FRANKLIN TEMPLETON

Franklin Templeton LifeSmart Portfolios

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Quarterly Commentary

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The US Federal Reserve (Fed) and the Bank of Canada kept interest rates unchanged throughout the third quarter of 2020, reinforcing steep cuts implemented earlier in the year.

The Fed adopted an increasingly dovish stance during the quarter, unveiling a new approach to interest-rate policy, which will permit inflation to move above its target level, to combat weaker demand and lower oil prices.

Elsewhere, the Bank of Canada committed to keeping interest rates low across the sovereign yield curve by continuing the large-scale purchase of government bonds, alongside provincial and corporate bonds. As a result, the Canadian sovereign yield curve steepened slightly during the third quarter, as long-term interest rates rose, while their shorter-term counterparts fell, influenced by central bank intervention. Municipal bonds outperformed their provincial counterparts due to a support package implemented by the Canadian government, while Canadian corporate credit outperformed both provincial and Federal issues.

Investors remained cautious amidst an uneven economic recovery, although risk assets saw robust performance during July and August driven by continued stimulus measures. Canadian credit benefitted from purchase programmes implemented by the Bank of Canada, designed to offset weaker corporate credit fundamentals and credit rating downgrades.

Global equity prices also rose throughout the quarter, led by emerging markets (EMs), which benefitted from the strength of Asian stocks. Regionally, North America led developed markets gains, influenced by large-capitalisation technology stocks, while credit spreads narrowed during the quarter as market sentiment remained largely positive.

The Canadian dollar strengthened against the US dollar, helped by the stabilisation of oil prices following volatility during the prior quarter.

ASSET ALLOCATION

Cross-asset allocation contributed due to an underweight to fixed income and an overweight to equities, which was only partially offset by an overweight to cash during a “risk-on” period. An underweight to international equities and an overweight to US equities also added value. We reduced exposure to US growth stocks mid-quarter, due to valuation concerns, before neutralising our equity overweight later in the period. In September, we reduced exposure to EM equities in favour of Canadian and international holdings.

CANADIAN FIXED INCOME

Exposure to Canadian corporate credit boosted results as spreads narrowed, while Canadian government bond holdings also added marginal value, in aggregate, as shorter-term issues outperformed the broad bond benchmark.

GLOBAL FIXED INCOME

Underlying global bond funds also boosted relative results, in aggregate. Franklin Liberty Global Aggregate Bond Fund also added value, benefitting from narrowing spreads on US investment-grade credit and falling yields on European government bonds.

CANADIAN EQUITY

Underlying domestic equity funds strengthened relative results, in aggregate. Franklin Bissett Canadian Equity Fund added value, benefitting from stock selection within the energy sector.

(cont’d.)

INTERNATIONAL AND EMERGING MARKETS EQUITY

Equity fund selection in international and EM regions also contributed to relative performance, in aggregate. Templeton Emerging Markets Fund added relative value, helped by an overweight allocation to the information technology sector and selection amongst communication services stocks. Conversely, Franklin Emerging Markets Core Equity Fund proved a drag on relative results, hurt by an underweight to the consumer discretionary sector and selection amongst materials and consumer stocks.

US EQUITY

US selection contributed, in aggregate, helped by exposure to growth stocks via a position in Franklin US Opportunities Fund, although gains were held back by Franklin US Core Equity Fund, which suffered from an overweight to energy stocks and selection within the information technology sector.

FORWARD-LOOKING INVESTMENT STRATEGY

We remain cautious on global equities, given increasingly stretched valuations and the intensity of political uncertainty in the US.

A new package of fiscal stimulus is likely to be approved by the US Congress, but its timing is clouded by the upcoming election, while the factors that initially informed our reduced conviction remain. We retain longer-term optimism towards equities, although greater certainty and clarity is needed around the global economic recovery before increasing our exposure.

Regionally, we retain a preference for US stocks but will likely lessen exposure as the global recovery progresses, while we prefer China over other EMs with less policy flexibility. We have moderated our cautious stance on Canadian equities as commodities headwinds abate, while we are also more positive on the eurozone and Japan, influenced by improving global trade.

We believe ongoing economic headwinds will continue to dampen inflation, despite dovish policy from the Fed. Rising government debt and market liquidity are contributors to an inflationary environment, but this is currently insufficient to offset high unemployment, in our view. Long-duration US Treasuries are becoming more attractive to us as the yield curve steepens and short-term rates remain at very low levels, while inflation-linked bonds and commodities continue to offer a slight tail-risk hedge should inflation increase.

Central bank support for credit, lower for longer risk-free rates and an expected sharp slowdown in new issuance, have set an attractive technical backdrop for Canadian credit over the coming quarter. We continue to prefer higher quality credits and larger, more liquid issues, as we believe the long-term impacts of the global economic slowdown are still to be felt in high-yield credit, suggesting more defaults.

Non-yielding assets such as cash are proving to be useful diversifiers in a market where yield is difficult to find.

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