FRANKLIN TEMPLETON INVESTMENTS

Investment Team Update

March 2017

Global Economic Perspective

PERSPECTIVE FROM THE FRANKLIN TEMPLETON FIXED INCOME GROUP®

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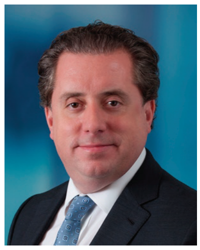


David Zahn

IN THIS ISSUE:

Investors Adjust to March Rate Hike, but US Growth Set to Remain Modest for Now

Even though confidence among US businesses and consumers has been lifted by the advent of a new administration, the question of whether this buoyant mood is likely to translate into a significant pickup in US economic growth remains unanswered, in our view. The US Federal Reserve (Fed) looks set to tighten monetary policy further, as inflation and unemployment move closer to its targets—underlining the strength of the domestic economy—and surging equity markets have added to already elevated consumer confidence. But the potential for delays and adjustments to anticipated growth-boosting policies poses risks, and we think the extent of these challenges may be underestimated.

Speculation about policy change has largely monopolised the attention of investors in the months since the US elections, but monetary policy came sharply back into focus during February. In her testimony to Congress, Fed Chair Janet Yellen—usually seen as one of the more dovish policymakers—delivered remarks that added weight to perceptions of a more hawkish stance from the Fed, although she was careful also to point out the considerable uncertainty around the outlook, particularly surrounding the new administration's economic plans. In reaction, market expectations that rates would rise three times in 2017—the Fed's indicated path for monetary policy—immediately increased, having fallen as low as 24% in early February, following the announcement of disappointing wage growth.

> **"Whether the buoyant US market mood will translate into a US economic growth spurt remains unanswered, in our view."**

This re-appraisal of the likely path for US monetary policy gathered pace when some of the other more dovish members of the Fed's rate-setting panel appeared to change tack and indicate they believed rates should rise soon. Following further remarks from Fed Chair Yellen in early March, it was clear a rate hike at the next Fed meeting was all but certain, and the release of a strong labour market report for February removed any last potential doubts over such a move. After repeated episodes stretching back to 2013 when the Fed had failed to deliver predicted rate rises, market participants were now faced with a specific warning from Fed Chair Yellen that policy accommodation would be removed more quickly than in previous years. As a result, market expectations were rapidly revised, so that a total of three rate hikes over the year was now seen as the most likely scenario, and predictions of four increases even gained some traction. The Treasury market initially remained fairly resilient to this reversal of sentiment, but by early March benchmark yields had reached their highest level so far this year, ahead of the Fed's confirmation of its decision to raise interest rates.

Sharp Turnaround in Market Expectations for March Fed Funds Rise

Exhibit 1: Fed Funds Rate Rise
2 January 2017–15 March 2017

Source: CME.

One of the data releases that may well have pushed the Fed to act was the strength seen in its preferred inflation indicator, the personal consumption expenditures price index, in January. Rising energy costs pushed the headline month-on-month figure up to 0.4%, while the annual gain rose from 1.6% to 1.9%, only a tenth below the Fed's target for inflation. However, mounting inflationary pressures were less apparent at the core level, where the equivalent monthly and annual numbers were 0.3% and 1.7%, the latter unchanged from the previous reading.

Business and consumer surveys broadly continued to suggest the post-election bounce in sentiment was intact, despite signs some policy initiatives from the Trump administration—including key tax and health care reforms—might take longer to implement, and in some cases be less radical, than earlier indications. Nevertheless, the new President's stance on reducing regulation remained an attractive message for companies and investors, and in his first address to Congress at the end of February, he underlined his intention to increase defence and infrastructure spending. In the wake of the President's address, broad US equity indexes posted new highs.

As mentioned, February's labour market report was strong, with nonfarm payrolls up by 235,000—well ahead of Consensus expectations of 200,000—and an upward revision to January's already robust job gains number. However, February's outsized rise may have been enhanced by unseasonably warm weather, with the number of additional construction jobs rising by the largest amount in several years. The unemployment rate dipped a tenth to 4.7%, despite a similar-sized increase in the labour force participation rate, which moved up to 63.0%. Average hourly earnings remained somewhat sluggish, up 0.2% from the previous month, although that rise was enough to push the annual figure back up, from 2.5% to 2.8%.

Notwithstanding the positive signals from the labour market and the pickup in sentiment, consensus estimates for US first-quarter 2017 growth showed little change, staying in the 1.5%–2.0% band that has prevailed in recent years. Early indications for consumer spending—which was revised sharply higher for the fourth quarter of 2016—pointed to a slight slowdown, with only a 0.2% monthly gain in January, compared with 0.5% in the previous month. But after figures showed trade had subtracted 1.7% from fourth-quarter gross domestic product (GDP) growth, this factor again seemed likely to prove a significant headwind, as January's trade deficit grew to its widest level since 2012.

We feel the restrained first-quarter GDP consensus forecasts reflect the contrast between a domestic economy doing relatively well, and which has spurred the Fed into action, and a less robust backdrop internationally. The Fed's move underlines that policymakers believe the current US expansion is resilient enough to withstand a less accommodative monetary stance. Nonetheless, we would not read too much more into the Fed tightening, and, while awaiting more substance on policy initiatives, we remain cautious about predictions that the US economy will soon break out of the pattern of modest growth seen in recent years.

China Announces Growth Target for 2017, and Oil Prices Dip as US Production Increases

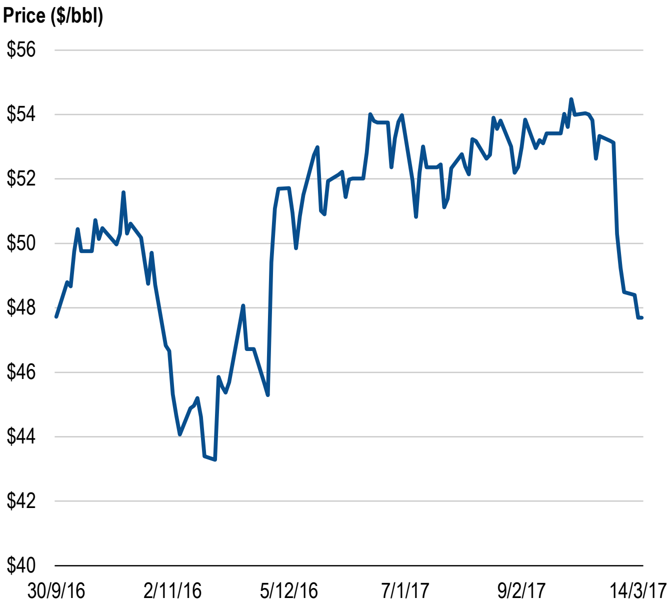
China's leadership announced the country's economic growth target for 2017 as around 6.5%, a slight dip from last year's 6.5%–7.0% range. The move was widely seen as a further sign of the shifting priorities of the Chinese government, with more of a focus on stability and risk management, rather than on the creation of additional debt in order to sustain previous levels of growth. In February, China's official purchasing managers' index (PMI) for the manufacturing sector remained well above the 50 level indicating expansion and showed a slight increase for January. Trade data for the same month revealed the country incurred its first trade deficit in local-currency terms since early 2014, mainly due to a surge in imports, although the figures were probably affected by the timing of the Lunar New Year holiday. In contrast, China's foreign-exchange reserves rose in February for the first time in eight months, providing some evidence—along with the relative stability of the Chinese renminbi so far this year—that the Chinese authorities' efforts to limit capital outflows have been having some effect.

The Mexican peso continued to rebound from its all-time low against the US dollar of around 22 pesos, reached soon after the start of this year. In February, Mexico's central bank launched a US$20 billion currency hedging programme—broadly similar to a policy used in 2015 by Brazilian policymakers to stem a fall in the Brazilian real—which had the advantage of providing support for the peso without draining the country's foreign-exchange reserves. The peso was subsequently boosted by comments from US Commerce Secretary Wilbur Ross, who struck a more conciliatory tone when describing relations between the United States and Mexico, even offering US assistance to help stabilise the Mexican currency. By early March, the peso had risen to its highest level against the dollar since the US elections.

Elsewhere, signs of increasing US shale production weighed on oil prices. Following an agreement late last year among members of the Organization of the Petroleum Exporting Countries and several other large oil-producing countries to restrict supplies, prices rose and largely held their gains as participants appeared to be mostly complying with the terms of the deal. But in early March figures revealed that a resurgence in production in US shale fields had increased US crude inventories to record levels, which pushed a leading benchmark for oil prices below US$50 per barrel for the first time this year.

Oil Prices Dip as US Shale Production Increases

Exhibit 2: West Texas Intermediate Crude Oil
30 September 2016–14 March 2017



Source: FactSet.

South Korean markets were generally stable after the country's president, Park Geun-hye, was removed from office by a court ruling, which upheld her impeachment by the South Korean parliament at the end of 2016. As the trial of the head of one of South Korea's largest conglomerates on corruption charges got underway, the president's ousting meant she lost her immunity to prosecution over the corruption scandal that forced her from office. South Korea has faced slowing growth and rising unemployment, while tensions with China, the country's largest trading partner, have risen after South Korea unveiled plans to deploy a US missile shield, although the front-runner to become the country's next president has said he will re-examine that decision if elected.

> "By early March, the peso had risen to its highest level against the dollar since the US elections."

The re-assuring signs about China's economic growth, along with the absence of protectionist measures so far from the Trump administration, have helped create a better backdrop for many emerging markets in recent months. We think several countries in this category appear to have sound fundamentals and should be well placed to weather any volatility if either of these factors cease to be supportive. Overall, however, we would agree with the recent assessment by the Organisation for Economic Co-operation and Development of only a relatively limited improvement to global economic growth over the rest of this year.

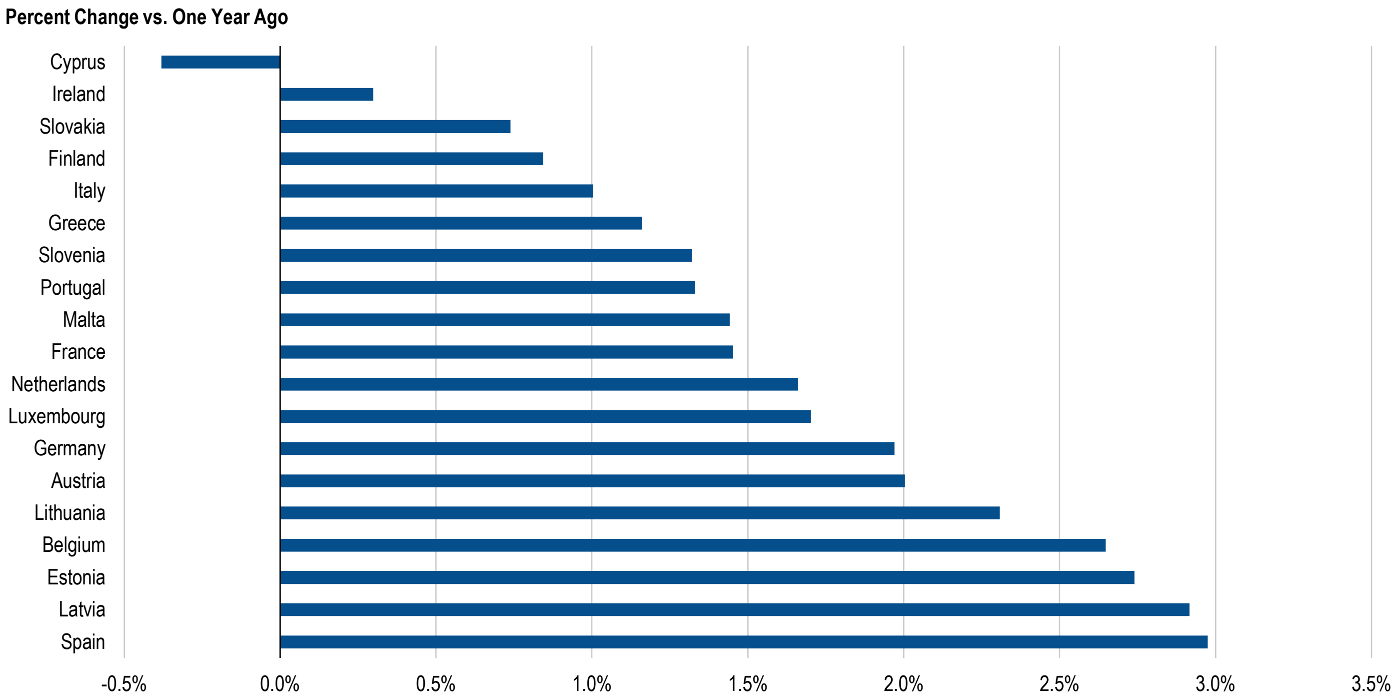
Political Uncertainty Likely to Overshadow Rising Inflation for ECB Policymakers

Data from the eurozone continued to indicate levels of growth close to the single-currency region's maximum potential rate, which remains constrained by the absence of any significant moves to adopt the type of structural reforms urged by many economists and market participants. The eurozone's manufacturing PMI for February rose to its best level since 2011, and a leading measure of German business confidence for the same month climbed back up to the four-year high seen at the end of 2016. Even French consumers seemed untroubled by ongoing political uncertainty ahead of the first round of the country's presidential election, scheduled for late April, as the February reading of a key measure of sentiment among the country's consumers remained at its highest level for a decade.

Inflation in the eurozone also continued its upward trajectory in February, hitting an estimated annual rate of 2.0%, its highest level in four years. But while the headline numbers were strong, after stripping out the fading impact of past declines in energy costs, core inflation over the same period remained subdued at just 0.9%. Earlier figures covering January marked an important

Prices Rise in Every Eurozone Country for First Time since 2013

Exhibit 3: Eurozone Inflation – Consumer Price Index
January 2017



Source: FactSet.

milestone in the region's battle against deflation, showing all of the monetary bloc's individual member states had recorded price rises for the first time since February 2013.

The ECB's meeting in March produced few surprises, though the central bank did increase its inflation forecast for the current year from 1.3% to 1.7%. However, the ECB left its estimate for 2019 unchanged—with inflation still expected to be short of its target of close-to-but-below 2%—underlining how policymakers view the upswing in pricing pressures as transitory. Market participants closely studied ECB President Mario Draghi's accompanying remarks for any clues about the path ahead for monetary policy, but he batted away suggestions of any changes to the ECB's bond-purchasing programme. Nevertheless, the apparent success of the ECB's policy in overcoming the threat of deflation increased speculation about a potential tightening of monetary policy, possibly even before the cessation of the central bank's bond purchases—scheduled to continue for at least the rest of the year—and in the wake of the ECB meeting pushed market estimates of the odds of a rise in official interest rates before the end of 2017 to more than 50%. The speculation also prompted rises in German Bund yields and the euro.

> **"We think speculation about future ECB tightening has moved too far ahead of economic/ political realities."**

In the first such event of a year crowded with European elections, the Netherlands prepared to go to the polls in mid-March, potentially providing an early reading of political sentiment among European voters following several populist upsets in 2016. However, the scope for another shock seemed limited by the fragmented nature of Dutch politics, which has traditionally produced a multi-party governing coalition, and meant even substantial gains for the leading populist party would be unlikely to allow it to gain access to power.

We think the speculation about a potential future tightening of monetary policy by the ECB—whether in the form of a tapering of bond purchases or a rise in interest rates—has moved too far ahead of the economic and political realities within the eurozone. Absent future significant inflationary pressures elsewhere in the global economy, the current pickup in inflation in the region seems likely to be a temporary phenomenon, and while the growth rate across much of the eurozone has improved, we believe it remains short of the levels necessary to be self-sustaining, with little sign of the political appetite for the structural reforms needed for such changes to take place. Indeed, given the uncertain political outlook, it could be argued any mandate at the national or regional level for such measures looks more remote than ever. Against this background, we believe ECB President Mario Draghi will likely persuade his colleagues to continue with current accommodative policies and resist calls to adopt a more hawkish line.

EUROLAND MACROECONOMIC DATA

FINAL OUTPUT				
Gross Domestic Product (GDP)[1]	**1Q16**	**2Q16**	**3Q16**	**4Q16**
GDP, Y/Y (%)	1.7	1.6	1.8	1.7
Private Consumption, Y/Y (%)	2.0	1.9	1.8	1.8
Gross Fixed Capital Formation, Y/Y (%)	2.5	3.8	2.3	1.5
ECONOMIC INPUTS[1]				
	Oct 16	**Nov 16**	**Dec 16**	**Jan 17**
Retail Sales, Y/Y (%)	2.9	2.7	1.2	1.2
Unemployment Rate (%)	9.8	9.7	9.6	9.6
Industrial Production, Y/Y (%)	0.9	3.3	2.5	0.6
INFLATION & WAGE PRESSURE				
Inflation Indicators[1]	**Nov 16**	**Dec 16**	**Jan 17**	**Feb 17**
Consumer Price Index (CPI), Y/Y (%)	0.6	1.1	1.8	2.0
Core CPI, Y/Y (%)	0.8	0.9	0.9	0.9
FINANCIAL MARKETS				
	Nov 16	**Dec 16**	**Jan 17**	**Feb 17**
Dow Jones EURO STOXX 50 Price Index EUR, Trailing P/E Ratio[2]	19.15	18.62	18.28	18.78
ECB Refinance Rate (%)[3]	0.00	0.00	0.00	0.00
10-Year Yield—German Bunds (%)[2]	0.28	0.21	0.44	0.21
BALANCE OF PAYMENTS[1, 3]				
Trade Balance	**Sep 16**	**Oct 16**	**Nov 16**	**Dec 16**
Billion Euro	25.04	19.93	25.36	28.14
Current Account Balance	**1Q16**	**2Q16**	**3Q16**	**4Q16**
% GDP	2.2	3.3	3.5	4.4

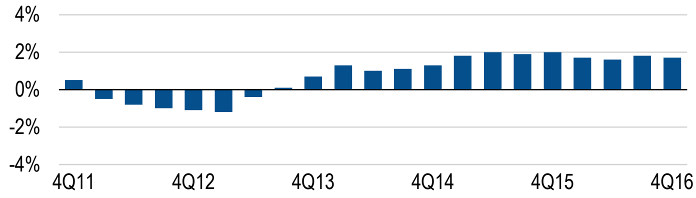
JAPAN MACROECONOMIC DATA

FINAL OUTPUT				
Gross Domestic Product (GDP)[4]	**1Q16**	**2Q16**	**3Q16**	**4Q16**
GDP, Q/Q ar (%)	1.9	2.2	1.2	1.2
Private Consumption, Q/Q ar (%)	-0.5	4.1	-0.5	0.7
Fixed Capital Formation, Q/Q ar (%)	-0.7	5.7	-0.4	8.4
ECONOMIC INPUTS				
	Oct 16	**Nov 16**	**Dec 16**	**Jan 17**
Unemployment Rate (%)[5]	3.0	3.1	3.1	3.0
Industrial Production, Y/Y (%)[6]	-1.4	4.6	3.2	3.2
Tertiary Index, Y/Y (%)[6]	-0.3	1.5	0.7	0.7
Corporate Activities	**1Q16**	**2Q16**	**3Q16**	**4Q16**
Corporate Profit Growth (%)[7]	-9.3	-10.0	11.5	16.9
Tankan Quarterly Survey (index level)[8]	6	6	6	10
INFLATION				
Inflation Indicators[5]	**Oct 16**	**Nov 16**	**Dec 16**	**Jan 17**
Consumer Price Index (CPI), Y/Y (%)	0.1	0.5	0.3	0.4
CPI ex-Fresh Food, Y/Y (%)	-0.4	-0.4	-0.2	0.1
FINANCIAL MARKETS[2]				
	Nov 16	**Dec 16**	**Jan 17**	**Feb 17**
Nikkei 225, Trailing P/E Ratio	23.5	22.6	22.3	22.4
3-Month Yield—JGBs (%)	-0.336	-0.391	-0.289	-0.327
10-Year Yield—JGBs (%)	0.025	0.046	0.087	0.056
BALANCE OF PAYMENTS				
Monthly Trade Balance[7]	**Oct 16**	**Nov 16**	**Dec 16**	**Jan 17**
Billion Yen	588	313	807	-853
Current Account Balance[9]	**1Q16**	**2Q16**	**3Q16**	**4Q16**
% GDP	3.4	3.5	3.7	3.8

Abbreviations: Q/Q ar: Quarter-over-quarter annualised rate. Y/Y: Year-over-year.

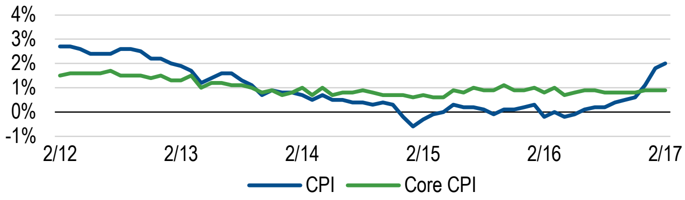
1. Source: © European Union 1995–2017.
2. Source: Bloomberg. P/E ratios of Dow Jones EURO STOXX 50 Price Index and Nikkei-225 Stock Average as calculated by Bloomberg.
3. Source: European Central Bank.
4. Source: Economic and Social Research Institute, Cabinet Office, Government of Japan.
5. Source: Ministry of Internal Affairs & Communication, Japan.
6. Source: Ministry of Economy, Trade and Industry, Japan.
7. Source: Ministry of Finance, Japan.
8. Source: Bank of Japan.
9. Source: Bloomberg Indexes.

Eurozone Real GDP, Y/Y



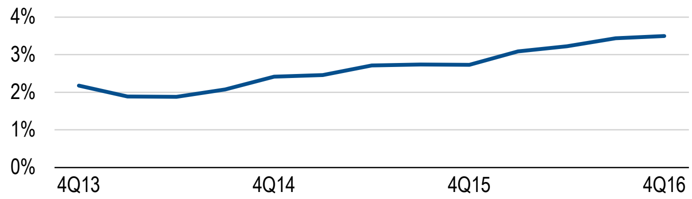
Source: © European Union 1995–2017, as at December 2016.

Consumer Price Index, Y/Y



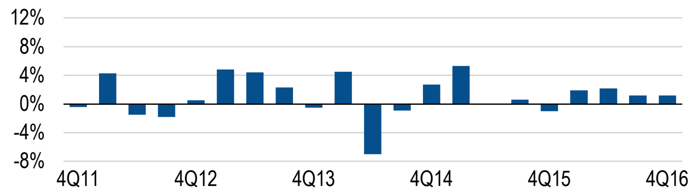
Source: © European Union 1995–2017, as at February 2017.

External Trade Balance, GDP



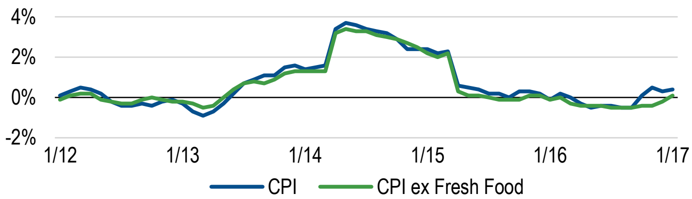
Source: © European Union 1995–2017, as at December 2016.

Japan Real GDP, Q/Q ar



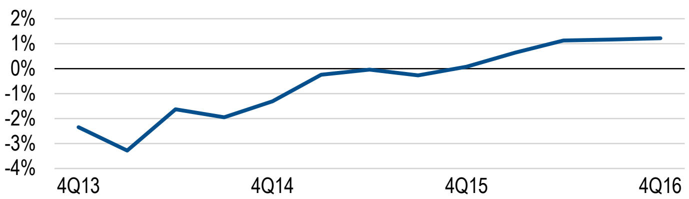
Source: ESRI, Cabinet Office, Government of Japan, as at December 2016.

Consumer Price Index, Y/Y



Source: Ministry of Internal Affairs and Communications, Japan, as at January 2017.

Visible Trade Balance, GDP



Source: Ministry of Finance, Japan and Economic and Social Research Institute, Cabinet Office, Government of Japan, as at December 2016.

Past performance does not guarantee future results.

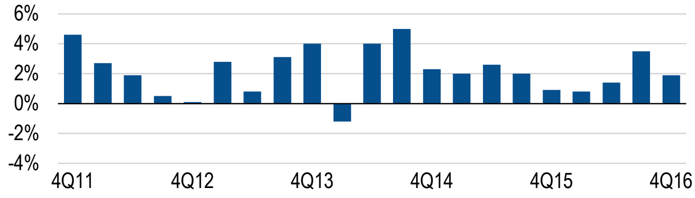
US MACROECONOMIC DATA

FINAL OUTPUT				
Gross Domestic Product (GDP)[2]	**3Q16**	**4Q16**	**1Q17E[1]**	**2Q17E[1]**
Q/Q ar (%)	3.5	1.9	2.1	2.4
ECONOMIC INPUTS				
CONSUMPTION/FINAL DEMAND				
Income/Savings[2]	**Oct 16**	**Nov 16**	**Dec 16**	**Jan 17**
Consumer Spending, Y/Y (%)	4.3	4.2	4.6	4.7
Personal Income, Y/Y (%)	3.7	3.7	3.6	4.0
Savings Rate (%)	5.7	5.7	5.4	5.5
Employment	**Nov 16**	**Dec 16**	**Jan 17**	**Feb 17**
Unemployment Rate (%)[3]	4.6	4.7	4.8	4.7
Participation Rate (%)[3]	62.6	62.7	62.9	63.0
Nonfarm Payrolls (in thousands)[3]	164	155	238	235
Jobless Claims, 4-wk average (in thousands)[4]	252	258	249	234
Housing[5]	**Oct 16**	**Nov 16**	**Dec 16**	**Jan 17**
Existing Home Sales (in millions)	5.53	5.60	5.51	5.69
Y/Y Change (%)	4.7	15.9	1.5	3.8
INVESTMENT				
Corporate Earnings[6, 11]	**3Q16**	**4Q16E**	**1Q17E**	**2Q17E**
Earnings, Y/Y (%)	3.1	5.7	9.7	8.8
Production & Utilisation[7]	**Oct 16**	**Nov 16**	**Dec 16**	**Jan 17**
Industrial Production, Y/Y (%)	-0.7	-0.3	0.7	0.0
Capacity Utilisation (%)	75.5	75.2	75.6	75.3
Nonresidential Fixed Investment[2]	**1Q16**	**2Q16**	**3Q16**	**4Q16**
Y/Y (%)	-0.4	-0.5	-1.1	0.0
INFLATION & PRODUCTIVITY				
Inflation Indicators	**Nov 16**	**Dec 16**	**Jan 17**	**Feb 17**
Personal Consumption Expenditure (PCE), Y/Y (%)[2]	1.3	1.6	1.9	–
Core PCE, Y/Y (%)[2]	1.6	1.7	1.7	–
Consumer Price Index (CPI), Y/Y (%)[2]	1.7	2.1	2.5	–
Core CPI, Y/Y (%)[3]	2.1	2.2	2.3	–
Producer Price Index (PPI), Y/Y (%)[3]	0.5	1.9	3.0	3.7
Core Producer Prices, Y/Y (%)[3]	1.7	1.7	1.7	1.6
Productivity[3]	**1Q16**	**2Q16**	**3Q16**	**4Q16**
Productivity, Q/Q ar (%)	-0.6	-0.1	3.3	1.3
Unit Labour Costs, Q/Q ar (%)	-0.3	6.2	0.7	1.7
FINANCIAL MARKETS				
Valuation	**Jan 17**	**Feb 17**	**Mar 17**	**Apr 17E**
P/E S&P 500[6]	20.84	21.61	–	–
Fed Funds Rate[7, 8]	0.75	0.75	1.00	0.89
BALANCE OF PAYMENTS				
US Monthly Trade Deficit[2, 9]	**Oct 16**	**Nov 16**	**Dec 16**	**Jan 17**
Billion USD	-42.6	-45.5	-44.3	-48.5
US Current Account Deficit	**4Q15**	**1Q16**	**2Q16**	**3Q16**
Quarterly (in USD billion)[2]	-113.4	-131.8	-118.3	-113.0
Annualised (% GDP)[10]	-2.5	-2.6	-2.6	-2.6

Abbreviations: Q/Q ar: Quarter-over-quarter annualised rate. Y/Y: Year-over-year. E: Estimate.

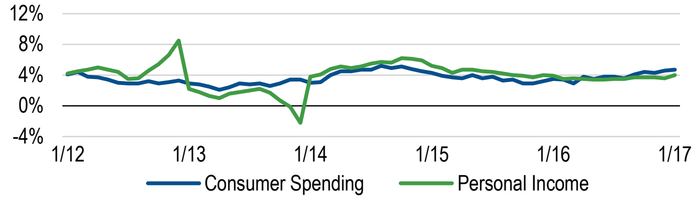
1. Source: Bloomberg Economic Forecasts as at 28/2/17.
2. Source: Bureau of Economic Analysis.
3. Source: Bureau of Labor Statistics.
4. Source: Department of Labor.
5. Source: Copyright National Association of REALTORS®. Reprinted with permission.
6. Source: Standard and Poor's.
7. Source: Federal Reserve. At the 15/3/17 meeting the Federal Reserve raised the main US interest rate to "a target rate" between 0.75% and 1.00%.
8. Source: Chicago Board of Trade (30-Day Federal Funds Futures Rate for March 2017 and April 2017), as at 13/3/17.
9. Source: US Census Bureau.
10. Source: Bloomberg Indexes.
11. Source: Bloomberg calculations are share-weighted y/y. Estimates as at 10/3/17.

Gross Domestic Product (GDP), Q/Q ar



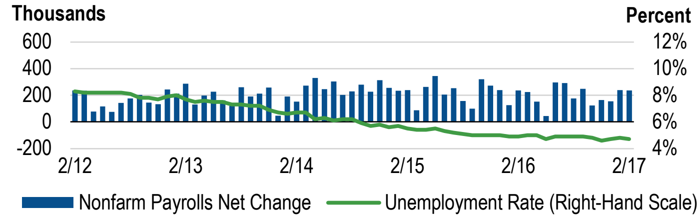
Source: Bureau of Economic Analysis, as at December 2016.

Personal Income & Expenditures, Y/Y



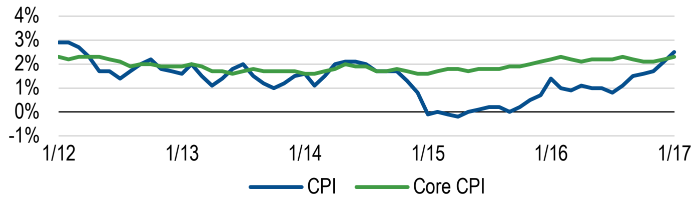
Source: Bureau of Economic Analysis, as at January 2017.

Nonfarm Payrolls & Unemployment Rate



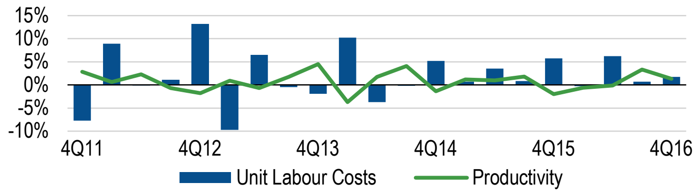
Source: Bureau of Labor Statistics, as at February 2017. All figures seasonally adjusted.

Consumer Price Index, Y/Y



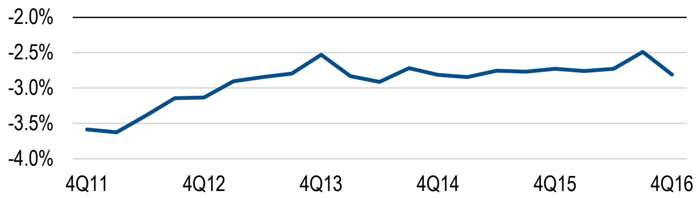
Source: Bureau of Labor Statistics, as at January 2017.

Productivity & Unit Labour Costs, Q/Q ar



Source: Bureau of Labor Statistics, as at December 2016.

US Annualised Trade Deficit, GDP



Source: Census Bureau and Bureau of Economic Analysis, as at December 2016.

Past performance does not guarantee future results.

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