERS

IN THIS ISSUE: ***The articles in this issue are as at 30 March 2016.***

A More Accommodative Fed: The US Federal Reserve (Fed) didn't find a compelling reason to raise interest rates at its March policy meeting, maintaining its benchmark short-term interest rate (fed funds rate) in the range of 0.25%–0.50%. While this was not a surprise to most market participants, policymakers communicated a more accommodative stance, suggesting a modest course of only two rate hikes likely this year. Franklin Templeton Fixed Income Group's Chris Molumphy talks about what this means for fixed income investors, and the long-term risk he sees that many market participants seem to be overlooking.

Why Europe Is Wrong to Ignore the Threat of Brexit: Although news headlines in the United Kingdom are currently dominated by speculation about the referendum on the country's continued membership of the European Union, interest in the subject among Continental European investors appears decidedly muted. But according to David Zahn, this vote will have profound ramifications, not just for the United Kingdom but for markets across Europe and beyond. He believes European investors need to be much more focused on the possible consequences of the referendum in order to recognise the potential opportunities, whichever way the vote goes.

Volatility Is Not an Indicator of US Recession: Signs of a global economic slowdown have impacted the US equity markets this year and led to discussions about a possible recession in both the US economy and US corporate profits. Grant Bowers, Vice President, Franklin Equity Group, says current conditions and the outlook for a key economic indicator don't warrant such strong language. In this Q&A, Bowers maintains that, with the help of stronger consumer spending, the backdrop for the US economy and US companies should remain generally positive for the remainder of 2016.

A More Accommodative Fed

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

There were no major surprises coming out of the March Federal Open Market Committee meeting, though it certainly did reinforce the dovish bias the Fed seems to have. We anticipate extremely accommodative policy to remain in place for the foreseeable future.

March Fed Meeting Takes More Accommodative Tone

When analysing the specific forecasts the Fed updated at its March policy meeting, the biggest shift is the update to the fed funds forecast for the end of 2016 and to some extent the forecast beyond that. What we saw was a forecast that conveyed two tightenings over the course of 2016—two 25-basis-point increases in the federal funds rate. In December 2015, the Fed had communicated a cycle of four likely 25-basis-point increases, so this was a fairly significant change.

In terms of other updates we saw from the Fed's forecast, US gross domestic product (GDP) growth expectations for 2016 were lowered slightly to 2.2% from 2.4% previously. We also saw inflation expectations scaled back a bit, with the forecast for personal consumption expenditures (PCE) moving to 1.2% from 1.6% previously.

When you put all this together, the primary rationale for all of these changes (according to the Fed) reflects general expectations for weak global growth as well as concerns about financial-market volatility that came to a head the first couple of months of the year but continue to persist.

In addition to the meeting summary, Fed Chair Janet Yellen also addressed some important questions and concerns during the press conference afterward. In regard to some of the metrics on the US economy, she remained fairly positive about the US employment outlook, even mentioning wages and a slight upward bias was noted there. She continued to be reasonably constructive on the overall US economy and pointed to some recent slight upticks in inflation. This backdrop is noteworthy in that it is accompanied by an extremely accommodative approach to monetary policy and a dovish bias as we look forward.

Global growth and other factors outside the United States can influence US employment and inflation trends, and thus, influence monetary policy. The Fed has referenced this specifically in its meetings during the first quarter of 2016. Having said that, one of the key themes for investors in 2016 is this tremendous divergence between monetary policy in the United States and the rest of the developed world. Europe, Japan and even China are pursuing even more accommodative policies than the United States. As the United States is moving (arguably at a slower pace) to a tighter policy, the rest of the developed world is continuing to ease.

As we go forward in 2016, we anticipate this monetary policy divergence will likely impact the US dollar; we would expect the dollar to appreciate against the major currencies over time. We would also expect to see an effect on longer-term US interest rates. We have already seen significant flows of global assets into US Treasuries this year, and in doing so, the level of long-term interest rates is being held down. When we look at US Treasury rates, fundamentally we would think they should be moving a bit higher, but again, that global flow into US assets is an offsetting force that we think could continue.

I'm not sure if the Fed's most recent update necessarily changes our outlook a great deal, but it offers reaffirmation of what we might expect going forward. That is, we believe even more so that we will continue to see extremely accommodative policy.

Inflation Risk

The United States is a services-dominated economy and, hence, labour inflation tends to drive overall inflation. We know labour markets have shown gradual improvement in the United States over the past several years, and unemployment rates are nearing levels where we would typically expect to see wage inflation tick up somewhat. If unemployment continues to move down and job additions remain at anything close to the strong pace we have seen over the past couple of years, we think it should translate into increased wage inflation. Average hourly earnings are currently running a little over 2% on a year-over-year basis, as of February. We wouldn't necessarily expect that reading to rise demonstrably, but it should start to tick higher over the course of this year and the next. Frankly, it concerns us that little focus has been placed on the possibility of wage inflation.

Looking specifically at the Fed's own projections, it tends to focus on PCE as the primary inflation metric; and even looking out over the next 2.5 years, this metric looks to be at or below 2%, near where it is today. It's interesting that Chair Yellen, while agreeing with the notion that tighter labour markets generally lead to inflation, seemed to defuse any inflation-related concerns during the March meeting's question-and-answer session.

While the market consensus currently seems unconcerned about inflation, we know this could change quickly. Longer term, we certainly think higher-than-anticipated inflation is a potential risk for fixed income investors.

High Yield Showing Signs of Stability

Looking at areas of the credit market more broadly, in December 2015 we saw media-fed volatility tied to a distressed hedge fund that negatively impacted the high-yield sector. In our view, the panic was to a large degree overblown. The sector actually hit a low point around mid-February, based on concerns for lower global growth as well as crude oil's slide below US$30 a barrel, but has rallied significantly over the past month. Investors seem to be returning to so-called risk assets, driven by the reversal of those two factors; there has been less concern about diminished global growth, and oil prices have rebounded.

Fundamentals drive a sector like high yield, and we see a positive environment for high yield, with valuations fairly valued to even slightly cheap. It's worth noting we are getting into the later stages of this particular economic cycle in the United States, but we don't necessarily see any end to the growth in the near term.

With respect to corporate credit overall, again we are reasonably constructive based on what appear to be reasonably positive economic prospects. When we look at investment-grade credit, high yield and leveraged loans, we see a lot of the same characteristics or fundamental drivers. When we look at corporate balance sheets and liquidity, overall we believe the corporate credit markets are in reasonable shape, and general business trends point towards a fairly constructive outlook and reasonably healthy environment.

We think greater global central bank-generated liquidity will be a positive for the corporate credit sectors and economically driven parts of the market, at least in the near-to-medium term. This would include investment-grade corporate credit, high yield and leveraged loans. Additionally, based on the theme of monetary policy divergence on a global basis, we would anticipate that, all things equal, the US dollar will likely strengthen versus other developed markets' currencies, particularly over the longer term.

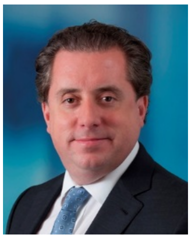
There have clearly been some issues affecting corporate credit over the past few months; energy and commodity-related credits have driven the marketplace in general and high yield in particular. It's our belief that bond prices for many of these companies have been trading at distressed levels, with a worst-case scenario seemingly priced in. That is, looking at the prices of some of these distressed names, the upside/downside from current prices, in our view, is significantly asymmetric. That is, asymmetric on the positive side, meaning, in our view, there is much more upside than downside. There is probably more volatility to come, but overall our view is that most of this is fully represented in market pricing.

Keeping an Eye on Inflation

I reiterate that we would be wary of potential inflation in the United States over the long term, at least more so than the market seems to be pricing in. Because of that, we are leaning towards being a bit shorter duration in most of our strategies and portfolios generally. While we will monitor fundamentals as we go forward, that is our current bias.

Finally, in our view, opportunities do continue to present themselves over the short-to-intermediate term in fixed income; longer term, we are cognizant that there could well be some rate risk down the line driven by inflation.

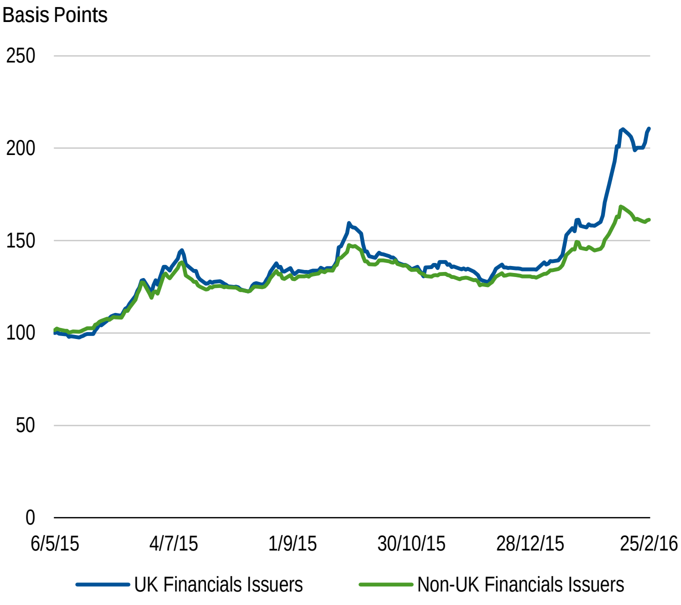
Why Europe Is Wrong to Ignore the Threat of Brexit



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

I've been struck during my travels in Continental Europe in recent days how little attention is being paid by investors there to the prospect of the United Kingdom voting to leave the European Union (EU). Many European investors seem to think this so-called "Brexit" decision, scheduled to take place on 23 June this year, is an issue that will only affect the United Kingdom. We at the Franklin Templeton Fixed Income Group think they're mistaken and that Brexit has significant implications for investment markets in Europe as a whole. Moreover, we think the possibility of a vote to leave is underpriced in the market currently.

Exhibit 1: Credit Spreads Since UK Election
6 May 2015–25 February 2016



Source: Barclays Capital POINT/Global Family of Indices. © 2016 Barclays Capital Inc. Used with permission.

In the days since UK Prime Minister David Cameron confirmed the date of the referendum, markets have experienced some volatility focused on UK-specific assets; spreads for some UK issuers of euro-denominated bonds have widened considerably for no apparent reason, which suggests to us that a lot of Europeans are selling their UK exposure.

As the date of the referendum approaches, we'd expect volatility to accelerate and to encompass other European assets, coming to a crescendo the day after the Brexit vote. Volatility brings opportunity as well as challenges, and we feel there will be opportunities for focused investors—whatever the outcome.

If UK voters choose to stay in the EU, we'd expect markets to calm down quite quickly. We'd also expect investments that had sold off could subsequently rally, and there could likely be some good opportunities to realise value. If there is a vote to leave, there should still be some opportunities, but we'd anticipate that there would be more volatility for longer in the wider European market as well as in the United Kingdom. We'd expect peripheral bonds to sell off quite considerably and anticipate questions about whether Brexit sets a precedent for other countries to consider their future in the EU.

In the event of Brexit, the glue that has traditionally held the EU together may not prove as strong, and in my view, that's something that the whole of Europe needs to watch.

Vote Is on a Knife Edge

Perhaps some Continental European observers don't yet realise that the outcome of the referendum is far from certain. Political lines are being drawn, but in the end the decision will be made by a public vote. When we've seen these sorts of votes in the past, we've tended to find that people don't make up their minds until the last minute, so any bad news coming out of Europe in the run-up to the referendum—or an escalation in the refugee crisis—might increase the chances of a vote to leave.

There may be a sense among some market participants and investors on the Continent that the current asset purchase programme of the European Central Bank (ECB) could be enough to offset any negative fallout of a British exit. I'd contend that the ECB can only do so much. Yes, the ECB might change or enhance its buying programme, but I think there would still be volatility.

There are still weeks of argument, debate and trading until the referendum is held, but amid all the clamour, I think the important thing to note is that Europe needs the United Kingdom and the United Kingdom needs Europe. In my view, neither side will win if the Brexit vote is a yes and the exit negotiations are handled badly. From that perspective, I believe it would be better if the United Kingdom votes to stay in.

If there is a vote to leave, attention will turn to the negotiations of the treaties that would replace the current EU treaty. There would still need to be trade as the EU is the United Kingdom's largest trading partner. There would still need to be movement of labour because a huge number of EU citizens work in the United Kingdom. And many other different issues will need to be negotiated.

Above all, as the debate rages, we are adamant that this is a decision that will have profound ramifications, not just for the United Kingdom, but for the continent of Europe as a whole, which is why we think it's something European investors cannot afford to ignore.

Volatility Is Not an Indicator of US Recession

Grant Bowers
Vice President, Research Analyst
Portfolio Manager
Franklin Equity Group

There seems to be a disconnect between the relatively strong fundamentals in the US economy and the weak performance of the stock market so far this year. What do you think is driving this, and is it warranted, in your view?

Concerns about growth in emerging markets and collapsing energy prices have led many to fear that despite generally positive economic data in the United States, we may not be able to avoid lapsing into a recession. This drove market pessimism to extremely high levels in the first few weeks of 2016.

Despite these fears, we continue to believe the US economy is performing well, and 2016 will likely surprise many with modest corporate earnings growth, strong consumer spending and GDP growth in the 2%–3% range. These types of broad-based selloffs typically create opportunities for long-term investors to buy high-quality companies at attractive prices, and we have been actively seeking bargains for our portfolios in recent weeks.

The upcoming presidential election in the United States has been dominating recent headlines. What impact do you think the election will have on the financial markets?

Politics and elections are not a large part of our fundamental analysis; we like to focus on tangible factors like earnings, free cash flow and identifying great potential growth opportunities. However, anytime you change the status quo you create uncertainty, and the markets don't like uncertainty.

I think the political uncertainty of the 2016 US presidential election has contributed to some of the volatility we have seen year-to-date. I would expect we will continue to see volatility in the markets until the presidential primaries are settled and we have a better understanding of who the major parties' nominees are and what their policy proposals will be.

Considering the recent volatility, are you constructive on the US equity market? If so, why?

Yes, we are currently constructive on the US equity market. Despite a rough start to the year, we don't see a recession on the horizon, and believe the US economy is stronger than many believe. Every expansion since World War II has gone through periods of slow growth. I believe that when we look back in the rear-view mirror later this year, we will see this period as a growth pause in a longer expansionary cycle.

The strength of the US consumer is one of the reasons we remain constructive on US equities. US consumer spending makes up approximately two-thirds of US GDP, so the health of the consumer is key to any investment outlook for the United States. Employment and job growth continue to be strong, and tight labour markets are starting to impact wages and salaries. We believe this should have a positive effect on consumer confidence this year.

Additionally, inflation remains low, as do interest rates. Relatively low interest rates will likely continue to support the ongoing housing market recovery in many areas as financing remains cheap. We also believe there is still pent-up housing demand in the market, which should also be beneficial.

Low energy prices should be a boon for US consumers, but we haven't seen the effects flow through to all areas of the economy. Do you expect energy savings to eventually boost consumption?

Many believe that lower energy prices put extra spending money in consumers' pockets immediately, but history has shown us that lower energy prices are a lagging indicator, as consumers initially save much of the windfall and don't change spending habits quickly. Much of last year's savings went to pay down debt or to increase savings, both of which we have seen in the economic data. We believe that as consumers become more comfortable with lower energy prices, they will start increasing their spending on discretionary goods and increased consumption.

You said you don't think an economic recession is on the horizon in the United States, but some pundits have said US companies already are in an "earnings recession." How do you respond to that?

We are almost done with earnings season here in the United States, and we have a good picture of how the fourth quarter of 2015 ended and what companies are expecting for 2016. It is true that earnings and revenues were down in the fourth quarter, on average, for the S&P 500,[1] and some might describe that as an earnings recession. But I think investors should look deeper into the numbers to see what the key drivers of the decline were.

We see two key themes that emerged from earnings season. First, a stronger US dollar was a headwind for many multinational companies, and the currency impact combined with slower global growth resulted in companies with high international exposure experiencing slower growth relative to more domestic or US-focused companies; second, lower oil and gas prices had a negative impact, where year-over-year earnings were down more than 70% for the energy sector,[2] dragging down the average growth rate.

But the top-down view does not always provide the clearest picture. When you look at earnings from the bottom up on a sector-by-sector level, you'll see that growth sectors like consumer discretionary and health care both had positive earnings on average for the quarter, and if we remove the energy sector from the discussion, earnings overall were positive on average for the S&P 500 in the fourth quarter of 2015.[3]

After posting very strong returns in the last few years, the technology and health care sectors have pulled back in 2016. Has this downturn changed your outlook, or do you think it has created a buying opportunity?

Despite this year's pullback, we still have a positive long-term outlook for technology and health care companies. Both the technology and health care sectors have great growth outlooks, in our view, with a tremendous amount of change likely to take place in the next few years.

The technology sector has always experienced some bouts of volatility, but historically these events have been excellent buying opportunities for investors. The outlook for spending remains strong, as many companies have realised that investments in technology improvements are required to remain competitive in the global marketplace. New software, factory automation and data analytics can all improve productivity and lower the cost of production for companies, keeping them ahead of the competition.

Some of the areas of technology that we are focused on are cyber security, "software as a service," cloud computing, digital payments, mobility and smart devices.

In the health care sector, we continue to like the long-term outlook, where an aging population globally will drive increased consumption of health care services and demand for improved treatments and cures. This demographic tailwind combined with innovation in drug development and medical technology is creating numerous investment opportunities as well.

As long-term investors, we always try to look through the short-term market noise and identify sectors and companies that are benefitting from large multiyear growth trends. Often these trends are driven by disruptive technologies, innovation, changing consumer habits or demographic shifts. The types of broad-based selloffs like the one we have seen recently typically create opportunities for long-term investors to buy high-quality companies at attractive prices.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Special risks are associated with foreign investing, including currency rate fluctuations, economic instability and political developments. Growth stock prices reflect projections of future earnings or revenues, and can, therefore, fall dramatically if the company fails to meet those projections. Smaller, mid-sized and relatively new or unseasoned companies can be particularly sensitive to changing economic conditions, and their prospects for growth are less certain than those of larger, more established companies. Historically, these securities have experienced more price volatility than larger company stocks, especially over the short term. To the extent the portfolio focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a portfolio that invests in a wider variety of countries, regions, industries, sectors or investments.

IMPORTANT LEGAL INFORMATION

1. Source: FactSet Earnings Insight, 16/2/16.
2. Ibid.
3. Ibid.

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