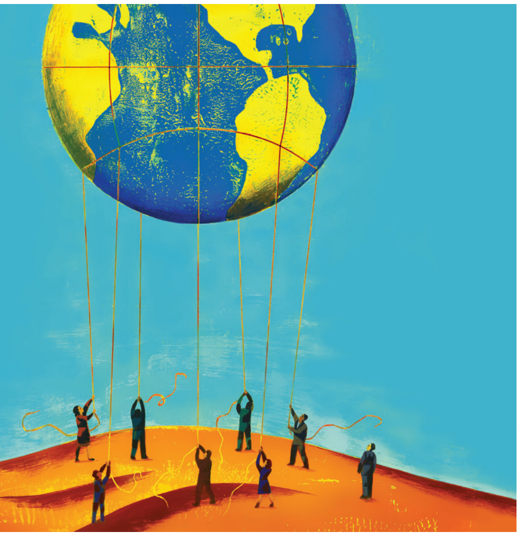
Q3 2018 | SUMMARY VERSION

How much further can global growth fly?

FRANKLIN TEMPLETON THINKS™ GLOBAL INVESTMENT OUTLOOK



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Global Macro

US leads the pack in global growth

We think the United States is going to lead the pack in the growth cycle among developed countries. But other major economies are showing less potential. Europe is decelerating, Japan is still kind of soft, and some emerging markets have run into some pretty big headwinds. But broadly, we think many emerging markets should be fundamentally stable. China's government, for example, has a lot of control over the economy, and can take over the banks and recapitalize them if there are problems. In the short term, we think the analysis that points to China heading into a credit crisis is wrong because the government has so many levers.

Responsible policies lead the way

Whereas Asia is pretty stable, Latin America is more of a turnaround story. Policies there were really bad, and are now either getting better, or actually leading the pack from a policy standpoint. We think that's a lot of what's behind currency performance in emerging markets. If a country's policymakers lead, then there is protection. In Turkey's case, however, they kept rates low, which obviously created a problem. But we think pockets of emerging markets have been very responsible.

Mexico, for example, has done what a central bank should do—buy insurance. They have hiked rates, so that if and when there is a shock, they have an ability to react. And we think you have seen a few emerging markets, when faced with a shock, pursue responsible monetary policy.

Broad market beta isn't cheap

We think it's pretty hard to argue that broad market beta is cheap; in fact, it is probably pretty expensive. We have been focusing more on idiosyncratic alpha opportunities and not just getting this broad market beta.

Multi-Sector Fixed Income

Investors are nervous about the markets

We think it's healthy there is a lot of investor skepticism. As soon as you lose that skepticism, that's usually the beginning of the end. We are now in the 10th year of a growth cycle in the United States, so clearly in the back of our minds we acknowledge we are in unchartered waters. But we focus on fundamentals, and US economic fundamentals in the near- and even intermediate-term look pretty good to us.

US gross domestic product (GDP) growth of 4%+[1] is likely unsustainable in our view, but even if it normalizes to 2.5% to 3% this year, that still represents a good pace of growth. Consumer savings rates look healthy and consumer confidence is near record highs. In our view, the health of the consumer, combined with a solid corporate sector, bodes well for the foreseeable future.

1. Source: Bureau of Economic Analysis, as of 30 June 2018.

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The Fed's rate hikes are healthy

The Federal Reserve (Fed) seems likely to continue raising its benchmark interest rate this year and next. We think it's important to emphasize that the Fed is moving toward a more neutral rate, which balances between managing the risk of inflation while not dampening economic growth. Quite frankly, the US economy has a lot of momentum, so we think the Fed should be getting its benchmark rate back up to neutral so it has some ammunition for the next economic cycle if needed.

The credit cycle still has legs

Corporate credit is by and large expensive on a historical basis. Despite that, we think the credit cycle still has legs, as market fundamentals remain very good. As an investor, if you are doing your due diligence in the corporate arena and staying on top of your credit research, you typically find lead indicators of credit deterioration. We haven't seen worrisome signs of deterioration yet. That said, we are clearly aware of the age of the US cycle and watching for initial signs that a turn may be coming.

Global Equity

Still positive on equities amid global growth

We think in the equity markets, particularly in the United States or even globally, you have to be prepared for the risks that are out there. That said, we think it probably is not the best time for investors to completely pull in risk exposure. One might want to be a little bit more conservative perhaps, but we think it is very hard to predict exactly when a correction in the market will happen. We are still quite positive on equity markets in general.

Trade fears are overblown

We think there is too much fear around the issue of trade. The United States had led the world in trade since World War II and had been willing to have lower tariffs than other countries, but probably it is time to relook at some of the older trade deals. China is one of those countries where, when it was starting to emerge, was the beneficiary of some very favorable trade deals. But China doesn't need that support in the same way anymore. Ultimately, we think trade reform is probably going to be good for China; it should be more stable.

The epicenter of growth shifts to the East

If one were to examine one factor, trade is the single most important one in driving global GDP growth. In 2017, emerging markets accounted for 59% of global GDP growth in US dollar real terms; China alone contributed 27%, while the United States contributed only 16%.[2] Admittedly, 2018 may be rather different given the strengthening of the US dollar but the long-term trend is evident.

We're not only witnessing a shift in the geographic epicenter of GDP growth to the East, but even within emerging markets there has been a transformation in the drivers of growth. For instance, several years ago China overtook the United States and Japan in terms of total patents filed, and this is but one of many indicators of the shift towards innovation, technology and more broadly the "new economy" that is taking place.

Multi-Asset Investing

Closely monitoring growth momentum

Generally, we expect continuation of positive global economic growth led by the United States. That said, we are monitoring growth momentum as we are seeing more desynchronization throughout the world at this time. The eurozone growth slump appears to be moderating, and China's leading growth indicators have been stable after a very strong first half of the year. We see some evidence of weakness throughout other emerging markets, but believe most of the volatility stems from idiosyncratic shocks; we therefore do not foresee a broader emerging-market crisis.

Uncertainties on Europe's horizon

We hold a less-favorable view on Europe than some other regions amid political concerns that remain at play; the far-right movement has increased in both popularity and individual-country impact. Positive economic headlines are slowing in pace, although we note that leading economic indicators appear to have stabilized at solid levels.

Regarding fixed income, European government bond valuations appear especially full in our view, where term premiums are the lowest among other government bonds. The European Central Bank's quantitative easing program is scheduled to end in December and we worry about the potential impact it may have on the corporate bond market.

Shifting our risk exposures

We have been more selective about our risk exposures, taking more targeted and concentrated position sizes. This is consistent with our view of a market offering attractive opportunities, though in less abundance than we have seen in years past. Essentially, our efforts are now focused on shedding asset-class allocation risk for more idiosyncratic risk exposures to specific investment opportunities.

2. Source: The World Bank, GDP (constant 2010 US$), from 2016 to 2017.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Stocks historically have outperformed other asset classes over the long term, but tend to fluctuate more dramatically over the short term. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Changes in the financial strength of a bond issuer or in a bond's credit rating may affect its value. Floating-rate loans and high-yield corporate bonds are rated below investment grade and are subject to greater risk of default, which could result in loss of principal—a risk that may be heightened in a slowing economy.

IMPORTANT LEGAL INFORMATION

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