FRANKLIN TEMPLETON INVESTMENTS

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Beyond Bulls & Bears Bulletin

INSIGHT FROM FRANKLIN TEMPLETON INVESTMENTS MANAGERS

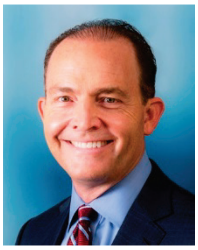
IN THIS ISSUE: ***The articles in this issue are as at 24 February 2017.***

An Emerging-Market Evolution: The way investors think about emerging markets has been evolving—along with the markets themselves. One thing Templeton Emerging Markets Group emphasises is that one can't consider emerging markets as one asset class; the opportunities are very differentiated between regions, countries and markets, with different fundamentals shaping them. Stephen Dover, managing director and chief investment officer of Templeton Emerging Markets Group and Franklin Local Asset Management, shares his view of how emerging markets have changed over time, how he thinks investors should think about them, and where he sees potential opportunities ahead.

How Rising Inflation Could Ride to the Rescue of Eurozone Earnings: As 2017 gets underway, the macro environment appears to present a rosy picture for European equities. However, the gap between European and US corporate earnings remains stubbornly in place. That could be about to change, according to Dylan Ball, executive vice president, Templeton Global Equity Group. He believes the prospect of higher inflation across the eurozone could be the catalyst that helps close the earnings gap.

The Sectors Most Likely To Cheer US Tax Reform: The financial markets seem to have high hopes for new business-friendly policies in the United States following Donald Trump's inauguration as the country's 45th president on 20 January. Whether Trump's campaign promises actually lead to policy changes still remains to be seen, but when it comes to potential tax reforms and fiscal spending initiatives, certainly some stock sectors look to benefit more than others. Ed Perks, chief investment officer, Franklin Templeton Equity, puts financials, consumer and industrial stocks (in general) in that category. While he's optimistic about the year ahead for the equity market, he notes that there are still many unknowns.

An Emerging-Market Evolution



Stephen H. Dover, CFA
Managing Director
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I think emerging markets are appropriately named—they are indeed emerging and have changed over time. With these changes, I believe the way people both think about and invest in the asset class also should evolve.

One example of the evolution we have seen is in regard to market capitalisation (market cap). In 1988, when the MSCI Emerging Markets Index was first launched, just two of the 10 countries in the index—Malaysia and Brazil—represented more than half of the index's market cap.[1] At that time, the entire market cap of the index was about US$35 billion, representing less than 1% of the world's equity-market capitalisation.[2]

If we fast-forward to 2016, there were 23 countries in the index, and the market cap had grown to US$4 trillion, representing about 10% of world market capitalisation.[3] The mix of countries in the index has also evolved over time. In terms of country weights, today, India represents 8% of the MSCI Emerging Markets Index and China—which wasn't represented at all in 1998—is nearly 27% of the index today. Meanwhile, Brazil's representation is much less today, at only 8%.[4]

What constitutes an emerging market has also changed significantly over time, but the waters in emerging markets have not always been very clear.

South Korea has been the subject of some debate in this regard. MSCI includes South Korea in the emerging-markets category, while another index provider, the FTSE Russell, considers it a developed market. This issue is quite important, as which countries are in which category and at what percentage in the indexes help determine how many investors position their portfolios. We have seen countries shift in and out of emerging-market status over time. For example, in 2013, MSCI reclassified Greece from developed to emerging-market status, and in 2016, MSCI announced Pakistan will be reclassified this year as an emerging market from frontier status.[5]

It really boils down to how one defines "emerging market," and there is some disagreement about exactly what the criteria should be. MSCI and FTSE have their own criteria for inclusion in a particular index, including explicit requirements for market size and liquidity, a country's openness to foreign ownership, foreign exchange and other aspects.

If you were to follow the World Bank's standards as to which countries are classified as "high-income" to determine developed-market status, you'd wind up with a very different set of constituents than the index providers—for example, Qatar's per-capita income ranks above that of Australia, Denmark and the United States.[6]

That said, we at Templeton Emerging Markets Group are active managers and not confined to a particular benchmark classification or index weighting when we make our investment decisions. We employ a bottom-up approach and focus on the fundamentals we see in individual companies. We may even invest in a company that is located in a country considered to be developed—if the bulk of its profits come from emerging markets.

Emerging Markets—Taking a Bigger Piece of the World's Pie

While emerging markets currently represent at least 10% of the world's stock-market capitalisation (based on MSCI indexes), in our various discussions with investors, we have found most have a smaller percentage of their portfolios invested in emerging markets. And worth noting, the 10% figure represents the traditional MSCI indexes—other measures of emerging-market capitalisation show emerging markets more broadly represent an even higher percentage.

We also have found that even though the world has become much more globalised, many investors still exhibit a "home-country bias," investing solely within their own borders even if markets elsewhere look more promising. We see room for growth in the emerging-markets realm—and a great potential opportunity for diversification that many investors aren't even considering. We also see many potential opportunities within frontier-market countries, many of which aren't even included in global indexes. These markets represent a smaller subset of emerging markets that are even less developed, and include most countries on the African continent.

Looking at other measures, we can see just how important emerging markets are to the global economy. Today, emerging markets represent nearly 50% of the world's gross domestic product (GDP) measured in nominal terms (nearly 60% when using purchasing-power parity) and account for nearly 80% of global GDP growth.[7]

Changing Economies

Emerging markets have also undergone structural changes. Over the past three decades, emerging markets largely achieved their phenomenal growth through exports—and many people have associated these markets with commodities. While many emerging-market countries still rely on exports, these economies are radically changing. As recently as 2008, commodities and materials stocks constituted 50% of the components of the MSCI Emerging Markets Index. Today, that category represents about 15% of the stocks in the index. To us, what's really exciting about this shift is that it opens up many more investment opportunities that are focused on consumption and services.

Many investors may not realise that some very sophisticated information technology (IT) companies are based in emerging markets. In 2008, IT companies represented about 7% of the MSCI Emerging Markets Index, and today, the sector represents 24% of the index—in fact, the top four constituents by weight are IT companies. Consumer/consumption-oriented stocks represented 7% of the index in 2008; today their weighting is 17%. So it is really not accurate to say emerging markets are pure commodity plays anymore, even though many people still consider them to be driven by the whims of commodity prices.

The weakness we have seen in many emerging-market currencies is something we think also strengthens our investment case. The US dollar is at a 15-year high and some predict it could strengthen even more as the Federal Reserve is expected to continue to raise interest rates as inflation picks up. In our view, emerging-market currencies have been quite weak—in some cases, unjustifiably so. We see this as supportive. Mexico, Argentina, Colombia, Indonesia and Malaysia are all examples of countries with currencies trading at what could be considered distressed levels—priced as if those economies are in great crisis. The fundamentals tell a different story. We believe the fundamentals in these countries look much better than their currency prices are reflecting.

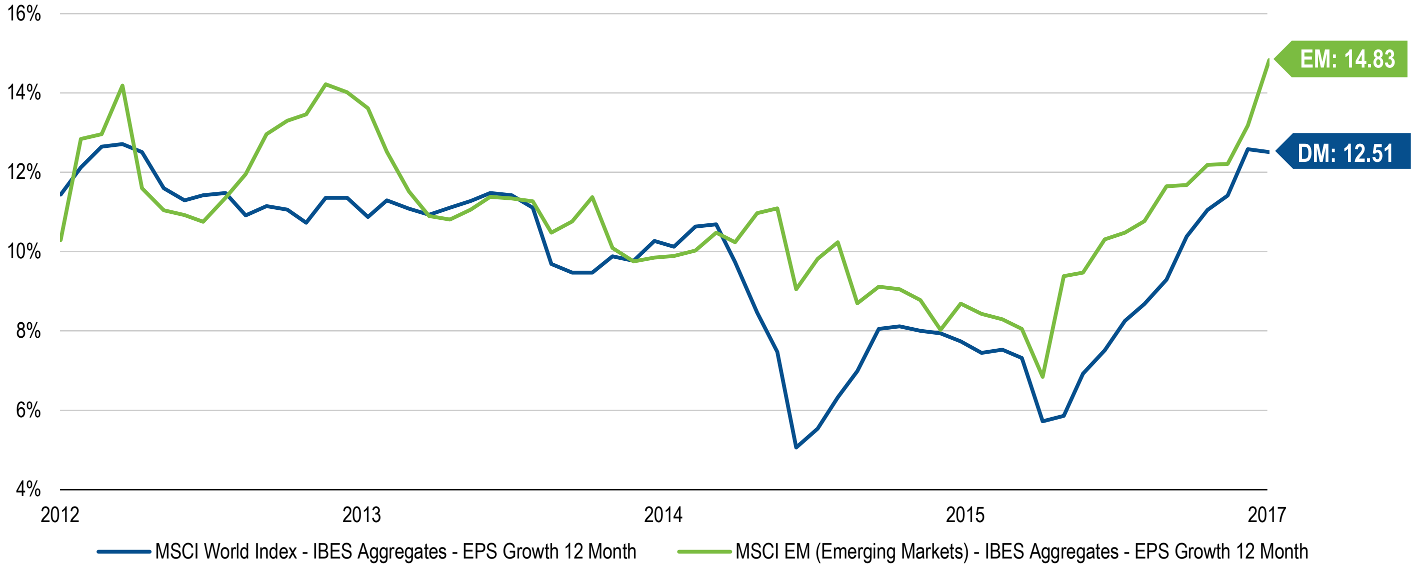
Additionally, we believe inflation appears poised to drop in many emerging-market countries, including Brazil, Russia, Colombia and Nigeria, and this allows their central banks to pursue more accommodative monetary policy, which could stimulate local equity markets.

More Reasons Why We're Optimistic

Despite some uncertainties, we see opportunity in emerging markets in 2017 and are optimistic many investors will see value in making greater allocations to them. GDP growth is expected to outpace that of developed markets, with the International Monetary Fund projecting growth of 4.5% in emerging and developing economies versus 1.9% in developed markets this year.[8] We see evidence that earnings growth in emerging markets could likely be higher than in developed markets, too. Emerging markets have been lagging in regard to earnings growth, but 2016 marked the first time in more than five years they outperformed developed markets. We think there's still quite a bit of room for emerging markets to further catch up.

Emerging Markets vs. Developed Markets

12-Month Forward Earnings-per-Share Growth
February 2012–January 2017



Source: FactSet, MSCI, as of 31 January 2017. The MSCI Emerging Markets Index captures large- and mid-cap representation across 23 emerging-market countries. The MSCI World Index captures large- and mid-cap representation across 23 developed-market countries. Indexes are unmanaged, and one cannot directly invest in an index. They do not reflect any fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future performance.**

And finally, the United States is near full employment and President Donald Trump's administration has proposed some policies that appear stimulative for economic growth, including potential tax cuts and fiscal spending. History has shown us that in general, a strong US economy is positive for emerging markets. Even if we do see some reduction in trade on a marginal level, we think an expansion in the global economy is likely to help emerging markets. And, as noted, emerging markets that are more domestically driven should be more insulated against global shocks in other markets.

Emerging markets are in fact, emerging, and we see many opportunities ahead in 2017.

How Rising Inflation Could Ride to the Rescue of Eurozone Earnings

Dylan Ball, ACA
Executive Vice President
Templeton Global Equity Group

After a year in which political surprises dominated headlines across the globe, we believe conditions are lining up for a positive year for European equities—and not before time.

Recent experience suggests that equity markets in general have a problem pricing in political events. However, we believe politics does not drive equity markets over the long term; rather, it provides a short-term opportunity to take advantage of longer-term trends.

As value investors, we try to stay focused on a longer-term investment horizon and use volatility as an opportunity to look for undervalued companies.

A Positive Macro Environment

A devalued euro, momentum in the credit cycle and the winding down of austerity across the continent are all considered generally positive for European equities.

More important for the asset class in 2017, we believe, is the prospect of higher inflation, which now seems likely to be coming down the pike. Inflation, in our view, should be positive for European earnings.

Traditionally, inflation has tended to lag movements in energy and commodity prices by approximately three to four months. By September last year, the price of oil had recovered from its historic lows, moving back up to around US$50 per barrel. The effect of that price increase is now showing up in the inflation figures, suggesting to us that Europe could be moving from a 1%-to-2% inflation environment to perhaps a 3%-to-4% inflation environment.

HOW SUSTAINABLE IS THE INFLATION STORY?

We think a number of factors point to a sustained period of higher inflation across Europe.

Higher oil and commodity prices feature in our base case, as a number of important commodity prices seem to us to have shown signs of bottoming out in the second or third quarter of 2016.

An increase in infrastructure spending in the United States and Europe would likely maintain that upward momentum. Oil prices remain supply driven. We don't have a crystal ball, but our research and calculations suggest global demand for oil could support a price above the recent US$55 per-barrel level.

After all, demand for oil continues to grow at 1%-to-2% per year globally.[9] While an increase in the US rig count might go some way to meeting demand growth, members of the Organization of the Petroleum Exporting Countries appear to be willing to restrict their output in order to push oil prices higher.

Meanwhile, during recent research trips in Europe, we came across some evidence that the debate on stimulus is moving out of monetary policy and into fiscal policy.

Some have suggested that if US President Donald Trump were to go down the fiscal leverage route, in which he starts spending and building, some European countries such as Germany might consider similar moves.

Furthermore, should the Trump administration press on with the more protectionist agenda that he advocated in his presidential campaign, that too could have an inflationary effect through higher import prices.

Why Does This Matter for European Earnings?

The stubborn gap between US and European earnings has failed to close over several years. European earnings currently remain 60% below some peaks during the 2008–2009 period, while US earnings are 10% above levels of eight or nine years ago.[10]

Observers have cited a number of possible reasons for this discrepancy, including a claim that the sort of monetary policy that the European Central Bank is pursuing cannot work effectively without fiscal unification.

Another suggestion is the positive earnings impact of share buybacks in the United States, where the tax regime has traditionally been supportive of such measures.

In our view, the overwhelming reason that European earnings continue to lag their US peers is that profit margins in Europe have not yet recovered in the way that one might hope.

It may be easy for observers to say that European labour markets are not as competitive as their US counterpart and can't respond as nimbly to lower demand. However, we don't think that is the case; labour costs in Europe have been very competitive, in our view.[11]

Instead, we think the underlying issue is pricing.

European companies tend to be price-takers. When inflation falls, European firms tend to cut prices to compete with their US and Asian peers. When inflation rises again, European companies tend to raise their prices.

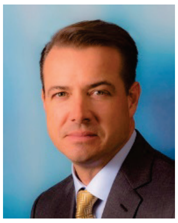
Therefore, once European companies respond to rising inflation, we'd expect a closure of the earnings spread with the United States.

Inflation: Good for Europe, Good for Value Investors

We've been in a deflationary world the last eight to nine years. As a contrarian investor during that time, we've taken an interest in companies that fare well when there's no inflation. Conversely, as inflation turns upwards, we believe for a rerating of industrials, financials, and oil and gas stocks in Europe.

And as we survey the landscape for European equities, it's that rerating story that seems to us to offer an opportunity for long-term returns.

The Sectors Most Likely To Cheer US Tax Reform



Ed Perks, CFA
Executive Vice President
Chief Investment Officer
Franklin Templeton Equity

In the United States, tax reform appears to be a cornerstone for Donald Trump's new administration, and we expect related policies will likely be passed within the next few months through the budget reconciliation process that could have investment implications. While there are few specific details available today, some distinct similarities in the proposals on the table should help guide us. To highlight three of these:

- Lower marginal federal income tax rate on corporate profits
- A simplification of the tax code and repeal of most—or at least many—corporate tax breaks
- A repatriation tax holiday on accumulated foreign profits

It's always tough to gauge the impact of policy shifts in isolation. However, we think broad tax reform combined with other fiscal stimulus measures, such as infrastructure spending and repatriation of foreign profits, could be very effective (at least in the short term) in providing a boost or acceleration in GDP growth over the next several years.

In terms of some possible market and sector implications, first we would consider the impact of corporate tax reform. We think the House Republican Tax Reform Task Force Blueprint is targeting some of the issues that have contributed to what many believe is an inefficient and uncompetitive tax system.

Currently, domestic companies' worldwide profits are subject to a US federal tax rate of 35%. Foreign earnings are taxed only when repatriated (also at a 35% rate) less a credit for any foreign taxes paid, but in reality this had ultimately incentivised multinationals to leave foreign earnings overseas to the tune of over US$2.5 trillion. We expect a one-time repatriation tax holiday on accumulated foreign earnings. Importantly, we think this is likely to come into play regardless of whether or not the cash is moved from foreign jurisdictions to the United States.

While some of the initial tax-reform proposals call for corporate tax rates as low as 15% to 20%, we ultimately think the rate will fall between 20% and 25%, and will likely include a significant reduction in the number of tax deductions and credits. This would meaningfully simplify the tax code.

Financials, Consumer Staples, Industrials Likely to Benefit

Potential US tax reforms are likely to have a wide range of impacts on different sectors and companies within the equity market, but ultimately it depends on an individual company's situation. That said, as we look across sectors, we see some companies more likely to benefit and some less likely to benefit. In our view, financial-oriented companies with higher effective tax rates are amongst the likely beneficiaries. We also would put consumer discretionary, consumer staples and industrials companies in that category, particularly companies with high domestic production operations and/or a specific export focus. Companies competing with large importers of goods may see a competitive advantage.

Those that may see a less significant benefit include health care and technology companies; in these areas we may actually see an increase in cash or GAAP tax rates,[12] particularly for companies that have been a bit more aggressive with tax-planning strategies and/or the offshoring of a significant component of their operations.

Overall, we think tax reform is likely to be positive for US equities in general. The benefit from lower tax rates is likely split between earnings and cash flow at the corporate level. Combined with the effects of higher spending and possible domestic investment and other stimulus measures, we see the potential for US GDP growth to accelerate between 0.5% and 1.0% over the next several years.

We remain optimistic about some combination of these different initiatives: tax reform, simplification of the tax code, repatriation of foreign profits, infrastructure spending, the ability to enhance or incentivise an increase in domestic spending, and an increase in domestic investment. One of the key factors causing a deceleration in earnings growth during the last several years has been a decline in productivity. We think that many of the aforementioned initiatives could help boost productivity and set us on a higher trajectory for earnings growth over the next several years. Our long-term focus and dedicated research can help us find interesting opportunities amidst an evolving landscape.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Investments in foreign securities involve special risks 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. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Value securities may not increase in price as anticipated or may decline further in value. To the extent a portfolio focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a portfolio that invests in a wider variety of countries, regions, industries, sectors or investments.

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1. Source: MSCI. Indexes are unmanaged, and one cannot directly invest in an index. They do not include fees, expenses or sales charges.
2. Source: MSCI. World Market Cap represented by the MSCI All Country World Index, a global equity index consisting of developed and emerging market countries. Indexes are unmanaged, and one cannot directly invest in them. They do not include fees, expenses or sales charges.
3. Source: Ibid.
4. Source: Ibid. Data as at January 2017.
5. Source: MSCI Annual Reclassification Review.
6. Source: World Bank, based on estimates of gross national income (GNI) per capita, data as at July 2015. High-income economies are those with a GNI per capita of US$12,736 or more.
7. Source: World Bank, International Monetary Fund, figures based on 2015 data.
8. Source: International Monetary Fund World Economic Outlook, January 2017 update. There is no assurance that any estimate, forecast or projection will be realised.
9. Source: International Energy Agency Oil Market Report, 2016 data and 2017 projection. There is no assurance that any estimate, forecast or projection will be realised.
10. Source: FactSet. Europe and the United States are defined by the MSCI Europe Index and MSCI USA Index, respectively. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI. All data as at 31 December 2016. **Past performance is not an indicator or a guarantee of future performance.** Indexes are unmanaged, and one cannot directly invest in them. They do not include any fees, expenses or sales charges.
11. Source: Eurostat, December 2016.
12. Generally accepted accounting principles (GAAP) represent accounting principles, standards and procedures companies must follow when preparing financial statements.

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