FRANKLIN TEMPLETON INVESTMENTS

Investment Team Update

17 October 2018

Notes on Global Equity Markets

PERSPECTIVE FROM THE TEMPLETON GLOBAL EQUITY GROUP

EXECUTIVE SUMMARY

- **Market Review:** Market conditions were mixed during the quarter, with the US market leading global indices higher.
- **United States:** Corporate earnings benefited from fiscal stimulus, which led to strong returns in the US market.
- **Europe:** Ongoing Brexit drama and concerns about Italy and Turkey negatively impacted performance.
- **Emerging Markets:** Volatility and weakness in select emerging market countries caused the asset class to underperform.
- **Health Care:** Attractive valuations, robust fundamentals and low trade-war risk (given the domestic nature of supply chains) should appeal to investors in a late-cycle environment of increasing uncertainty.
- **Information Technology:** More cyclical segments were hurt by macro uncertainty; semiconductors and electrical equipment lagged while software and IT services outperformed.
- **Energy:** The sector has performed well as steady growth in demand combined with reduced supply have caused oil prices to rebound.
- **European Financials:** Weakness was driven by European economic and political concerns.
- **Outlook:** Rising interest rates, a steepening yield curve and reasonable global growth are all positive signs for value investors.

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Market Review

The market focused on a few macro risks that seemed to escalate during the quarter: trade wars, Brexit negotiations, the Italian budget, emerging market volatility and interest rates. And it wasn't all risks. The market was also focused on recent strength in the US economy, S&P 500 earnings and until recently, the leadership of US tech. We continued to see volatility and weakness in emerging markets, which were much weaker than developed markets. The euphoria around the US gross domestic product (GDP) growth in the second quarter—which came in at a record 7.6%—turned into concerns about how long this macroeconomic expansion could continue and importantly, the pace of Federal Reserve Board (Fed) interest rate hikes. Markets were led by the strength in the US, a pattern we have seen in most of the last few years and that resulted in a widening valuation gap between the mostly fully valued US market and the rest of the world.

Brexit/United Kingdom

Brexit presents a risk that is hard to analyze, so our strategy has been to focus on UK-domiciled multinationals that source most of their revenue abroad. We also favor companies that are defensive in nature and less likely to be impacted by an economic slowdown.

United States

The valuation gap between the US and the rest world has widened. We believe it implies a much more favorable backdrop for long-term returns outside the US. Expectations are not only lower, but the economic cycles are lagging behind the US. We have been of the view that Europe is anywhere between 18 and 24 months behind the United States in terms of its economic outlook, and so some of the trends we have seen in the US—maybe not quite as extreme—could eventually start to make their way around the world. So we do think there is an opportunity to close the valuation gap in coming years and close the performance gap. Many of the individual companies we analyze are reporting margins that look to us, based on our analysis, very close to peak levels, and tax rates are currently at levels we haven't seen in decades. This makes it a bit more difficult to assume improvement in some of the US companies. So while we are able to find some individual bargains in the US, we find greater value in Europe.

European Financials

We have been positive on European financials, particularly the banking space, for the last few years. After strong performance in 2016-2017, the performance of European banks was weak in recent quarters, along with the European market in general. It seems that when macro risk is heightened, the easy thing to do is to sell the financials, to sell the banks, without really considering the fundamentals. The profit results for 2017 and the first half of 2018 have been solid. We have seen strong lending growth overall. Interest income hasn't grown as fast, but loan loss was better than expected. The balance sheets for the banks are stronger and the bulk of the destabilizing post-crisis re-regulation efforts is now also complete. Looking ahead, a gradual, less accommodative stance by the European Central Bank should be positive for bank earnings. With the recent pullback, the sector looks undervalued again. Despite all these improvements, valuations remain compelling.

Emerging Markets

Emerging markets have been hit by a series of headwinds including a stronger dollar, lower liquidity due to rising interest rates in the US and the uncertainty surrounding trade. China's attempts at deleveraging have also hurt emerging markets. Keep in mind that, in 2017, emerging markets delivered some of their best returns since 2009. So we're not totally surprised to see some of those gains given back. Emerging market valuations have declined a long way from their recent peak, but are still above average in recent years, and the decline merely brings them back to long-term historical averages.

The sell-off in emerging markets has not been indiscriminate. In general, the countries that run both a fiscal and current account deficit and have a high level of US-dollar debt have seen more weakness than countries with relatively healthy external positions or those willing to make policy changes to reduce imbalances. We continue to be constructive on some Asian emerging markets such as China, Thailand, South Korea and Taiwan, where the fiscal and current accounts are in good shape.

China

China is trying to pivot away from an economy driven by fixed asset investment to one that is more balanced, with a lower reliance on exports and a higher component of consumption. Trade wars have introduced an element of uncertainty in the region and are causing a delay in investment decisions. This will have an impact on the profit outlook for the more cyclical or industrial companies, and this is consistent with the opportunity set we are finding among "defensive growth" stocks.

Japan

Due to Prime Minister Abe's economic policies, the Japanese yen has weakened, nominal GDP has grown, unemployment has declined and the average return on equity of the stock market has increased. However, overall returns on equity (ROE) are still low relative to many other markets, and this is reflected in the relatively low multiples that investors pay on book value. Why are ROEs so low? We believe this boils down to corporate governance and corporate culture. Having gone through the boom and bust cycle of the 1990s property bubble, many corporates developed a fear of leverage. In fact, they have gone to the other extreme, with Japanese firms collectively holding the equivalent of about US$1 trillion in cash on their balance sheets. One way to reduce this drag on returns on equity would be to reduce this cash hoard by either paying higher dividends or by buying back shares, but, unfortunately, the incentives of Japanese CEOs are not aligned with shareholders in that way. Corporate Japan has scope to improve returns, but this will be on a case-by-case basis as some companies will still be late to reform.

Health Care

From a bottom-up standpoint, the companies that we hold—and across the industry—reported relatively solid earnings. Free cash flow has been strong, and dividends remained solid, and in some cases they are increasing. At the same time, some of the pricing rhetoric coming out of Washington that had scared the market has not worsened, and it appears manageable for the industry. Remember that the companies and the industry itself has been adapting for several years now to fairly severe pricing declines in several, categories. The pricing rhetoric around mid-term elections isn't anything the industry has not seen before, and more importantly, it's not worse. So when we look at what we hold, we maintain discipline and believe the current fear in the market is an opportunity that has continued to create value.

Energy

It is more difficult to find value in the sector now than it was two years ago, when oil was $30 per barrel—sentiment was extremely pessimistic then. Today, a lot of energy stocks have re-rated. As oil prices moved up, we have found value in large integrated energy firms. These stocks have responded well to rising oil prices, but have not discounted anywhere close to current oil prices. So we still see good value in these integrated oils where they are very focused on returns over growth and being capital-disciplined. As oil prices have risen, cost and capital expenditures have stayed flat, and they have generated significant free cash flow to pay dividends and return to shareholders. They will generate more free cash flow this year than they did when oil was at $100 per barrel. This is expected to improve as new production comes online with a lower cash breakeven level. The cash will allow them to pay dividends and buy back stocks, pay down debt and make targeted mergers and acquisitions. So compared to higher beta service and E&P (exploration and production) companies, integrated energy firms have lower oil-price sensitivity. Given where we are in the cycle, we feel integrated energy firms are the right place to be, although we are also watching the service space, given how much it has underperformed.

Information Technology (IT)

IT was a top performer in the quarter, although it was skewed heavily to the US. And if you look beneath the covers a bit, there is a crack in the armor of the industry. The more cyclical segments were hurt by some of the macro uncertainty we have already touched upon, so semiconductors and electrical equipment lagged while software and IT services outperformed. We continue to find value in software stocks that we believe have long-term potential as their businesses transition over the next three to five years. We also have some semiconductor companies with long-term structural growth potential and a smattering of undervalued hardware stocks around the world in Asia and the US.

Communication Services: Telecommunications

Risk/reward for the telecom industry has become more compelling. As of quarter end, the price/earnings ratio for the industry relative to the broader market was at near its cheapest level in a decade. It has nearly twice the dividend yield and the free cash flow yield compared to the market. Broadly, we think a lot of the negatives are well discounted and the market has overlooked the countercyclical or defensive quality of the sector. Having said that, we are selective in what we hold. Our preference is tilted toward markets that have better growth and improving market structure and companies with strong balance sheets.

Value

On the global side, value continued to underperform growth in the quarter – the seventh consecutive quarter. Having said that, the underperformance of value, which is 950 basis points for the trailing year, only underperformed in the quarter by 40 basis points. And in turn, on the non-US side, value actually outperformed growth for the first time in seven quarters by 205 basis points.

In the aftermath of the global financial crisis, central banks aggressively and artificially depressed interest rates globally in an attempt to work through the bursting of the debt bubble. So the combination of low to, in some cases, negative rates combined with a weak economic recovery placed a tremendous premium in investors' minds on companies able to demonstrate sustained above-GDP levels of earnings growth, regardless of the valuation. The macro environment of low growth and low interest rates has been a tremendous headwind for value investors. If history holds, as rates start to go back up, we believe unsustainable business models will disappear and valuations will more fully reflect future earnings prospects.

In our view, conditions that are historically associated with the refocus on valuations and a more favorable environment for value investing are starting to fall into place. Typically, value stocks do well when interest rates are increasing, the yield curve is steepening and global growth is positive, and the global economy is in pretty good shape right now. Outside of the US, value started to show signs of life in the third quarter and showed positive performance relative to growth. So far, in October with the extreme volatility we have had so far, both international and global value have performed better relative to growth during these dislocations. So we would just remind everyone that in the short term, valuation tends to be uncorrelated to short-term returns, but over the long-term we believe it's the best driver of performance. Rising interest rates, the yield curve starting to steepen and global growth remaining at a reasonable pace are all positive signs for a turn in value investing.

Outlook

Of all the different macroeconomic and political factors that have been on investors' minds over the last few months, we think interest rates are likely to be the most important. As we continue to see central banks reduce quantitative easing and move toward interest-rate normalization in the major regions of the world, we are going to continue to focus on the dislocations that this may cause on currencies, equity markets and valuations. On trade wars, it really is a focus on China, and we will continue to monitor this and assess the relative competitiveness on various industries with supply chains going back to China. While European politics are always likely to be messy, Brexit and Italian budget deficit proposals are the two immediate issues. Although these events may impact valuations in the short-term—in fact, they already have—as we move through these events, we believe the market is going to unlock the substantial value that we find in the region.

Sir John Templeton had a lot of sayings, and one of our favorites was, "To beat the index, you have to be positioned differently than the index," and sometimes that will lead to periods of underperformance. Some of the markets and sectors that have benefited the most from momentum and flows and whose valuations seem to be the most stretched have been the weakest in this correction. Perhaps this move to higher interest rates will trigger value's long-awaited outperformance.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. 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. To the extent a strategy focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a strategy that invests in a wider variety of countries, regions, industries, sectors or investments.

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