Allocation views

Perspective from Franklin Templeton Multi-Asset Solutions

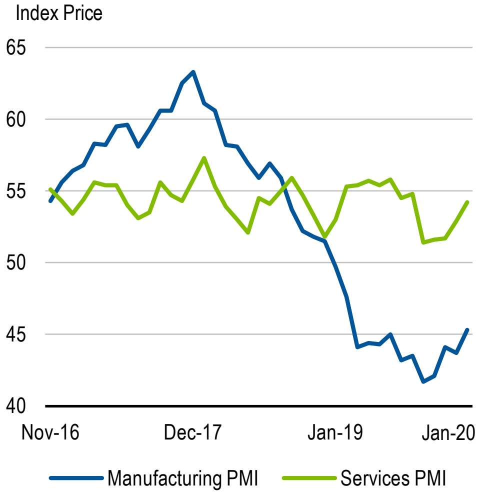
FEBRUARY 2020

Uncertainty tempers our enthusiasm

Our view of global growth has been getting more optimistic over the last few months as signs of stabilization have appeared in many economies. Areas that were notably weak, such as manufacturing in Germany, have turned up somewhat (see Exhibit 1). This has been supported by an easing of global trade tensions—though we are not complacent in seeing that the underlying issues are yet to be resolved—and by central banks that seem willing to underwrite a continued period of relative stability.

SIGNS OF STABILIZATION IN GERMANY

Exhibit 1: Manufacturing and Services Purchasing Managers' Indexes (PMI)
November 2016–January 2020



Sources: Franklin Templeton Capital Market Insights Group, IHS Markit, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com. The PMIs represent economic trends in manufacturing and service sectors. A reading above 50 indicates that the sector is generally expanding; below 50 indicates that it is generally declining.

However, we have been reminded of the value of keeping an open mind and a diversified portfolio. For example, developments in the Middle East earlier in January highlighted geopolitical risks. More recently the economic impact of the outbreak of a new coronavirus strain (Novel Coronavirus or nCov for short) has added new pressures to global markets.

Unexpected shocks and volatility in asset prices can provide temptation to trade around news flow and emotion. Our investment process is designed to avoid these pitfalls and instead focus on economic and market fundamentals. This does not mean that we ignore events like the nCov virus. Instead, we focus on how such events will affect the fundamentals and adjust our portfolio asset allocation accordingly.

We have written specifically on the multi-asset implications of the coronavirus outbreak, posted on our global insights views. The situation remains troubling and fluid. However, market responses appear to be following a well-established pattern. Initial concern builds to a point where a sharp drop in confidence or activity is discounted in markets. This is typically followed by a willingness to look through the near-term concerns and re-establish positions to benefit from the longer-term return potential. In our view, it is too early to determine the true extent of the economic impact or when investor concern will peak.

Where we have greater confidence is our view that the biggest disparity in market impact will likely be regional instead of across the capital structure. Regionally, our preference would be to focus on economies that have both policy flexibility and are more insulated from the nCov threat. Two such markets are the United States and United Kingdom; both are relatively closed economies in which trade contributes a smaller portion to gross domestic product growth. Additionally, the United States and United Kingdom still can cut interest rates if policymakers feel the need to respond to a growth slowdown.

Conversely, the eurozone and Japan are more reliant on trade as a contributor to growth, and policymakers in these regions have less room to counteract a growth slowdown. Taken together with the improving growth outlook that is anticipated for 2020, this leaves us with a relatively balanced view, encapsulated in our theme that sees us **"Cautiously Optimistic about Global Growth."**

Inflation expectations remain modest

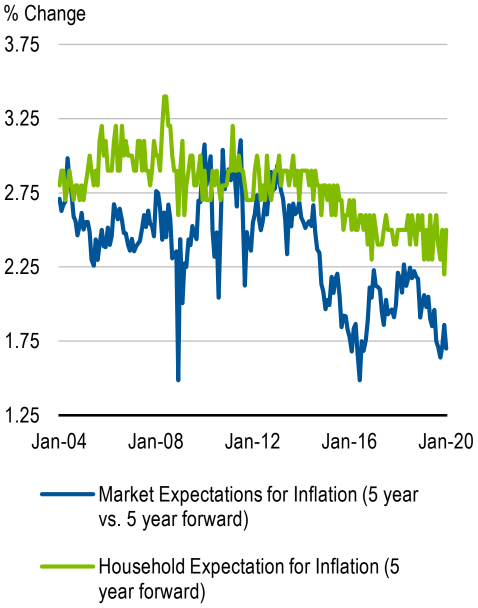
Over recent months, we have noted that geopolitical risks might present an upside risk to inflation. Indeed, the rise in oil prices earlier this year could be seen as a textbook example of this effect. However, we view this as a risk to our base case that inflationary pressures remain modest.

Market-based measures of inflation expectations, derived from the yields of nominal and real return bonds, remain low. These so-called breakeven inflation rates (where the prospective returns on nominal and real return bonds are equal) responded directly to headline inflation and any move in commodity prices. Weakness in oil and broad commodities since the nCov episode started has contributed to a renewed decline in recent weeks.

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.

INFLATION EXPECTATIONS REMAIN CLOSE TO LOWS

Exhibit 2: Household inflation expectations follow market level lower
January 2004–January 2020



Sources: Franklin Templeton Capital Market Insights Group, Bloomberg, Factset, Macrobod, University of Michigan, St. Louis Fed. Important data provider notices and terms available at www.franklintempletondatasources.com.

We continue to believe, for now, that the primary drivers of inflation are trends in demand. As a result, the deceleration in global growth that we saw in 2019 is anticipated to cap inflation during 2020. Any further interruption to growth as a result of the nCov epidemic, and its impact on global demand, will reinforce this trend. This effect has been felt broadly, including in emerging markets, reinforcing our theme that sees **"Subdued Inflation Across Economies."**

Sentiment will likely turn up before growth

Investors appear to be showing a degree of resilience in the face of threats to growth and fears of regional instability. Such optimism is partly justified by a belief that central banks' stand ready to ease policy in the face of any threat to market or economic stability.

In the case of China, which is currently the most directly impacted by the evolving threat from the nCov outbreak, such hope has already been backed up by action. Injections of liquidity into the banking system, and administrative guidance to lessen the short-term loss in riskier assets, have already been delivered. In addition, we believe the People's Bank of China has greater flexibility to cut interest rates more broadly and to facilitate credit expansion locally, if needed.

However, it has not been long since authorities in China were highlighting the need to reduce leverage in the economy to ensure longer-term stability. The current environment will test the inherent conflict between these objectives and will be a focus of our analysis in the months ahead.

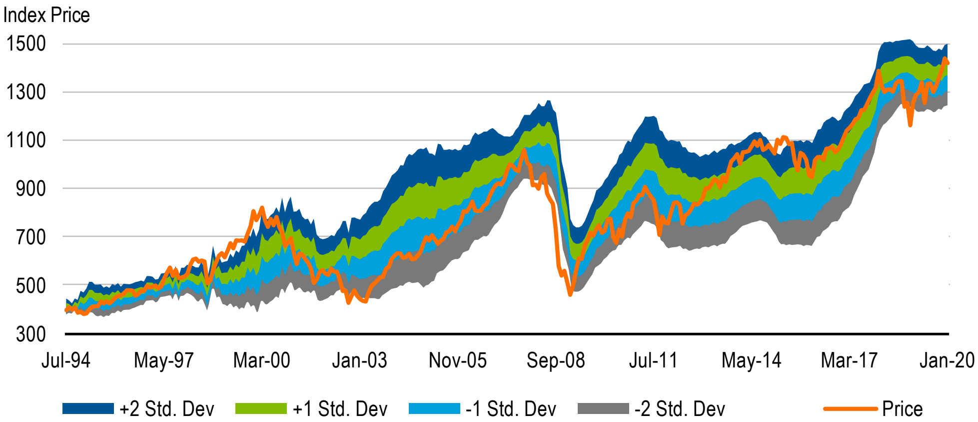
Having scaled back our cautious stance on risk assets last quarter, we have moved to a truly neutral conviction on global equities. Our view reflects the balance between longer-terms growth attractions and residual concern over valuations, which are high in a historical context, but not extreme (see Exhibit 3).

The US Federal Reserve (Fed) also stands ready to cut interest rates if necessary, and other central banks in the developed world continue to show a policy response asymmetry. This reflects a common concern that inflation is undershooting targets and a fear that inflation expectations might become un-anchored. This is at least part of the reason for relative calm in financial markets, despite the ongoing tensions, and is reflected in our final theme of a **"Dovish Bias to Monetary Policy."**

This bias toward cutting interest rates, even from the low levels already reached, supports our preference for an evenly balanced portfolio of bonds and stocks at this time. We expect that positive sentiment towards risk assets will turn up before growth, but we note that uncertainties remain evident. We continue to believe that navigating the challenges the year ahead presents will require nimble management.

EQUITY VALUATIONS ARE HIGH BUT NOT EXTREME

Exhibit 3: MSCI ACWI Forward Twelve Months PE Valuation Bands (Five-Year Look Back)
July 1994–January 2020

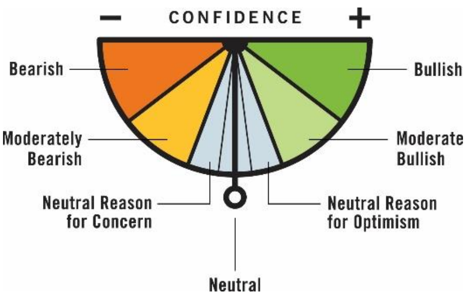


Sources: Franklin Templeton Capital Market Insights Group, IHS Markit, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com. The MSCI ACWI is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International (MSCI) and is comprised of stocks from 23 developed countries and 24 emerging markets. There is no assurance that any estimate, forecast or projection will be realized. There is no assurance that any estimate, forecast or projection will be realized.

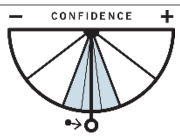
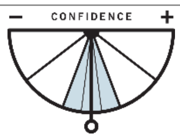
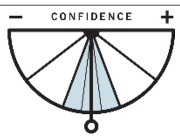
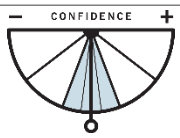
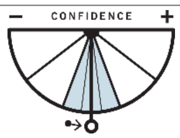
Allocation settings—February 2020

Asset Class	Conviction	Our viewpoint
RISK TIER		
Risk Off/On		We see global growth stabilizing, coupled with subdued inflation. Given modest economic imbalances, we see no more than a moderate probability of a global recession. As a result, we have adopted a neutral stance toward riskier assets. Our view balances optimism over growth with some reasons for concern over the diverging expectations across markets.
HIGH LEVEL ALLOCATION TIER		
Equities		Corporate earnings still support global equities, but profit margins have peaked. Concerns remain about downside risk to capital investment plans, even as growth picks up. We are monitoring the potential for renewed market volatility, but supportive liquidity conditions offset these concerns, and are reflected in our move to a less cautious stance.
Bonds		Modest global growth and a bias toward easier monetary policy contrast with long-term valuations that have remained expensive, reflecting low term premiums. Some widening of corporate bond spreads is likely if 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.

Asset Class	Conviction	Our viewpoint
ALLOCATION TIER		
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, the 2020 presidential election cycle and whether Fed interest-rate cuts are effective in stimulating demand.
Canada		We see modest opportunities in Canada, with earnings growth slowing and commodities remaining 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 stabilized, but global trade concerns and weak manufacturing activity have led to negative sentiment. The European Central Bank (ECB) has made efforts to offset the effect of lower rates, but we see banks remaining a drag. However, our neutral view reflects the market discounting a low base for earnings, and a higher current earnings yield.
United Kingdom		Domestic political tensions have eased but uncertainty over Brexit and UK economic prospects remains. This defensive market appears historically cheap and corporate profits remain high, but we retain a truly neutral view reflecting low conviction over near-term developments.
Japan		Equity valuations, particularly on a price-to-book value basis, have been attractive relative to other markets, in our view. However, a late-cycle environment is typically unfavorable for companies with higher operational leverage and 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 Australian and Hong Kong banks persist. The region is vulnerable due to the coronavirus, 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		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 growth concerns and optimism regarding the longer-term attractions of emerging markets.
China		China's equity market has seen measured stimulus, but the economy is still slowing and faces an uncertain impact from the coronavirus. Further support from fiscal or monetary measures may be required. Trade disputes remain unresolved in the longer term, even as a partial deal has been signed, and are a symptom of broader tensions. Although valuations remain attractive to us, we see reasons for caution and maintain a truly neutral view of this market.
Fixed Income Sectors US Treasuries		The Fed completed a sequence of interest-rate cuts in October and has paused more recently. Further easing as an insurance against global uncertainties is now less likely, but the Fed remains biased to cut if needed. Stretched valuations and supply dynamics concern us, but on balance we see reasons for some optimism.
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 asset purchases. Growth stabilization has seen yields rise modestly and although we maintain a cautious stance, we have moved to a truly neutral position.
UK Government Bonds		Continued uncertainty over Brexit is weighing on sentiment, and weak productivity growth is holding back activity. The Bank of England appears more likely to cut interest rates with inflation below target. We have moved from a cautious position in line with other developed market bonds and hold a more constructive stance, reflecting reasons for optimism.
Canada Government Bonds		Canada is vulnerable to global trade concerns and oil-price volatility hitting business confidence. Expectations for the Bank of Canada mirror those for the Fed, but risks support interest-rate cuts. We maintain a broadly neutral view overall, but hold a more constructive stance than some other developed markets, reflecting these reasons for optimism.

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		Strong demand continues to support the investment-grade sector; however, leverage is high, yield spreads are modest and the market response to disappointing results has been notable. Some widening of yield spreads is likely if growth slows and financial conditions tighten, but yields remain attractive to us in a global context.
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. Overall, we have moved to reflect a tactical preference away from riskier assets.
Emerging Market Debt		We regard emerging market bond valuations as fair among local- and hard-currency bonds. Dovish global central bank policy measures 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 broadly neutral view of assets that benefit directly from rising prices, such as inflation-linked bonds.
Commodities		Any deceleration of economic growth would create a less supportive environment for broad commodities. We believe that stimulus measures in China are likely to be focused on supporting domestic consumers more than financing major infrastructure projects. With inflation pressures remaining subdued, we continue to hold a more cautious view.
Risk Premia		In an environment of sustained growth and ample liquidity, we see good prospects across asset classes and in market-neutral or naturally diversifying assets. We hold a neutral view of risk premia, reflecting the balance between reasons for the continuation of established trends and concerns over valuations becoming extended, which we continue to monitor.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. The positioning of a specific portfolio may differ from the information presented herein due to various factors, including, but not limited to, allocations from the core portfolio and specific investment objectives, guidelines, strategy and restrictions of a portfolio. There is no assurance any forecast, projection or estimate will be realized. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. 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. 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. Derivatives, including currency management strategies, involve costs and can create economic leverage in a portfolio which may result in significant volatility and cause the portfolio to participate in losses (as well as enable gains) on an amount that exceeds the portfolio's initial investment. A strategy may not achieve the anticipated benefits, and may realize losses, when a counterparty fails to perform as promised. Currency rates may fluctuate significantly over short periods of time and can reduce returns. Investing in the natural resources sector involves special risks, including increased susceptibility to adverse economic and regulatory developments affecting the sector—prices of such securities can be volatile, particularly over the short term.

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