Navigating Political Uncertainty

with Michael Hasenstab, Ph.D., Ed Perks and Rick Frisbie

2016 Global Investment Outlook – August Update

Market Resiliency in the Face of Uncertainty

Perspective on the US Election and Global Political Landscape

What Investors Should Watch For
Earlier this year, Franklin Templeton Investments featured market outlooks from three senior leaders representing our global macro, equity and multi-asset capabilities. We have reconvened the group to discuss their views for the remainder of the year.

**FEATURED SENIOR LEADERS**

**Michael Hasenstab, Ph.D.**
As CIO of Templeton Global Macro, Michael leads a team of economists, trained in some of the leading universities in the world, who integrate global macroeconomic analysis with in-depth country research to identify long-term imbalances that translate to investment opportunities. Michael and his team manage Templeton global bond strategies, including unconstrained fixed income, currency and global macro.

**Ed Perks, CFA®**
Ed oversees our well-established equity teams that include Franklin Equity Group, Templeton Global Equity Group, Templeton Emerging Markets Group, Franklin Mutual Series and Franklin U.S. Value. Our equity teams continue to manage their own bottom-up research. By sharing perspectives across teams embedded in several key equity markets, they can strengthen their overall convictions.

**Rick Frisbie**
Rick heads Franklin Templeton (FT) Solutions®, our group dedicated to multi-strategy solutions. Every year, FT Solutions reviews the data and themes driving capital markets in order to build asset return expectations for different asset classes for the next five to 10 years. The team incorporates these expectations into their long-term portfolio positioning process.

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This document summarizes the video content from our panel discussion.
Market Resiliency in the Face of Uncertainty

There has been no shortage of market moving issues this year, including Brexit, negative interest rates, and continued geopolitical uncertainty, yet some markets continue to make new highs. What’s driving this resiliency, in your view, and what risks might be under the surface?

MICHAEL HASENSTAB:
At the beginning of the year, one of our strongest convictions was that, even in the midst of global uncertainty, emerging markets had been oversold. We have seen no shortage of surprise shocks and global volatility but despite a lot of the headline noise, the fundamentals throughout most of the emerging markets remained sound. The markets have shown incredible resilience, though it was clear to us the underlying fundamentals in individual countries matter. So, to us that is one of the highlights: the resilience of emerging markets within a period of volatility.

ED PERKS:
When we reflect on how we viewed global markets at the end of last year and heading into 2016, we looked at the perception versus the reality. There was a tremendous amount of turmoil in the equity markets, but the reality we saw did not seem to justify it. Many of the fears that developed early in 2016 didn’t play out as anticipated.

The Fed had begun to raise interest rates at the end of 2015, and there were expectations that it was going to be on a determined path to raise rates in 2016 regardless of the economic data and other dynamics, such as the commodity slump intensifying.

Since then, it has become more apparent the Fed’s path does seem data-dependent. Ultimately, I think the resilience we have seen in the equity markets this year is due at least in part to the realization that corporate health is actually pretty strong. Companies remain pretty balanced, and many have decided to allocate their capital in ways that have benefited shareholders, including initiating or increasing dividends, and buying back shares.

“So, to us that is one of the highlights: the resilience of emerging markets within a period of volatility.”

– Dr. Michael Hasenstab
Perspective on the US Election and Global Political Landscape

Political uncertainty has clearly had an impact on global financial markets in 2016. How does that impact the views of your investment teams?

RICK FRISBIE:

We think many risks exist in the world, so it is a good time to be defensive. Having said that, emerging market economies in general have seen positive economic growth speeding up for the first time in four years, and we saw the stabilization of the much overdone, oversold, sharp pull-down in commodities. But from our point of view, the world is filled with dislocations, and decoupling is likely in different interest-rate regimes and different currency regimes.

ED PERKS:

As we reflect on the Brexit implications and the unpredictability leading up to the vote, there was a fair amount of surprise. After some extreme post-Brexit vote volatility, the global market generally began to stabilize. I think ultimately it reinforces the reality that it is very difficult to predict the outcome of these situations.

At Franklin Templeton Equity, we focus most on understanding economic conditions and the financial health and fundamentals of the individual companies in the various sectors and industries in which we are investing. As unexpected events play out, they may create dislocations, but they also may create opportunities for longer-term investors. We aim to potentially take advantage of some of those short-term dislocations.

“ We think many risks exist in the world, so it is a good time to be defensive. ”

– Rick Frisbie
Perspective on the US Election and Global Political Landscape

On the heels of the historic Brexit vote, there is another highly charged political climate in the US with an election coming up in November. How would you characterize the economic and market environment in the US right now and how would you put the US election into perspective for investors?

**ED PERKS:**

If there were two words to characterize the US economy and the markets, I would choose stable and resilient. As we wrap up second-quarter earnings season, the majority of S&P 500 companies have reported their performance and their expectations for the future. It is kind of anecdotal, but if you listen to the calls and talk to the analysts, the US election is not among the top-five issues that companies seem most focused on.

Companies are still very focused on currency trends that are impacting their business as well as on margin pressures—whether it’s cost inflation through wage growth or price deflation and the compression of margins. They are still very focused on Brexit and its potential impact on eurozone growth and their businesses in the region.

But generally, the US election has fallen a bit more into the background. Ultimately as we get closer to the election, and certainly in third-quarter earnings season, it may take a bit more focus. I also think it will prove to be something the markets are able to digest and ultimately move forward from.

**MICHAEL HASENSTAB:**

I think what is interesting about the volatility we are seeing related to the political polarization in the United States and Europe, is that it is juxtaposed against a very different dynamic happening in emerging markets.

In developed markets, we have seen a rise in populism because some voters see themselves as disenfranchised, and there has been a lack of real wage growth, causing real political upheavals. In emerging markets, countries such as Brazil and Argentina that went off track in terms of unorthodox policies have returned to sort of state-planning systems; those political regimes have ended, and the countries have come back to more mainstream orthodox policies.

There are hotspots globally, and there is policy uncertainty in the United States, but we have been focused on the emerging market theme because we have found that economies that we used to think of as politically unstable have actually proved to be less so as they pursue more orthodox types of policies.
As you look to the latter part of 2016 and into 2017, what factors or events should investors be watching for? What impacts do you think these factors will have on markets?

MICHAEL HASENSTAB:
As we look toward the end of the year, we have to question whether the type of US government bond yields we have today make sense given rising inflation and the resiliency we’ve seen in the US economy. Our view is the rally in US Treasuries can reverse as quickly as it ran up, so our team is really avoiding that space. Second, we have concerns in the eurozone about the rise of nationalism, which questions the whole eurozone construct; the ability to form a fiscal union given all the geopolitical issues developing within Europe is incredibly problematic. We favor being short euro as a hedge against political risks that could continue to unfold.

Additionally, the exceptional rally in the Japanese yen is stifling the economy, and it is reigniting deflationary pressures. In our view, the Japanese economy and policymakers will likely find it very difficult to deal with the yen at these inflated levels; the massive yen rally appears tenuous to us and poised for a reversal.

We are being very selective in emerging markets. I think what will be key as we look ahead is examining individual countries’ policy decisions and the political landscape—the variances will likely be massive.

As the year progresses and we move into next year, we think the differentiation will be critical. You cannot treat emerging markets as uniform—that is our main message.

ED PERKS:
We clearly have had a tremendous amount of global leadership from the US equity market in 2016. On a relative-value basis, looking at equities and other markets, we are very mindful of what impact Brexit will have on eurozone growth, but more broadly, as Michael alluded to, there are regions of the world where economies are much healthier than the general perception might indicate.

A key point I think of equity markets going into 2017, and while we remain constructive on the US market, there’s an opportunity to pass the baton a little bit from the US equity market in terms of global market leadership.

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– Ed Perks
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