FRANKLIN TEMPLETON INVESTMENTS

Investment Team Update

September 2017

Global Economic Perspective

PERSPECTIVE FROM THE FRANKLIN TEMPLETON FIXED INCOME GROUP®

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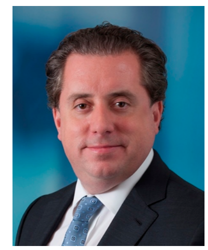

David Zahn

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- Short-Term Concerns Mask Robust US Economic Fundamentals
- Further Evidence of Synchronised Recovery across the Global Economy
- ECB Flags Tapering amidst Stronger Growth but Weak Inflation

Short-Term Concerns Mask Robust US Economic Fundamentals

The issues that have dominated news cycles in recent weeks—North Korea, along with extreme weather in the southern United States—should not obscure the robust underlying fundamentals of the US economy, in our view. Though some short-term weather-related disruption is possible, the economy seems to be maintaining its path of moderately strong growth, aided by healthy contributions from consumer spending and business investment. These conditions have continued to allow the US Federal Reserve (Fed) to move further towards its goal of normalising monetary policy, after policymakers left interest rates unchanged in September, but maintained their forecast of a rate hike before the end of the year. We believe the Fed's decision to begin downsizing its balance sheet in October is likely to have only a marginal impact on the economy and financial markets.

Though market activity was somewhat subdued due to the traditional lull during August, a series of events—ranging from geopolitics to adverse weather—increased investor demand for the perceived safe haven of US Treasuries. Tensions between North Korea and the United States and its allies rose after several missile and nuclear tests by the North Korean regime, including one projectile that passed over northern Japan. The increasingly strident rhetoric from both sides and absence of consensus amongst major powers on how to respond to North Korea's actions increased uncertainty, and by early September benchmark Treasury yields had fallen to their lowest level so far this year.

The US states of Texas and Louisiana were hit by Hurricane Harvey in late August, with severe flooding particularly affecting Houston, the fourth-largest US city and the capital of the country's energy industry. In the aftermath, as many as a third of US oil refineries, many of which are located in the area around Houston, were estimated to have been impacted by flooding or supply disruptions. While the immediate impact was evident in higher wholesale gasoline prices, the overall effect on US economic growth appeared likely to be limited. Past experience suggested any short-term setback could be offset by increased expenditure in the months ahead, as infrastructure is rebuilt and economic activity rebounds. Nevertheless, with Hurricane Irma causing extensive damage across the state of Florida in early September, the potential for further weather-related disruption to the economy during the third quarter remained in focus.

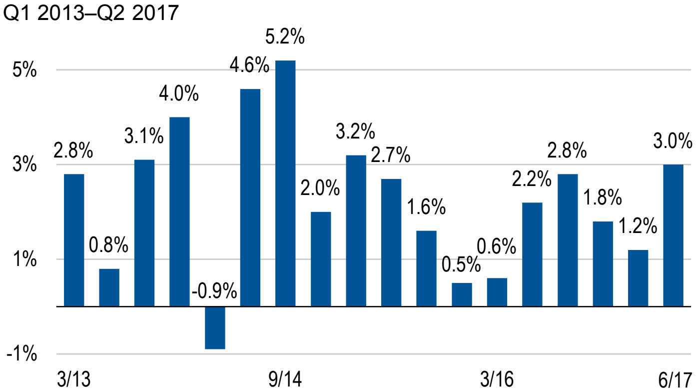
Will investor appetite for so-called "safe havens" accelerate with North Korea tensions?

One of the other issues that had been overshadowing the Treasury market in recent months was temporarily resolved, after US President Donald Trump agreed to provide a short-term increase in the country's debt ceiling, and at the same time postponed a deadline to pass a budget. The president's decision appeared to have been triggered by the need to avoid any shutdown of US government services that could hinder hurricane relief efforts.

In spite of these concerns, data elsewhere signalled the US economy maintained its robust footing. The estimate for annualised second-quarter 2017 growth was revised up from 2.6% to 3.0%—its quickest rate of expansion since the start of 2015—due to higher levels of consumer spending and business investment than initially thought. This pattern of a stronger-than-expected contribution from US consumers was reflected in July's retail sales report, which not only came in well ahead of consensus expectations, but also included significant upward revisions to the weak figures seen in May and June. The positive backdrop meant consensus forecasts for third-quarter growth remained moderately strong, in the range of 2.5%–3.0%, even after the weather-related disruptions.

Second Quarter Sees Strongest US Growth Since Early 2015

Exhibit 1: US Real GDP Growth, Annualised
Q1 2013–Q2 2017



Source: FactSet, US Bureau of Economic Analysis.

Though the 156,000 jobs added in August's labour market report fell short of the figure predicted in consensus forecasts, any disappointment was muted by the historical tendency of data in August to be adjusted at a later date, with the initial level of hiring revised higher in five of the last six years.

Nevertheless, combined with downward revisions to June's and July's payrolls, the August data were sufficient to push the unemployment rate off its 16-year low of 4.3% and back up to 4.4%. Hiring gains in manufacturing were a notable highlight, with the number of positions added matching the highest monthly total in four years. The robust conditions in US factories were underlined by the August reading for the Institute for Supply Management's purchasing managers' index (PMI), which climbed to its highest level in six years.

However, inflation readings showed no sign of breaking out of the passive trend of recent months. July's core personal consumption expenditures price index—the Fed's favoured measure of inflation—managed only a 0.1% monthly rise, taking the annual rate down one-tenth to 1.4%. These figures were also replicated at the headline level. July's Consumer Price Index painted a similarly weak picture, with respective monthly and annual gains of 0.1% and 1.7% held back by moderating housing costs and sharply lower cell phone charges. August's labour market report showed annual wage growth stuck at 2.5%, despite the consistently high level of job creation.

In seeking to explain why inflation—and particularly wage growth—has remained so tepid, it may be useful to consider the demographic structure of the US workforce. Research has suggested that as workers from the "baby boomer" generation with relatively high salaries have retired, they have been replaced by younger employees receiving lower wages, thereby suppressing the rise in paychecks. When like-for-like wage growth (for the same job) was analysed, it appeared to be roughly in line with the corresponding point in previous economic cycles. In addition, as baby boomers retire, the labour force participation rate would normally be expected to decline, whereas in fact it has stayed relatively high as the labour market has tightened. This would indicate that new entrants and former workers have been attracted into the workforce, although often into lowly paid, and often part-time, positions. The conclusion may be that there is some way to go before the dampening effects of demographics on wages and inflation are fully worked through.

Further Evidence of Synchronised Recovery across the Global Economy

The recent indications of a synchronised recovery across the global economy have continued. A rally in industrial commodity prices pointed to rising demand from China, the world's largest consumer of such metals, many of which are integral to its construction of real estate and infrastructure. Official and independent PMIs for the Chinese manufacturing sector posted solid numbers in August, and both exceeded consensus expectations. Ahead of the next congress of the Chinese communist party in October, where President Xi Jinping will unveil his new leadership team, there have been indications that Chinese policymakers have increasingly shifted their emphasis away from potentially disruptive reforms aimed at reducing excessive debt levels, particularly amongst local governments, and towards stabilising the level of economic growth. After the Chinese renminbi appreciated to its highest level in nearly two years against the US dollar, the country's central bank eased some restrictions on the currency, a signal that the Chinese authorities' concerns about capital outflows were easing.

Mexico is one of the countries where a turnaround in economic sentiment over the last 12 months has been most evident. In the second half of 2016, the Mexican economy faced multiple problems, including fears a Trump presidency would herald a more protectionist stance from the United States, the aftermath of a worldwide slump in oil prices and escalating inflation, the latter of which was exacerbated by a fall in the Mexican peso. In response to the threat from inflation, which in August of this year reached a 16-year high, Mexico's central bank sharply tightened monetary policy, increasing interest rates at seven consecutive meetings up to June.

Mexican Peso Recovers 2016 Losses

Exhibit 2: Mexican Peso per US Dollar
FX Rate – Spot Mid
1 January 2015–12 September 2017

Source: FactSet.

Moreover, while the threat of protectionist measures has remained, the political problems of the Trump administration may have lowered the possibility of aggressive unilateral measures by the United States on trade. The first two rounds of talks between the United States, Canada and Mexico—the member countries of the North American Free Trade Agreement—on reforming the agreement have so far been relatively uneventful, even if they are still at an early stage. The generally more positive backdrop for Mexico was highlighted by its central bank, which in August increased growth forecasts for 2017 and 2018, as well as stating its belief inflation had peaked. The change in sentiment has seen the Mexican peso climb back to levels last seen in mid-2016 against the US dollar, making it one of the world's best-performing currencies this year.

After a surprise switch to a more hawkish stance in its monetary policy in previous months, the Bank of Canada (BOC) once more caught investors off-guard by following up July's interest-rate rise with another hike in September, a month earlier than expected by consensus market forecasts. The central bank cited stronger-than-expected economic data—in the first half of this year, Canada's gross domestic product (GDP) expanded by the most in 15 years—in support of its view that the country's growth was becoming more broadly based and self-sustaining. Following the BOC's decision, the Canadian dollar added to its gains against the US dollar, posting a two-year high.

> **"A turnaround in economic sentiment over the last 12 months has been evident in Mexico."**

As more and more countries deliver positive economic news, it raises the question of how sustainable the current upturn in the global economy could be. At this stage, we are still inclined to view this development as a cyclical recovery, rather than anything more significant. Determining a particular inflection point for inflation remains problematic, given the persistent structural forces that have suppressed prices since the global financial crisis. However, we continue to foresee a global environment characterised by higher interest rates.

ECB Flags Tapering amidst Stronger Growth but Weak Inflation

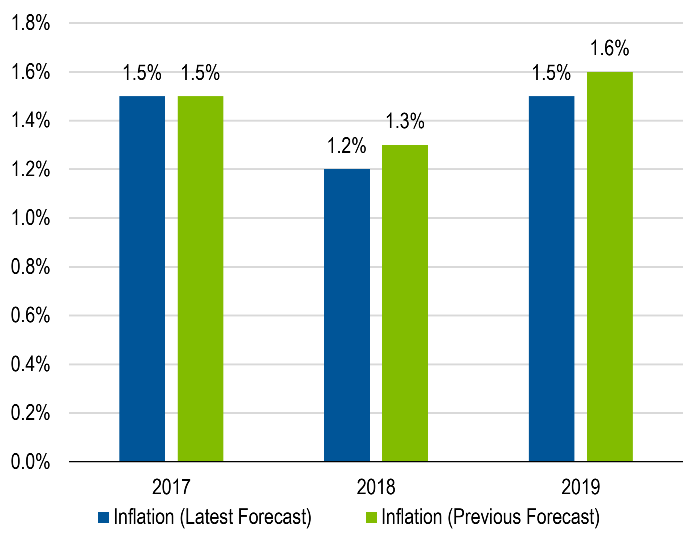
During August and into September, data from the eurozone remained upbeat, with an already solid second-quarter performance revised even higher, pushing year-on-year growth to 2.3%, the quickest pace since the region's debt crisis of 2011–2012. Business and consumer surveys pointed to continued momentum in the third quarter, keeping the single-currency bloc on course to potentially deliver its strongest calendar year of growth in a decade. Despite these signals, inflation showed little sign of life. An uptick in annual headline inflation in August was primarily driven by rising energy prices, and core inflation remained stuck at 1.2% for a second consecutive month.

The progress clearly underway in the eurozone's economy heightened speculation about a tapering of the European Central Bank's (ECB's) quantitative easing (QE) programme. This sentiment was most noticeable in currency markets, where the euro continued to move higher against many other major currencies. At first, market participants looked to a speech being given by ECB President Mario Draghi at the annual Jackson Hole symposium of central bankers late in August, seeking hints about a change in monetary policy. When President Draghi's remarks there concentrated on other topics, attention turned to the ECB meeting in early September. Here, policymakers confirmed they had initiated discussions on how to wind down the programme of bond purchases. However, they also indicated a more detailed announcement on the subject would follow, most likely at their next meeting in October. The rise in the euro—seen as likely to prove a drag on inflation—was described by the ECB as a "source of volatility" that required monitoring. But in the absence of any suggestion that the currency's appreciation would delay a tapering of bond purchases, the single currency's rally—which by the end of August had taken it above US$1.20 for the first time since the start of 2015—resumed, following a brief pause in the run-up to the ECB meeting.

The difficulty for the ECB in managing market expectations on monetary policy in the face of stronger economic growth was evident elsewhere in President Draghi's remarks, as he repeatedly stressed the need to keep the region's interest rates at current levels while the central bank winds down its QE programme. In response, market participants scaled back their bets on an interest-rate hike in 2018. The eurozone has undergone a loosening of the traditionally positive correlation between growth and inflation also seen in many other parts of the global economy. The latest set of macroeconomic forecasts from the ECB underlined this trend. Partly due to the stronger euro, policymakers slightly reduced their inflation forecasts for 2018 and 2019, while at the same time upgrading GDP estimates for the current year from 1.9% to 2.2%. Nevertheless, President Draghi re-iterated his belief that by 2020, inflation will have moved in line with the ECB's target of close to but below 2%.

ECB Trims Inflation Forecasts Despite Stronger Growth

Exhibit 3: ECB Inflation Forecasts
Latest (September) vs. Previous (June)



Source: European Central Bank.

> "We think the ECB has adeptly negotiated the first stage of a potentially precarious path ahead."

All in all, we believe the ECB adeptly negotiated the first stage of a potentially precarious path ahead at its September meeting. A highly accommodative stance has clearly boosted domestic demand, and policymakers are now looking to reduce the level of monetary stimulus, which seems appropriate, given the strength of economic activity. By downplaying the euro's strength, they suggested any potential deflationary effects caused by the rise in the single currency are likely to be limited, barring an outsized further appreciation. At the same time, ruling out any increase in interest rates while bond purchases are scaled back, in our view, signals President Draghi's determination to resist any political pressure to speed up the process of normalising monetary policy. It also emphasises his dovish inclination to await evidence of more sustainable inflationary pressures before contemplating any further major policy shift.

EUROLAND MACROECONOMIC DATA

FINAL OUTPUT				
Gross Domestic Product (GDP)[1]	**3Q16**	**4Q16**	**1Q17**	**2Q17**
GDP, Y/Y (%)	1.7	1.9	2.0	2.3
Private Consumption, Y/Y (%)	1.9	2.0	1.6	1.8
Gross Fixed Capital Formation, Y/Y (%)	4.6	4.4	3.8	2.0
ECONOMIC INPUTS[1]				
	Apr 17	**May 17**	**Jun 17**	**Jul 17**
Retail Sales, Y/Y (%)	2.7	2.6	3.3	2.6
Unemployment Rate (%)	9.2	9.2	9.1	9.1
Industrial Production, Y/Y (%)	1.2	4.1	2.8	3.2
INFLATION & WAGE PRESSURE				
Inflation Indicators[1]	**May 17**	**Jun 17**	**Jul 17**	**Aug 17**
Consumer Price Index (CPI), Y/Y (%)	1.4	1.3	1.3	1.5
Core CPI, Y/Y (%)	0.9	1.1	1.2	1.2
FINANCIAL MARKETS				
	May 17	**Jun 17**	**Jul 17**	**Aug 17**
Dow Jones EURO STOXX 50 Price Index EUR, Trailing P/E Ratio[2]	20.00	17.66	17.66	17.52
ECB Refinance Rate (%)[3]	0.00	0.00	0.00	0.00
10-Year Yield—German Bunds (%)[2]	0.30	0.47	0.54	0.36
BALANCE OF PAYMENTS[1, 3]				
Trade Balance	**Apr 17**	**May 17**	**Jun 17**	**Jul 17**
Billion Euro	16.66	20.11	26.23	23.16
Current Account Balance	**3Q16**	**4Q16**	**1Q17**	**2Q17**
% GDP	3.8	3.7	2.5	2.5

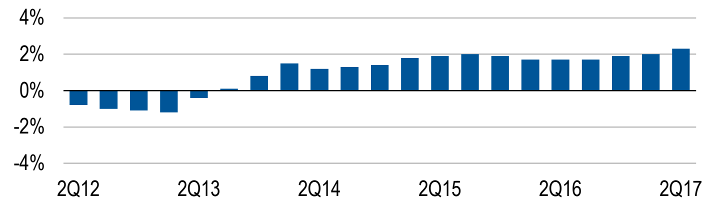
JAPAN MACROECONOMIC DATA

FINAL OUTPUT				
Gross Domestic Product (GDP)[4]	**3Q16**	**4Q16**	**1Q17**	**2Q17**
GDP, Q/Q ar (%)	0.9	1.6	1.2	2.5
Private Consumption, Q/Q ar (%)	-1.0	1.0	0.9	3.1
Fixed Capital Formation, Q/Q ar (%)	-1.0	8.1	2.1	2.1
ECONOMIC INPUTS				
	Apr 17	**May 17**	**Jun 17**	**Jul 17**
Unemployment Rate (%)[5]	2.8	3.1	2.8	2.8
Industrial Production, Y/Y (%)[6]	5.7	6.5	5.5	4.7
Tertiary Index, Y/Y (%)[6]	0.8	1.9	1.0	1.0
Corporate Activities	**3Q16**	**4Q16**	**1Q17**	**2Q17**
Corporate Profit Growth (%)[7]	11.5	16.9	26.6	22.6
Tankan Quarterly Survey (Index Level)[8]	6	10	12	17
INFLATION				
Inflation Indicators[5]	**Apr 17**	**May 17**	**Jun 17**	**Jul 17**
Consumer Price Index (CPI), Y/Y (%)	0.4	0.4	0.4	0.4
CPI ex Fresh Food, Y/Y (%)	0.3	0.4	0.4	0.5
FINANCIAL MARKETS[2]				
	May 17	**Jun 17**	**Jul 17**	**Aug 17**
Nikkei 225, Trailing P/E Ratio	18.6	18.1	18.0	17.8
3-Month Yield—JGBs (%)	-0.128	-0.095	-0.131	-0.201
10-Year Yield—JGBs (%)	0.049	0.086	0.083	0.009
BALANCE OF PAYMENTS				
Monthly Trade Balance[7]	**Apr 17**	**May 17**	**Jun 17**	**Jul 17**
Billion Yen	554	-115	519	567
Current Account Balance[9]	**3Q16**	**4Q16**	**1Q17**	**2Q17**
% GDP	3.6	3.8	3.8	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 and Communications, 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.

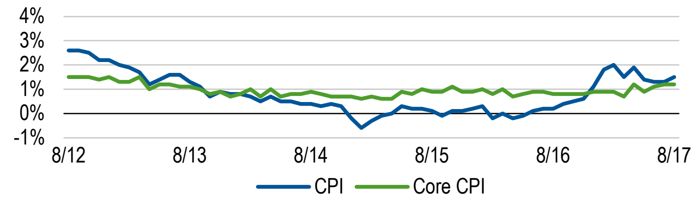
Past performance does not guarantee future results.

Eurozone Real GDP, Y/Y



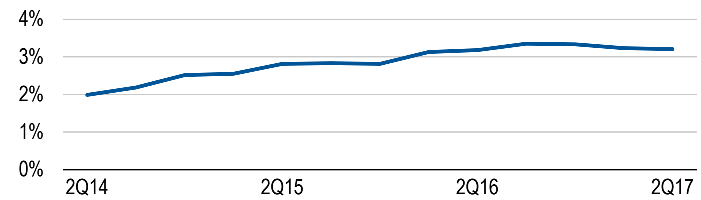
Source: © European Union 1995–2017, as at June 2017.

Consumer Price Index, Y/Y



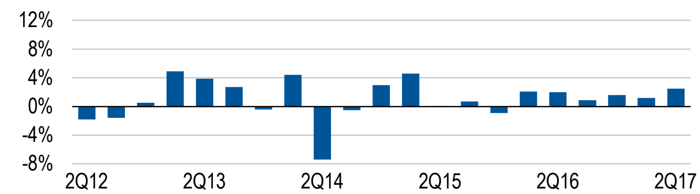
Source: © European Union 1995–2017, as at August 2017.

External Trade Balance, GDP



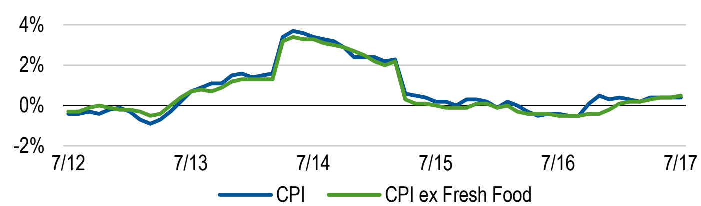
Source: © European Union 1995–2017, as at June 2017.

Japan Real GDP, Q/Q ar



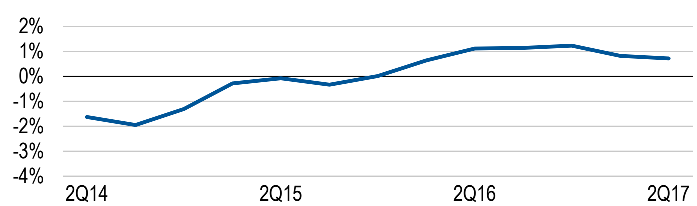
Source: ESRI, Cabinet Office, Government of Japan, as at June 2017.

Consumer Price Index, Y/Y



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

Visible Trade Balance, GDP



Source: Ministry of Finance, Japan and Economic and Social Research Institute, Cabinet Office, Government of Japan, as at June 2017.

US MACROECONOMIC DATA

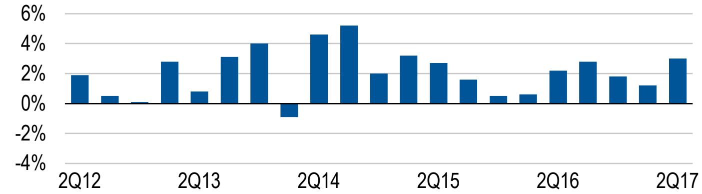
FINAL OUTPUT				
Gross Domestic Product (GDP)[2]	**1Q17**	**2Q17**	**3Q17E[1]**	**4Q17E[1]**
Q/Q ar (%)	1.2	3.0	2.6	2.4
ECONOMIC INPUTS				
CONSUMPTION/FINAL DEMAND				
Income/Savings[2]	**Apr 17**	**May 17**	**Jun 17**	**Jul 17**
Consumer Spending, Y/Y (%)	4.6	4.4	4.1	4.2
Personal Income, Y/Y (%)	2.9	3.0	2.7	2.7
Savings Rate (%)	3.7	3.8	3.6	3.5
Employment	**May 17**	**Jun 17**	**Jul 17**	**Aug 17**
Unemployment Rate (%)[3]	4.3	4.4	4.3	4.4
Participation Rate (%)[3]	62.7	62.8	62.9	62.9
Nonfarm Payrolls (in Thousands)[3]	145	210	189	156
Jobless Claims, 4-Wk Average (in Thousands)[4]	240	244	242	237
Housing[5]	**Apr 17**	**May 17**	**Jun 17**	**Jul 17**
Existing Home Sales (in Millions)	5.56	5.62	5.51	5.44
Y/Y Change (%)	1.5	2.7	0.6	2.1
INVESTMENT				
Corporate Earnings[6, 11]	**1Q17**	**2Q17**	**3Q17E**	**4Q17E**
Earnings, Y/Y (%)	14.0	11.0	5.8	12.1
Production & Utilisation[7]	**Apr 17**	**May 17**	**Jun 17**	**Jul 17**
Industrial Production, Y/Y (%)	2.0	2.1	2.1	2.2
Capacity Utilisation (%)	76.5	76.5	76.7	76.7
Nonresidential Fixed Investment[2]	**3Q16**	**4Q16**	**1Q17**	**2Q17**
Y/Y (%)	-0.7	0.7	3.5	4.4
INFLATION & PRODUCTIVITY				
Inflation Indicators	**May 17**	**Jun 17**	**Jul 17**	**Aug 17**
Personal Consumption Expenditure (PCE), Y/Y (%)[2]	1.5	1.4	1.4	–
Core PCE, Y/Y (%)[2]	1.5	1.5	1.4	–
Consumer Price Index (CPI), Y/Y (%)[2]	1.9	1.6	1.7	1.9
Core CPI, Y/Y (%)[3]	1.7	1.7	1.7	1.7
Producer Price Index (PPI), Y/Y (%)[3]	2.6	2.2	2.2	2.9
Core Producer Prices, Y/Y (%)[3]	1.8	1.7	1.8	1.7
Productivity[3]	**3Q16**	**4Q16**	**1Q17**	**2Q17**
Productivity, Q/Q ar (%)	2.5	1.3	0.1	1.5
Unit Labour Costs, Q/Q ar (%)	0.1	-5.7	4.8	0.2
FINANCIAL MARKETS				
Valuation	**Jul 17**	**Aug 17**	**Sep 17E**	**Oct 17E**
P/E S&P 500[6]	21.17	21.16	–	–
Fed Funds Rate[7, 8]	1.00	1.25	1.16	1.16
BALANCE OF PAYMENTS				
US Monthly Trade Deficit[2, 9]	**Apr 17**	**May 17**	**Jun 17**	**Jul 17**
Billion USD	-47.4	-46.4	-43.5	-43.7
US Current Account Deficit	**2Q16**	**3Q16**	**4Q16**	**1Q17**
Quarterly (in USD Billion)[2]	-108.2	-110.3	-114.0	-116.8
Annualised (% GDP)[10]	-2.4	-2.4	-2.4	-2.4

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

1. Source: Bloomberg Economic Forecasts as at 31/8/17.
2. Source: US Bureau of Economic Analysis.
3. Source: US Bureau of Labor Statistics.
4. Source: US Department of Labor.
5. Source: Copyright National Association of REALTORS®. Reprinted with permission.
6. Source: Standard and Poor's.
7. Source: US Federal Reserve. At the 14/6/17 meeting the US Federal Reserve raised the main US interest rate to "a target rate" between 1.00% and 1.25%.
8. Source: Chicago Board of Trade (30-Day Federal Funds Futures Rate for September 2017 and October 2017), as at 15/9/17.
9. Source: US Census Bureau.
10. Source: Bloomberg Indexes.
11. Source: Bloomberg calculations are share-weighted y/y. Estimates as at 31/8/17.

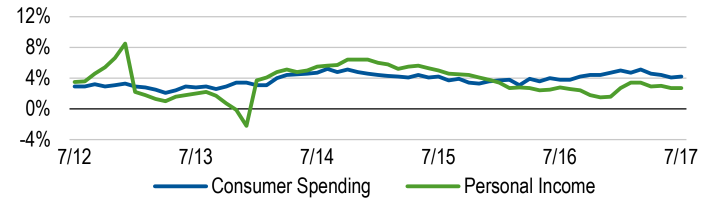
Past performance does not guarantee future results.

Gross Domestic Product (GDP), Q/Q ar



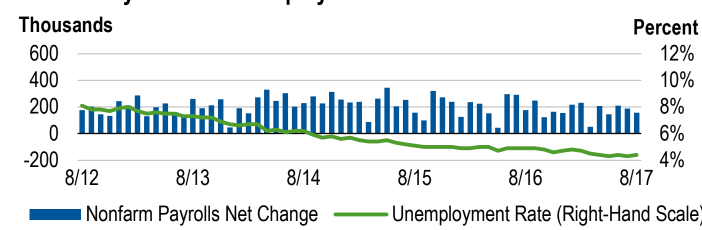
Source: US Bureau of Economic Analysis, as at June 2017.

Personal Income and Expenditures, Y/Y



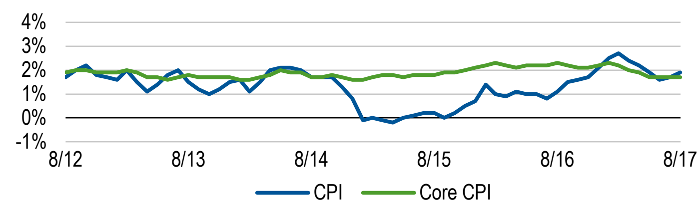
Source: US Bureau of Economic Analysis, as at July 2017.

Nonfarm Payrolls and Unemployment Rate



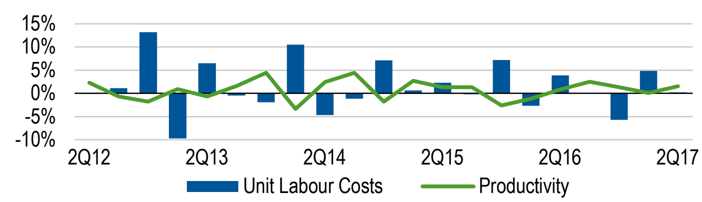
Source: US Bureau of Labor Statistics, as at August 2017. All figures seasonally adjusted.

Consumer Price Index, Y/Y



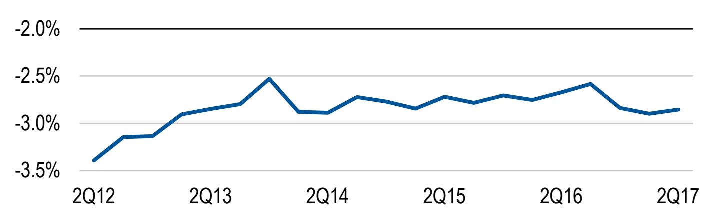
Source: US Bureau of Labor Statistics, as at August 2017.

Productivity and Unit Labour Costs, Q/Q ar



Source: US Bureau of Labor Statistics, as at June 2017.

US Annualised Trade Deficit, GDP



Source: US Census Bureau and US Bureau of Economic Analysis, as at June 2017.

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