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 August 2018.***

Cutting through the Noise: Trump, Trade and Twitter: In 2018, US President Donald Trump's tweets on international trade have led to bouts of market volatility and concerns of a global economic slowdown. Against this backdrop, Franklin Templeton Multi-Asset Solutions' Matthias Hoppe explains why he thinks economic fundamentals will determine the fate of the global economy more than Trump's words will.

Shining the Spotlight on Domestic Mid-Cap Stocks, Despite Brexit Uncertainty: Appetite for UK mid-capitalisation stocks has suffered as investors try to digest the impact of various Brexit scenarios. However, Franklin UK Equity Team's Paul Spencer thinks uncertainty about the UK's future could present opportunities for long-term investors through the widening valuation gap between UK stocks and overseas shares. He highlights some potential drivers behind UK mid-cap stocks.

Why We Think the US Bull Market Could Keep Running Into 2019: Now that the US equity bull market has officially hit the history books as the longest on record, some observers are concerned it could soon stumble. Grant Bowers, vice president and portfolio manager, Franklin Equity Group, outlines why he thinks it could keep running into 2019.

Cutting Through the Noise: Trump, Trade and Twitter

Matthias Hoppe
Senior Vice President,
Portfolio Manager
Franklin Templeton Multi-Asset Solutions

Background

In recent months, US President Donald Trump has imposed import tariffs on long-standing US allies, including Canada, Mexico and the European Union (EU). He's also enacted tariffs on a growing list of products from China.

As the chart on the next page shows, the two US neighbours—and the EU—have been the largest US trading partners over the past 10 years.

Trump Tweets and the Stock Market Trembles

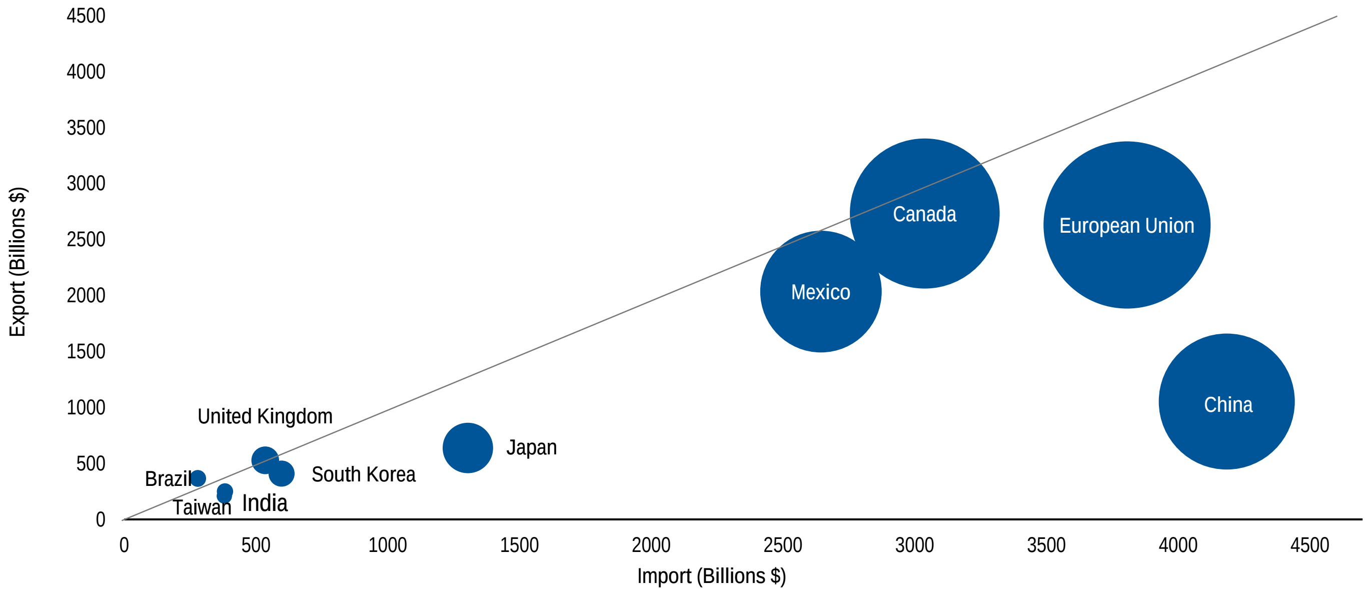
The communication channel for Trump's thinking on trade issues always seems to be the same: Twitter. The impact of his recurring threats to raise even more customs duties on even more goods from abroad are felt not just on stock markets but across the full gamut of financial markets.

As soon as Trump tweets about punitive tariffs, US stock indices often fall or rise, bond yields typically move, sometimes the US dollar depreciates or gains in value in one day. No wonder investors seem disorientated.

Despite the volume of headlines, Trump's Twitter pronouncements haven't done too much damage to global stock market performance overall this year—at least not yet. On the other hand, some emerging-market asset classes, particularly currencies, have been volatile as the world's second-largest economy—China—has responded with tit-for-tat tariffs.

Top US Trading Partners

US Major Trading Partners (USD)
2008–2017



Source: United States Census Bureau. Data as at 18 June 2018. Size of the series indicates the US total trade with the country from January 2008 until December 2017.

As the chart to the right shows, emerging-market currencies, as measured by the JP Morgan Emerging Markets Currency Index,[1] fell about 7% in the first half of 2018.

Why Trump Tweets Are Likely to Continue

In our view, the political noise related to trade and tariffs is likely to remain with us for the foreseeable future.

In the United States, mid-term elections take place in November. One-third of US senators and the entire House of Representatives are up for election.

For now, Republicans hold the majority in both houses of Congress. However, according to recent polls, Republicans are not necessarily assured of a renewed majority in November.[2] And so we expect Trump to remain motivated to mobilise his electoral base. Experience tells us he thinks that is best achieved through campaigns against foreign powers.

Additionally, his approval ratings have generally improved this year—although from a very low base.[3]

In our eyes, there is little evidence that his protectionist stance has contributed to the better opinion poll results. Rather, we think they stem from the United States' good economic situation. In the second quarter of 2018, US gross domestic product (GDP) grew at an annual rate of 4.1%, up from a growth rate of 2.2% for the previous quarter.[4]

However, we expect to see further barrages of tweets on punitive tariffs and security policy.

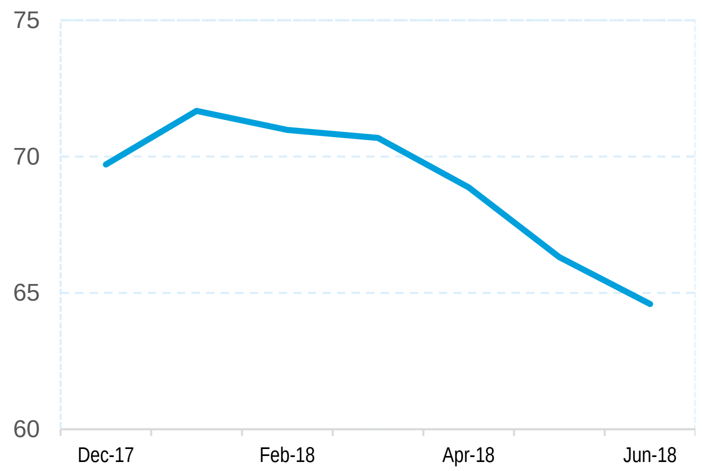
Investment Implications

Could Trump's words have a long-term impact on global stock markets? At the moment, the leading economic indicators, especially in the United States, continue to point to robust growth.

At the end of the day, we think economic fundamentals, rather than Twitter pronouncements, will decide.

JP Morgan Emerging Markets Currency Index

Monthly Data
December 2017–June 2018



Sources: Bloomberg; JP Morgan Currency Index, as at 30 June 2018. Indices 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.

If the economy continues to grow, we believe that should be positive for risk asset classes like equities. The question is how long the rally in the ageing equity bull market can go on.

Already we're starting to see signs of softer capital expenditure (CapEx) plans. That's a marked difference from the beginning of the year, when indicators suggested firms were more bullish on investment.

Consumer confidence is another important measure and, while slipping recently, remains high. The US job market is still buzzing and the collective consumer mood seems to be correspondingly positive.

But how long can a strong US labour market cover the burgeoning problems of slowing world trade? Sentiment can turn quickly and that could in time also likely impact the fundamentals.

Stock markets, which we consider to be the leading indicator par excellence, could price in relatively weaker growth relatively quickly, especially if they see world trade numbers deteriorate. Initial reports are already showing a slowdown in imports and exports. International trade is particularly important for Europe and the emerging markets, not only for general economic growth but also for corporate profits.

We believe Trump should want to balance political gain and economic disadvantage. At first glance, the potential costs of a trade war with China are significantly higher than those with the EU, because the integration of supply chains between the United States and China is far-reaching.

Trade with Europe is more likely to consist of finished products, most notably automobiles. However, the current account between the United States and the EU is balanced. While the trade balance in goods is negative as the EU ran a surplus of US$153 billion with the United States, in services, by contrast, the United States posted a surplus of US$51 billion.[5]

In addition, the United States ran a surplus in so-called primary income, which mainly consists of corporate profits made by EU subsidiaries of US companies, of US$106 billion.[6] This might explain Trump's relatively conciliatory tone after the meeting with European Commission (EC) President Jean-Claude Juncker on 25 July.

In contrast, the US overall current account deficit with China is indeed imbalanced as it totalled US$358 billion in 2017—thanks to the fact that China has long since restricted investments by foreign companies.[7] Our expectation, therefore, is that the rhetoric towards China should weaken somewhat after the November US elections—especially if the Republicans do well.

The pressure on its European allies seems to have softened already after Trump's meeting with Juncker. We might see negotiations with the EC on lower tariffs. That would allow Trump to show his constituents that he is achieving results.

All this, however, is speculation. And so investors should not be too impressed by the political noise. Much more important, we think, are any signals that might prompt uncertainty in the economy.

At the moment, sentiment indicators from the US and Europe do not appear to show any dire warning signs. We'd expect sound growth is likely for the rest of this year and well into 2019.[8] But today more than ever since the end of the financial crisis of 2007/2008, we think it is advisable to be a bit more cautious and not to take excessive portfolio risks.

Shining the Spotlight on Domestic Mid-Cap Stocks, Despite Brexit Uncertainty

Paul Spencer
Vice President,
Portfolio Manager
Franklin UK Equity Team

It's understandable that UK mid-capitalisation (mid-cap) stocks might have fallen out of favour with some investors, as Brexit creates the potential for heightened risks to economic growth and prosperity. However, we think it is prime time to dig a little deeper into some investment themes we've seen at play within the UK mid-cap market. Mid-cap stocks offer exposure to structurally expanding markets that we think could be insulated from wider economic uncertainties.

To this end, we have sought to gain domestic exposure in three themes that we believe should drive the mid-cap space: an older, wealthier UK population, the shortage in UK housing and the recovery in global industrial production.

- As the number of affluent UK pensioners rise, we expect to see increased demand for retirement living accommodation and aftercare, home emergency services, self-pay private hospital care and wealth-management solutions.
- Equally, there is undoubtedly a shortage of appropriate housing in the United Kingdom, which we think could benefit areas that are likely to provide long-term support to rectify the state of the housing sector. A combination of robust homeowner demand, a competitive mortgage market and supportive government policy should provide longer-term support to those involved in residential construction, including housebuilders, building-material manufacturers and merchants.

- Lastly, we think exposure to overseas markets is unlikely to provide a panacea to all investment uncertainties, especially given the potential negative impact of protectionism on free trade. That said, we still look favourably on companies exposed to rising global industrial production as we've seen some recovery in this sector. This includes companies involved in manufacturing engineering, electrical and electronic components with a geographical bias towards the United States.

That said, mid-cap stocks in many international markets have become too expensive to justify, in our view. However, we do see areas in the domestic mid-cap space that have potential for long-term value. Which is why we look more favourably on stocks with a domestic bias.

According to our research, roughly 55% of FTSE 250 Index operating profits are derived from the United Kingdom, so the index is more exposed to the prosperity of the domestic economy than the more internationally biased FTSE 100 Index.[9] This reflects mid-cap exposure to sectors such as retailers, travel and leisure, transport, construction and real estate.

With that in mind, we look less favourably on areas that are particularly reliant on domestic discretionary consumer spending. Many companies involved in these sectors face structural and macro-related pressure from weaker sales growth, rising costs and changing consumer spending patterns.

Taking the Contrarian Route

As active managers, we're convinced that investing in companies that trade significantly below their intrinsic value is the route to sustained, long-term investment opportunities. So, at times, this may involve taking a contrarian stance with shares which appear deeply out of favour. Equally, it means avoiding companies where the valuation seems to be detached from reality—or as we saw in a broker note recently, that "shares are reassuringly expensive."

And, as the legendary Sir John Templeton once said: "To buy when others are despondently selling and to sell when others are avidly buying requires the greatest of fortitude and pays the greatest ultimate rewards." While we haven't seen enough evidence to be hugely optimistic on the UK's economic outlook, we do see reasons to consider focusing our attentions on domestic mid-cap stocks.

Why We Think the US Bull Market Could Keep Running Into 2019

Grant Bowers
Vice President
Portfolio Manager
Franklin Equity Group

We have seen volatility return to the equity markets this year after an unusually calm 2017. The synchronised global growth environment that prevailed for the last two years has started to show some cracks, with many global markets seeing growth moderate.

The United States is bucking the trend when it comes to growth.

US GDP growth has accelerated in 2018, hitting 4.1% in the second quarter. This is the fastest rate in nearly four years. This rate of growth is impressive, but the combination of tax cuts and increased federal spending may have pulled some of this growth forward into 2018, meaning it may be hard to replicate in the future.

Two Main Pillars of the US Economy Appear Solid

Even with policy changes that may have accelerated growth, when we look deeper at the foundation of the US economy—the consumer and corporate earnings—we see a healthy backdrop. These two pillars have both been performing well and are not showing signs of stress that we would consider indicative of the economic cycle nearing a negative inflection point or recession.

The US consumer continues to benefit from a very strong employment market, continued low inflation and low interest rates by historical standards. This is keeping consumer confidence (and consumer spending) healthy despite moderating global growth and increasing trade concerns.

On the corporate side, earnings for companies in the S&P 500 Index were up more than 20% (year-over-year) in the second quarter of 2018.[10] While lower corporate tax rates provided a lift, the resulting higher profits will likely drive increased capital spending. In our view, this should add life to the ageing economic expansion as profits are reinvested and the CapEx cycle drives improved productivity. For many companies, we think these benefits could last well into 2019 or 2020.

Bull Markets Don't Die of Old Age Alone

There's been a lot of discussion about the duration of this current US equity bull market. While we don't expect markets to keep climbing forever without corrections, history has shown us that bull markets don't generally die of old age alone. Historical triggers that typically have heralded the end of a bull market have included rapidly rising inflation or interest rates, the buildup of speculative excesses or bubbles, or a geopolitical shock that impacts demand. Above all, economic recessions usually mark the death-knell for bull markets.

The current US economic expansion has certainly been long by historical standards, but investors should remember it has also been very shallow and slow compared to past periods of economic expansion. This slower rate of growth is a result of the severity of the global financial crisis a decade ago, but also the low-inflation, low-interest-rate environment that followed. Given the modest rate of growth in the nine years post-crisis, it is not surprising to us that the recovery has lasted longer than many expected and has not generated levels of excess that typically begin to appear this late in the cycle. At this time, we don't see any of the classic signs the economic cycle is turning, or that a recession is on the horizon.

At the macroeconomic level, we are watching trends in inflation, interest rates, employment and credit-default levels for signs of change. As bottom-up investors, we are also constantly talking to individual company management teams to get an assessment of end-market demand, global competition and the health of their customers.

We still think the US economy is strong and equities have the potential to do well in the coming years. That said, preparing for an economic downturn or market pullback is something that is done over time, as we build our portfolios stock-by-stock. Our rigorous, fundamental research focuses on companies that are not just growth businesses, but also those which meet our quality criteria. We seek to invest in companies with strong competitive positions, solid financials and innovative management teams. We believe these types of high-quality companies can outperform the market over the economic cycle and are more likely to prove structural winners over time.

The Big Three Risks: Trade, Inflation, Interest Rates

Tariffs and trade restrictions continue to be in the news and probably are the biggest uncertainty for the markets right now—with potentially significant impact on economic growth. We are watching these developments cautiously and constantly working to understand the potential exposure of the companies we invest in.

Not to diminish the risk, but we think trade tensions should be viewed through the lens of American politics: A trade dispute or tariff threat may be more of a means to an end of scoring political points with a targetted set of voters. We see a low risk of an all-out trade war, or a serious erosion of the trade regime that has underpinned the rise in global prosperity since the end of World War II.

The second challenge is inflation. As US economic growth has accelerated this year, we are seeing a modest pickup in inflation, and the US Federal Reserve (Fed) seems to have grown more hawkish as a result. The market appears comfortable with the current pace of interest-rate increases given the country's economic strength, but there are concerns the Fed could overshoot its targets, especially if growth moderates in 2019.

The last challenge is more political—the US midterm elections. Elections always bring some uncertainty and volatility as the market reacts to a potential change in the political and regulatory landscape. The mid-term elections in the United States get a lot of press, but, in our view, a change to a more divided Congress wouldn't likely have a huge fundamental impact on the economy or broad investment landscape. The pro-business, less-restrictive regulatory backdrop that started in late 2016 would likely continue. We would just have more gridlock in Washington, which, ironically, could actually be good for the markets, as markets don't like uncertainty.

Pocket of Rich Valuations, but Tech Bubble Comparisons Irrational

The S&P 500 Index currently trades at about 16.5x next year's earnings, which is right about at the five-year average and modestly above the 10-year average, which covers the depths of the financial crisis.[11]

Valuations have moderated in 2018, and the US market is cheaper on a price-to-earnings (P/E) basis than it was at the end of 2017.[12] The rapid earnings growth we have seen in 2018 partly explains why that's the case, but the moderation in valuations is also a reflection of the increase in risks being priced into the market.

Overall, valuations for the US equity market appear fair to us at current levels, reflecting the strong economy and the bright corporate earnings backdrop balanced against the risks of trade and rising interest rates.

Looking at valuations in the technology sector in particular, there are some pockets of rich valuations that grab headlines. But when looking broadly across technology stocks, they are trading at a slight P/E premium to the overall market, about 18.6 vs. 16.5x for the S&P 500.[13]

We see the technology sector premium as well deserved, given that technology companies have delivered the best growth over the past three years and should be able to continue to see strong growth in the coming years. Additionally, from a quality standpoint, the technology sector has some of the highest margins and best balance sheets in the market, according to our research.[14]

It is also worth noting the technology sector has changed dramatically over the past 20 years. In our view, comparisons to the late 1990s "Tech Bubble" are not rational. Tech companies today have been highly profitable and are much less levered. Revenue is less economically sensitive and more focused on software and services, which have the potential to bring recurring revenue that would likely be more stable in an economic downturn.

Growth and Value Investing: Is the Tide Turning?

"Growth" has outperformed "Value" as an investment style since the end of the financial crisis.[15] The market has rewarded companies that can produce consistent earnings and cash-flow growth in what has been until recently a modest GDP-growth environment. The low-interest-rate backdrop has created an additional tailwind for growth equities where investors are often looking out 3–5 years at a company's growth potential and discounting those profits back to measure a company's fair value today.

In recent months, we have seen performance of value stocks improve, coinciding with the acceleration of economic growth in the first half of the year and the rise in short-term interest rates.

Despite this near-term "Value" outperformance, I think many traditional value industries are facing significant competitive challenges from faster-moving competitors or new well-funded entrants. When we look across the investment landscape, we see the pace of disruption is accelerating and many traditional value industries face rapidly changing competitive environments. In my view, much of this risk is not captured simply by a low valuation multiple, and some investors may risk falling into a trap.

Some examples of old line, traditional value industries that are facing new competitive challenges include the transportation sector, where cheaper and faster competitors are rethinking how we move people and goods, and the retail sector, where online competition is driving prices down for consumers and in turn limiting pricing power for traditional brick-and-mortar retailers.

In the industrials sector, we are seeing companies embrace digital transformation and the use of data analytics. Robotics and artificial intelligence are shifting long-held cost advantages.

The question is not whether value stocks will have periods of outperformance or not—they absolutely will. Rather, the question is whether that outperformance is sustainable in a world where many industries are being disrupted at an increasingly rapid pace.

In my view, investors should not be debating "Growth" versus "Value," but really focusing on sustainability and quality (growth or value) for long-term investments in a diversified portfolio.

What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. 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 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 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. Investing in fast-growing industries, including the technology sector (which has historically been volatile) could result in increased price fluctuation, especially over the short-term, due to the rapid pace of product change and development and changes in government regulation of companies emphasizing scientific or technological advancement. Value securities may not increase in price as anticipated or may decline further in value. Growth stock prices reflect projections of future earnings or revenues, and can, therefore, fall dramatically if the company fails to meet those projections.

1. Sources: Bloomberg; JP Morgan Currency Index, as at 30 June 2018. Indices 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.**
2. Source: Bloomberg, "Here's What's at Stake for Trump in the Midterms," 19 July 2018.
3. Source: FiveThirtyEight.com, "How popular is Donald Trump," 31 July 2018.
4. Source: US Commerce Department, Bureau of Economic Analysis, 27 July 2018.
5. Sources: US Commerce Department, Bureau of Economic Analysis; CESifo Group Munich, "EconPol Policy Report: On the EU-US Current Account," July 2018.
6. Source: Ibid.
7. Source: US Commerce Department.
8. There is no assurance that any projection, estimate or forecast will be realised.
9. The FTSE 100 is a capitalisation-weighted index of the 100 largest companies listed on the London Stock Exchange. The FTSE 250 is a capitalisation-weighted index of the 101st to the 350th largest companies listed on the London Stock Exchange. Indices are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges. **Past performance is not an indicator or guarantee of future results.**
10. Source: FactSet Earnings Insight, as at 10 August 2018.
11. Source: FactSet, as at 17 August 2018.
12. Ibid.
13. Source: Factset, as at 17 August 2018. Technology sector as represented by the S&P 500 Technology Sector Index. Indexes are unmanaged and one cannot invest in them. They do not include fees, expenses or sales charges. The price-to-earnings (P/E) ratio is a valuation multiple defined as market price per share divided by annual earnings per share (EPS).
14. Source: FactSet, based on three years through 23 August 2018.
15. Source: FTSE. Calculation period 31 December 1988 through 1 January 2018. Growth stocks represented by the FTSE Russell 1000 Growth Index. Value stocks represented by the FTSE Russell 1000 Value Index. Indices are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges. **Past performance is not an indicator or guarantee of future performance.**

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