Allocation views

Perspective from Franklin Templeton Multi-Asset Solutions

MAY 2020

Hold the course

As the world adjusts to life with the specter of COVID-19, it is increasingly clear that much has changed. We have become used to social distancing and unimaginably weak economic data. However, although we have become familiar with these new features of our lives, we hope that they will not be with us for too long!

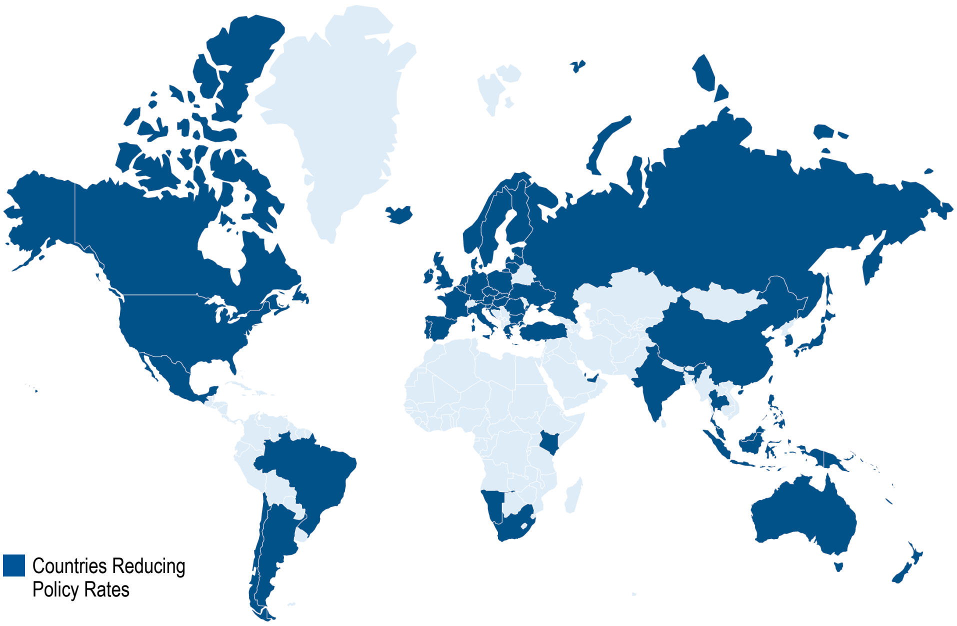
One thing has not changed, and perhaps it is a fundamental feature of financial markets: government bond investors typically see the glass as half empty, whereas equity markets are the more optimistic half of this comparison. Part of the conundrum relates to investment horizon. Stockholders typically buy into optimism, with the promise of longer-term growth or the realization of underappreciated value. Meanwhile, bond investors worry about not making it quite that far, and are more concerned about whether they will be paid their next coupon.

When we listen to central bankers such as US Federal Reserve (Fed) Chairman Jerome Powell, they are aligned in their message of doing "whatever it takes." As we discussed last month in Allocation Views, calls for the coordination of monetary and fiscal policy have become a new normal. But we also hear something like the "pragmatism" of a bond investor speaking to us. Despite the Fed cutting interest rates to effectively the zero bound and providing an array of lending programs to underpin liquidity across financial markets, Powell worries that it might not be enough. Interest-rate futures markets also

CENTRAL BANKS AROUND THE WORLD ARE PROVIDING MONETARY STIMULUS IN 2020

Exhibit 1: Countries providing monetary stimulus in 2020

As of April 30, 2020



Canada	Mexico	Malaysia	Slovenia
United States	Peru	Pakistan	Croatia
Denmark	Czech Republic	Taiwan	Romania
Israel	Egypt	Thailand	Bulgaria
Norway	Hungary	Kenya	Greece
Sweden	Poland	Namibia	Spain
Switzerland	Qatar	Iceland	Portugal
United Kingdom	Russia	Italy	Ireland
Australia	Saudi Arabia	Singapore	Belgium
Hong Kong	South Africa	Philippines	Luxembourg
Japan	Turkey	Finland	France
New Zealand	United Arab Emirates	Estonia	Germany
Argentina	China	Latvia	Netherlands
Brazil	India	Lithuania	Ukraine
Chile	Indonesia	Slovakia	
Colombia	South Korea	Austria	

Sources: Franklin Templeton Capital Market Insights Group, Bloomberg.

share some of this concern and have moved to discount the possibility of rates falling below zero in the United States, even though the Fed strenuously resists this notion.

Powell also worries about the lasting effects a recession could have on business investment and the impact on productivity growth and incomes. This is why the Fed is emphasizing the need for fiscal stimulus while continuing to buy US Treasury and mortgage-backed securities in whatever amounts are needed to support market functioning. It promises to do so until the United States is well on track to attaining the Fed's inflation and employment goals. Powell's peers at all the major central banks share such uncertainties over the outlook (see on previous page Exhibit 1, map of central banks providing stimulus).

The outlook in Europe is at least as uncertain as it is in the United States, and European Central Bank (ECB) President Christine Lagarde seems similarly concerned. The ECB has introduced new refinancing and liquidity operations, but like the Fed, it is not in the business of handing out public money; that is the preserve of elected governments and hopefully in the medium term, a collective European Union (EU) effort. Lagarde's difficulties were compounded by the recent German Constitutional Court ruling against the European Court of Justice's support for the ECB's asset purchase program. We do not believe that this will result in a premature end to this program, but it does present an obstacle and shows the EU in a poor light. Despite this, Lagarde seems intent on leaving the markets under no illusion that the central bank will hold the course.

The global economy is already in a severe recession, and it is unclear how smoothly the phased release of lockdowns will be. A second wave of infection might lead to renewed restrictions and a slower recovery. Reflecting the balance of issues noted above, we are focused on the potential for the risks in the near term to remain skewed to the downside.

As a result, this leaves us with a relatively cautious view, encapsulated in **"Significant Headwinds to Global Growth."**

Inflation remains subdued

Over the past few months, we have seen very sharp swings in the market's expected path for inflation. The main transmission mechanism for this move appears to be volatility in the price of crude oil. However, we view it as probably just an example of our broader theme, which sees movements in demand as the primary driver of inflation expectations.

Market-based measures of inflation expectations, derived from the yields of nominal and real-return bonds, have recovered somewhat but remain subdued. These so-called breakeven inflation rates (where the prospective returns on nominal and real return bonds are equal) respond directly to headline inflation and any move in 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 led this move (see Exhibit 2). This may largely reflect a decline in the risk premium for inflation uncertainty as government bond yields have fallen.

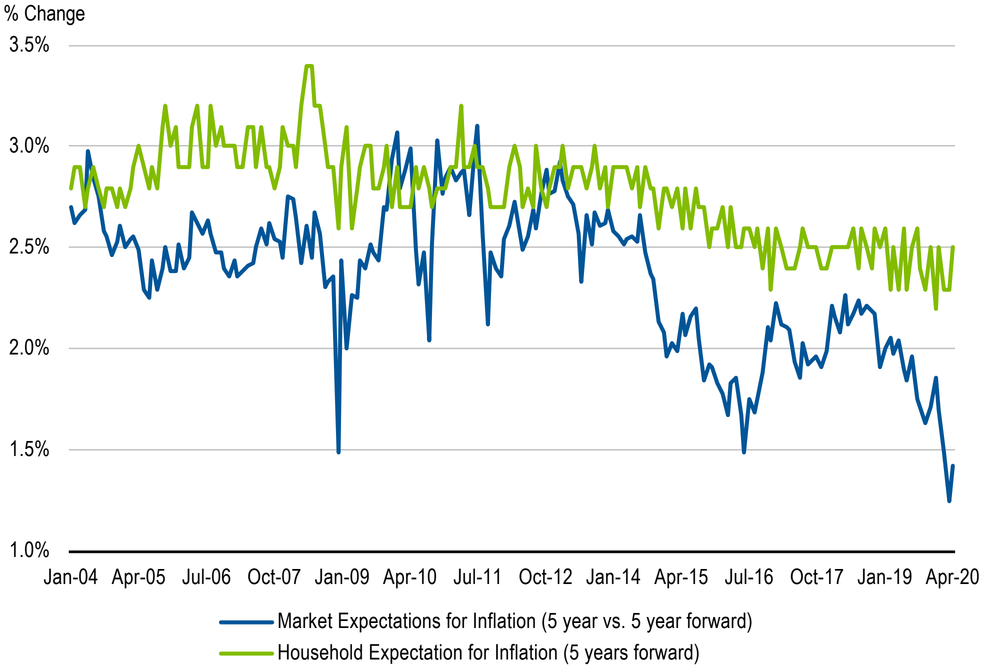
We continue to believe that the deceleration in global growth that we saw in 2019, even before this crisis, was anticipated to cap inflation during 2020. The further interruption to growth that is occurring will reinforce the trend. This effect has been felt broadly, including in emerging markets, reinforcing our theme that sees **"Subdued Inflation Across Economies."**

Bond investors take the central banks at their word, and will worry about higher rates once they stop worrying about the risks of deflation. In the longer term, yields seem artificially depressed, but it seems to be a problem for tomorrow, not today. Equity markets, in contrast, may have gotten ahead of themselves in pricing in optimism over the eventual recovery, but will likely continue to try to stay one step ahead of the game.

INFLATION EXPECTATIONS REMAIN SUBDUED

Exhibit 2: Market vs. Household expectations for inflation

As of April 30, 2020



Source: Franklin Templeton Capital Market Insights Group, Bloomberg, Factset, Macrobond, University of Michigan, St. Louis Fed.

We favor an approach of looking for medium or longer-term factors to drive our investment preferences. In this regard, we are holding the course and have maintained a modestly higher conviction toward global equities than bonds, reflecting relatively more attractive valuations over the longer term. In broad terms, bonds have become more highly valued and equity prospects have improved, but we do not yet view them as cheap in a historical context (see Exhibit 3).

Low-hanging fruit

The extreme illiquidity and volatility conditions seen in March have continued to moderate. Market expectations of further policy easing, if needed, are embedded within them. We continue to believe that policymakers will offer emergency support to limit the pain associated with the hard stop that economies have experienced. This is reflected in our final theme of a **"Dovish Bias to Policy."**

Indeed, such emergency measures have exceeded consensus expectations so far, but the easy wins have been delivered. It is easier to promise to do "whatever it takes" when you are in the teeth of the storm, as we discussed in Allocation Views last month. As the immediate crisis passes, helping to rebuild damaged economies will require continued support. However, it may well be that the low-hanging fruit has already been picked.

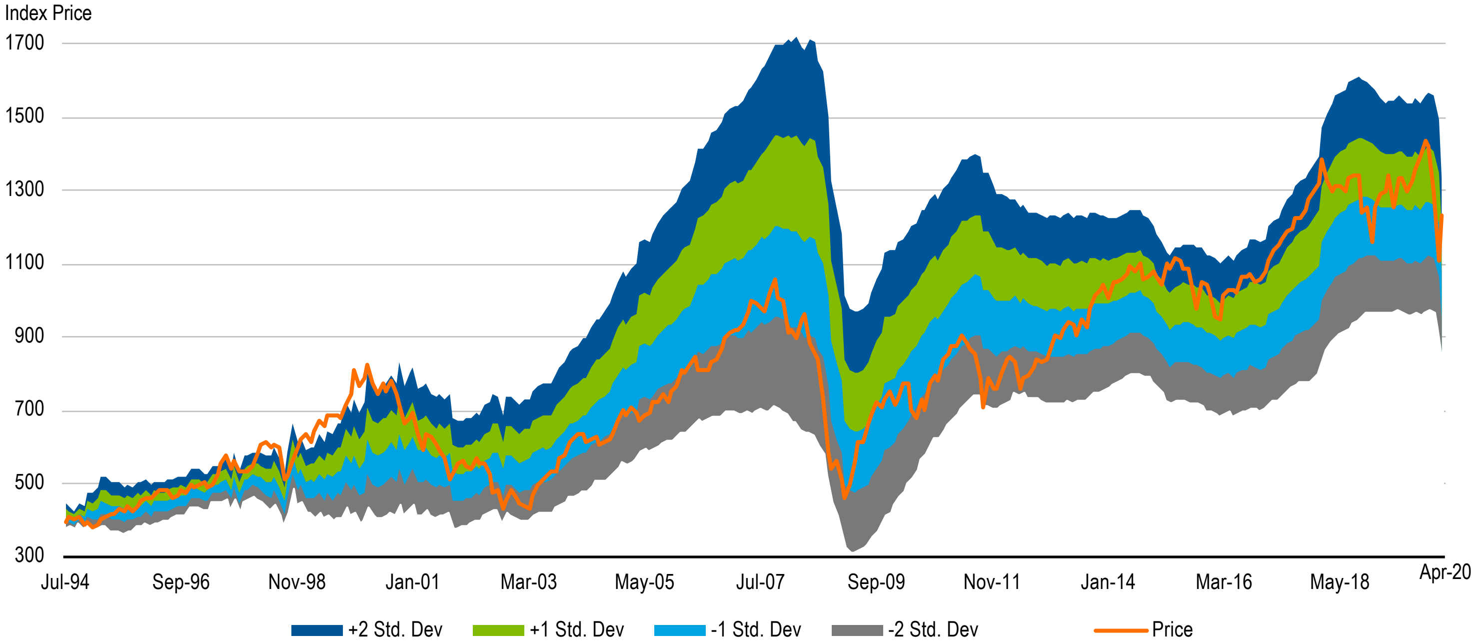
The passage of time will likely see tensions ease further, even though the path of growth may falter. As our experience of this threat expands, we will all become better adapted, and may feel we are able to cope. Together this helps explain the recent improvement in the mood of financial markets, despite the ongoing virus concerns. However, in our view, cementing the rebound into durable recovery will require policymakers to hold the course.

We continue to look for opportunities to take advantage of valuations we regard as attractive while maintaining a broadly diversified portfolio. Periods of dislocation in markets and sharp adjustments to economic expectations often present new opportunities, and the path ahead is unlikely to be smooth or straight. We continue to believe that navigating the challenges the year ahead presents will require nimble management.

GLOBAL EQUITY VALUATIONS REMAIN AT RELATIVELY ATTRACTIVE LEVELS FOR PURCHASE

Exhibit 3: MSCI AC world index price and valuation bands

As of April 30, 2020

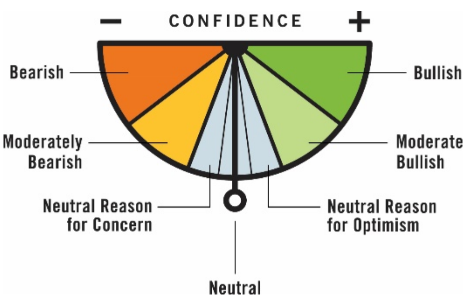


Source: Franklin Templeton Capital Market Insights Group, MSCI, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

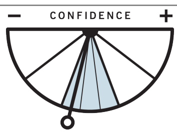
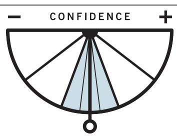
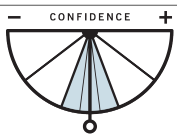
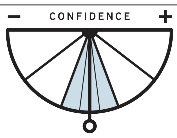
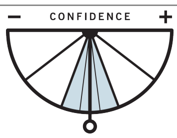
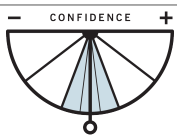
Allocation settings—May 2020

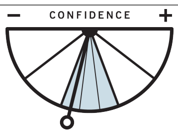
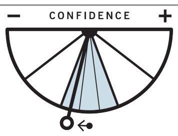
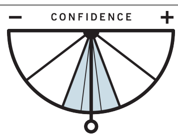
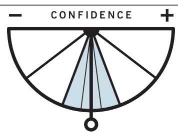
Asset Class	Conviction	Our viewpoint
RISK TIER		
Risk Off/On		We expect a sharp contraction in global growth—especially in the next few months—and moderate inflation over the long term. COVID-19 presents a significant and evolving headwind that is pushing the global economy into recession. As a result, we retain a broadly neutral stance toward riskier assets. Our view balances caution regarding growth with optimism that a broad policy response will be supportive.
HIGH LEVEL ALLOCATION TIER		
Equities		In broad terms, corporate earnings will dip, and eventual economic recovery will be needed to support global equities, as profit margins have peaked. Concerns remain about downside risk to capital investment plans that reflect general uncertainty. However, we anticipate an easing of market volatility and supportive liquidity conditions to offset these concerns. And we think longer-term prospects have improved, which is reflected in our more optimistic bias.
Bonds		Weak global growth, and a bias toward easier monetary policy, contrast with long-term valuations that have become more expensive, reflecting low term premiums. Further widening of corporate bond spreads may occur as growth slows and financial conditions tighten. We maintain a more cautious view of bonds at the asset-allocation level, reflecting valuation concerns.
Alternatives		The inflation that was feared as the economic cycle entered its later stages has not appeared, and commodity price declines will weigh on headline inflation. 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		The defensive features of cash remain attractive to us, despite its drag on portfolio yield. Short-term US Treasury bill yields reflect falling policy rates rather than greater supply. Cash has attractions as a means of diversification from low-yielding government bonds.

Understanding the Pendulum Graphic



Arrows represent any change since the last quarter-end.

Asset Class	Conviction	Our viewpoint
ALLOCATION TIER		
Equity Regions United States		Despite significant headwinds, trend US growth remains stronger than in other developed markets, and technology exposure sustains the market opportunity. The market's attention will likely focus on valuations, the 2020 presidential election cycle, and whether Fed policy programs are effective in stimulating demand.
Canada		We see modest opportunities in Canada, with earnings growth slowing and commodities a notable 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 had stabilized before recent virus concerns, but weak manufacturing sentiment persists. The ECB has made efforts to offset the effect of lower rates, but we see banks remaining a drag. We have moved to a more cautious view, which reflects a lower outlook for earnings, and valuations that remain expensive relative to history.
United Kingdom		Domestic political tensions have eased, but uncertainties over Brexit and UK economic prospects remain. Earnings per share were improving prior to the spread of the coronavirus. This defensive market appears historically cheap, so long as corporate profits are not too severely impacted. We reflect these opportunities in a more constructive view on this market, tempered by caution over remaining uncertainties.
Japan		Equity valuations, particularly on a price-to-book-value basis, have been attractive relative to other markets, in our view. However, weaker economic activity following a consumption tax rise and growth vulnerabilities due to COVID-19 are unfavorable for the Japanese market. Earnings per share and return on equity are weakening relative to peers. 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 banks in Australia and Hong Kong persist. The region is vulnerable due to local tensions in Hong Kong and subdued global trade flows. However, at valuations we regard as supportive, we are not bearish, though we see reasons for concern.
Emerging ex China		Risks to global growth highlight emerging markets' idiosyncratic risks and underlying cyclicality. However, valuations remain attractive to us relative to developed market peers, and return on equity is improving. We see a balance of near-term growth concerns and optimism regarding the longer-term structural attractions of emerging markets.
China		China's equity market has seen increasing stimulus, but the economy is still weak and faces a longer-term impact from COVID-19. Further support from fiscal or monetary measures may be required. Trade disputes remain unresolved in the longer term and are a symptom of broader tensions. Although valuations remain attractive to us, we see reasons for caution and maintain a neutral view of this market.
Fixed Income Sectors US Treasuries		The Fed has delivered a sequence of interest-rate cuts in response to the coronavirus threat, easing toward zero. However, the Fed remains biased to provide more stimulus as needed and to maintain a stable US Treasury yield curve during the crisis response phase. Stretched valuations and supply dynamics balance slower growth and subdued inflation expectations, and we have moved to a truly neutral position.
Eurozone Government Bonds		Valuations appear full in the eurozone, where term premiums are the lowest among government bonds. However, in response to growth concerns, the ECB will continue to provide stimulus, including additional asset purchases. European yields have followed US equivalents, but to a more muted extent.
UK Government Bonds		Continued uncertainty over Brexit was weighing on sentiment before the virus threat increased, and weak productivity growth was holding back activity. The Bank of England has cut interest rates to their lower bound but remains biased to provide more stimulus as required. We remain broadly neutral overall, in line with other developed markets.
Canada Government Bonds		Canada is vulnerable to a hit in business confidence from oil-price volatility. Expectations for the Bank of Canada mirror those for the Fed. Canada has seen bond yields fall, but they now broadly match those in the United States. We maintain a broadly neutral view overall, in line with other developed markets.

Asset Class	Conviction	Our viewpoint
ALLOCATION TIER		
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 policy will remain stimulative for an "extended period" but seems less likely to ease in the near term, with fiscal policy taking a larger role in providing stimulus. Low sensitivity to global yields is likely to continue.
Investment Grade		The investment-grade sector has weakened on coronavirus concerns, reflecting deteriorating corporate liquidity and high leverage. Yield spreads have widened dramatically, as the market has focused on the risk of rising defaults. However, Fed support has calmed markets significantly. Renewed widening of yield spreads is possible as growth slows and financial conditions tighten, but valuations have become more attractive to us in a global context. As such we have moved to a more constructive view.
High Yield		Pressure on energy companies and broader fears of recession weigh on the outlook for lower-rated fixed income sectors such as high yield. Default rates are rising to above historical averages. Overall, we maintain a tactical preference away from these riskier assets, while Fed support is more focused on investment-grade issuers. Longer term, we have adopted a somewhat more constructive view on this market, tempered by caution over remaining fundamental uncertainties.
Emerging Market Debt		We regard emerging market bond valuations as fair among local- and hard-currency bonds, but fundamental pressures due to global economic weakness offset these. Concerns over exchange-rate risks in local-currency bonds remain prominent. With continued fears regarding global growth, we have adopted a more cautious view on these markets, and we continue to 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 has fallen sharply. However, we maintain a broadly neutral view of assets that benefit directly from rising prices, such as inflation-linked bonds.
Commodities		Risks to economic growth create a less supportive environment for broad commodities. We believe that fiscal stimulus measures are likely to be focused on supporting consumers and preserving jobs rather than on major projects. However, prices have fallen dramatically already, which balances inflation pressures remaining subdued, and sees us move to a neutral overall view.
Risk Premia		In an environment of slower growth but ample liquidity, we see mixed prospects across asset classes and in market-neutral or naturally diversifying assets. We hold a neutral view of risk premia, reflecting a balance between concerns over the reversal of established trends and the prospect of valuations becoming more attractive.

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