FRANKLIN TEMPLETON
INVESTMENTS

30 January 2018

Beyond Bulls & Bears Bulletin

INSIGHT FROM FRANKLIN TEMPLETON INVESTMENTS MANAGERS

IN THIS ISSUE: ***The articles in this issue are as at 30 January 2018.***

Winded Markets May Face a More Difficult Climb in 2018: Global stocks benefitted from broad economic growth in 2017, and some forecasters expect growth in 2018 to be slightly better. Yet Franklin Equity Group's Coleen Barbeau thinks equity valuations, particularly in the US market, already reflect that rosy outlook. Here, she explains why investors should be cautious this year.

Keeping One's Options Open: The Case for Global Convertibles: When the outlook is uncertain, it can be good to keep one's options open. Alan Muschott, vice president and portfolio manager, Franklin Equity Group, says convertible securities' ability to adapt to myriad market conditions makes them an attractive vehicle as we head into the uncertainties of the year ahead. He outlines why companies issue convertible securities—and why many investors find them an attractive addition to their portfolios.

Underappreciated Story: How Brexit Threatens to Shift the Balance of Power in the EU: For fixed income investors eyeing opportunities in Europe, 2018 should be the year economic fundamentals reassert their worth, according to David Zahn, Franklin Templeton's head of European Fixed Income. Nonetheless, he believes many investors are underappreciating the long-term implications for Europe of the biggest political uncertainty for the region—Brexit.

Winded Markets May Face a More Difficult Climb in 2018

Coleen Barbeau
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Director of Global Growth Portfolio Management,
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After running hard in 2017, global equity markets may find it more difficult to maintain pace in 2018. Although we think the economic backdrop is likely to remain largely unchanged in the new year, we see a more entrenched global economic recovery giving central banks more leeway to withdraw stimulus.

This past year, the information technology sector and other growing areas of the market have benefitted from optimism about the global economic recovery and improving corporate earnings.

We've also seen ebbing political and policy fears. The populist impulse that characterised 2016 looks to have receded. In 2017, a number of world leaders from Chancellor Angela Merkel in Germany to Prime Minister Shinzo Abe in Japan won reelection.

As economic conditions have continued to improve in Europe and parts of Asia, we have seen markets outside the United States push into the lead. Emerging markets also began to outperform in 2017, amidst sturdy growth in China and India and a turnaround in Brazil.

Why the Favourable Global Backdrop Should Persist in 2018

We think the global economy can continue to hum along in 2018. According to the International Monetary Fund, the pace of global economic growth is likely to remain steady in 2018, with global gross domestic product growing a projected 3.7% in 2018 after expanding 3.6% in 2017.[1]

Based on projections, we think the United States is likely to see solid growth, low inflation and limited wage growth, while in Europe the economic expansion can become further entrenched. Growth in China may weaken modestly amidst a slowdown in the property market and government investment.

In addition, we think Chinese President Xi Jinping is likely to continue the government's crackdown on corruption and the shadow banking system. We believe Xi has carefully orchestrated the implementation of both of these measures so as to not rattle markets.

In Japan, the global economic expansion fed through to a better equity market performance in 2017. However, the country has an aging population and limited immigration policies that have led to labour shortages that have kept the recovery anaemic.

As a result, we think Japan may be the only economy to still maintain an extraordinary monetary policy throughout 2018. Although the focus on the yield curve has led to fewer bond purchases, the Bank of Japan may have little choice but to continue to inject significant amounts of liquidity into an economy that remains beset by demographic challenges.

In contrast, monetary policy in the United States by the end of 2018 may look almost normal, with the US Federal Reserve likely to hike rates two to three times while continuing to shrink its balance sheet.

We also expect the European Central Bank (ECB) is likely to be in a place to end its quantitative easing (QE) programme and begin policy normalisation by the end of 2018. However, at this time, it's unclear how markets will react as balance sheets are unwound and QE ends.

Finding Value in Global Equity Markets

We believe this rosier global outlook is largely priced into global equities. The US market is looking the most expensive to us at a time when US corporate earnings are already well past their prior peaks.

In our view, many other markets are less expensive, but more fairly valued on a historical basis and will need to see a significant pickup in earnings growth to continue their run. And with the US market having gone more than a year without a major correction, we see the heightened potential for the advance to falter.

We see a number of issues that could throw stocks off their stride in 2018. A more protectionist US trade policy and potential changes to the North America Free Trade Agreement could bring new economic uncertainty into the global economy. In addition, a US decision to pull out of the Iran nuclear deal or a ratcheting up of tensions in the Middle East as Iran and Saudi Arabia vie for greater influence could also have dire consequences for the region and investor sentiment.

For these reasons, we think 2018 may be a more challenging year for stocks overall. However, we believe it can create greater opportunities for individual stock selection. We anticipate that non-US companies with compelling secular growth stories and unassailable competitive advantages can stand out regardless of how the broader markets perform over the course of the year.

Keeping One's Options Open: The Case for Global Convertibles

Alan Muschott, CFA
Vice President,
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Bond-Equity Hybrids Let Investors Keep Their Options Open

Convertible securities are a unique asset class in the investment world, offering investors both the growth potential of common stocks and the income offered by bonds. Issued by companies looking to raise capital, these hybrid investments are generally structured as some form of debt (bonds, debentures) or preferred shares with an embedded option that allows conversion into common shares under predetermined conditions.

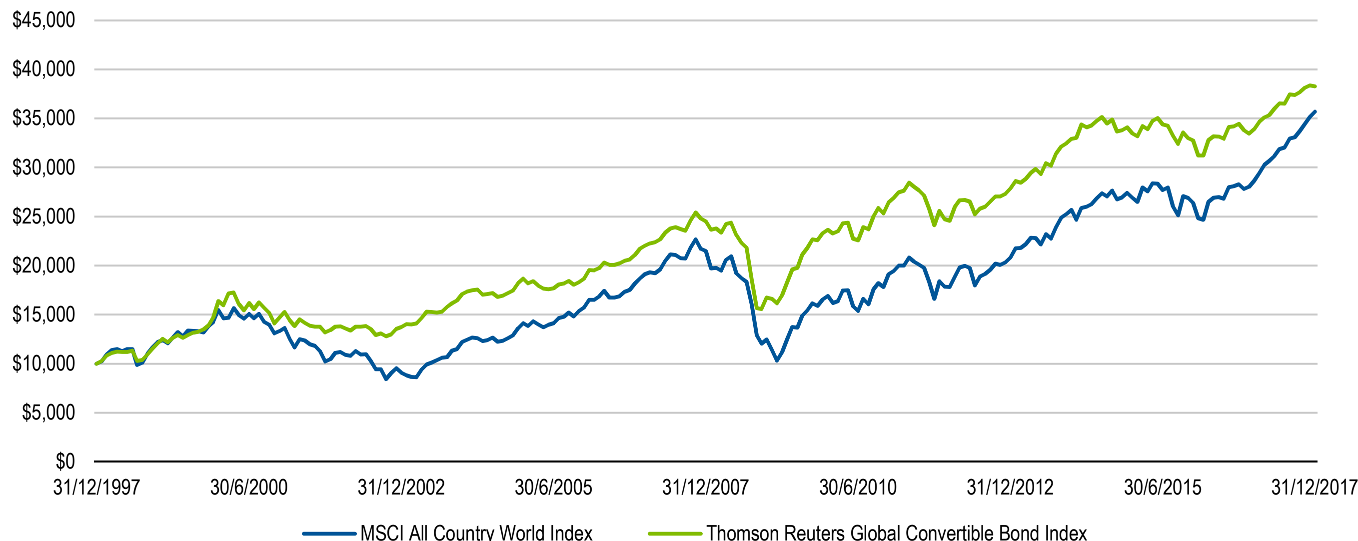
The debt features of convertibles stem from the interest payments and claim to principal. In this respect, convertibles are similar to bonds, with characteristics that can potentially offer less value erosion in declining markets than the underlying common stock. But they are also similar to stocks because their embedded conversion component allows investors to participate in the stock's price appreciation potential.

If a company's common stock rises, the convertible security should increase in value because of the conversion option. If the common stock does not perform well, the fixed income component may help provide a buffer against greater losses than the common stock alone might experience. Because of these unique characteristics, convertibles may be classified as fixed income securities, equity securities or as a separate asset class.

Convertibles are attractive in low interest-rate environments when sources of income may be scarce. Historically, they have tended to perform well during periods of above-average market volatility, when cautious investors with a generally positive view of the equity markets seek risk-controlled equity exposure to reduce potential downside risk.

Convertibles' Performance in Varying Market Conditions

Growth of a US$10,000 Investment
20 Years Ended 31 December 2017
In USD



The MCSI All Country World Index is a market-capitalisation weighted index designed to provide a broad measure of equity-market performance throughout the world. The Thompson Reuters Global Convertible Bond Index is designed to provide a broad measure of performance of the investable, global convertible bond market. **Past performance does not guarantee future results.** The above is a hypothetical example used solely for illustrative purposes. It does not represent securities of an actual account or portfolio. Indexes are unmanaged and one cannot directly invest in an index. They do not include fees, expenses or sales charges.

Rising stock markets also tend to favour convertibles due to the price relationship with the underlying common stock. We believe this ability to adapt to myriad market conditions makes convertibles an attractive vehicle for increasing a portfolio's diversification.

Why Companies Issue Convertibles

Convertibles allow companies to finance activities through a lower-cost form of debt that offers less potential dilution to the common shares than selling common stock. While convertibles can come with elevated risks, there are some potential advantages.

Potential advantages to the issuer include:

- Lower interest payments relative to straight debt.
- Less potential share dilution compared to equity issuance.
- Equity issued at a premium to the current stock price.
- Ability to reach a broader range of investors.

Within a company's capital structure, convertibles can be ranked at various levels of seniority ranging from the most junior preferred stock to senior secured debt. Most convertibles are issued as senior unsecured debt, which ranks higher than stocks with respect to income distribution or liquidation.

ANATOMY OF A CONVERTIBLE

Convertibles possess a distinct structure that includes characteristics that may be unfamiliar to some investors such as the conversion ratio, parity, conversion premium and delta.

Conversion ratio sets out the number of common shares due upon conversion to the underlying stock. The conversion price, which is calculated by dividing the price of the convertible at issue by the conversion ratio, determines the price of the underlying common stock that is required for conversion. Generally, the conversion price is set upon issuance at a premium of anywhere from 15% to 50% relative to the price of the underlying common stock, with 20% to 30% being the most typical range.

Parity refers to the value of the convertible upon conversion. It is calculated by multiplying the conversion ratio by the current stock price.

Conversion premium is the value by which the price of the convertible exceeds its parity and is calculated as a percentage of parity.

Delta measures the sensitivity of the convertible price to changes in the price of the underlying common stock.

Four Good Reasons to Consider Investing in Convertibles

1. **Current Income.** Investors seeking yield from equity securities may find convertibles an appealing option, as they generally provide a more attractive income component than stocks alone (although generally lower than traditional bonds), while still allowing participation in the stock's price movement.
2. **Potentially Attractive Risk/Reward Profile.** Historically, convertibles typically have exhibited a low correlation to fixed income and demonstrated imperfect correlation with stocks. This creates potential for an investor to help enhance portfolio diversification, dampen volatility and improve a portfolio's overall risk profile. Note, diversification does not guarantee profit or protect against risk of loss.
3. **Attractive Potential for Long-Term Risk-Adjusted Returns.** Critics point out that convertibles do not increase as rapidly in value as stocks during rising markets; nor does their potential downside protection equal that of bonds during market declines. Nevertheless, historically they have been able to deliver attractive long-term risk-adjusted returns compared with both stocks and bonds.
4. **Robust and Diverse Opportunity Set.** The flexible nature of convertibles makes them appealing to a broad range of investors. As a group, convertibles have historically presented an attractive risk/reward profile, but within the group there is considerable variation in the level of risk, sensitivity to movements in the underlying stock, and upside participation. Not only are these securities diversified across credit ratings, sectors, market capitalisation and investment characteristics, they are also available worldwide.

Taking It Global

With a value of over US$330 billion as of the third quarter of 2017, the global convertible securities market is a sizeable player in the world's capital markets. The United States accounted for over half that amount, followed by the Europe, Middle East, Africa (EMEA) and Asia-Pacific regions, respectively.[2]

Perhaps more important is the ample room for growth. Following a peak in 2007, issuance declined as companies took advantage of low yields, a high equity risk premium relative to credit spreads and strong flows into the credit markets to issue straight debt rather than convertibles. The perception was that raising capital through straight debt was relatively cheap, even when convertible securities were issued at slightly lower rates due to the added concern of share dilution. Companies were also hesitant to issue convertible securities as equity valuations were inexpensive relative to historical levels.

In 2017, we saw slightly stronger issuance figures than in the prior year, driven by better equity market performance, a rise in interest rates and higher spreads.

Potential catalysts for increased issuance include:

- An increase in US interest rates that may lead companies to prefer more cost effective means of raising capital (such as convertibles) than traditional debt, particularly as equity valuations have been near or at historical highs for many issuers.
- A secular shift in Europe from loan to bond financing and high funding cost for high-yield issuers.
- Refinancing of existing convertibles in the Asia-Pacific region.
- Long-term growth coupled with financing requirements in China reducing risk through portfolio construction.

Some investors may have concerns about the credit profile of a convertible issuer. Active portfolio management, fundamental research and a bottom-up approach to security selection can be used to address these concerns by targeting companies with rising credit profiles.

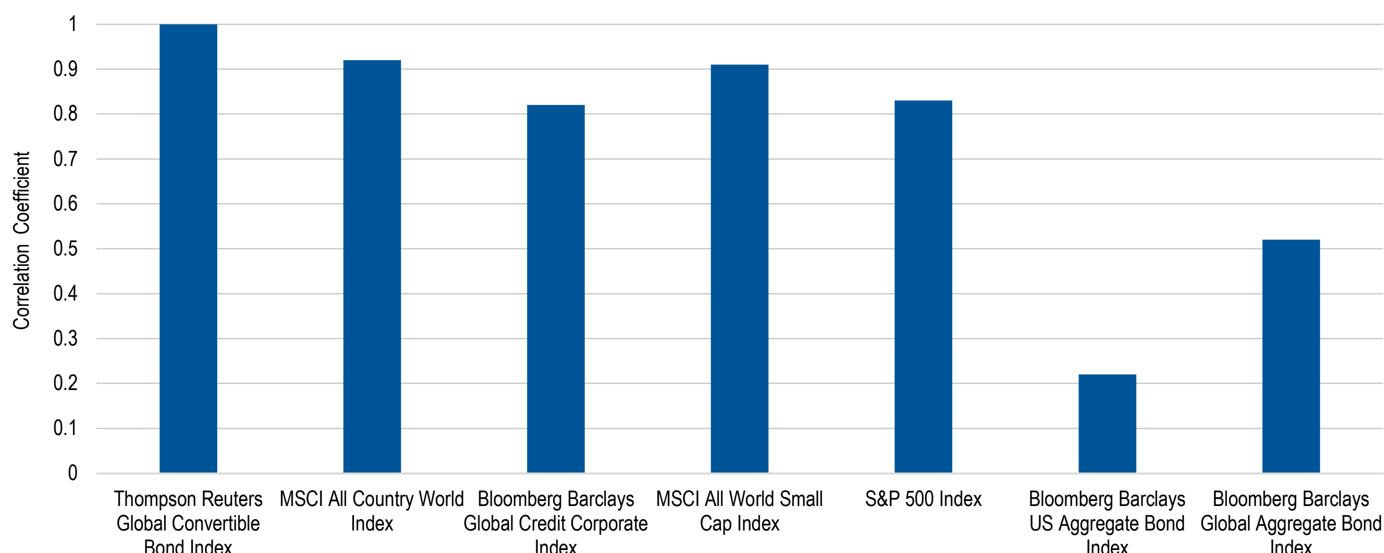
While default risk is an important factor when evaluating securities, many other elements must be considered before making an investment, such as business fundamentals, asset and cash flow coverage of debt and fixed costs, and the likelihood of improvement in the underlying credit profile.

Convertibles: Broadening the Opportunity Set

Although past historical performance cannot guarantee future results, global convertibles, based on historical characteristics, offer the potential for low correlation to other asset classes, a broad universe of opportunities, and exposure to emerging as well as developed regions, which may help to reduce risk through portfolio diversification.

Correlation of Global Convertibles to Select Asset Classes:

15–Year Period Ended 31 December 2017



Source: Morningstar. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges. **Past performance does not guarantee future results.**

Convertible securities can present opportunities for investors to "hedge their bets" by providing characteristics of both the fixed income and equity markets. For those seeking income and risk-managed equity exposure, these investments offer numerous potential benefits, including:

- Current income that is usually higher than a stock's dividend.
- Upside participation in the underlying common stock's price with less downside risk.
- Typically less volatility than the underlying common stock alone.
- Additional diversification potential and a means that seeks to improve the risk/reward profile in a portfolio.
- A claim on the issuer's assets senior to holders of common shares.

Worldwide, convertible securities are garnering increasing attention from both issuers and investors. The asset class has ample room for expansion as companies look for financing and endeavour to attract investors to their common shares at the lowest possible cost.

We believe higher levels of creditworthiness in the developing markets and fiscally healthy companies in the developed markets point to abundant opportunities for participating in corporate growth, even in uncertain markets—possibly the strongest argument for including a component of global convertible securities in a diversified portfolio of investments.

The Underappreciated Story: How Brexit Threatens to Shift the Balance of Power in the EU

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After a year in which politics dominated the European investment agenda, we expect 2018 to bring more focus on economic fundamentals.

However, looking further out, we see politics returning to the agenda as the full implications of the departure of the United Kingdom from the European Union (EU) reveal themselves.

In particular, we see Brexit having a significant impact on the balance of power in the trading bloc and on the way it operates.

The election of Emmanuel Macron as French president and the re-election of Angela Merkel as German chancellor—both proponents of further European integration—suggests to us that political leadership for the EU is probably more stable than it has been for many years.

So in 2018, at least, we think politics will take a backseat and markets will be more focused on the ECB's monetary policy course, as well as the macro economy.

Our view is the growth story in Europe is generally positive, although there are reasons to be cautious. Some regions are weaker than others and inflation across the eurozone remains well below the ECB's 2% target level—all of which continues to justify the ECB's continued accommodative stance. We'd expect the ECB to extend its QE programme slightly beyond its current September timeframe.

Equally, we don't expect to see the ECB start raising interest rates until well after QE is completed. So we're looking at 2020–2021 before eurozone interest rates begin to rise.

On the other hand, we expect the composition of the ECB could change over the next 18 months. Mario Draghi's tenure as ECB president is due to end in October 2019, with several other members of the ECB governing council also expected to step down over the next year.

Taking all of these considerations into account, we'd expect bonds in Europe will probably be range-bound for the year. Yields may rise slightly higher than they are now, but we wouldn't expect to see any substantial increase without inflation coming back much more strongly not just in Europe, but outside as well.

However, we do see some potential pockets of opportunity in certain European currencies— notably the Norwegian krona and Swedish krone—which have sold off quite a bit recently.

Brexit Threatens to Shift Balance of EU Power Longer Term

For all the current bluster, we believe there will eventually be some kind of Brexit deal between the United Kingdom and the EU. Certain parts of Europe—notably Ireland and Germany—could potentially be hit quite hard if the United Kingdom were to leave the EU without a deal. So we think those parts of Europe will likely be focused on making sure there is some type of deal, although not necessarily the best deal for all sides.

But longer term, we think the United Kingdom's departure from the EU may start to reveal differences of attitude amongst different factions within the trading bloc. And it may bring about a switch in the balance of power in the European Parliament towards eurozone countries.

Countries such as Germany and France want to have a more integrated EU, while others, for example in Central Europe, favour a looser grouping that offers them trading benefits while allowing greater control over their sovereignty.

Under European Parliament rules, a vote or veto needs 67% support to pass. Currently eurozone countries represent around 70% of the votes in the European Parliament, with non-eurozone countries, including the United Kingdom, representing the remaining 30%.

So currently, dissention from just one eurozone country could scupper a vote. But after the departure of the United Kingdom, which represents 12% of European Parliament votes, the voice of non-euro countries will have less force.

We think this could mean the EU becoming much more of a euro club. Those countries that have not adopted the euro may have to rethink their position if they want to have a say in the future of the bloc.

On a similar note, the United Kingdom has tended to take a more economically austere approach to the EU budget, often voting with other mainly northern European member states (including Germany) against spending increases.

Once the United Kingdom leaves, countries in favour of more EU spending may find themselves in the majority, with the potential to succeed in votes even in the face of possible German opposition.

We think that too could create some different dynamics in the trading bloc, although probably not in the immediate future. Still, we think European politicians will already be starting to plot their approach to this changing situation, and it's something we think should be on the watchlist for investors.

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. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size and lesser liquidity. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. High yields reflect the higher credit risk associated with these lower-rated securities and, in some cases, the lower market prices for these instruments. Convertible securities are subject to the risks of stocks when the underlying stock price is high relative to the conversion price (because more of the security's value resides in the conversion feature) and debt securities when the underlying stock price is low relative to the conversion price (because the conversion feature is less valuable). A convertible security is not as sensitive to interest rate changes as a similar non-convertible debt security, and generally has less potential for gain or loss than the underlying stock.

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