Allocation views

Perspective from Franklin Templeton Multi-Asset Solutions

AUGUST 2020

Looking Forward to Back to School?

As we enter the typically quieter months of the northern-hemisphere summer, we are starting to adapt to a new way of doing things. It is not quite as it was before, but it is better than we faced in the depths of the virus-induced shutdown seen in many economies earlier this year.

Becoming more familiar with what our new world is like, it's clear that this is not a normal summer. Although we have seen attempts to restart mass tourism, many travelers remain cautious and the sudden reimposition of government-imposed restrictions will dissuade others. Together with the rolling back of some of the easing steps that may have been taken in haste highlights a growing realization that localized flare-ups of the virus are an ongoing threat.

As a result, we are not surprised to see a cooling of the pace of recovery in some of the high-frequency data that are helping investors and policymakers to monitor this fluid and fast-moving environment. Indicators of consumer spending on credit cards and bookings at restaurants—especially in the southern portion of the United States—have rolled over. We have believed the recovery would be uneven since the very start of the crisis. More importantly, we agree with the views of the central bankers, repeated recently by US Federal Reserve Chair Jerome Powell, that the path forward remains extraordinarily uncertain.

With the persistence of recovery foremost in our mind, we continue to focus on the persistence of the virus. We will likely be facing this threat for many quarters to come, even if the news on developing an effective vaccine or improved treatment protocols advances as well as is hoped. Staying the course on fiscal and monetary policy coordination will remain vital as we continue to see the risks to recovery as tilted to the downside.

As we have commented on in Allocation Views over the past two months, the European Union (EU) seems to be making progress on fiscal coordination. With strong persuasion from German Chancellor Angela Merkel, European heads of government agreed to proceed with the Next Generation EU plan.

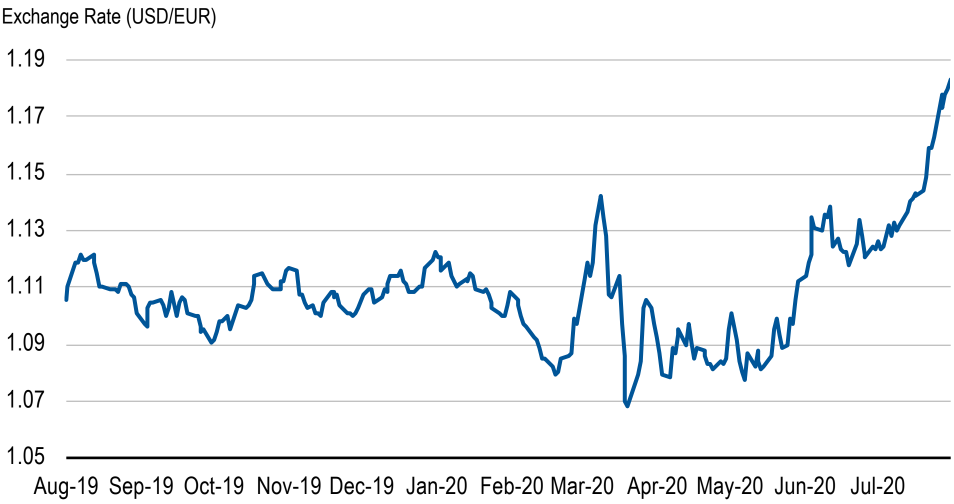
Although it took longer than anticipated, and debate continued long into the night, the avoidance of catastrophic political conflict marks the end result as a success. Indeed, we view this plan as potentially opening a path toward greater stability and a more complete monetary union for the eurozone. It appears that currency investors share this greater optimism as the euro has appreciated sharply in recent weeks (see Exhibit 1).

However, as the US presidential election approaches in November, we believe politics may have a growing impact on financial markets. A rational desire to see schools reopen and allow parents to return to more normal work patterns is key to driving forward an economic recovery.

THE EURO IS SHOWING SIGNS OF GROWING CONFIDENCE

Exhibit 1: Euro vs US Dollar Exchange Rate

As of July 31, 2020



Source: Franklin Templeton Capital Market Insights Group, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com. Past performance is not an indicator or a guarantee of future results.

However, even this move comes with its own risks. The interplay of virus levels, fiscal stimulus measures and health policy risks being politicized. With the typical escalation of campaign rhetoric as the vote nears, we are increasingly concerned about the sustainability of the US equity market's leading position in the recovery from March lows. However, helped by the heavy weighting of technology stocks, the US NASDAQ equity index remained near new all-time highs at July-end. We retain a somewhat more constructive view of US stocks, but have moderated the level of our conviction given the extent of recent gains.

Overall, momentum in the global economy is improving, but we expect lingering impacts from the deep recession that followed the coronavirus crisis. Expectations of a sharp rebound have become well-established and are increasingly discounted in current market levels for risk assets. Political uncertainty contributes to an outlook that remains less clear than usual and presents an ongoing drag on business investment intentions. We expect the rebound to be partial for some sectors and see the risks to recovery as tilted to the downside, in part due to the second-wave infection threat. As a result, this leaves us with a relatively cautious view, encapsulated in our theme that sees **"Ongoing Headwinds to Global Growth."**

Prices are rising among some commodities

One of the notable effects of the last major global recession was a lack of inflation. The global financial crisis and the subsequent stresses in the eurozone saw Consumer Price Index (CPI) inflation persistently fail to meet central bank targets. This has prompted the European Central Bank (ECB) and the Fed to review their mandates and consider moving to some form of average inflation targeting. We may see the fruits of these discussions in the months ahead.

However, the current COVID-19 induced recession arrived before the global economy had experienced any significant cyclically driven rise in prices, leading to concerns about maintenance of price stability across economies. With previous commodity price declines still weighing on headline inflation, it is easy to assume that inflation is not a problem.

Indeed, core CPI (the underlying level of inflation after the direct effect of food and energy price fluctuations has been excluded) remains depressed in a range of economies. In the eurozone, core inflation dipped back toward the lows seen over the last 10 years (see Exhibit 2) before rebounding slightly in the most recent data. To an extent, this rise could reflect supply disruptions and a desire to move production closer to home. However, we believe that it is premature to call an end to globalized production, despite some examples of onshoring. We also remain skeptical of the link between rapidly expanding money supply and generalized inflation, as opposed to asset price gains.

Oil prices and some other industrial commodities have rebounded, reflecting a better balance between supply and demand. While we anticipate a continued move higher, and reflect this in a modestly higher conviction in commodities, it does not appear to pose an inflation risk more broadly. We will discuss this, and a growing confidence in assets such as Treasury Inflation-Protected Securities (TIPS) that can help to provide protection against rising inflation in our Allocation Views quarterly focus on Alternative Assets next month.

More broadly, however, we continue to believe changes in demand will be the main driver of inflation. Recent supply shocks may have lowered productive capacity, but the deceleration in global activity that we have seen since 2019 will be much more powerful, in our view. This effect has been felt broadly, including in emerging markets, reinforcing our theme of **"Subdued Inflation Across Economies."**

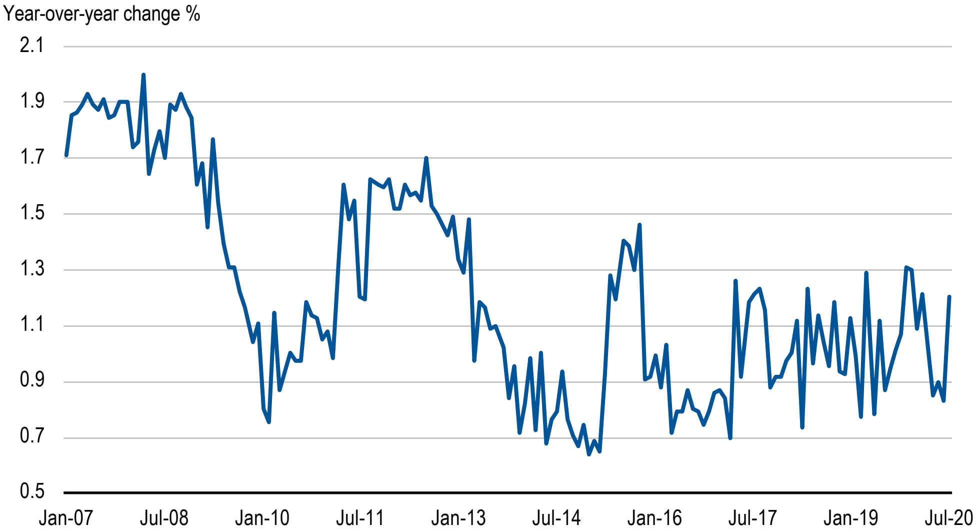
Policy support is key

COVID-19 presents an ongoing headwind to the global economic recovery. However, we have seen consistent and unstinting support from independent central banks, together with coordinated fiscal policy.

CORE INFLATION REMAINS DEPRESSED IN THE EUROZONE

Exhibit 2: Eurozone core CPI since 2007

As of July 31, 2020



Source: Franklin Templeton Capital Market Insights Group, Eurostat, Macrobond. 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 a guarantee of future results.**

It is this policy response that has eased the path through a deep global recession and allowed investors to look ahead to a period of recovery and rebuilding. This is reflected in our final theme of a **"Dovish Bias to Policy."**

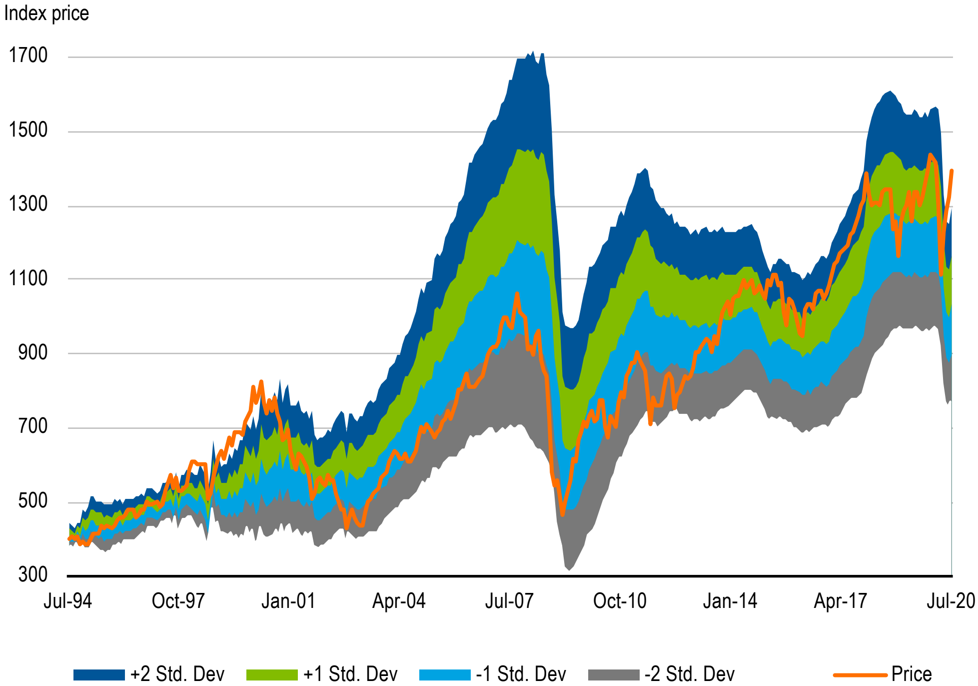
The emergency response measures have exceeded expectations, but the easy wins have been delivered. The effect of ample liquidity, which is likely to continue to be provided across developed economies, has propelled many markets to quite elevated levels. We have reflected this is a lower conviction toward corporate bonds and a more cautious stance on emerging market investments generally. Overall, we retain a broadly neutral stance toward riskier assets. Our view balances policy support that aims to do whatever it takes, with caution regarding valuations and politics.

As we focus on the longer-term return potential for stocks and believe that they should earn their equity risk premium over time, we continue to balance this with shorter-term concerns that have tempered our enthusiasm. We maintain a modestly higher conviction toward global equities than bonds, reflecting relatively more attractive valuations over the longer term. In broad terms, bonds have become more highly valued and equity prospects have improved relative to them, but we do not view them as cheap in a historical context (see Exhibit 3.)

GLOBAL EQUITY VALUATIONS ARE NOT CHEAP, BUT ARE ATTRACTIVE TO US RELATIVE TO BONDS

Exhibit 3: MSCI All Country World Index price and valuation bands (based on 10-year average P/E and current EPS estimate [forward 12 months])

As of July 31, 2020



Source: Franklin Templeton Capital Market Insights Group, MSCI, Macrobond. Important data provider notices available at www.franklintempletondatasources.com. 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 a guarantee of future results.**

Allocation settings—August 2020

Asset Class	Conviction	Our viewpoint

RISK TIER

Risk Off/On

We have seen a sharp contraction in global growth—likely bottoming in 2020's second quarter—and expect moderate inflation over the long term. COVID-19 presents an ongoing headwind to the global economic recovery. As a result, we retain a broadly neutral stance toward riskier assets. Our view balances caution regarding growth with optimism that a broad policy response will be supportive.

HIGH LEVEL ALLOCATION TIER

Equities

In broad terms, global equities require sustained economic recovery to support valuations, as corporate earnings are expected to weaken through the second quarter. Concerns remain about downside risk to capital investment plans that reflect general uncertainty. However, we anticipate supportive liquidity conditions to offset these concerns. Longer-term prospects have improved, which is reflected in our relatively optimistic bias.

Bonds

Inconsistent global recovery, and a bias toward easier monetary policy, contrast with long-term valuations that have become more expensive, reflecting low term premiums. Renewed widening of corporate bond spreads may occur if the recovery slows or financial conditions tighten. We maintain a more cautious view of bonds at the asset-allocation level, reflecting valuation concerns.

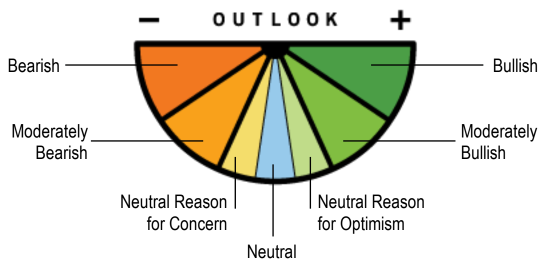
Alternatives

We believe that inflation expectations may start to normalize from depressed levels, even as overall inflation remains subdued. We see better prospects in naturally diversifying assets such as TIPS. We maintain a neutral view overall, reflecting the balance between reasons for optimism and market-driven concerns that we continue to monitor.

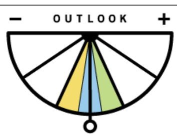
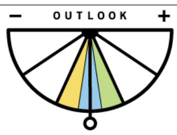
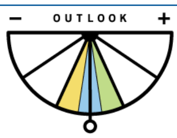
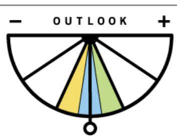
Cash

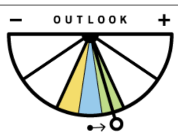
The defensive features of cash remain attractive to us, despite its drag on portfolio yield. Short-term US Treasury bill yields reflect depressed policy rates rather than greater supply. Cash has attractions as a means of diversification from low-yielding government bonds.

Understanding the Pendulum Graphic



Arrows represent any change since the last quarter-end.

Asset Class	Conviction	Our viewpoint
ALLOCATION TIER		
Equity Regions United States		Despite COVID-19 headwinds, trend US growth remains stronger than in other developed markets, and technology exposure sustains the market opportunity. The market's attention will likely focus on valuations, the 2020 presidential election cycle and whether Fed policy programs are effective in stimulating demand.
Canada		We see modest opportunities in Canada as earnings growth slows. Domestic housing concerns and low net interest margins continue to burden Canadian banks. However, commodities headwinds are abating. We have moderated our caution and adopted a more neutral stance.
Europe ex UK		European policymakers are showing greater unity, but weak manufacturing sentiment persists. The ECB has made efforts to offset the effect of lower rates, but we see banks remaining a drag. We maintain a more cautious view, which reflects a lower outlook for earnings, and valuations that are no better than neutral relative to history.
United Kingdom		Domestic political tensions have eased, but uncertainties over Brexit and UK economic prospects remain. This defensive market appears historically cheap, so long as corporate profits are not too severely impacted. We reflect these opportunities in a more constructive view on this market, tempered by caution over remaining uncertainties.
Japan		Equity valuations, particularly on a price-to-book-value basis, have been attractive relative to other markets, in our view. However, weaker economic activity following a consumption tax rise and global trade concerns are unfavorable for the Japanese market. Earnings per share and return on equity are weakening relative to peers. However, we have tempered our caution about this cyclical market.
Pacific ex Japan		With banks and related financial companies representing heavier weights in the region, concerns about banks in Australia and Hong Kong persist. The region is vulnerable due to tensions over Hong Kong and subdued global trade flows. However, at valuations we regard as supportive, we are not bearish, though we see reasons for concern.
Emerging ex China		Risks to global growth highlight emerging markets' idiosyncratic risks and underlying cyclicality. However, valuations remain attractive to us relative to developed market peers, and return on equity is improving. We see a balance of near-term growth concerns and optimism regarding the longer-term structural attractions of emerging markets.
China		China's economy faces a persistent impact from COVID-19, weak global demand and heightened geopolitical tensions. Further support from fiscal or monetary measures may be required. Trade disputes remain unresolved in the longer term and are a symptom of broader tensions. Valuations have become elevated, and we maintain a neutral view of this market.
Fixed Income Sectors US Treasuries		The Fed has delivered a sequence of interest-rate cuts in response to the coronavirus threat, easing toward zero. However, the Fed remains biased to provide more stimulus as needed and to maintain a stable US Treasury yield curve as it moves beyond the crisis-response phase. Stretched valuations and supply dynamics balance weak growth and subdued inflation expectations, and we maintain a broadly neutral position.
Eurozone Government Bonds		Valuations appear full in the eurozone, where term premiums are the lowest among government bonds. However, in response to growth concerns, the ECB will continue to provide stimulus. The Next Generation EU recovery fund has demonstrated greater fiscal unity and supports peripheral markets. European yields have followed US equivalents, but to a more muted extent, and we have moved to a slightly more constructive position.
UK Government Bonds		Continued uncertainty over Brexit was weighing on sentiment before the virus threat increased, and weak productivity growth was holding back activity. The Bank of England has cut interest rates to the lower bound and remains biased to provide more stimulus as required. We remain broadly neutral overall, in line with other developed markets.

Asset Class	Conviction	Our viewpoint
ALLOCATION TIER		
Canada Government Bonds		Canada is vulnerable to a hit in business confidence from oil-price volatility. Expectations for the Bank of Canada mirror those for the Fed. Canadian bond yields broadly match those in the United States and are likely to remain closely linked. We maintain a neutral view overall, in line with other developed markets.
Japan Government Bonds		The Bank of Japan has maintained its monetary policy stance, which targets low 10-year government bond yields. It has also provided guidance that policy will remain stimulative for an "extended period" but seems less likely to ease in the near term, with fiscal policy taking a larger role in providing stimulus. We believe low sensitivity to global yields is likely to continue, making this market somewhat more attractive in the case of a stronger global economic recovery. We have moved to a slightly more constructive position.
Investment Grade		The investment-grade sector has benefited from robust Fed support, which has calmed markets significantly. Supportive corporate liquidity offsets high leverage and the risk of rising defaults. Yield spreads have narrowed as the market has focused on central-bank buying. Renewed widening may occur if the recovery slows, but valuations remain supportive in a global context. As such, we have returned to a broadly neutral view.
High Yield		Pressure on energy companies and persistent impacts of recession weigh on the outlook for lower-rated fixed income sectors such as high yield. Default rates are rising to above historical averages. Overall, we maintain a tactical preference away from these riskier assets, while Fed support is more focused on investment-grade issuers. Longer term, we retain a somewhat more constructive view on this market, offset by caution over near-term fundamental uncertainties.
Emerging Market Debt		We regard emerging market bond valuations as less attractive for hard-currency bonds, and fundamental pressures due to global economic weakness compound these concerns. Exchange-rate risks in local-currency bonds remain prominent, in our view. With continued fears regarding global growth, we maintain a more cautious view on these markets, and we continue to think selective positioning is important.
Alternative Assets Inflation-linked bonds		The level of inflation discounted in inflation-linked securities remains depressed. We believe that these expectations may continue to normalize, even as overall inflation remains subdued. We have moved to a more constructive view of assets that benefit directly from rising prices, such as inflation-linked bonds.
Commodities		Risks to economic recovery have created a less supportive environment for broad commodities. However, we believe that fiscal stimulus measures and liquidity support will boost growth and demand. Prices remain depressed, which balances subdued inflation pressures, and sees us move to a more constructive overall view.
Risk Premia		In an environment of slower growth but ample liquidity, we see mixed prospects across asset classes and in market-neutral or naturally diversifying assets. We hold a neutral view of risk premia, reflecting a balance between concerns over the reversal of established trends and the prospect of valuations becoming more attractive.

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. Diversification does not guarantee profit or protect against risk of loss. 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.

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