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 30 August 2017.***

Navigating an Uncertain Second Half: Receding political anxiety and a gathering economic recovery in Europe helped global equity markets advance in the first half of 2017. Yet Templeton Global Equity Group's Cindy Sweeting and Tony Docal say investors should be somewhat cautious in the second half of the year. They believe rich stock valuations and shifting central bank policies could lead to bouts of volatility.

Macron at 100 Days: New French President Faces Busy Autumn: A large chunk of French President Emmanuel Macron's first 100 days in office came at a time when many Europeans were on holiday break. Here, Philippe Brugere-Trelat, Franklin Mutual Series Executive Vice President and Portfolio Manager, says it's unfair to judge Macron on such a short timeframe. He asserts that the first true test for Macron's reform agenda will come in autumn, and says that France and Germany seem to be working even more closely to keep the European Union (EU) together in the wake of last year's UK Brexit vote.

India's Reform Movement Gains Momentum: India has embarked on a sweeping reform movement under Prime Minister Narendra Modi, which has attracted investors' attention. Templeton Global Macro CIO Michael Hasenstab recently visited India, and takes a look at some of the reforms he's most excited about as a global fixed income investor. He believes India's future looks bright and that its growth trajectory should remain strong—despite some short-term adjustments.

Navigating an Uncertain Second Half

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Global equities advanced solidly during the second quarter, capping a strong first half of 2017 and a similarly strong one-year period. Developed and emerging-market equities benefitted from resilient corporate earnings, abundant liquidity and broad growth across most regions and sectors.

In retrospect, the markets' lurch lower in the aftermath of the United Kingdom's Brexit vote one year ago marked the bottoming phase of what had been a challenging and volatile time. It set the stage for a renewed advance in this multi-year bull market.

As we enter the second half of the year, markets now appear to reflect a somewhat cautious, if not uncomfortable, optimism. Experimental central bank monetary policy across the globe has fuelled global stock price appreciation, but a dangerous dependency on stimulus to generate ever-higher market returns is a possible side effect. This could present challenges for future equity market performance as major central banks gradually move to normalise extraordinarily supportive policy measures.

In the current environment, we think long-term investors should not buy equities indiscriminately. However, we do see pockets of opportunity in certain markets and sectors across the globe. We believe this is an environment where value discipline and active risk management will be rewarded over the long term.

China's Year of Calm

The Chinese government's recent measures to rein in credit creation and fiscal stimulus while avoiding a major economic slowdown appear to be proceeding steadily.

We expect these themes to remain dominant ahead of this fall's 19th National Congress assembly, where President Xi Jinping is likely to further cement his authority.

Nevertheless, we cannot ignore the country's sizeable and unresolved credit excesses, the result of an investment boom that led to overcapacity in real estate and industrial sectors. If China's economy slows too much, we believe China is likely to shelve its newer reforms and return to past measures to boost growth.

China's issues are well known. So in large part, we've avoided the vulnerable and opaque banking sector, state-owned enterprises and the oversupplied industrial complex. We see value in companies with underappreciated growth potential, mainly in the health care, insurance and information technology sectors. Certain franchises in the telecom sector where we find a combination of cheap valuation and strong free cash flow also appear attractive to us.

Uncertainty in the United States

Despite the ongoing resiliency of the US economy and equity markets, we have a few concerns.

Investor confidence in President Donald Trump's ability to enact pro-business policies appears to have diminished since last year's election. At this time, it's unclear if his administration's plans to lower taxes or boost infrastructure spending will actually materialise in legislation.

It's also hard to ignore the fact that, after eight years of unconventional US Federal Reserve (Fed) stimulus, US stocks are on the second-longest winning streak since World War II. We believe Fed members face challenges as they transition to a more traditional and sustainable monetary policy framework.

In our view, US stocks aren't cheap and do not adequately reflect the political and market risks we see. However, we do see value in select technology, financial and health care stocks, and in the beaten-down energy sector.

It's been a tough year so far for oil, with concerns about excess US inventory amongst factors driving prices lower. While we believe that current energy market fundamentals justify an oil price of US$50 per barrel or above, we also note that productivity gains in US shale fields have increased the elasticity of supply from these critical swing producers, a factor that could cap any significant price appreciation. As such, we expect oil prices could stay range-bound in the near term, and we will remain opportunistic at the stock level amidst expected price fluctuations.

Europe's Move to Growth

During the past six months, positive economic growth, supportive monetary policy and market-friendly election results have benefitted European markets.

Recently elected French President Emmanuel Macron's consolidation of power in the legislature offers opportunities for pro-business reforms. In our view, his plans to loosen labour laws and cut both taxes and spending look promising for the country and the eurozone at large.

Overall, the euro-area economy has been experiencing a broad recovery and transitioning to a multi-year growth cycle. In fact, European gross domestic product (GDP) growth has outpaced US growth over the past year and corporate profits have been accelerating.

We also see signs that interest rates are moving upward in some countries, with the potential for further increases ahead. Financial stocks, in particular, stand to benefit from higher rates, as well as from the increasing demand for credit in the eurozone. These factors, combined with declining loan losses, more favourable regulations and tighter costs controls are boosting bank earnings growth expectations.

We continue to find attractive opportunities in financial stocks, as well as in the industrials, materials and energy sectors.

United Kingdom's Political Disarray

The United Kingdom has had a tougher time than broader Europe. Prime Minister Theresa May's grave electoral miscalculation was the latest episode in the unfolding spectacle that is Brexit. After calling early elections, May squandered her Conservative Party's parliamentary majority and breathed new life into the opposition.

Despite the justifiable macro concerns in the United Kingdom, we see value in certain stocks there. With a few exceptions, we favour predominately multinational corporations with sizeable overseas revenues. These types of companies, while domiciled in the United Kingdom, should have less exposure to domestic economic pressures.

Indeed, despite noisy political headlines and genuine domestic economic threats, we think the United Kingdom remains a relatively attractive equity market. UK stocks (as measured by the FTSE 100 Index) offer the highest dividend yield of any major region (as measured by the MSCI World Index).[1] UK valuations are the cheapest relative to the rest of the world in 15 years.[2] What's more, FTSE 100 Index companies with more than 70% of their revenues from abroad stand to benefit from the weaker pound.

Opportunities in Emerging Markets

Emerging-market valuations appear attractive when compared with developed markets based on a number of metrics.[3] However, we remain selective stockpickers.

Weakness in the Asian tech cycle, global trade or a more notable slowdown in China's economy could negatively impact equity market returns. A slump in commodity prices and waning US dollar liquidity as the Fed downsizes its balance sheet are two additional risks that could negatively impact emerging-market equities.

We've found most of our emerging-market bargains in Asia, where we see corporate governance slowly improving. Management teams are engaging more with minority and foreign shareholders. We believe transparency, liquidity and market access are generally moving in the right direction.

Japan is also moving in this direction, but amongst Asian emerging markets we would point to South Korea as perhaps the best example of the corporate governance improvements and reforms in the Asian region. In our view, newly elected President Moon Jae-in is likely to deliver fiscal stimulus, work to begin to reform the anti-competitive and opaque practices of powerful conglomerates known as "chaebols", and move to normalise economic ties with China. The country's banking sector stands to benefit from this political stability, in addition to economic growth and rising interest rates. Despite these favourable trends, South Korean banks are still trading at undemanding valuations.

Putting it all Together

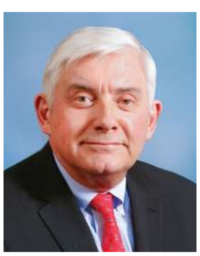
In our view, corporate earnings and cash flow generation will matter most for equity returns going forward. We remain highly focused on corporate business trends and company fundamentals.

We think central-bank policy will continue to demand market attention in the second half of the year. Over the last several weeks, it has become increasingly evident that many of the world's central banks are looking to wind down the extraordinary monetary stimulus that has supported asset prices since the global financial crisis.

As fundamentally oriented investors, we would welcome a return of policy normalisation.

With that in mind, we also think investors should consider preparing for rising volatility following an unusually quiet period for global financial markets. We are most interested in stocks that appear currently undervalued relative to long-term business fundamentals, as well stocks that offer some degree of counter-cyclical or contrarian defensive characteristics should the US-led, central bank-fuelled bull market eventually run out of steam.

Macron at 100 Days: New French President Faces Busy Autumn



Philippe Brugere-Trelat
Executive Vice President,
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Sworn in on 14 May, French President Emmanuel Macron vowed to loosen labour laws and cut both taxes and spending.

His 100th day in office fell on 22 August, when many Europeans were returning from summer holidays.

It's hard to gauge the president's success on such a short timeframe, but Macron's party's rounding victory in June's French parliamentary elections stands out as a highlight. In my view, nobody expected his Republic on the Move party, known as LREM, and its Democratic Movement allies to secure such a strong majority with 350 out of 577 seats.

Although polls have shown that Macron's approval ratings have fallen since the election, I don't see this drop as cause for concern. The ebbs and flows of popular polls are natural, in my opinion, following the giant wave of hope that swept Macron into office. That hope is now meeting the cold light of reality.

In my view, Macron has now the means to carry out the keystones of his reform agenda. Since the June election, Macron and his government have been hard at work putting together proposals to reform the labour market, tighten the French budget and promote EU cohesiveness.

I think it's premature to judge Macron's effectiveness before he presents his plan in September.

That said, I think Macron's upcoming negotiations with France's trade unions will be a true litmus test for his presidency. Unions in France have enjoyed extensive political power for a very long time, and are likely to kick off protests in September that will gain widespread media coverage and may unsettle some French voters.

If Macron is successful with labour reforms, I believe he will prove to be a leader who can get things done both in France and the broader EU. In particular, I think a victory on that front would establish his legitimacy with German Chancellor Angela Merkel.

I believe close cooperation between France's Macron and Germany's Merkel will be very positive for the future of the EU, particularly at a time when the Brexit negotiations are taking place. I see EU economies looking for stronger leadership, and both Germany and France could lead that effort.

I think real cooperation between France and Germany can be a key economic driver of the EU. It might be seen in the financial sector, in the defence sector and in infrastructure, for example, which I believe would be beneficial to the economy and the stock market. There is momentum which is ready to start rolling once Macron has proved he is indeed the man who can deliver on the long-expected reforms of France's labour market.

The media, like everybody else, is impatient to see Macron meet expectations. I have every reason to think he will. He has the backing of the parliament, and he has the backing of the French people. I think Macron is very pro-European. I believe part of his initial measures to be presented during the next three months will be measures to promote a closer European unity. That said, Macron has first to earn his credibility.

India's Reform Movement Gains Momentum

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Earlier this summer we travelled to India—it was a good time to visit. The country has put through some ambitious reforms in recent years under the leadership of Prime Minister Narendra Modi, who took office in May 2014. India's economy has appeared invigourated under Modi, with annual GDP rising from 5.5% in 2013 before he took office to 7.5% in 2015 and 8.0% in 2016.[4] That growth rate has been the highest amongst the world's largest economies, and it has attracted waves of foreign capital in recent quarters.

However, we are at an important juncture in Modi's tenure—growth has moderated a bit in 2017 (estimated annual growth is 7.1%[5]) as some reform efforts have generated short-term headwinds. Some market participants have seemed concerned, but the short-term negative effects on growth are often necessary consequences of pursuing the right longer-term solutions.

The key to India's economic future likely won't depend on what happens to growth over the next few quarters, but instead on whether Modi can continue to push through the types of long-lasting transformational reforms that India needs, and whether they can meaningfully expand the country's economic potential. We believe they can.

Already, we've seen bankruptcy laws enacted (May 2016) that are intended to help enforce contracts and ultimately encourage more lending activity by bolstering confidence in the financial system. We have also seen a massive revision of the tax code, putting in place goods-and-services taxes (implemented in July 2017) to help remedy the complexities and inefficiencies of the domestic tariff system.

The government also deployed a bold plan to pull money out of the shadow economies and bring it into the formal economy by demonetising 86% of the currency in circulation (November 2016). These are unprecedented and important structural reforms for India—Modi's government has been able to push ahead in areas of policy that have languished for decades under prior governments.

From a macroeconomic standpoint, Modi has also instilled much-needed stability. The Reserve Bank of India has maintained responsible monetary policy, in our view, while using inflation targeting to break periods of high inflation that could destabilise the economy. Inflation in India has dropped from more than 10% in 2013 to below 2% on a year-over-year basis in 2017.[6] On the fiscal side, we think the government has also done its part by maintaining a responsible budget. The current account has also significantly improved from the large deficits of 2013.

Taken together, we believe India's macro picture looks relatively healthy. However, what's good for long-term health can sometimes feel like tough medicine in the short term. A credible central bank may need to maintain higher interest rates and a government may need to spend less to maintain fiscal discipline—these measures can inhibit short-term growth but fortify the longer-term health of the economy.

We may see a deceleration in India's economic activity over the next year or so, but we think it's important for investors to recognise that it would be a moderation of growth in the world's fastest-growing large economy, not a contraction or derailment. India is re-envisioning its economic future, and these near-term adjustments could unlock tremendous economic potential over the decades ahead.

Overall, we continue to have a positive outlook for India, despite some near-term challenges. There are a number of additional actions the government can take in upcoming years to change how the economy may perform for decades to come. Efforts to deal with the accumulation of non-performing assets in the banking sector and to improve overall confidence in the financial system will be important. There are also a number of inefficiencies in the land and labour markets, and in utility and transport infrastructure, that could benefit from comprehensive reform.

Nonetheless, as fixed income investors, we think India is at a compelling stage—it has a fiscally conservative government, a moderating but largely resilient economy, and a central bank that has brought down inflation and maintained appropriate rates. These are strong conditions for bonds, and we continue to see attractive valuations across India's local-currency markets. On the whole, we remain optimistic for Modi's reform efforts, and we continue to see greater economic potential ahead.

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1. Source: JP Morgan Global Equity Research, Equity Strategy: July Chartbook. UK stocks are represented by the FTSE 100 Index. Indexes are unmanaged and one cannot directly invest in an index. They do not include fees, expenses or sales charges**. Past performance is not an indicator or guarantee of future performance.**
2. Ibid.
3. Emerging markets are represented by the MSCI Emerging Markets Index. Developed markets are represented by the MSCI World Index. Indexes are unmanaged and one cannot directly invest in an index. They do not include fees, expenses or sales charges.
4. Sources: India Central Statistical Organisation, Bloomberg. India Annual GDP (constant 2011–2012 prices, y/y).
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