FRANKLIN TEMPLETON

Allocation Views

Perspective from Franklin Templeton Multi-Asset Solutions

FEBRUARY 2019

A Market-Led Fed or a Fed-Driven Market?

When we wrote about our Allocation Views last month, we highlighted ongoing uncertainties. We continued to point to shorter-term concerns that tempered our enthusiasm for stocks. But at the same time we recognized the longer-term return potential of such investments. We questioned the sequencing of further market pain, a potential US Federal Reserve (Fed) pause and the chance of a rebound, noting that it would require nimble management to navigate the challenges that 2019 looks set to present.

January brought both a pause by the Fed and a rebound in markets—both more categorical in nature than many had expected. Weakness in high-yield corporate bonds and other less liquid parts of the credit market was quickly reversed (see Exhibit 1). Having lowered our conviction in leveraged loans during the final months of last year, we remained constructive on credit more generally given the outlook for the business cycle remains favorable, though we are more cautious on investment-grade credit.

SHARP REBOUND IN SUBINVESTMENT-GRADE CREDIT

Exhibit 1: ICE BAML (US) High Yield Total Return Index
2 January 2018–31 January 2019

Source: Franklin Templeton Capital Market Insights Group, Bloomberg. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future performance.

However, our question on the sequencing of these events remains pertinent. How much further will clarification of the Fed's retooled reaction function drive markets? A return to long-run levels of market volatility, rather than the muted levels seen for much of the past 10 years, indicates that we have entered a new volatility regime. A rational desire to expand the "defensible space" within portfolios has seen many investors shift toward cash and higher-grade bonds and away from equities, especially from the riskier parts of the market. We continue to believe that a change of mind-set may be required as markets transition from a momentum-driven to a range-trading environment.

Slower Global Growth, but No Recession…Yet

The global economic outlook is more complex than has been the case for a long time. Cyclical indicators continue to show few signs of imbalances, and though the current expansion is moving into its latter stages, we do not expect a significant risk of imminent recession. However, growth momentum has slowed—a move most pronounced in the eurozone (see Exhibit 2) and China but which has been felt globally. This has driven the Fed to shift its stance to emphasize patience and a more data-dependent response function.

GLOBAL ECONOMIC GROWTH SLOWING, LED BY EUROPE

Exhibit 2: Markit Eurozone Purchasing Managers' Index
February 2016–January 2019

Source: Franklin Templeton Capital Market Insights Group, Bloomberg. Important data provider notices and terms available at www.franklintempletondatasources.com.

In such an environment, it is especially important to maintain a diversified portfolio. We believe the recent return to a market in which bonds and stocks deliver traditional diversification benefits is likely to persist, especially if this is a growth-driven, rather than an inflation-driven, environment.

The turbulence of the final quarter of 2018 and the rebound of stocks into the new year have highlighted the importance of understanding what is in your portfolio and having the ability to manage your allocation actively. It has also been a period when multi-factor smart-beta strategies have been able to show their worth.

This year is likely to be a period when it is particularly valuable to monitor factor exposures and concentrations within a portfolio and focus on naturally diversifying assets. Active management of the overall allocation mix of portfolios will also be key. For now, we hold a neutral mix of global stocks and global bonds.

Muted Inflation but Corporate Fundamentals Remain Strong

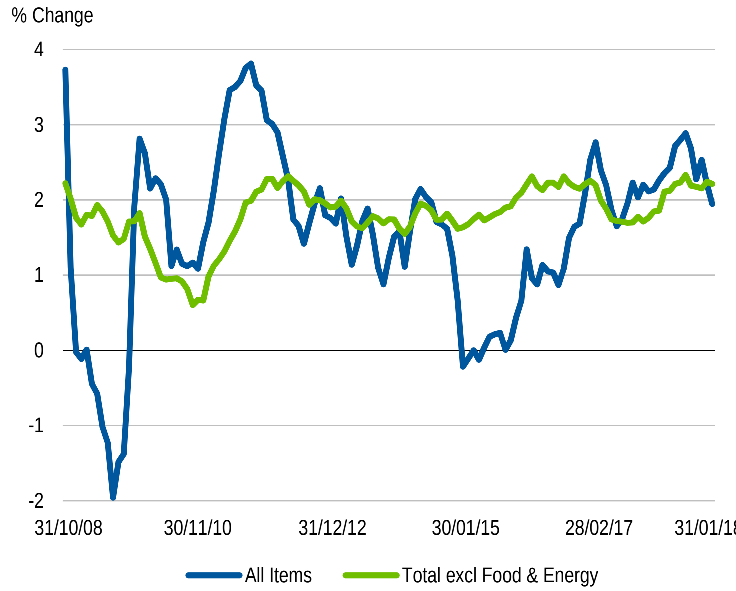
Corporate fundamentals remain strong despite the moderation in global growth. This is likely to help support the outlook for global equities generally. While labor markets are tight in many leading economies, wage growth appears to be picking up, to an extent, but the broad inflationary environment remains benign. This combination of factors may start to weigh on profit margins and is likely to slow the pace of earnings growth. To reflect this, we have trimmed our position in US stocks as part of a more defensive stance within global equities.

In addition, a lower oil price has fed into a decline in broad inflation, and core measures remain subdued (see Exhibit 3). As a result of our muted inflation outlook, we have lowered our conviction toward real assets such as commodities and inflation-linked bonds (Treasury Inflation-Protected Securities, or TIPS).

We remain positive on the longer-term growth potential of emerging markets. However, for much of the past year, these markets were held back by concerns over trade tensions, rate hikes from the Fed and an appreciating US dollar. This saw the currencies of many emerging markets remain under pressure. More recently, these headwinds have abated and the valuation attractions of emerging-market stocks have been able to shine through. We are increasingly comfortable in taking solace from the longer-term attractions of these markets. We have increased our conviction in both bonds and stocks in emerging markets.

CORE INFLATION REMAINS SUBDUED

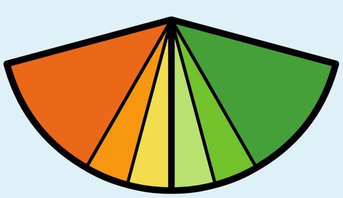
Exhibit 3: US Consumer Price Index (CPI) vs. Core CPI, Year-over-Year Change
October 2008–December 2018



Source: Franklin Templeton Capital Market Insights Group, FactSet, Bureau of Labor Statistics. Important data provider notices and terms available at www.franklintempletondatasources.com.

Pendulums explained

In Allocation settings, we are presenting a new graphical representation of our allocation views and the extent of conviction being expressed.



The central two segments of these pendulum charts both represent a neutral overall conviction toward the asset in question. We have split it into two segments to represent nuanced views. On the left, "reasons for concern, but not bearish" and on the right "reasons for optimism, but not bullish." These can indicate a direction of travel or underlying longer-term view. For truly neutral views, we highlight both segments.

Where we hold a stronger conviction, we "light-up" more of the segments, working out from the mid-line to the left or right respectively. Two segments for moderate conviction, all three for full conviction.

We show arrows (→) below the pendulum to show changes over the last month.

These images support a clearer representation of our views and are less prone to ambiguity about how strong a view is being shown.

We show our views in three allocation tiers—working down from a top tier that reflects "risk-on" or "risk-off." Secondly, the top-level allocation, equities, bonds, alternatives and cash along with the rationale for each position. In the third tier, we highlight global, regional or sector preferences, aiming to show those where we have a view. This last tier will evolve appropriately over time but is unlikely to have many neutral views.

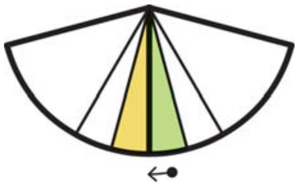
Allocation settings—February 2019

To better understand the graphical representation of our allocation views refer to the “Pendulums Explained” description on the previous page.

Asset Class | **Conviction** | **Our viewpoint**

RISK TIER

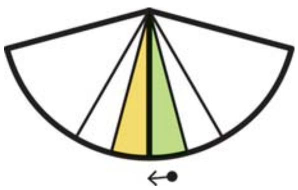
Risk Off/On



We anticipate continued global growth and muted inflation. With few imbalances, and remaining signs of a late-stage favorable cyclical environment, we are less likely to see extreme swings in output. Growth remains strong enough to support risk assets over a longer-term horizon. However, we have moved to a truly neutral view, reflecting the balance between reasons for optimism and market-driven concerns that we continue to monitor.

HIGH LEVEL ALLOCATION TIER

Equities

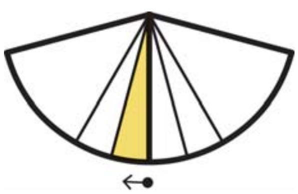


Global equities are still supported by corporate earnings and strong profit margins, although we are monitoring growth momentum and pressure on profit margins, given strong labor markets. Within a balanced view of equities, we are carefully monitoring the potential for continued market volatility.

Bonds

Ongoing global growth leads us to prefer lower exposure to government bonds and duration. Long-term valuations have remained expensive, reflecting low term premiums. The economic environment still remains more supportive of corporate bonds.

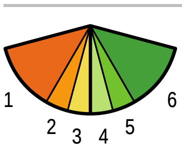
Alternatives



Our view of alternative assets reflects reasons for concern but is not bearish. The inflation that was feared, as the economic cycle entered its later stages, has not appeared. We see better prospects in naturally diversifying assets, rather than passing any comment on the level of inflation discounted in inflation-linked securities. We have reduced our conviction on real assets, including commodities.

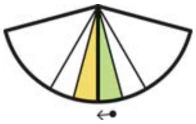
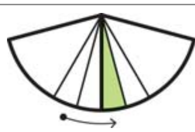
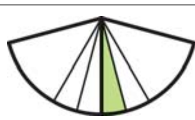
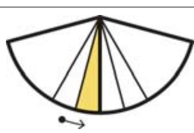
Cash

Cash yields have increased, with short-term US Treasury bill yields reflecting greater supply and progress toward monetary policy normalization. Cash is no longer a significant drag on portfolio yield, boosting its attractions to us generally.



These scores are on a scale of 1 to 6, with 3/4 being neutral. Arrows represent month over month change.
No arrow = no change from previous.

For Financial Professional Use Only. Not For Public Distribution.

Asset Class	Conviction	Our viewpoint
ALLOCATION TIER		
Equity Regions Developed		The constructive economic growth story in developed markets, led by the United States, remains intact despite a loss of momentum around the world. Corporate fundamentals are currently on par with historical norms, with above-average margins and return-on-equity ratios.
United States		Despite elevated geopolitical headlines and trade tensions, growth fundamentals continue to be positive, with tax reforms still providing a tailwind for earnings and margins. With increased volatility and lower valuations, the market's attention will focus on both corporate earnings growth and Fed policy moves.
Europe Ex UK		Economic activity has disappointed as declining global trade growth and domestic activity led to negative sentiment. With the European Central Bank not yet close to embarking on a rate-hiking cycle, we see the bank acting as a drag along with fears of populism ahead of European parliament elections.
United Kingdom		UK equity market uncertainty has been driven by domestic economic headwinds. Political tension and uncertainty over Brexit have dominated market sentiment. However, corporate profit remains high and from here, while we see reasons for concern, we are not bearish.
Japan		Equity valuations, particularly on a price-to-book value basis, have remained attractive to us relative to other markets. However, declining global growth and a late-cycle environment is typically poor for companies with higher operational leverage and for the Japanese market.
Canada		We see select opportunities within Canada, with earnings growth expectations providing room for positive surprises. However, Canadian banks remain burdened by the Fed pause and domestic housing concerns.
Emerging		Emerging markets have seen return on equity continue to rise and valuations are attractive to us relative to developed-market peers. Although the risk of an escalating trade war remains, headwinds from Fed policy normalization and a strong US dollar have abated. We have increased our conviction, reflecting the longer-term attractions of emerging markets.
Fixed Income Sectors US Treasuries		The Fed has shifted its stance, to emphasize patience and a more data-dependent response function. However, the economic backdrop remains positive and unemployment is at multi-decade lows, suggesting further hikes may still occur. We remain concerned about decreased support from global central banks through quantitative easing and supply-demand dynamics. We prefer short duration and exposure to Treasury bills for now.
Eurozone Government Bonds		Valuations appear full in the eurozone, where term premiums are the lowest among government bonds. However, with growth slowing, any rate hikes remain a distant prospect, supporting hedged yields to an extent.
High Yield		Valuations remain attractive to us, and the economic backdrop is supportive of riskier fixed income sectors such as high yield. We believe bank loans can be an attractive complement to high yield, given less sensitivity to interest rates, but are also vulnerable due to previous relaxation of covenants.
EM Debt		Improved sentiment in the asset class and valuations we view as attractive, particularly among hard-currency bonds. With continued fears over protectionism and geopolitics, selective positioning is important, in our view. Some countries are more exposed to any rise in the cost of capital. Exchange rate risks may hold back local-currency bonds.
Alternative Assets Inflation-linked Bonds		The expected inflation that was feared as the economic cycle entered its later stages has not appeared, and the level of inflation discounted in inflation-linked securities has fallen. However, with muted inflation risks we have lowered our conviction on assets that benefit directly from rising prices, such as inflation-linked bonds.

For Financial Professional Use Only. Not For Public Distribution.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. The positioning of a specific portfolio may differ from the information presented herein due to various factors, including, but not limited to, allocations from the core portfolio and specific investment objectives, guidelines, strategy and restrictions of a portfolio. There is no assurance any forecast, projection or estimate will be realized. 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 the 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, of which frontier markets are a subset, 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. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Derivatives, including currency management strategies, involve costs and can create economic leverage in a portfolio which may result in significant volatility and cause the portfolio to participate in losses (as well as enable gains) on an amount that exceeds the portfolio's initial investment. A strategy may not achieve the anticipated benefits, and may realize losses, when a counterparty fails to perform as promised. Currency rates may fluctuate significantly over short periods of time and can reduce returns. Investing in the natural resources sector involves special risks, including increased susceptibility to adverse economic and regulatory developments affecting the sector—prices of such securities can be volatile, particularly over the short term.

IMPORTANT LEGAL INFORMATION

This material is intended to be of general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice.

The views expressed are those of the investment manager and the comments, opinions and analyses are rendered as at publication date and may change without notice. The information provided in this material is not intended as a complete analysis of every material fact regarding any country, region or market. **All investments involve risks, including possible loss of principal.**

Data from third party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments opinions and analyses in the material is at the sole discretion of the user. Products, services and information may not be available in all jurisdictions and are offered outside the U.S. by other FTI affiliates and/or their distributors as local laws and regulation permits. Please consult your own professional adviser for further information on availability of products and services in your jurisdiction.

Issued in the U.S. by Franklin Templeton Distributors, Inc., One Franklin Parkway, San Mateo, California 94403-1906, (800) DIAL BEN/342-5236, franklintempleton.com - Franklin Templeton Distributors, Inc. is the principal distributor of Franklin Templeton Investments' U.S. registered products, which are available only in jurisdictions where an offer or solicitation of such products is permitted under applicable laws and regulation.

Australia: Issued by Franklin Templeton Investments Australia Limited (ABN 87 006 972 247) (Australian Financial Services License Holder No. 225328), Level 19, 101 Collins Street, Melbourne, Victoria, 3000. Austria/Germany: Issued by Franklin Templeton Investment Services GmbH, Mainzer Landstraße 16, D-60325 Frankfurt am Main, Germany. Authorized in Germany by IHK Frankfurt M., Reg. no. D-F-125-TMX1-08. Canada: Issued by Franklin Templeton Investments Corp., 5000 Yonge Street, Suite 900 Toronto, ON, M2N 0A7, Fax: (416) 364-1163, (800) 387-0830, www.franklintempleton.ca. **Dubai:** Issued by Franklin Templeton Investments (ME) Limited, authorized and regulated by the Dubai Financial Services Authority. Dubai office: Franklin Templeton Investments, The Gate, East Wing, Level 2, Dubai International Financial Centre, P.O. Box 506613, Dubai, U.A.E., Tel.: +9714-4284100 Fax:+9714-4284140. **France:** Issued by Franklin Templeton France S.A., 20 rue de la Paix, 75002 Paris France. **Hong Kong:** Issued by Franklin Templeton Investments (Asia) Limited, 17/F, Chater House, 8 Connaught Road Central, Hong Kong. **Italy:** Issued by Franklin Templeton International Services S.à.r.l. – Italian Branch, Corso Italia, 1 – Milan, 20122, Italy. **Japan:** Issued by Franklin Templeton Investments Japan Limited. **Korea:** Issued by Franklin Templeton Investment Trust Management Co., Ltd., 3rd fl., CCMM Building, 12 Youido-Dong, Youngdungpo-Gu, Seoul, Korea 150-968.

Luxembourg/Benelux: Issued by Franklin Templeton International Services S.à r.l. – Supervised by the Commission de Surveillance du Secteur Financier - 8A, rue Albert Borschette, L-1246 Luxembourg - Tel: +352-46 66 67-1 - Fax: +352-46 66 76. **Malaysia:** Issued by Franklin Templeton Asset Management (Malaysia) Sdn. Bhd. & Franklin Templeton GSC Asset Management Sdn. Bhd. **Poland:** Issued by Templeton Asset Management (Poland) TFI S.A.; Rondo ONZ 1; 00-124 Warsaw **Romania:** Issued by Bucharest branch of Franklin Templeton Investment Management Limited ("FTIML") registered with the Romania Financial Supervisory Authority under no. PJM01SFIM/400005/14.09.2009,, and authorized and regulated in the UK by the Financial Conduct Authority. **Singapore:** Issued by Templeton Asset Management Ltd. Registration No. (UEN) 199205211E. 7 Temasek Boulevard, #38-03 Suntec Tower One, 038987, Singapore. **Spain:** Issued by the branch of Franklin Templeton Investment Management, Professional of the Financial Sector under the Supervision of CNMV, José Ortega y Gasset 29, Madrid. **South Africa:** Issued by Franklin Templeton Investments SA (PTY) Ltd which is an authorised Financial Services Provider. Tel: +27 (21) 831 7400 Fax: +27 (21) 831 7422. **Switzerland:** Issued by Franklin Templeton Switzerland Ltd, Stockerstrasse 38, CH-8002 Zurich. **UK:** Issued by Franklin Templeton Investment Management Limited (FTIML), registered office: Cannon Place, 78 Cannon Street, London EC4N 6HL. Authorized and regulated in the United Kingdom by the Financial Conduct Authority. **Nordic regions:** Issued by Franklin Templeton International Services S.á.r.l. (FTIS), Swedish branch filial, Blasieholmsgatan 5, SE-111 48 Stockholm, Sweden. Phone: +46 (0) 8 545 01230, Fax: +46 (0) 8 545 01239. FTIS is authorised and regulated in the Luxemburg by the Commission de Surveillance du Secteur Financier and is authorized to conduct certain financial services in Denmark, in Sweden, in Norway and in Finland. Offshore Americas: In the U.S., this publication is made available only to financial intermediaries by Templeton/Franklin Investment Services, 100 Fountain Parkway, St. Petersburg, Florida 33716. Tel: (800) 239-3894 (USA Toll-Free), (877) 389-0076 (Canada Toll-Free), and Fax: (727) 299-8736. Investments are not FDIC insured; may lose value; and are not bank guaranteed. Distribution outside the U.S. may be made by Templeton Global Advisors Limited or other sub-distributors, intermediaries, dealers or professional investors that have been engaged by Templeton Global Advisors Limited to distribute shares of Franklin Templeton funds in certain jurisdictions. This is not an offer to sell or a solicitation of an offer to purchase securities in any jurisdiction where it would be illegal to do so.

FRANKLIN TEMPLETON

Please visit www.franklinresources.com to be directed to your local Franklin Templeton website.

For Financial Professional Use Only. Not For Public Distribution.