

Distortion, divergence and diversification

FRANKLIN TEMPLETON THINKS™

GLOBAL INVESTMENT OUTLOOK

2019 OUTLOOK

Was 2018 as good as it gets?
Our view of what may lie ahead

Unloved stocks may draw
new interest

Diversifying against rising
rates in the post-QE era

Addressing desynchronized
global economic growth
and volatility



FRANKLIN TEMPLETON
INVESTMENTS

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All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds adjust to a rise in interest rates, the share price may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging market countries 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. Such investments could experience significant price volatility in any given year. High yields reflect the higher credit risk associated with these lower-rated securities and, in some cases, the lower market prices for these instruments. Interest rate movements may affect the share price and yield. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Treasuries, if held to maturity, offer a fixed rate of return and fixed principal value; their interest payments and principal are guaranteed.

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Volatility has plagued equity markets globally in 2018—most notably emerging markets and US equity markets. As the US economic expansion officially crossed the nine-year mark in 2018, many investors started to wonder when the cycle would change—and what the catalyst might be.

Our senior investment leaders see plenty of reasons to be optimistic about the year ahead, but recognize investment opportunities may be more divergent, with some previously overlooked countries or asset classes potentially taking the spotlight.

Key viewpoints

- We think it's important to recognize that the state of the world that investors have become accustomed to for the last decade is not going to continue indefinitely. Market dynamics continue to shift even as the sustainability of extremely low correlations becomes a lower-probability outcome. We think this environment is likely to favor active management.
- Local-currency emerging markets show the highest level of undervaluation across the global fixed income markets, in our assessment. But it's important to recognize that the asset class is not uniform. Individual countries are far more distinct than they were decades ago.
- US earnings may have a hard time keeping pace with 2018 levels as the benefits of substantial fiscal stimulus from US tax cuts and greater public spending wane. However, we see opportunities globally as earnings and economic disparities narrow between the United States and other countries.

Featured senior investment leaders



Stephen H. Dover, CFA
Head of Equities



Michael Hasenstab, Ph.D.
Chief Investment Officer
Templeton Global Macro



Edward D. Perks, CFA
Chief Investment Officer
Franklin Templeton
Multi-Asset Solutions

Was 2018 as good as it gets? Our view of what may lie ahead

Ed Perks

The global economy holds the potential to maintain solid momentum in 2019, in our view, underpinned by the strength of US fundamentals and demand. Volatility returned to global financial markets in 2018 as the narrative around synchronized global growth became more pessimistic. However, growth trends remain broadly positive and desynchronization might not be the headwind that markets may have feared at times. Of keen interest to us is how countries' economic divergences and policy differences will ultimately be reconciled, given their prospective impacts on trade, currencies and the normalization of monetary policy in the advanced world.

We see few signs of emerging-market volatility affecting other markets as yet, and believe the widening relative performance dispersion between markets we witnessed throughout most of 2018 may be sustained. Consequently, we see little reason for the leading central banks to deviate significantly from the monetary policy trajectories they have currently laid out. In the United States, the current combination of above-trend growth, benign inflation and near-full employment could continue for some time, in our view. We believe the prospects for a US recession are still several quarters away.

Stephen Dover

The year ahead looks to be one of restrained global equity market performance. As the benefits of substantial fiscal stimulus from US tax cuts and greater public spending wane, US earnings and the broader global economy may have a hard time keeping pace with 2018 levels. However, we see opportunities outside the United States as earnings and economic disparities with the United States narrow. We also believe equity valuations in non-US markets remain attractive relative to the United States. Additionally, we expect companies with low debt and high, strong cash generation to do well as economic and earnings growth moderates.

With interest rates rising and political issues a concern, the quality of earnings along with valuations will be an increasingly important investment consideration.

Michael Hasenstab

A decade after the global financial crisis peaked in 2008, financial markets have only just begun to correct the asset price distortions that were created by the US Federal Reserve's (Fed's) massive quantitative easing (QE) program. QE was originally deployed to stabilize financial markets during the crisis, but instead of being a limited intervention to restore

markets over a few years, it expanded and became an ongoing endeavor. It succeeded in pushing down bond yields and pushing up asset prices, steering many investors toward riskier assets while also keeping the costs of capital artificially suppressed. But continuous QE also led to ongoing price distortions in bonds and equities, while incentivizing leverage and rewarding complacency among investors who appeared to view persistently low yields and the Fed's "buyer of last resort" role as a permanent arrangement.

However, those conditions are neither normal nor permanent, in our view, and we expect the reversal of QE to have significant impacts on bond and equity markets alike in the upcoming year. Just this past fall (October 2018), we saw bond and equity markets in the US decline concurrently as rates rose. That may seem anomalous, but because bonds and equities were equally propped up by Fed intervention, they have been equally vulnerable to the opposite effect as Fed policy unwinds. These are the types of valuation corrections we expect to see as the artificial effects of prolonged monetary accommodation are dismantled. Investors that are not prepared for concurrent price corrections in US Treasuries (USTs) and other asset classes in 2019 may be exposed to unintended risks.

“Of keen interest to us is how countries' economic divergences and policy differences will ultimately be reconciled...”

— Ed Perks

The easy gains appear over, but unloved stocks may draw new interest

Stephen Dover
Head of Equities

Emerging opportunities

We see opportunities beginning to emerge in many unloved areas of the global equity markets. While headline rhetoric about the trade war's impact on the Chinese economy has made many investors wary of Chinese equities, we believe growth in China is driven more by domestic consumption than trade these days. And although the residential real estate market is a concern and economic growth has been decelerating, we do not see a "hard landing" ahead. We believe there could

be long-term opportunities in China's more domestically oriented sectors over the longer term.

Latin America also offers new promise. The election of Jair Bolsonaro as Brazil's new president suggests to us a return to more orthodox economic policies, despite some of his more extreme political rhetoric. Similarly, we have seen a return to better economic policy in Argentina in recent years. While it is still early, with ongoing political and economic challenges facing both countries, we believe the days of the

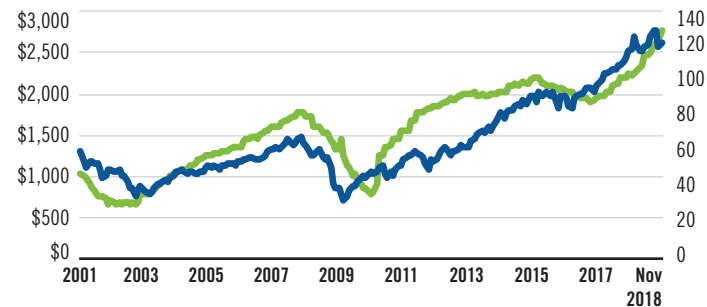
kind of significantly bad economic policy that hobbled both countries may be ending. In general, the underlying fundamentals in emerging markets look positive to us and valuations have been falling back to levels that historically have proven attractive to us.

So while the easy gains for global equities look to be over as growth rates in the United States moderate and geopolitical and trade issues persist, a rising-rate environment can lead to a shift in leadership as unloved stocks and regions begin to draw renewed interest.

REGIONAL DIFFERENCES IN EARNINGS CYCLES SUGGEST ROOM FOR NON-US STOCKS TO RUN

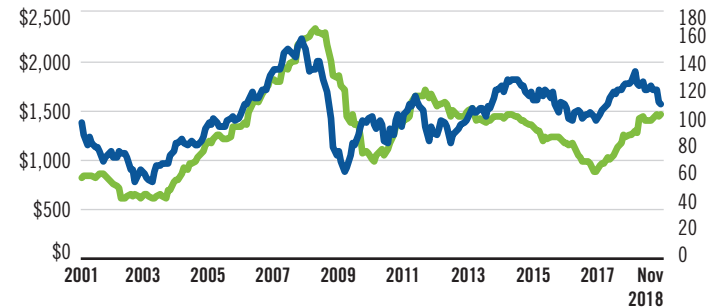
MSCI USA Index

January 2001–November 2018



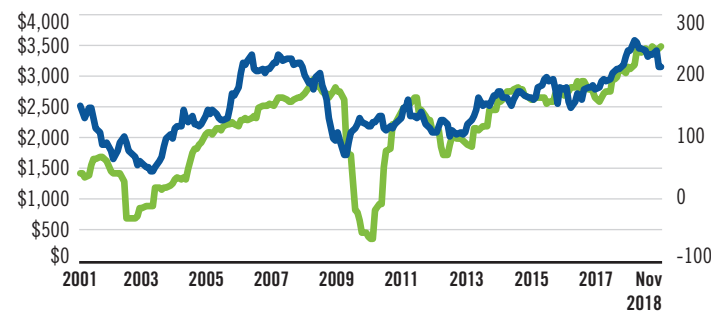
MSCI Europe Index

January 2001–November 2018



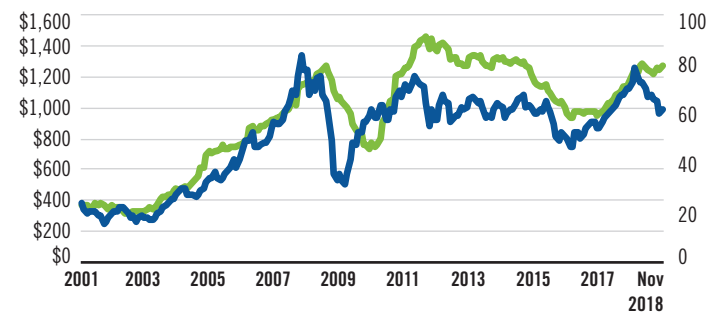
MSCI Japan Index

January 2001–November 2018



MSCI Emerging Markets Index

January 2001–November 2018



— Price in USD (LHS) — Earnings per share, last 12 months (RHS)

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“Over the longer term, we continue to see tremendous opportunities in disruptive companies. Major US and Chinese technology companies are innovating and have become a more important part of the global economic and political landscape. We believe the question for investors now is how much value to assign to this growth.”

— Stephen Dover

Falling back in line

US companies had a strong run in earnings and revenue growth in 2018, with numbers largely surprising on the upside in the aggregate. A run like that looks unlikely in 2019, and companies are already signaling that they will not be able to keep up the pace in the next year.

The hurdles come both from a slowing economy and steeper input costs. The US economy's growth rate is set to slow as the benefits of the tax cuts and greater public spending have less impact on the broader economy. Nonetheless, growth is likely to remain relatively robust, and the business environment should remain favorable, helped by continued efforts to pare back onerous regulations and the broad benefits of the US shale oil boom.

Meanwhile, input costs, both in terms of labor and materials, have been rising. Getting profit margins to increase from already lofty levels would require a surge in productivity. And while technology may help on that front, a significant increase likely won't be forthcoming in the near term.

All in all, US corporate earnings and economic growth rates should fall back in line with other regional markets in 2019. The International Monetary Fund (IMF) sees US growth in 2019 slowing to 2.5% from a projected 2.9% in 2018, while it forecasts European growth to come in at about 2% over 2018 and 2019. Overall global economic growth is expected to hold steady at 3.7% in both 2018 and 2019, according to IMF forecasts.

Less distinction between US and non-US corporate earnings growth could help get investors more interested in non-US stocks in 2019. Many non-US markets have been undervalued relative to the United States for the past few years, in our assessment, due to the strong US corporate earnings performance. Europe, for instance, has not seen as robust growth, giving European corporations an easier hurdle to clear in 2019. Meanwhile, the Japanese market, which has seen decent earnings growth, could benefit from any signs of a more durable pickup in inflation.

Politics' rising importance

The main challenge for European markets may be the increased political

uncertainty that looms in 2019. Populism and economic nationalism remain on the rise. Brexit negotiations between the United Kingdom and European Union (EU) may have reached a breakthrough on a deal in November, but substantial uncertainty remains. And Germany faces some significant political changes in the coming years as the era of Chancellor Angela Merkel draws to a close.

We think the continued rise in populism, not just in Europe but globally, is slowly chipping away at some of the economic and political institutions that have been the bedrock of many market-based economies. We also believe the rise in economic nationalism bears close watching. If countries look increasingly inward, the environment may become more favorable for domestically focused firms instead of larger multinationals.

The US-China trade war also is less about the economics of trade, in our view, and more about China's growing geopolitical influence. We expect those issues to be much more difficult to resolve in the near term, creating greater uncertainty.

Diversifying against rising rates in the post-quantitative easing era

Michael Hasenstab

Chief Investment Officer, Templeton Global Macro

Select emerging markets are better positioned to absorb rising rates

Local-currency emerging markets show the highest level of undervaluation across the global fixed income markets, in our assessment. But it's important to recognize that the asset class is not uniform. Individual countries are far more distinct than they were decades ago. Several countries have diversified their economies, significantly broadened their local-currency debt markets, expanded their domestic investor bases and built up resiliencies to external shocks. Others continue to have

persistent structural imbalances, unreliable institutions and fragile economies. It's crucial to accurately identify those differences. In 2019, it will be increasingly important to identify countries that offer idiosyncratic value that is less correlated to broad-based beta (market) risks, in our view, as rising rates in the US should impact individual countries in starkly different ways. Countries with low rate environments, or large structural imbalances and economic soft spots, could be vulnerable to external rate shocks. However, countries with stronger economies, balanced current accounts and relatively higher yields should be in

a stronger position to absorb rate shifts of 100 basis points or higher.

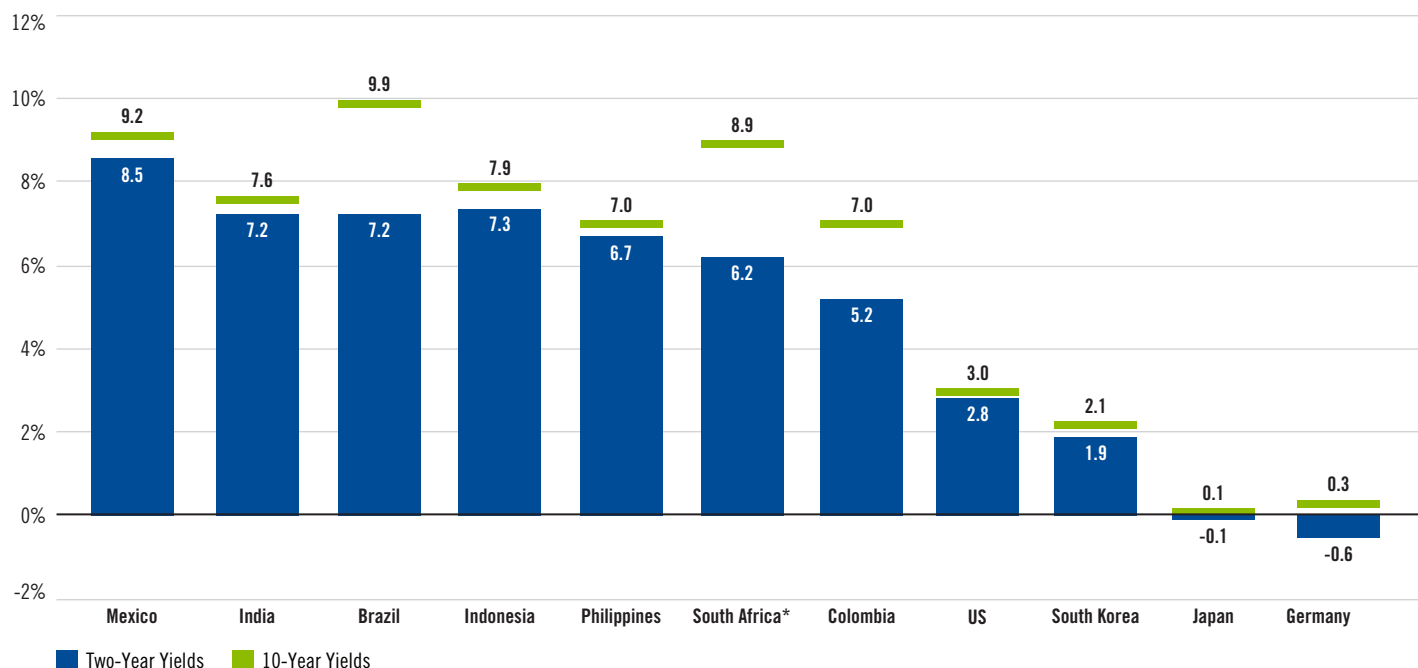
Europe remains vulnerable to rising populism and structural risks

Another risk that investors may be overlooking is the growing political and structural risks across Europe. Five years ago, European voters were focused on traditional issues such as the economy, fiscal spending and unemployment. Today, European Commission surveys indicate much stronger voter concern for immigration and terrorism. That shift in focus has been reflected in

HIGHER YIELDS AVAILABLE IN SELECT EMERGING MARKETS

Government bond yields: Two- and 10-year yields

As of November 30, 2018



Source: Bloomberg. Past performance does not guarantee future results. Important data provider notices and terms available at www.franklintempletondatasources.com.

*South Africa does not offer a 10-year bond yield. Therefore, a 9-year bond yield is shown.

“Overall, we think it’s important to recognize that the state of the world that investors have become accustomed to for the last decade is not going to continue indefinitely.”

— Michael Hasenstab

the political landscape. Support for far-right nationalist parties has grown in several eurozone countries, notably including France, Germany, Italy and Austria, among others. Outside of the eurozone, countries like Hungary, Poland and the Czech Republic have slid even further toward protectionism and far-right nationalism, building barriers and increasingly emulating the Russian approach to governance rather than the EU’s. This is a worrying trend for European integration, in our view, as inward-looking governments are less likely to work together in a time of crisis.

Currently, European political and structural risks can be most acutely seen in Italy, where disparate political parties in the governing coalition share common ground on euroskepticism, protectionism and increased fiscal spending. Of primary concern for Europe is the risk that Italian debt would become unsustainable at a 10-year yield around 3.6%, in our analysis. While a crisis is not imminent, the likelihood that the EU would come together to bail out Italy as it did for Greece in 2011 appears far less likely today. In 2011, there was barely enough political cohesion to hold the union together, but leaders at the time saw the greater good of doing so. Today, fewer people in power share that same thinking. On the whole, investors may be underappreciating the full scope of potential risks in Europe, in our opinion. We think the euro will remain vulnerable to unresolved structural and political risks in the upcoming year.

US Treasuries are facing a perfect storm of rate pressures

Three key factors are lining up to drive UST yields higher, in our assessment: increased borrowing needs from the US government, a decline in UST buying from the Fed and foreign governments, and rising inflationary pressures. The first storm on the horizon is the growing fiscal deficit. Increased spending from the Trump administration, along with tax cuts, and ongoing mandatory spending are projected to drive the fiscal deficit toward 5% of GDP (gross domestic product), in our analysis. That increases the already high borrowing needs of the government. The second storm is the diminished official buying demand, both domestically from the Fed as it unwinds QE, as well as externally from foreign governments. This leaves a large funding gap that will need to be filled by price-sensitive investors, who would need to roughly triple their current levels of buying to fill the void. Less buying volume and more supply volume means yields need to rise to find new clearing levels.

Those two dynamics alone would probably be enough to drive yields higher. But a third storm is brewing in the form of inflation. Wage pressures have been rising on exceptional strength in the US labor market, along with a lack of skilled and unskilled labor in certain sectors. The labor pools have been further constrained by restrictions on both legal and illegal immigration from the Trump administration.

Additionally, late-cycle fiscal stimulus, deregulation and tax cuts have added fuel to an already strong economy. Sector tariffs are also expected to raise costs for consumers. Each of these conditions has inflationary implications, in our assessment. Given the current environment, we expect the Fed to continue hiking rates toward the neutral rate in 2019. Taken together, all of the aforementioned factors form a perfect storm of rate pressures that we expect to drive UST yields higher in the upcoming year.

Bonds and equities may see positive correlations as rates rise

Overall, we think it’s important to recognize that the state of the world that investors have become accustomed to for the last decade is not going to continue indefinitely. In 2019, we expect UST yields to rise and various asset classes to endure price corrections as monetary accommodation unwinds. The challenge for investors will be that the traditional diversifying relationship between bonds and equities may not hold true as UST yields rise. We have already seen periods in 2018 when risk assets declined as the “risk-free” rate (UST yield) ratcheted higher. Those types of simultaneous declines across bonds, equities and global risk assets have the potential to recur, in our view, as markets exit an unprecedented era of financial market distortion. These are the types of risks and opportunities we think global fixed income investors need to prepare for in 2019, not only to defend against current risks in multiple asset classes, but to look for ways to potentially benefit as rates rise.

Addressing desynchronized global economic growth and volatility

Ed Perks

Chief Investment Officer, Franklin Templeton Multi-Asset Solutions

Late-cycle concerns in equities

Strong manufacturing data and earnings growth, along with higher short-term interest rates, all reflect a healthy economy, but they can also lead investors to wonder if this is as good as it gets. Market dynamics, underscored by correlations between stocks reaching some of the lowest levels of the past two decades (and well below the 10-year average), continue to shift in favor of active management, even as the sustainability of extremely low correlations becomes a lower-probability outcome.

We are following a positive but highly selective, fundamentally driven approach toward equities as central bank monetary policy becomes less accommodative in 2019 and beyond. Rising corporate earnings and profit margins are supportive of equity valuations, though we are carefully monitoring inflation and the potential for increased market volatility.

Issues surrounding trade and tariffs may foster market instability, but they have probably already been reflected in company valuations. We continue to

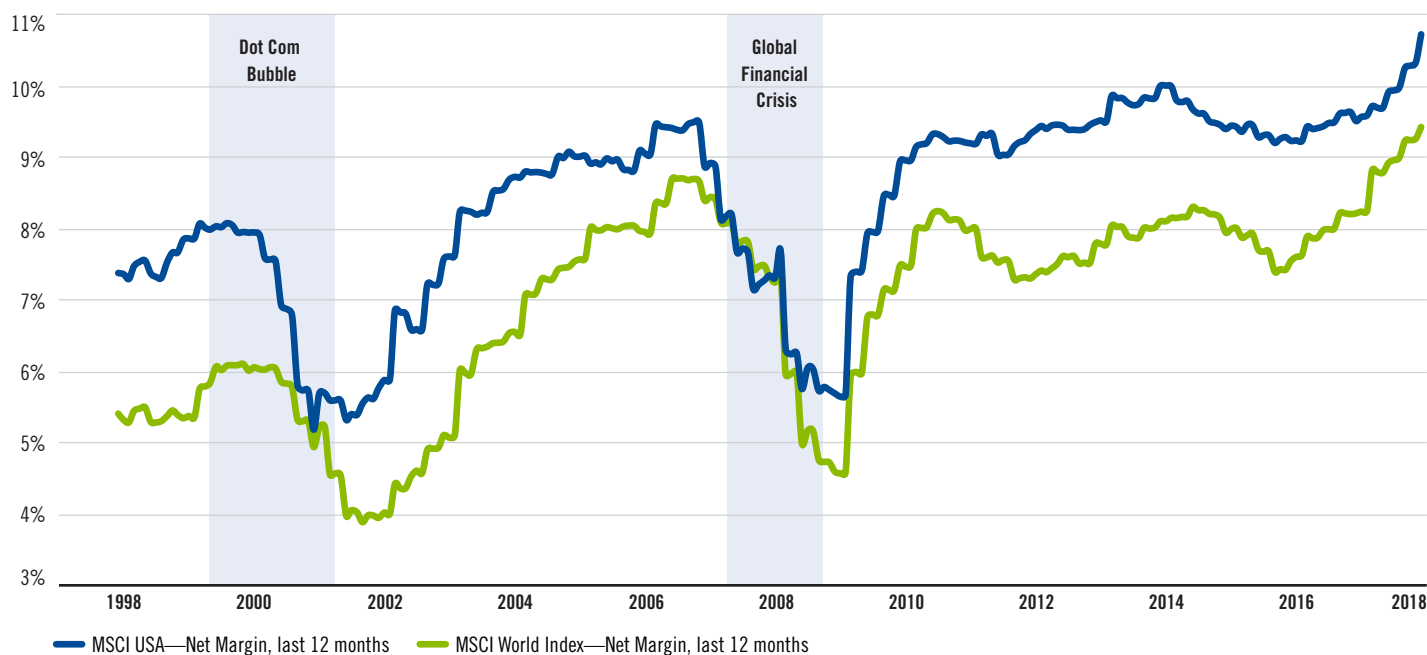
expect the United States and China to successfully navigate trade issues and ultimately reach an agreement, particularly once the crucial intellectual property policy issues are addressed.

Despite elevated geopolitical headlines and trade tensions, US growth fundamentals looked solid in late 2018, and while the market is offering attractive opportunities, they look less abundant than in recent years. We believe selectivity in risk exposures has taken on greater importance, as broad market beta appears to be more expensive to us

STRONG PROFIT MARGINS REFLECT ROBUST CORPORATE FUNDAMENTALS

Net profit margins: MSCI World Index and MSCI USA Index

November 1998–November 2018



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“ In the United States, the current combination of above-trend growth, benign inflation and near-full employment could continue for some time, in our view. We believe the prospects for a US recession are still several quarters away.”

— Ed Perks

than previously. The US is driving the global growth train, but less robust international growth and political concerns abroad may be offset by more attractive valuations outside the United States. With respect to emerging markets, we believe stronger investment opportunities likely exist in countries with domestically driven growth prospects that have demonstrated resilience to the impact of rising trade costs. The implementation in multi-asset portfolios can get quite granular in seeking out idiosyncratic opportunities at the country level. This analysis has taken on a greater role for our team as the cycle has progressed, and we would expect that to continue.

Burgeoning debt levels, inflation risks and alternative assets

As we head toward 2019, we recognize there are reasonably full valuations in certain parts of both the equity and fixed income markets, and while favorable corporate fundamentals remain in place, we have become incrementally more cautious. We have grown concerned about elevated government debt levels (focused on some major eurozone countries, Japan, the United States, China and other emerging markets). Inflation remains moderate globally; however, we are mindful of the risks of increasing

inflation. Thus while equities and fixed income typically remain the largest asset class exposures in our multi-asset portfolios, we also hold a constructive view of real assets, including commodities. We favor assets that typically perform well during the latter stages of a business cycle or offer explicit inflation protection such as inflation-linked bonds. Additionally, alternative assets could provide diversification against potential weakness in stocks and bonds if an unexpected uptick in inflation occurs.

More 2019 viewpoints

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