



Allocation views

Perspective from Franklin Templeton Multi-Asset Solutions

JULY 2020

Growth momentum in the global economy is improving

Last month in Allocation Views, we wrote about financial markets becoming inured to the publication of data that had been shockingly weak. Indeed, the level of uncertainty about the path toward economic recovery might go some way to explain why some extraordinary data was ignored. As the sharp fall in activity caused by COVID-19 lockdowns is reversed, will markets similarly ignore startlingly good news? At this stage, they seem to be doing so. Measures of economic surprises in the United States have swung from historic lows to all-time-highs in less than two months (see Exhibit 1). At the same time, US equities have started to lose momentum and Treasury bond yields have not risen.

In contrast, European fundamentals have done little more than stabilize at low levels as we examine similar economic data. However, on two other measures, corners may have been turned. As we discussed last month, the European Union is showing greater unity in its response to the current slowdown. Investors remain aware of the challenges that lie ahead, but policymakers seem to be making progress in agreeing on a coordinated stimulus package. We share the sense of cautious optimism that the “Next Generation EU”¹ plan might be a game-changing moment. The relative strength of European equity markets in June serves as evidence of an easing of investor concerns. We have moved to increase our conviction in European government bonds as we share this growing confidence. This is driven by

the improved outlook for higher-yielding markets, such as Italy, that stand to benefit from the recovery fund.

The other area where Europe and Asia seem to be turning the corner is in the suppression of the coronavirus itself. Levels of new infection have moderated in many countries, allowing further steps along the road toward reopening of economies. We remain alert to the risks of a second wave of infections later in the year, but expect that localized or partial closures might contain them. In contrast, the Americas seem to be struggling to contain the first wave of infections, with both Brazil and the United States reporting record levels of new cases. For now, these developments are being met by modest adjustments to business activity and little more than concerned glances by many equity investors. Helped by the heavy weighting of technology stocks, the US NASDAQ equity index remained near new all-time highs at June-end. We retain a somewhat more constructive view of US stocks but have moderated the level of our conviction, given the extent of recent gains and ongoing headwinds to local and global growth.

Overall, momentum in the global economy is improving, but it is too early to call an end to the deep recession that has followed the coronavirus crisis. Expectations of a sharp rebound have become well established and are increasingly discounted in current market levels for risk assets. Corporate bonds, having benefited directly from central bank support, no longer offer much protection

ECONOMIC ACTIVITY HAS A SURPRISINGLY SHARP REBOUND

Exhibit 1: US Economic Surprise Index

As of June 30, 2020



Source: Franklin Templeton Capital Market Insights Group, Citi, Macrobond. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

from the wave of defaults that remain likely to occur in the quarters ahead. As a result, we have moderated our conviction in this class of bonds. Political uncertainty contributes to an outlook that remains less clear than usual and presents an ongoing drag on business investment intentions. We expect the rebound to be partial for some sectors and see the risks to recovery as tilted to the downside, in part due to the second wave infection threat. As a result, this leaves us with a relatively cautious view, encapsulated in our theme that sees **“Significant Headwinds to Global Growth.”**

Inflation expectations remain subdued

Since plunging to extraordinary lows in April, the price of crude oil has made a sustained recovery. In part, this reflects the efforts of producers to curtail supply. The Organization of the Petroleum Exporting Countries (OPEC) and other significant producers, such as Russia, continue to show strong discipline as they attempt to stabilize this market. They have been aided by a resumption of industrial activity in many economies and by confidence that this will continue to spread more widely. However, global trade remains constrained, and the travel and tourism industry may take many years to return to previous peaks. Demand developments may overshadow attempts at supply management. As a result, we retain a neutral level of conviction on commodity investments more broadly, reflecting a balance of risks and opportunities.

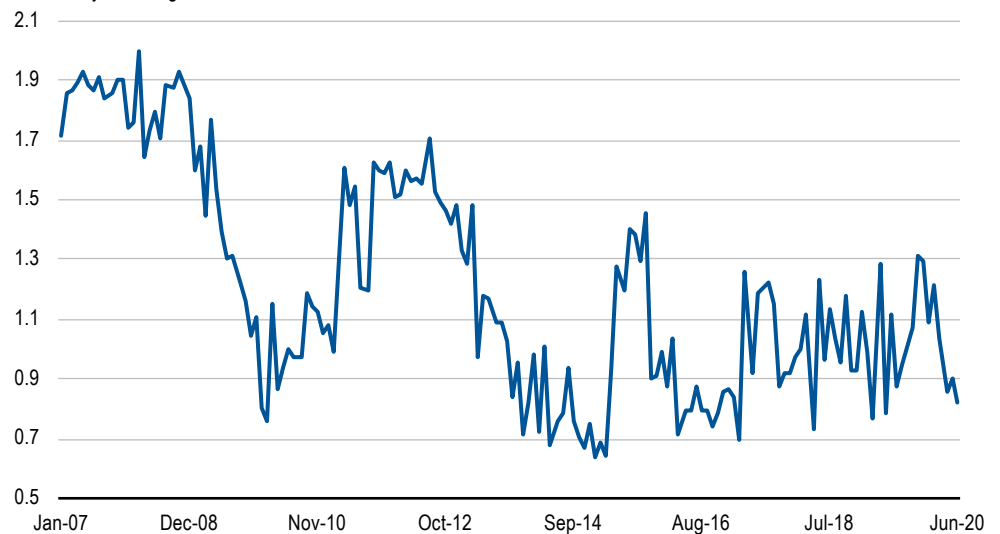
Consumer Price Index (CPI) inflation has been held down by depressed commodity prices. However, the impact of declines in demand are being felt more deeply than just at the headline level, with core CPI (the underlying level of inflation after the direct effect of food and energy price fluctuations has been excluded) falling sharply in a range of economies. In the eurozone, core inflation has dipped back toward the lows seen over the last 10 years (see Exhibit 2). This highlights

CORE INFLATION REMAINS DEPRESSED IN THE EUROZONE

Exhibit 2: Eurozone core CPI since 2007

As of June 30, 2020

Year-over-year change %



Source: Franklin Templeton Capital Market Insights Group, Eurostat, Macrobond. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

the ongoing struggle that central banks are waging in their attempts to maintain expectations of price stability.

We continue to believe changes in demand will be the main driver of inflation. Recent supply shocks may have lowered productive capacity, but the deceleration in global activity that we have seen since 2019 will be much more powerful, in our view. This effect has been felt broadly, including in emerging markets, reinforcing our theme of **“Subdued Inflation Across Economies.”**

Policymakers continue to offer support

In responding to the current COVID-19 crisis, policymakers remain highly accommodative and suggest that they will do whatever it takes. This requires ongoing coordination between central banks that can seemingly offer unlimited liquidity support, as well as elected governments that can offer more direct emergency funding for consumers and their struggling employers and landlords.

The behavior of government bond markets suggest investors generally believe the

central banks’ more cautious analysis and outlook for the global economy, and the need for ongoing support. The level of developed market bond yields indicates that official interest rates will remain at current low levels for the foreseeable future. Indeed, in recent weeks they have suggested that further steps into unconventional policy measures might be considered. The Bank of England (BoE) is contemplating the merits of joining the negative policy rate club. The US Federal Reserve (Fed) is reviewing the option of following Australia’s move earlier this year—joining Japan in directly targeting the level of government bond yields rather than simply influencing them by the quantity of bonds purchased.

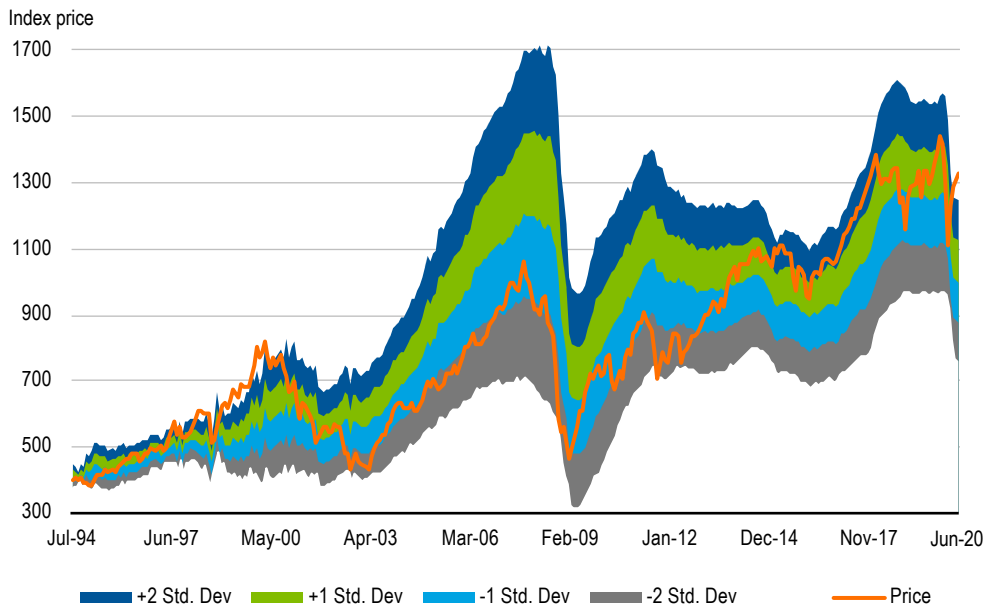
The extreme illiquidity and volatility conditions seen in March have continued to moderate. Market expectations of further policy easing, if needed, are embedded within them. We continue to believe that policymakers will offer ample support to limit the pain associated with the hard stop that economies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

As we focus on the longer-term return potential for stocks and believe that they should earn their equity risk premium over time, we continue to balance this with shorter-term concerns that have tempered our enthusiasm. We maintain 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 relative to them, but we do not view them as cheap in a historical context (see Exhibit 3.)

GLOBAL EQUITY VALUATIONS ARE NOT CHEAP, BUT ARE ATTRACTIVE TO US RELATIVE TO BONDS

Exhibit 3: MSCI ALL COUNTRY WORLD INDEX price and valuation bands (based on 10-year average P/E and current EPS estimate [forward 12 months])

As of June 30, 2020



Source: Franklin Templeton Capital Market Insights Group, MSCI, Macrobond. Important data provider notices available at www.franklintempletondatasources.com. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

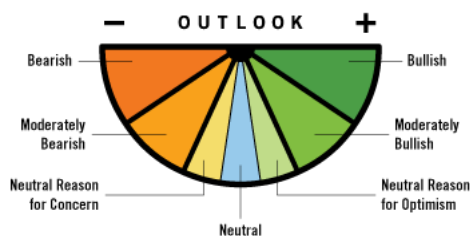
Endnotes

1. "Next Generation EU" is a major recovery instrument proposed by the European Commission to ensure a sustainable and inclusive recovery from the current economic slowdown.

Allocation settings—July 2020

Asset Class	Conviction	Our viewpoint
RISK TIER		
Risk Off/On		<p>We have seen a sharp contraction in global growth—likely bottoming in 2020's second quarter—and expect moderate inflation over the long term. COVID-19 presents a significant and evolving headwind to the global economic recovery. 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.</p>
HIGH LEVEL ALLOCATION TIER		
Equities		<p>In broad terms, global equities require sustained economic recovery to support valuations, as corporate earnings are expected to weaken through the second quarter. Concerns remain about downside risk to capital investment plans that reflect general uncertainty. However, we anticipate supportive liquidity conditions to offset these concerns. Longer-term prospects have improved, which is reflected in our relatively optimistic bias.</p>
Bonds		<p>Weak global growth, and a bias toward easier monetary policy, contrast with long-term valuations that have become more expensive, reflecting low term premiums. Renewed widening of corporate bond spreads may occur if the recovery slows or financial conditions tighten. We maintain a more cautious view of bonds at the asset-allocation level, reflecting valuation concerns.</p>
Alternatives		<p>The inflation that was feared as the economic cycle entered its later stages has not appeared, and past 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.</p>
Cash		<p>The defensive features of cash remain attractive to us, despite its drag on portfolio yield. Short-term US Treasury bill yields reflect depressed policy rates rather than greater supply. Cash has attractions as a means of diversification from low-yielding government bonds.</p>

Understanding the Pendulum Graphic




Arrows represent any change since the last quarter-end.

ALLOCATION TIER

Equity Regions

United States		<p>Despite COVID-19 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.</p>
Canada		<p>We see modest opportunities in Canada as earnings growth slows. Domestic housing concerns and low net interest margins continue to burden Canadian banks. However, commodities headwinds are abating. We have moderated our caution and adopted a more neutral stance.</p>
Europe ex UK		<p>Economic activity had stabilized before recent virus concerns, but weak manufacturing sentiment persists. The European Central Bank (ECB) has made efforts to offset the effect of lower rates, but we see banks remaining a drag. We maintain a more cautious view, which reflects a lower outlook for earnings, and valuations that are no better than neutral relative to history.</p>
United Kingdom		<p>Domestic political tensions have eased, but uncertainties over Brexit and UK economic prospects remain. 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.</p>
Japan		<p>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. However, we are tempering our caution about this cyclical market.</p>
Pacific ex Japan		<p>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.</p>
Emerging ex China		<p>Risks to global growth highlight emerging markets' idiosyncratic risks and underlying cyclicity. 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.</p>
China		<p>China's economy faces a longer-term impact from COVID-19, weak global demand and heightened geopolitical tensions. 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. Valuations have become less supportive, and we maintain a neutral view of this market.</p>
Fixed Income		<p>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 as it moves beyond the crisis response phase. Stretched valuations and supply dynamics balance weak growth and subdued inflation expectations, and we maintain a broadly neutral position.</p>
Sectors		<p>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 as it moves beyond the crisis response phase. Stretched valuations and supply dynamics balance weak growth and subdued inflation expectations, and we maintain a broadly neutral position.</p>
US Treasuries		<p>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 as it moves beyond the crisis response phase. Stretched valuations and supply dynamics balance weak growth and subdued inflation expectations, and we maintain a broadly neutral position.</p>
Eurozone		<p>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. The proposed recovery fund has demonstrated increasing fiscal unity and supports peripheral markets. European yields have followed US equivalents, but to a more muted extent, and we have moved to a slightly more constructive position.</p>
Government		<p>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. The proposed recovery fund has demonstrated increasing fiscal unity and supports peripheral markets. European yields have followed US equivalents, but to a more muted extent, and we have moved to a slightly more constructive position.</p>
Bonds		<p>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. The proposed recovery fund has demonstrated increasing fiscal unity and supports peripheral markets. European yields have followed US equivalents, but to a more muted extent, and we have moved to a slightly more constructive position.</p>
UK Government		<p>Continued uncertainty over Brexit was weighing on sentiment before the virus threat increased, and weak productivity growth was holding back activity. The BoE has cut interest rates to the lower bound but remains biased to provide more stimulus as required. We remain broadly neutral overall, in line with other developed markets.</p>
Bonds		<p>Continued uncertainty over Brexit was weighing on sentiment before the virus threat increased, and weak productivity growth was holding back activity. The BoE has cut interest rates to the lower bound but remains biased to provide more stimulus as required. We remain broadly neutral overall, in line with other developed markets.</p>

ALLOCATION TIER

<p>Canada Government Bonds</p>		<p>Canada is vulnerable to a hit in business confidence from oil-price volatility. Expectations for the Bank of Canada mirror those for the Fed. Canadian bond yields broadly match those in the United States and are likely to remain closely linked. We maintain a broadly neutral view overall, in line with other developed markets.</p>
<p>Japan Government Bonds</p>		<p>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. We believe low sensitivity to global yields is likely to continue, making this market somewhat more attractive in the case of a stronger global economic recovery. We have moved to a slightly more constructive position.</p>
<p>Investment Grade</p>		<p>The investment-grade sector has benefited from robust Fed support, which has calmed markets significantly. Supportive corporate liquidity offsets high leverage and the risk of rising defaults. Yield spreads have narrowed as the market has focused on central bank buying. Renewed widening may occur if the recovery slows, but valuations remain supportive in a global context. As such, we have returned to a broadly neutral view.</p>
<p>High Yield</p>		<p>Pressure on energy companies and broader impacts 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 retain a somewhat more constructive view on this market, offset by caution over near-term fundamental uncertainties.</p>
<p>Emerging Market Debt</p>		<p>We regard emerging market bond valuations as less attractive for hard-currency bonds, and fundamental pressures due to global economic weakness compound these concerns. Exchange-rate risks in local-currency bonds remain prominent, in our view. With continued fears regarding global growth, we maintain a more cautious view on these markets, and we continue to think selective positioning is important.</p>
<p>Alternative Assets Inflation-linked bonds</p>		<p>The level of inflation discounted in inflation-linked securities has fallen sharply. We believe that these expectations may start to normalize, even as overall inflation remains subdued. However, we maintain a broadly neutral view of assets that benefit directly from rising prices, such as inflation-linked bonds.</p>
<p>Commodities</p>		<p>Risks to economic recovery 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 had fallen dramatically, which balanced inflation pressures remaining subdued, and saw us move to a neutral overall view.</p>
<p>Risk Premia</p>		<p>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.</p>

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