FRANKLIN TEMPLETON

27 February 2019

Beyond Bulls & Bears Bulletin

INSIGHT FROM FRANKLIN TEMPLETON INVESTMENTS MANAGERS

IN THIS ISSUE: ***The articles in this issue are as at 27 February 2019.***

Convertible Securities: Don't Believe Everything You Hear

Alan Muschott, CFA
Vice President
Portfolio Manager
Franklin Equity Group

Since the US stock market selloff in the fourth quarter of 2018, many investors have asked us how convertible securities performed during the upheaval. Issued by companies looking to raise capital, these hybrid investments are generally structured as some form of debt or preferred shares with an embedded option that allows conversion into common shares under predetermined conditions.

According to our analysis, convertible securities generally outperformed their underlying stocks during the fourth quarter when the US equity market saw its steepest declines. That's no surprise to us considering that convertibles have tended to perform well during periods of above-average market volatility.

During periods where the overall stock market is declining, the fixed income component in convertible securities tends to provide some protection against erosion of value. Conversely, when a company's common stock rises, the convertible security should participate in the rise in value because of the conversion option.

However, as long-term investors, our overall view on convertible securities doesn't change from quarter to quarter or during periods of market volatility. The average life of a convertible security is about five years before it converts, and we often will hold a convertible to maturity, regardless of market gyrations in the interim.

In our view, convertibles can be attractive during various types of market environments, including rising markets, due to the potential asymmetric price relationship with the underlying common stock.

Often called "balanced" convertibles, those with deltas (a measure of their equity sensitivity) near the middle of the range from 0.0 to 1.0 can participate more with an issuer's equity upside than they do with the downside. These are the types of convertibles we prefer, as we feel this is the most appealing aspect of the asset class.

We believe this ability to adapt to myriad market conditions can make convertibles an attractive vehicle for increasing a portfolio's level of diversification. However, we've seen a few misconceptions about this hybrid investment class that investors might want to consider.

Convertible Securities Defy Labels

In some parts of the world, it seems many investors view global convertible securities as a fixed income investment. However, we think this classification is far from complete.

Convertible securities are a unique asset class in the investment world that can offer investors both the growth potential of common stocks and the income potential of bonds. Because of these unique characteristics, convertibles may be classified as fixed income securities, equity securities or as a separate asset class.

Most Convertibles Are Issued in the United States

When we analyse global convertible securities, we take a different approach than many of our peers. We don't base our holdings on a benchmark index, which tend to comprise an equal weighting between US, European and Asian markets. That may come as a surprise to certain investors in Europe or Asia who think we should have more exposure to their home countries.

In our view, an equal weighting between those markets doesn't reflect the actual market. As the chart to the right shows, the United States accounts for about 60% of issuance in the global convertible securities market. We often source investments to the primary market, as newly issued securities exhibit the balanced characteristics we prefer. Therefore, we tend to have a larger exposure to US convertible securities than many of our peers.

Investment Implications

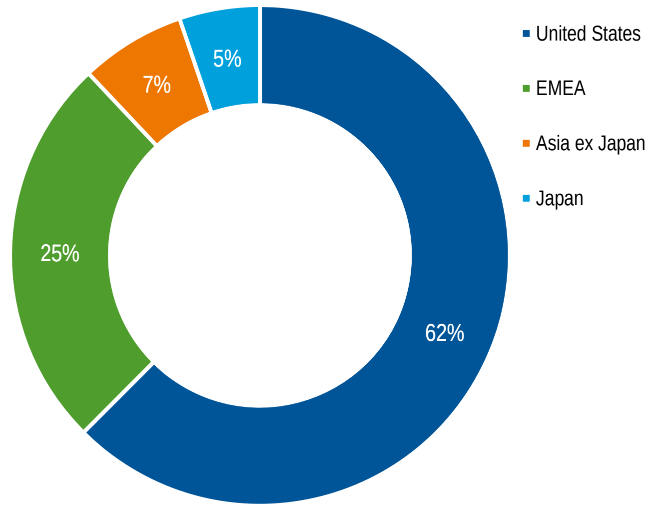
The global convertibles universe also tilts towards higher growth sectors like information technology, health care and consumer discretionary. Fortunately, these are all sectors where we see compelling growth drivers over the next several years.

We see technology as increasingly becoming a non-discretionary expense for a wide range of companies and industries. In particular, we like certain convertible securities within growth themes, like on-demand software. Many companies often lack the expertise, personnel and resources to develop this technology in-house, which creates opportunities for firms in the cloud computing and software-as-a-service areas.

Elsewhere, we continue to see opportunities amongst companies showing high levels of innovation in the health care space. With accommodating regulators and novel new drug delivery methods and targets, we see a continuing wave of innovation in the health space.

Global Convertible Securities Market

Share of Market Value by Region
As at 31 August 2018



Source: Barclays. See www.franklintempletondatasources.com for additional data provider terms and conditions. As at 31/08/2018. Indices are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. For illustrative purposes only.

THREE GOOD REASONS TO CONSIDER INVESTING IN CONVERTIBLE SECURITIES

1. Potential for Additional Diversification. Historically, convertibles typically have exhibited a low correlation to fixed income and demonstrated imperfect correlation with stocks. This creates the potential for an investor to help enhance portfolio diversification, dampen volatility and improve a portfolio's overall risk profile. Note, diversification does not guarantee profit or protect against risk of loss.

2. Attractive Potential for Long-Term Risk-Adjusted Returns. Critics point out that convertibles do not increase as rapidly in value as stocks during rising markets, nor does their downside protection equal that of bonds during market declines. Nevertheless, historically they have delivered attractive long-term risk-adjusted returns compared with both stocks and bonds.

3. Robust and Diverse Opportunity Set. The flexible nature of convertibles makes them appealing to a broad range of investors. As a group, convertibles have historically presented an attractive risk/reward profile, but within the group there is considerable variation in the level of risk, sensitivity to movements in the underlying stock, and upside participation potential. Convertible securities are diversified across credit ratings, sectors, market capitalisation and investment characteristics.

Why European Investors Might Consider Fixed Maturity Investing

David Zahn, CFA, FRM
Head of European Fixed Income
Senior Vice President, Portfolio Manager
Franklin Templeton Fixed Income Group

The search for yield presents European investors with a conundrum at the moment.

Interest rates in the eurozone remain stubbornly low and while rates in other parts of the world, including the United States, have started rising from historic lows, hedging costs can make that an expensive option.

European investors pay a significant premium to hedge dollar assets back to euros. That can quickly eat away at any return advantage that US assets might offer compared with European assets.

Little Sign of the Interest-Rate Tide Changing Soon

The latest figures suggest economic growth in the eurozone is slowing. On top of that, the region faces a series of political headwinds. For example, we expect Brexit to impact the wider region more deeply than some are predicting.

Furthermore, European Parliament elections are due to take place in May, bringing the very real prospect of populist parties from the extreme left and right of the political spectrum making gains.

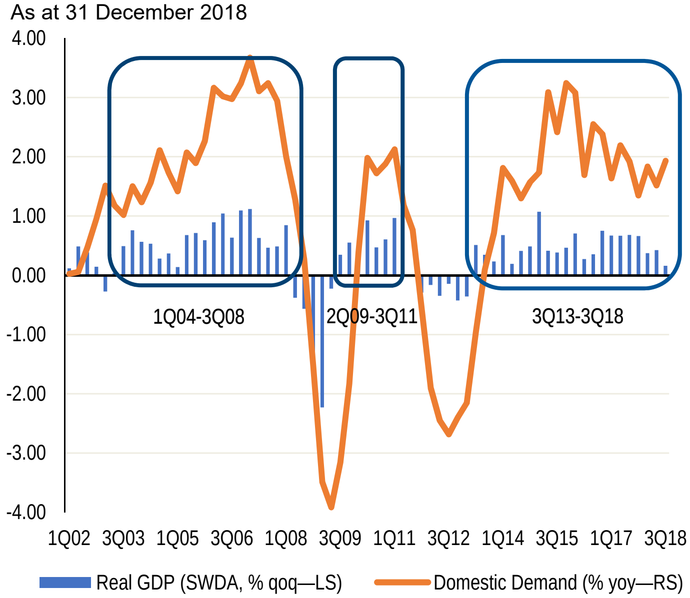
All things considered, we reckon the prospect of eurozone interest rates starting to rise imminently has receded. But, like all investors, we hope and expect interest rates will rise eventually.

Our analysis suggests the European Central Bank (ECB) likely won't start hiking rates until 2021.

Against this background, we're seeing a resurgence of interest in so-called "buy-and-hold," or fixed maturity investment strategies.

Eurozone Growth

Quarter-Over-Quarter (%)
As at 31 December 2018



Source: Eurostat. SWDA stands for Seasonal Work Day Adjusted. As at 31 December 2018.

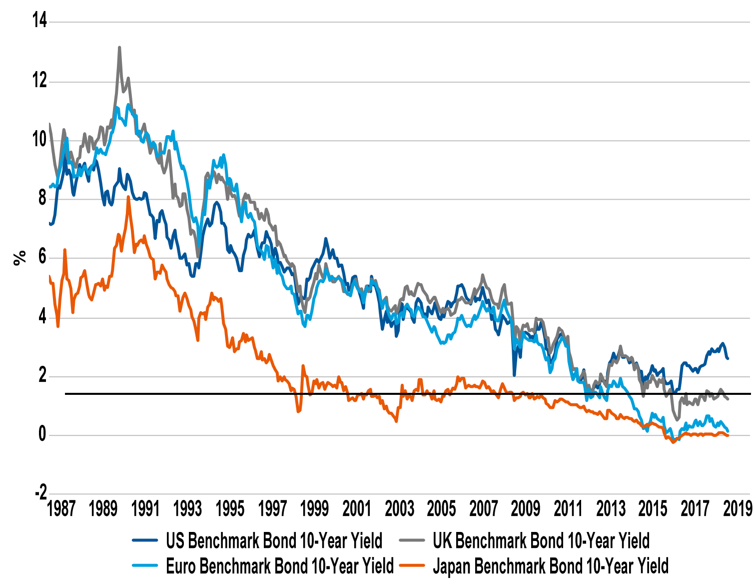
Limiting Duration Risk

Although growth has been slowing down in the eurozone, it still appears healthy from our point of view, and we are not worried about the risk of a recession in the region. Domestic demand, as well as consumer and business confidence, appears to still be strong.

While we're sceptical that eurozone interest rates will rise soon, we recognise that central bankers will act eventually, and that the next movement is likely to be a rate hike.

Interest Rates Have Declined for Almost Three Decades

10-Year Benchmark Bond Yield (%)
December 1986–January 2019



Source: FactSet, Tullett Prebon Information. Important data provider notices and terms available at www.franklintempletondataresources.com.

So for many investors, duration risk—in other words, exposure to changing interest rates—remains a prominent concern.

A fixed maturity investment can reduce that exposure. An investor holding bonds that mature in line with his or her investment horizon likely will not care what happens to interest rates in the meantime, as long as they are being paid their coupon.

Re-emergence of Credit as an Attractive Consideration

The challenge, therefore, is seeking out an appropriate coupon.

In the current sustained low-interest-rate environment, we think credit is emerging as an attractive asset class for investors seeking income. In recent months, both high-yield and investment-grade credit have sold off significantly.

The asset class rallied somewhat in January but still spreads remain much wider than they were in the middle of last year.

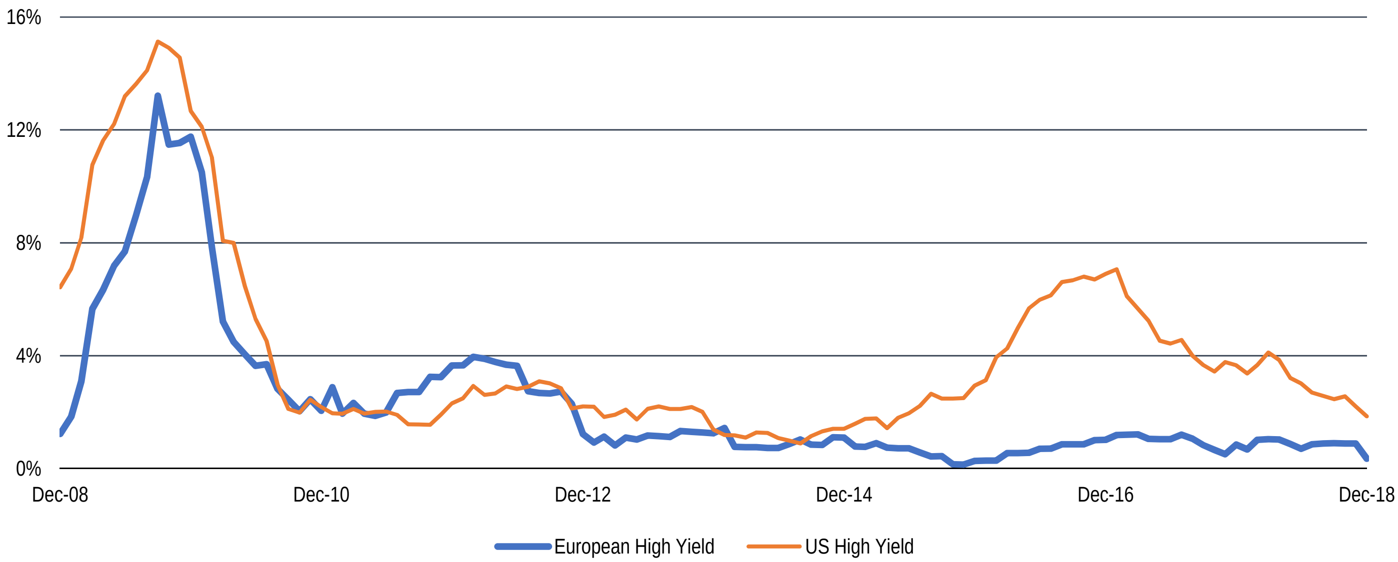
While corporate credit comes with a higher risk of defaults than sovereign debt, we feel investors are now getting better compensated for that risk. Furthermore, default rates are low at the moment, and we'd anticipate they should likely remain low for several years.

Still, we think it's important to look at credit in a diversified manner and not to overly concentrate on individual corporate names.

And as ever we remain strong proponents of an active investment management approach. That should mean if the fundamentals of assets within the fixed maturity portfolio do deteriorate, action can be taken and potentially new assets with similar maturities swapped in.

European High Yield Default Rates Remain Near Historical Lows

European and US High-Yield Bond Default Rates
10-Year Period Ended 31 December 2018



Source: Intercontinental Exchange ("ICE"). ICE BofAML Euro High Yield and US High Yield index data referenced herein is the property of Intercontinental Exchange (and/or its licensors and has been licensed for use by Franklin Templeton. ICE and its licensors accept no liability in connection with this use. Indexes 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.**

A Measured But Constructive Market View

Antonio T. Docal, CFA
Director of Portfolio Management
Templeton Global Equity Group

Heather Arnold, CFA
Director of Research
Portfolio Manager, Research Analyst
Templeton Global Equity Group

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.

Value Investing

The past five or six years have been very difficult for value investors. This has been primarily 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. In our view, 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.

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 towards 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.

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 historical 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.

United States

We focus on valuations, and our analysis on a stock-by-stock level suggests to us the US market has been expensive for some time. Where does the US market go from here? The US market has significantly outperformed other regions over the last decade, and that outperformance accelerated last year on earnings 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 United States was the first major economy going into a recession at the start of the global financial crisis, and massive stimulus helped the United States lead the way out. So, while on one hand, this expansion has been the longest on record, it's also been one of the weakest. On the other hand, we are near full employment with low inflation, and the benefit of President Trump's fiscal stimulus last year will likely prove to have run its course.

Trade Wars

Over the past four decades, the opening up of various economies and the expansion of world trade have been major contributors to global economic growth. The current trade war between the United States and China, as well as other skirmishes between the United States and its major trading partners, has added to uncertainty and exerted a drag on global growth.

Currently, US tariffs have been imposed on US$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, have hit company margins and are being passed on to the US consumer.

Investors are hoping that, given economic pressures in China and the prospects of slowing growth in the United States, both parties seek some sort of resolution to their differences at some point this year.

Emerging Markets

Last year was tough for most emerging markets, which generally 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. Economic growth differentials could favour 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.

Brexit

UK Prime Minister 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 United Kingdom 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 possible outcomes—including no deal—have to be considered. Whatever the eventual 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 gross domestic product 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, a potential pause in Fed normalisation and an even more dovish ECB. 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 crisis after political crisis. In the meantime, European equities had the lowest valuations of any major region (as at year-end), and companies continue to execute and grow earnings.

Energy

Oil prices fell during 2018 as the Organization of the Petroleum Exporting Countries (OPEC) 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 7 December 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. 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 amongst the price-sensitive segments of the energy markets following their sharp correction.

Health Care

Health care was one of the best stock sectors last year, but recall that it was one of the worst-performing sectors in 2017—and, in fact, had underperformed for several years until last year. The sector had de-rated significantly on the back of several different concerns: consolidation of the 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

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 fades. 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—the trade war with China could lessen or be resolved, Brexit could be softened or even not happen at all, and US interest-rate increases could pause and other central banks could 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's 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 United States 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 globalisation 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.

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 the 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.

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. Authorised 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, authorised 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 the Bucharest branch of Franklin Templeton Investment Management Limited, 78-80 Buzesti Street, Premium Point, 7th-8th Floor, 011017 Bucharest 1, Romania. Registered with Romania Financial Supervisory Authority under no. PJM01SFIM/400005/14.09.2009, authorised 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. Authorised and regulated in the United Kingdom by the Financial Conduct Authority. **Nordic regions:** Issued by Franklin Templeton Investment Management Limited (FTIML), Swedish Branch, Blasieholmsgatan 5, SE-111 48 Stockholm, Sweden. Phone: +46 (0) 8 545 01230, Fax: +46 (0) 8 545 01239. FTIML is authorised and regulated in the United Kingdom by the Financial Conduct Authority and is authorised to conduct certain investment 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.

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.

Important data provider notices and terms available at www.franklintempletondatasources.com.

FRANKLIN TEMPLETON

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