



FRANKLIN TEMPLETON  
INVESTMENTS

## 2012 Outlook

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*“The risks and challenges we see this year have moved to a more granular level, focusing first on specific implementation of policy and second on the impact of global linkages between Europe, the U.S. and emerging markets.”*

Last year, our view of global financial markets was anchored by three questions: Will the United States enter a second recession? Will the eurozone break up? Will China experience a “hard landing”? On all three questions, markets were far more pessimistic than we were—indeed expecting and pricing in dramatically poor outcomes, particularly during the latter part of the year. At the start of 2012, however, the answer to two of these questions appears to us to be even more clearly a “no.” In the U.S., recent employment and economic activity numbers have improved, and growth appears to be holding up. In China, gross domestic product (GDP) grew by more than 9% last year,<sup>1</sup> easing fears of a hard landing. Europe continues to weigh on investors’ minds, but we believe that continued “disaster-level” pricing does not properly account for the progress that has been made. While there is still the possibility of a policy slip-up, the nature of the questions being debated in Europe has changed from existential to practical. We begin 2012 with, in many ways, fewer unknowns than we saw going into 2011. The risks and challenges we see this year have moved to a more granular level, focusing first on specific implementation of policy and second on the impact of global linkages between Europe, the U.S. and emerging markets.

Although the policy response to the crisis in Europe has been far slower than ideal, in our view, important progress was made on three fronts. The European Central Bank (ECB) rolled out its own version of quantitative easing (QE), despite its much vaunted aversion to using its balance sheet in this fashion. This effort eased pressures on both the banking system as well as sovereign debt markets. A new government took power in Italy and enacted tough fiscal measures and draconian pension reform. Lastly, and perhaps most importantly, European countries no longer argue whether they should be moving toward fiscal union. It has become an accepted fact that this is what the common currency area will have to look like in the future. With these countries having overcome the inertia of inaction, risks in 2012 now lie in the actual implementation of policy. Going forward, we believe the questions in Europe have shifted to: How will the fiscal compact that was agreed to late last year evolve into a deeper fiscal union? Will Italian Prime Minister Mario Monti be able to implement ambitious structural reforms now that the ECB’s long-term refinancing operation has eased pressure on Italian bond yields? Will a Greek restructuring be orderly? Will the ECB continue its *de facto* QE?

The region has a very ambitious and demanding agenda at both the national and the eurozone-wide level. We believe individual countries need to strike the right balance between fiscal austerity and growth-enhancing structural reforms. Curtailing fiscal deficits and putting public finances on a more sustainable footing is necessary to rebuild market confidence and to gradually reduce public debt-to-GDP ratios from currently elevated levels. A number of countries have moved in this direction, including Italy, which was already running a small primary surplus last year. However, structural reforms are even more important to make the economies more flexible and to raise potential growth rates. We think labor market reform ranks on top of the list. Steps are needed to make labor markets more flexible, relaxing hiring and firing rules, and moving away from the current “insider/outsider” dichotomy, which in a number of countries leaves young people in a more vulnerable position with very weak employment prospects, while many long-standing employees continue to enjoy a very high degree of job security. In addition, further steps to liberalize services and product markets, such as reducing the degree of protection afforded to so-called “closed professions,” would help make economies more flexible. These moves could help boost potential growth rates and would complement eurozone-wide steps toward stronger fiscal rules (including debt brakes in individual countries’ constitutions) and stronger financial support mechanisms. The challenges are significant, and the devil is often in the details. However, all of these questions show a marked change in the terms of the debate within the region compared to the past year.

In the United States, we think it is quite unlikely that there will be significant fiscal consolidation or much needed entitlement reform in the lead-up to the presidential election. Many of the temporary stimulative measures currently in place may continue to be extended on a piecemeal basis as they expire. For example, unless the unemployment rate goes down drastically, the unemployment benefit extension could continue to be a recurring issue every three months. After the elections, however, we believe fiscal reform should be substantially accelerated. The International Monetary Fund projects that by 2015 the U.S. debt-to-GDP ratio could reach 120%—Italy’s current level—and the Congressional Budget Office has flagged the risk of a further unsustainable rise in the years ahead. We believe significant reform, including measures to curb the projected growth of entitlements, will be

essential to put public finances on a more sustainable path, but at this stage, we are quite pessimistic concerning its implementation in the U.S.

Lastly, we think the emerging-market economies face a very different type of policy challenge. Their challenges are likely to include potentially rolling back their pre-emptive easing measures should liquidity begin to flow into their economies. Many of these economies had been in rate-hiking cycles to cool their swift recovery from the 2008 crisis until mid-2011. When the global backdrop became less favorable, many engaged in pre-emptive policy easing to help protect against a drop in external demand. In our view, the implementation risk for these economies is to avoid getting too far behind the curve in resuming their tightening cycles should the global economic environment become more benign.

A second set of issues concerns the global linkages through which an untoward event in Europe could be transmitted to the rest of the world. We think the two channels through which this might occur are trade and capital flows.

If Europe experiences a significant downturn, there would likely be a slowdown in global demand. However, Europe is not the main engine of the global economy. Furthermore, there is an important distinction to be drawn between a scenario of a European downturn and the global financial crisis of 2008, when the United States suffered a full-blown crisis. While the United States has increasingly become a more open economy, trading with more and more countries, the eurozone has remained relatively closed. And while the common currency did boost intra-regional trade significantly, Europe still does not act as a significant driver for global demand. Additionally, even though Europe appears to us as likely to enter a recession, economic indicators have pointed to a potentially much shallower downturn than the one following the global financial crisis in 2008. And though the politics in the United States may continue to be a constraint, we believe U.S. growth could potentially be able to average 1%–2% annually going forward, despite ongoing deleveraging. In our view, this backdrop should be enough to hold up global demand.

But trade only provides part of the linkage. The more important linkages can come from capital markets. The European Banking Authority's requirement for banks to reach a Tier 1 capital ratio of 9% by June of this year will require broad-based deleveraging. As raising fresh capital is extremely difficult, one other avenue could be to shed assets, including assets abroad. However, we believe Asia and other emerging markets should not suffer unduly. Most foreign banks are present in Asia and other emerging markets through wholly-owned subsidiaries, which cannot simply siphon capital back to their parent companies. Many of these subsidiaries are some of the most profitable parts of their businesses, and growing profits provide one important way to recapitalize. Shutting down all business lines in emerging markets would leave these banks without this important source of profits and force an even greater reliance on a weak domestic banking market in Europe. Furthermore, a plan to temporarily exit and re-enter may not be possible, as a foreign company that leaves town during hard times would typically not be quickly welcomed or permitted back. Lastly, should there be no other choice for a European bank but to sell and exit, there are likely other domestic and foreign banks that would gladly step in, as demonstrated recently when European banks sold parts of their Latin

American business to local institutions. Indeed, even at the height of the post-Lehman Brothers financial crisis, Asia did not see a wholesale pulling out of assets.

But this deleveraging by many European banks is only part of the capital flow story. Meanwhile, as noted above, the ECB has launched its version of quantitative easing, which now augments the extraordinarily loose monetary policies of the U.S., Japan, Switzerland and the U.K. We now see the most aggressive printing of money in modern times. While these policies aim to address domestic conditions, most notably to ease the deleveraging of domestic banks, capital cannot be contained within national borders. Given open capital markets, we believe abundant global liquidity should continue to flow into emerging markets that are blessed with strong macroeconomic fundamentals, like those of Asia, particularly as the region's currencies still appear largely undervalued. Short-term volatility excluded, monetary policy in these major economies should ultimately facilitate net capital inflows into Asia and many other asset markets, and thus could help reduce the risk of a recession-induced credit crunch in Asia.

Also, we believe strong economic and political fundamentals support many emerging and some developed markets. For example, many emerging Asian economies have built ample liquidity cushions through significant accumulation of international reserves. Unlike Europe or the U.S., Asia and much of the emerging world have built up plenty of room to potentially provide fiscal stimulus and to lower interest rates in response to a worsening external environment as debt levels generally remain low and interest rates were pre-emptively hiked at the end of the recession. Additionally, the largest countries like China, India and Indonesia can potentially count on robust and resilient domestic demand to counter weak external demand. Also, consumers and corporations in Asia have broadly maintained strong balance sheets.

Against this background, we think China should be able to achieve a relatively benign moderation of growth to the 8%–9% range. We believe that the variety of tightening measures undertaken by the government over the 2010–2011 period has reduced the risk of economic overheating and asset bubbles, particularly in the real estate sector. Largely as a result of these policies, GDP growth has moderated somewhat in the short term to a pace that is still robust and should prove more sustainable over the longer term. In efforts to make growth sustainable, China is also working to rebalance its economy away from excessive reliance on investment and toward private consumption. Together with decelerating growth of labor supply, this effort is gradually resulting in rising wage pressure domestically, which in turn could add to global price pressures, especially if the renminbi remains on a steadily appreciating path.

To conclude, it is worth noting that even if a European downturn does lower the absolute level of its growth, we believe it is relative pricing that matters for capital flows and for investment decisions. The markets have historically priced assets according to boom or bust scenarios and are not used to pricing “mediocrity” in a nuanced manner. We see the market as currently pricing in an extremely bearish outcome for global growth rather than the mediocre growth we envisage in the G-3 (i.e., the United States, the eurozone and Japan) coupled with what we consider to be relatively robust health in much of the emerging world. Thus, even a

level-shift down would not change the relative attractiveness at current price levels that we see in many non-leveraged countries, both advanced and emerging. We continue to see unorthodox policies being followed in some major advanced countries as having potentially serious long-term consequences, including asset price bubbles and upward surges in commodity prices. We have continued to position ourselves in seeking to manage the interest-rate risks that we expect from the combination of historically low interest rates and easy monetary policy in the G-3, rising price pressures emanating from China and global demand that we believe is far from collapsing. Thus, as of year-end 2011 we have generally maintained an extremely short duration within our strategies, while seeking to take advantage of what we deem as the relative attractiveness of currencies of countries whose fundamentals are likely to support medium-term potential.

1. Source: World Economic Outlook Update, January 2012. © By International Monetary Fund. All Rights Reserved.

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