FRANKLIN TEMPLETON INVESTMENTS

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Beyond Bulls & Bears Bulletin

INSIGHT FROM FRANKLIN TEMPLETON INVESTMENTS MANAGERS

IN THIS ISSUE: ***The articles in this issue are as at 28 December 2017.***

The Market Implications of US Tax Reform a Bit Unclear: Efforts to overhaul the US tax code have been a long time in coming (more than three decades), but this year they finally came to fruition. Congressional approval of sweeping tax reform will impact individuals, businesses—and the entire economy. Ed Perks, chief investment officer, Franklin Templeton Multi-Asset Solutions, offers his perspective on the likely economic and market implications.

Is the Energy Sector Starting to Turn?: Recalling the shocks of the sharp oil-price downturn back in 2014–2015, many investors have remained wary of energy stocks even as prices began to rebound this year. Here, Fred Fromm, vice president and portfolio manager, Franklin Equity Group, says they shouldn't be. Short-term volatility aside, he digs deeper into industry fundamentals that he thinks make for an attractive longer-term investment case for oilfield services stocks.

Why GCC Fixed Income Is an Overlooked Asset Class: Many investors could be underinvested in Gulf Cooperation Council (GCC) bonds, according to Dino Kronfol, chief investment officer, Global Sukuk and MENA Fixed Income. He explains why he believes the fixed income landscape is approaching a turning point—and why more investors may want to consider adding this dynamic asset class to their portfolios.

The Market Implications of US Tax Reform a Bit Unclear

Ed Perks, CFA
Executive Vice President
Chief Investment Officer
Franklin Templeton Multi-Asset Solutions

Broadly speaking, the market appears to have been pricing in the passage of the tax reform bill, thus we don't expect a major reaction as President Trump signs it into law. Some market observers have expressed optimism that US tax reform will prove bullish for stocks—and the economy overall—but the reality is that there will be some winners and losers and we don't ultimately know what the magnitude of the impact will be. We would point to some areas that stand out to us that could have broad market and economic impacts.

Corporate Income Tax Rates

In the reconciled version of the tax reform bill, corporate income tax rates were reduced to 21% from 35%, which wasn't as low as in prior versions of the legislation but is still quite significant. It seems obvious that lower US corporate income tax rates would lead to higher net after-tax income for US companies, which would in turn boost the S&P 500 and other major market indexes. However, given the significant differences between companies' current effective tax rates, the after-tax net-profit impacts of the tax bill will in reality vary considerably from company to company.

A reduced tax rate on repatriated foreign earnings and mandatory back payment on those past earnings will likely lead to a larger quantity of foreign cash coming home to the United States. That repatriation of cash could lead to possible increases in share buybacks, dividends and US domestic capital expenditure (capex). Capex could also get an additional boost from accelerated depreciation.

Many observers are also optimistic that tax reform will be the key to boosting US economic growth. Overall, we believe the tax legislation could stimulate higher US gross domestic product (GDP) growth, but we would have to make some positive assumptions. The Goldilocks scenario is where the combination of lower corporate tax rates, more repatriated foreign earnings, and accelerated depreciation all lead to higher US domestic capital spending, which in turn contributes to a faster pace of economic growth going forward.

That said, the factors influencing economic growth are complex, and taxes are only one aspect.

The Deficit Downside

One thing we are more certain of is that the new tax legislation will add to the size of the US federal deficit, with some estimates putting the amount added to the deficit upwards of US$1 trillion (via reduced federal tax revenues) over the next decade. Though the actual impact of a larger federal deficit from tax reform will depend in part on how much incremental new US GDP growth, income growth and federal tax revenue growth it stimulates within the US economy, we believe the likely outcome will be an increase in long-term US interest rates.

Prospects for a growing deficit coincide with the US Federal Reserve's (Fed's) shift to unwind its balance sheet while several major buyers of Treasuries (e.g., foreign governments, Asian central banks and oil-producing nations) have been scaling back their purchases. With more debt for global markets to absorb, one has to ask if current yield levels are high enough to entice buyers. Our expectation is that yields will have to migrate higher in order to find a supply/demand balance.

The likelihood of tax reform stimulus on continued economic expansion eventually contributing to an inflationary environment also supports our expectation of rising rates. We agree with the views of our Templeton Global Macro colleagues that multiple factors, even aside from tax policy, have created conditions for rising inflation over the next couple of years. As the Fed unwinds its balance sheet from unprecedented levels, any market uncertainties could have an outsized impact on bond valuations, in our view. We think investors have reason to be cautious about return potential in long-duration Treasury securities.

What This Means to Us

In this environment of synchronised global economic growth, modest inflation, and supportive liquidity conditions, we favour risk assets; generally this translates into a preference for equities over fixed income within our multi-asset strategies. Within equities, we prefer non-US exposures, including Japan and emerging markets; within fixed income, our bias is towards short-duration exposure over longer-duration exposure.[1] Given our assessment that the impact of these tax-policy changes will vary by industry and by company, we believe the implementation of fundamentally driven active management in security selection will be an important differentiator going forward.

Is the Energy Sector Starting to Turn?

Fred Fromm, CFA
Vice President
Portfolio Manager and Research Analyst
Franklin Equity Group

Global oil prices rose to two-year highs in early November of this year after booking monthly gains in September and October. Oil prices have benefitted from strong demand growth in many parts of the world—emerging markets in particular—and output restraint that has tightened supply-and-demand fundamentals.

Despite the recent oil-price rally, many investors have remained reluctant to buy energy stocks, as evidenced by the sector's general underperformance this year.[2] Oilfield services stocks have been particularly weak.

Why Investors Are Reluctant to Buy Energy Stocks

Many investors remain wary of energy stocks following a three-year slump in oil prices. Prices began to fall in 2014 when global supply started to rapidly outpace demand, largely due to the US shale oil revolution. By 2016, benchmark West Texas Intermediate and Brent oil prices fell below US$30 a barrel, leading many companies to either go bankrupt or slash exploration and production spending.

An initial decline in US production combined with coordinated supply cuts by major suppliers in the Organization of the Petroleum Exporting Countries (OPEC) and partners have helped bring oil back up to US$50–US$60 a barrel this year. However, prices are still far below the US$100+ peak we saw four years ago.

Given the current lower-price environment, market volatility and future uncertainty, many investors have perceived oilfield services stocks as too risky. That, in turn, has led to more attractive valuations for these stocks that we believe could be creating attractive investment opportunities.

In our view, there is a common misconception that energy stocks require higher oil prices to realise upside potential. We have found that it's price stability that can provide a fertile environment for growth-oriented companies to thrive. Also, spending by producers is largely a function of their cash flow, which can benefit from declining costs and efficiency gains.

Of course, producers would benefit from a rise in prices, but it is not a necessary ingredient. In particular, we see many oil-and-gas exploration and production firms today that have ample opportunities for growth at historically low levels of risk, given the factory model which is being followed to develop unconventional resources.

It seems to us many investors are cautious about energy stocks for other reasons too. Some believe increased US oil production will cause prices and spending to weaken, despite multiple reports that have suggested otherwise. And, in fact, the only way production is likely to continue growing is through increased spending and drilling activity, which will benefit service companies.

We do see production growing at a quicker pace over the coming quarters, but we do not think it will be overly problematic for oil-market fundamentals and, at some point, will be required to offset the natural decline in rates elsewhere in the world. Based on our analysis, we think a higher level of spending will be required to maintain market balance over the long term.

Many investors also question when widespread electric vehicle (EV) adoption will likely curb the demand for oil. Although we do not dismiss the risk posed by EVs, most rational expectations do not call for a meaningful impact until perhaps the middle of the next decade.

Even then, we believe the impact to oil demand from EV adoption will likely be much smaller than high-level assumptions have suggested. We have seen that even the most pro-EV advocates see growth in sales of gas-powered cars in coming decades.

In the near term, we believe oil prices should continue to benefit from output restraint that has tightened supply-and-demand fundamentals.

Outlook for Oilfield Services Stocks

We believe the oilfield services industry has suffered from investor intransigence. In our view, soft US production trends, declining inventories and rising oil prices should have been seen as supportive of future spending patterns.

For the reasons above, we see opportunities in select oilfield services stocks. The estimates of future revenue and earnings for these stocks have been reduced as analysts perceived that this year's sharp increase in activity simply pulled spending forward.

In our view, estimates now appear not only reasonable, but also possibly overly conservative. For many companies, 2018 estimates can be reached by annualising expected fourth-quarter results. This signals that estimates can be achieved with flat activity levels. We think this is an unlikely outcome with oil prices at two-year highs.

We believe valuations appear attractive based on these more conservative estimates. That could lead to renewed upside for oilfield services shares as expectations recalibrate.

Oilfield services stocks with high levels of exposure to the US onshore market are particularly attractive to us. We also see several smaller companies experiencing rapid growth in the strongest market—pressure pumping or hydraulic fracturing in the Permian Basin of Texas.

However, we also believe spending will broaden in other markets over the next year. In our view, this spending may favour companies providing other services in the US and those that have been out of favour due to exposure to offshore and non-US markets.

Why GCC Fixed Income Is an Overlooked Asset Class

Mohieddine (Dino) Kronfol
Chief Investment Officer, Global Sukuk and MENA Fixed Income
Franklin Local Asset Management

The landscape for fixed income investing has evolved significantly in recent years. The steady decline of bond yields has been well documented in recent decades, and a lack of divergence in returns has made it harder for managers to benefit from market movements, making alpha[3] more difficult to achieve.

This has likely been a consequence, at least in part, of the dearth of global liquidity developed-market central banks had created through quantitative easing. It has led investors to seek areas outside of traditional asset classes and geographies in the search for yield, alpha and diversification.[4] We think that, despite this trend, many investors continue to miss out on

opportunities and overlook bonds in the Gulf Cooperation Council (GCC).[5]

We believe GCC fixed income is an attractive asset class that generally has lower volatility and potentially offers higher yields than developed-market bonds. And we'd argue these assets often have better underlying fundamentals and higher credit ratings than emerging-market bonds in other regions.

However, while some investors may believe active managers with a global or broad emerging-market mandate may already be providing sufficient exposure to GCC bonds, our research suggests this is most likely not true. According to our analysis, very few active bond managers appear to invest in GCC countries.

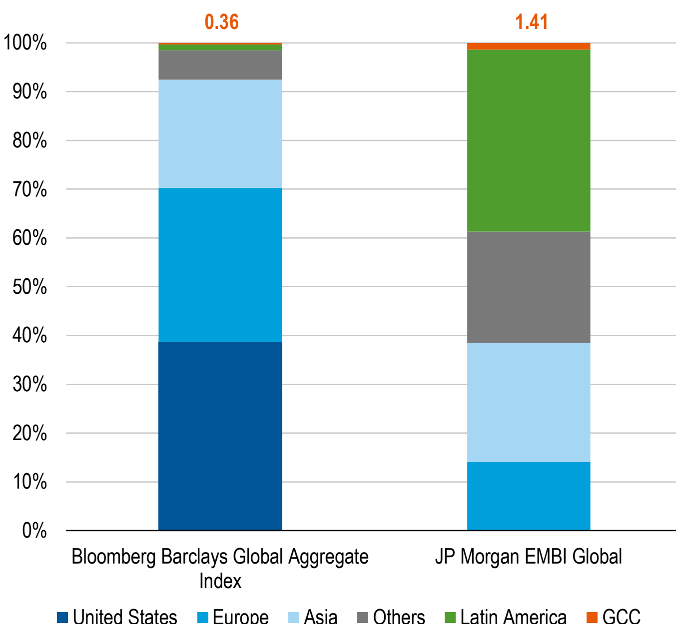
GCC Fixed Income Is an Overlooked Asset Class

We consider GCC fixed income to be a growing asset class with characteristics of both emerging and developed markets, and an area which many—if not most—global investors underappreciate.

Firstly, GCC bonds are not included in most major benchmark indices, or have negligible representation in them. In the chart below, the region has only a 0.4% allocation in the Bloomberg Barclays Global Aggregate Index, and a 1.4% allocation within the JP Morgan EMBI Global.[6, 7]

GCC Representation in Global Indices

As at 30 September 2017



Source: FactSet. The Bloomberg Barclays Global Aggregate Index measures global investment-grade debt from 24 local currency markets and includes treasury, government-related, corporate and securitised fixed-rate bonds from both developed- and emerging-market issuers. The JP Morgan Emerging Market Bond Index (EMBI) Global is an index of US dollar-denominated sovereign bonds issued by emerging-market countries. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future performance.**

The GCC's negligible representation in these benchmarks is due in part to the backward-looking nature of index construction, which is based on historical debt-issuance trends. Over the past several decades, developed-market countries such as the United States, Japan and some European countries have increased leverage and issued vast stocks of debt amidst a steadily decreasing global interest-rate environment.

In contrast, GCC countries have self-financed government expenditures in recent decades while simultaneously building sizeable financial reserves—thanks to large oil-export revenues.

Looking ahead, we believe we are at an inflection point which has accelerated since 2014, when oil prices faced a steep decline. GCC governments have wisely recognised the unsustainable nature of their economies in the long term due to their young and fast-growing populations, as well as the inefficiencies built up over years of bloated bureaucracies and dominating public sectors. This recognition is causing an increase in investment spending to transition GCC economies away from oil and towards service sectors that are faster-growing and better-positioned for long-term growth. These include technology, health care and tourism.

Investment spending to boost the growth of non-oil economies and the partial retention of historical fiscal largess in the form of subsidies and other benefits have come at a cost, however. GCC countries are now operating with growing deficits. These deficits, which we believe are likely to remain for the medium term, can be financed either via liquidation of large asset reserves built up over recent decades, or via debt issuance. While it is likely that a mix of these two approaches will likely finance government deficit spending going forward, it is our view that GCC debt issuance could rise, making it an increasingly important part of the global fixed income universe for many bond investors. This is one of the reasons why we believe demand will remain strong in a low-return world, and that there is a capacity for many investors to absorb significantly more GCC debt.

GCC Fixed Income Is Becoming an Increasingly Important Component of the Investable Universe

There may be a few reasons for investors' under-allocation towards the GCC region.

Firstly, GCC bonds appear to suffer from a lack of active managers who have "boots on the ground." And without that on-the-ground research, it could be a difficult market for a non-local investor base to understand. Secondly, many investors assume the GCC is susceptible to headline risk and oil price volatility, despite the counterintuitive reality that GCC bonds have very low correlations to the price of oil, as an example.

Therefore, the assumption that active investment managers (even in the emerging-market space) provide significant exposure to the GCC is not a correct one. And this under-allocation limits investors' potential to achieve alpha.

The GCC Is an Attractive Bond Market Benefitting from Solid Fundamentals

In summary, we believe the GCC bond market is an attractive asset class for a number of reasons. The market's size alone is one representing some US$300 billion.[8] In addition, there's been a healthy level of issuance growth that has picked up over the last few years amidst the lower oil price environment. The GCC region also benefits from credit fundamentals such as sizeable pools of reserve assets, relatively low debt to GDP, and a well-capitalised and committed investor base.

Moreover, GCC bonds generally benefit from strong credit ratings. Even amidst the new lower oil-price environment (which prompted rating actions on the weaker sovereign credits, namely Bahrain and Oman), the region continues to retain an attractive and high investment-grade average rating and further downgrades appear limited, in our view. In a fixed income environment where potential downgrades are at historic highs, we believe the GCC, with almost US$3 trillion in foreign exchange reserves (representing approximately 200% of the region's GDP),[9] is more insulated than the rest of the global credit universe.

And lastly, GCC bonds have proven relatively stable amidst geopolitical uncertainties. Dedicated domestic demand for GCC bonds remained resilient even during downside scenarios. Therefore, amidst the geopolitical tension we could face in the coming year, we think GCC fixed income could be an increasingly attractive asset class for many investors moving forward.

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1. Duration is a measurement of a bond's sensitivity to interest-rate movements.
2. Source: Bloomberg LP. Data from January 2017 to November 2017.
3. Alpha is a risk-adjusted measure of the value that an active portfolio manager adds to or subtracts from a portfolio's return.
4. Diversification does not guarantee profit or protect against risk of loss.
5. The Gulf Cooperation Council is an alliance between six Middle Eastern countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates (UAE).
6. The Bloomberg Barclays Global Aggregate Index measures global investment-grade debt from 24 local currency markets and includes treasury, government-related, corporate and securitised fixed-rate bonds from both developed- and emerging-market issuers. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
7. The JP Morgan Emerging Market Bond Index (EMBI) Global is an index of US dollar-denominated sovereign bonds issued by emerging-market countries. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
8. Source: Bloomberg, as at 30 September 2017.
9. Source: International Monetary Fund World Economic Outlook, April 2017, Sovereign Wealth Fund Institute.

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