FRANKLIN TEMPLETON INVESTMENTS

Investment Team Update

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Notes on Global Equity Markets

PERSPECTIVE FROM THE TEMPLETON GLOBAL EQUITY GROUP

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EXECUTIVE SUMMARY

- **Market Review:** US equities outperformed everything else again, with the US only down 4.4% and the rest of the world, as represented by the MSCI All Country World Ex-US Index, down 13.8%. In global markets, only two sectors were positive for the year: health care and utilities.
- **Volatility:** Given the degree to which many markets corrected in 2018, we believe many risks are now adequately discounted in pockets of global equity markets. We are going to use the volatility we anticipate to continue to find and invest in attractive opportunities in today's markets.
- **United States:** Our analysis on a stock-by-stock level suggests the US market has been expensive for some time. The US has massively outperformed other regions over the last decade, and that outperformance accelerated last year.
- **Trade Wars:** US trade negotiations with China are currently in a 90-day reprieve that concludes at the end of February, and investors are hoping that, given economic pressures in China and the prospects of slowing growth in the US, both parties seek some sort of resolution to their differences.
- **Emerging Markets:** 2018 was a tough year for most emerging markets, which underperformed developed markets. But for us, it always comes down to a company's valuation, its potential upside and the risks around that, whether the company is in Tokyo or Taipei.
- **Brexit:** Whatever the outcome, Great Britain will remain plagued by uncertainty until this critical issue is resolved. We continue to look for value, but haven't found much in domestic UK companies. We do find value in large multinationals that have been derated by Brexit.
- **Europe:** European politics remain highly uncertain, but we believe some of the current issues should be resolved by mid-year. European equities have the lowest valuations of any major region (as of year-end), and companies continue to execute and grow earnings.
- **Value vs Growth:** Growth has outperformed value since the financial crisis because investors have been willing to pay a very high premium for visible and predictable earnings growth. We continue to believe expensive growth stocks are vulnerable to further interest rate normalization and a slowing global economy.
- **Energy:** Large global integrated oil companies offer high dividend yields that we believe are well-covered by improving capital discipline and growing cash flows. We are now starting to look more in earnest for new bargain ideas among the price-sensitive segments of the energy markets following their sharp correction.
- **Health Care:** Like consumer staples and utilities, demand for pharmaceuticals products and services is largely stable and predictable. Yet, unlike those two sectors, pharma is less of a simple bond proxy, offers defensiveness independent of rate fluctuations and has still-attractive valuations, in our view.
- **Outlook:** To best weather a volatile environment, we continue to remain focused on investing in companies with decent fundamentals, solid or improving balance sheets, quantifiable risks and trading at discounts that seem to largely—if not overtly—reflect all these factors.

Value Investing

The past five or six years have been very difficult for value investors. Primarily this was driven by the monetary environment that followed the global financial crisis. When you make the cost of money close to zero, fundamental valuations don't act as binding constraints in the way they would in a more normal environment, and, for that reason, value investing has been a very difficult place to be. We are now at the end of that cycle. The cost of money is going up, reflecting the fact that the financial system is now much more secure and the safety blanket that zero-cost of money provided is no longer necessary. This is starting to bring valuations into a much more normal position. And that explains a lot of the issues the Templeton group has faced over the past number of years.

Market Review

US stocks outperformed every other equity market again, with the US only down 4.4% and the rest of the world, as represented by the MSCI All Country World Ex-US Index, down 13.8%. In global markets, only two sectors were positive for the year: health care and utilities, both with small gains. Financials and materials were the worst-performing sectors for the year, down about 15% each. Importantly, what we have been calling the defensives – the bond proxies such as consumer staples, utilities and real estate – were the three strongest sectors in the fourth quarter and in all of 2018. As volatility spiked in the last few months of the year, the outperformance of these defensive sectors really benefited from a flight to quality, which was a major reversal from these sectors' underperformance over the prior four to five quarters.

Volatility

Volatility tends to rise with interest rates, and interest rates were definitely rising in 2018. Volatility spiked up from its historic lows of 2017, and we feel market swings were further exacerbated by rising political risks and signs of a slowing global economy, led by a slowdown in China and emerging markets and, to some degree, Europe. Volatility usually increases toward the end of a market cycle, and, after 10 years of economic expansion and equity market growth, we think investors should anticipate greater volatility going forward. But, volatility in and of itself shouldn't be feared by long-term investors, in our view. Instead, we believe it can offer good opportunities to exit fully valued holdings and add to those that are oversold. It also provides many with an opportunity to upgrade portfolios as investors continue to rightly focus on balance sheets. Given the degree to which many markets corrected in 2018, we believe many of these risks are now adequately discounted in pockets of global equity markets. We are going to use the anticipated volatility to continue finding and investing in attractive opportunities in today's markets.

United States

The US market has been tough for Templeton since the global financial crisis. We focus on valuations, and our analysis on a stock-by-stock level suggests the US market has been expensive for some time. Where does the US market go from here? The US has massively outperformed other regions over the last decade and that outperformance accelerated last year on earning tailwinds from corporate tax cuts, the repatriation holiday and many companies buying back their shares. Despite what may be recent signals from the Federal Reserve Board ("the Fed") of a pause in higher interest rates, the US cycle is maturing. Recall the US was the first major economy going into a recession at the start of the global financial crisis, and massive stimulus helped the US lead the way out. So on the one hand, this expansion has been the longest on record, but it's also been one of the weakest. And on the other, we are near full employment with low inflation, and the benefit of the Trump fiscal stimulus last year will have likely run its course.

Trade Wars

Over the past four decades, the opening up of various economies and the expansion of world trade has been a major contributor to global economic growth. The current trade war between the US and China, as well as other skirmishes between the US and its major trading partners, have added to uncertainty and exerted a drag on global growth. Currently, US tariffs have been imposed on $350 billion worth of Chinese exports, which has caused the Chinese economy to slow, and it also exerted a drag on its trading partners in emerging markets and Europe. The US economy has been the least impacted, but still, higher import tariffs are contributing somewhat to US inflation and have hit company margins and are being passed on to the US consumer. The US trade negotiations with China are currently in a 90-day reprieve that concludes at the end of February, and investors are hoping that, given economic pressures in China and the prospects of slowing growth in the US, both parties seek some sort of resolution to their differences at some point this year.

Emerging Markets

2018 was a tough year for most emerging markets, which underperformed developed markets. We look at emerging market holdings in the context of the company's valuation, macro risk and at the country level, including currency valuation. The expected change in Fed policy could be supportive of a softer dollar, which would be positive for emerging-market currencies, and economic growth differentials could favor emerging markets as we move into this year. But for us, it always comes down to a company's valuation, its potential upside and the risks around that, whether the company is in Tokyo or Taipei.

Brexit

Teresa May's Brexit deal suffered the largest defeat for any government in UK parliamentary history. She has, however, subsequently survived a vote of no-confidence. Throughout this extraordinary period, the British pound has strengthened recently, reflecting the growing prospect the UK will either opt for a soft Brexit, no Brexit at all or, possibly, that the British are granted some form of extension of Article 50. Our view remains that it's virtually impossible to predict the outcome of Brexit and that all outcomes—including no deal—have to be considered. Whatever the outcome, Great Britain will remain plagued by uncertainty until this critical issue is resolved. We continue to look for value, but haven't found much in domestic UK companies. We do find value in large multinationals de-rated by Brexit that we believe should not be unduly affected by any of these outcomes.

Europe

If we step back from all the political headlines, the selloff in European equities last year was more a function of sentiment than fundamentals. European stocks—especially the cyclicals—underperformed to an extent that's typically associated with contraction and recession. Although growth did slow through the course of last year, economic data remained firmly expansionary and GDP growth was positive.

Looking ahead, lead indicators in Europe may be bottoming out as the inventory cycle improves and euro strength fades. Moreover, Europe's economy is much more linked to the global economy and we see signs of Chinese stimulus and a potential pause in Fed normalization, and an even more dovish European Central Bank. These could all be positive for Europe.

European politics remain highly uncertain, but we believe some of the current issues should be resolved by mid-year. Europe has a long history of muddling through political crises after political crisis. In the meantime, European equities had the lowest valuations of any major region (as of year-end), and companies continue to execute and grow earnings.

Value vs Growth

Growth as a style has outperformed value since the financial crisis because investors have been willing to pay a very high premium for visible and predictable earnings growth. Growth stocks were trading at extremely high earnings and other valuation multiples in 2018 and recently have begun derating in earnest in response. We believe this is due to rising interest rates, slowing global growth and the heightened uncertainty associated with trade wars. We think value stocks have started to benefit a bit from the absence of further negatives. Value stocks continue to be priced at multiyear lows, and many of these are found outside the US market where risks have been absorbed by investors. We continue to believe expensive growth stocks are vulnerable to further interest rate normalization and ultimately, a maturing and slowing global economy. In our view, value stocks—particularly those outside the US—look well-positioned to relatively outperform during this period.

It's important to understand how we think about value, and it's quite different from what's commonly used in the industry and what's applied to create value benchmarks. The value benchmarks are backward looking, and compare today's stock price to historic fundamentals. We define value using a forward-looking framework and define value as stocks whose prices are lowest in relation to their intrinsic value. Now, intrinsic value has little to do with last year's earnings or book value, and instead looks at what we believe the fundamentals are going to look like in the future.

Energy

Oil prices fell during 2018 as OPEC [Organization of Petroleum Exporting Countries] and US producers increased production and Iranian exports did not fall as much as expected following the imposition of US sanctions. Essentially, global supply exceeded slowing global demand and oil prices fell accordingly. On December 7th [2018], OPEC agreed to cut production, which should help restore some balance to energy markets. We continue to be positioned defensively in the energy sector, having sold most of our oil-price sensitive holdings in 2017. Large global integrated oil companies offer high dividend yields that we believe are well-covered by improving capital discipline and growing cash flows. We are now starting to look more in earnest for new bargain ideas among the price-sensitive segments of the energy markets following their sharp correction.

Health Care

Health care was one of the best sectors last year, but recall that it was one of the worst performing sectors in 2017—and, in fact, underperformed for several years until last year. The sector had de-rated significantly on the back of several different concerns: consolidation of the PBM's (Pharmacy Benefit Managers), news of exorbitant drug price increases, the Trump administration and Congress looking to lower prices, and headlines of pharmaceutical companies initiating complex tax mitigation strategies. All these risks are still in place, but instead of focusing on those negative headlines, the market focused on what we have been seeing, which is a combination of defensiveness, growth and attractive valuations. We remain constructive on the sector. Like consumer staples and utilities, demand for pharmaceuticals products and services is largely stable and predictable. Yet, unlike those two sectors, pharma is less of a simple bond proxy, offers defensiveness independent of rate fluctuations and still has attractive valuations, in our view. We believe the sector also offers world-class innovation and untapped market potential.

Outlook

We believe the global economy should continue to grow modestly in 2019. Chinese growth could revive a little bit later in the year if its monetary and fiscal stimulus takes hold and, particularly, if trade tensions abate. European economies could improve if Chinese growth picks up, and importantly, if Italian, French and British political tensions begin to subside. The US economy should slow, and this would be due to the drag exerted by the government shutdown, current uncertainty over trade wars and ongoing political turmoil—and also as the one-off boost from tax cuts subsides. Still, if anything, this could encourage the Fed to pause its tightening, which should provide the US economy and global markets with a little bit of added relief. In our view, many of the headwinds of 2018 could abate or even reverse themselves somewhat in 2019 if the trade war with China lessens or is resolved, Brexit could be softened or maybe not happen at all, and interest rate increases could pause and other central banks choose to add a bit of liquidity to markets.

So any positives, we believe, would be well received by the markets given that so many negatives appeared to be fully reflected in stock valuations—particularly those outside the US market. The rest of the world performance could further be enhanced by any possible weakening of the US dollar, which is typically associated with a bit of growth picking up outside the US relative to that of the US market. However, we have to remember that 2019 will not be without risks. This has been one of the longest periods of economic and market expansion in history, which makes it vulnerable to rising inflation and interest rates and maturing and ultimately slowing economic growth.

Political risks remain high given the widening gap around the world between the very rich and the very poor. A retreat from globalization represents a major sea change for most economies. Extremely high government debt levels serve to heighten all these risks. So to best weather a volatile environment, we will continue to remain focused on investing in companies with decent fundamentals, solid or improving balance sheets, quantifiable risks and trading at discounts that seem to largely—if not overtly—reflect all these factors. On balance, our view is measured but constructive when we look out into 2019.

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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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