



Global Economic Perspective

PERSPECTIVE FROM THE FRANKLIN TEMPLETON FIXED INCOME GROUP®



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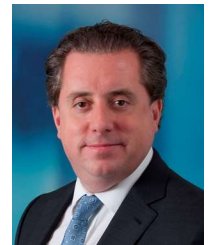
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- Few Signs of Emerging-Market Volatility Affecting Other Markets as Yet
- Growing Risks to UK and EU Economies Make Agreement on Brexit Deal More likely



Positive Domestic Fundamentals Could Sustain US Economy's Strong Momentum

The US economy's current combination of above-trend growth, benign inflation and near-full employment could continue for some time, in our view. Domestically, the picture appears remarkably positive, with relatively few signs of any near-term concerns, bar some supply shortages of materials and labor, as well as a slight easing of credit conditions, which often occurs in the later stages of an economic cycle. This sunny outlook suggests to us that the pickup in the economy's momentum caused by the recent fiscal stimulus could potentially last longer than a couple of quarters, particularly since the US Federal Reserve (Fed) looks to be taking a moderately dovish view of the robust pace of activity. The main threats to such an upbeat scenario are political ones, most significantly the ongoing uncertainty about the Trump administration's future path on trade policy. But for now, we would agree with Fed policymakers that US growth is likely to remain above its potential in the second half of 2018.

Data indicated the US economy was on course to maintain its strong performance over the third quarter. Retail sales for July beat consensus expectations, as sales growth accelerated from the previous month, while a leading measure of US consumer confidence hit its highest level since 2000. Among companies, a survey of optimism among US small businesses in August gave its strongest-ever reading. In the same month, the Institute for Supply Management's Manufacturing Index reached a 14-year high, with particular strength in new orders and production. Underlining labor shortages, one measure indicated a record 38% of small firms had job openings they could not fill in August.

August's payroll report contained a signal that the tightness of the labor market might finally be feeding through to wages. Average hourly earnings rose by 2.9% from a year earlier, the quickest pace since 2009 and well ahead of consensus forecasts. The number of positions added during the month was also higher than expectations, but was more than offset by revisions to the totals in previous months, leaving the three-month average at a solid 185,000. The labor participation rate dipped by 0.2% to 62.7%, but nevertheless the unemployment rate held steady at 3.9%.

The jump in wage growth in August reinforced widespread speculation the Fed would raise interest rates at its meeting toward the end of September, with a further rise in December looking probable, according to market participants. However,

“**The US economy’s current combination of above-trend growth, benign inflation and near-full employment could continue for some time, in our view.**”

interest-rate expectations for 2019 remained far less aligned, as the Fed’s projections continued to suggest a further three increases, while the fed fund futures market indicated only a single hike.

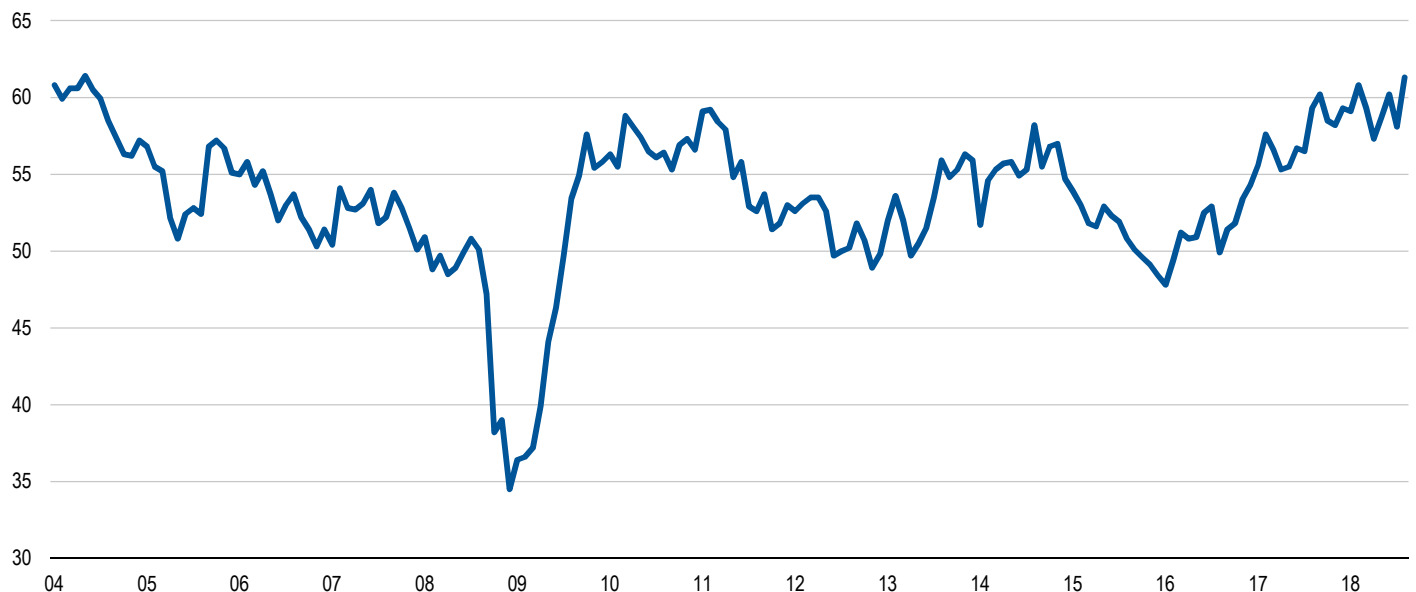
In July, the core personal consumption expenditures price index, the Fed’s favored gauge of inflation, moved up by 0.1% from the previous month, to reach the central bank’s target of 2% year-on-year. But Fed Chair Jay Powell said policymakers saw no clear sign of inflation accelerating and believed the risk of the economy overheating was not elevated. Powell also stressed the difficulties of gauging key variables such as the so-called “neutral” interest rate, at which the economy would grow at its trend rate and inflation would remain stable. Market participants generally interpreted the comments as increasing the likelihood the central bank would move conservatively until there were clearer signals of higher inflation.

The flattening of the US yield curve continued during the first weeks of August, with the difference between two- and 10-year Treasury yields reaching its lowest level for a decade toward the end of the month. In the past, an inverted yield curve has provided an early signal of a coming recession. However, some commentators have argued the indicator has less significance in the current economic cycle due to the amount of quantitative easing undertaken by central banks since the 2007–2008 global financial crisis. Conversely, the inverted yield curve’s relevance was endorsed in research released by the San Francisco Fed at the end of August, even though the authors of the paper pointed out that despite the prolonged flattening that has taken place, there was still some way to go until an actual inversion occurred. Nevertheless, in early September a leading Fed official argued that the central bank should not be inhibited by a potential inversion of the yield curve in determining the optimal path for monetary policy.

The Trump administration maintained its tough stance on trade with China, as further talks between the two countries ended without progress. Later, a deadline passed for public comments on US proposals to expand existing tariffs on Chinese imports valued at US\$50 billion to an additional US\$200 billion of Chinese goods. A number of leading US companies and business organizations warned that a further escalation of the trade dispute between the two countries could result in increased prices for US consumers, and urged the administration to pull back. Ahead of the congressional midterm elections in November, there seemed little prospect of such a moderation in US trade policy, and the extent of any subsequent headwinds to the robust pace of consumer demand remained unclear.

US Manufacturing Index Hits Highest Level In 14 Years

Exhibit 1: US ISM Manufacturing PMI (Production Manufacturing Index)
31 January 2004–31 August 2018



Source: Institute for Supply Management.



Few Signs of Emerging-Market Volatility Affecting Other Markets as Yet

In early September, the pressures on emerging markets (EMs) that had been building up for several months appeared to reach a new level of intensity. Though Argentina and Turkey remained the countries facing the most serious problems, many investors increasingly regarded any suggestion of negative news flow in other EMs as a reason to lighten their holdings. Indeed, with liquidity ever more limited in many of the most pressured markets, some widely traded EM assets attracted selling from market participants searching for more readily available opportunities to reduce their overall EM exposure.

One of the main factors widely deemed to be responsible for increasing stresses on EMs has been the US dollar's rise in response to the Fed's tightening of monetary policy. But while the dollar's trade-weighted index reached a 14-month high in mid-August, the measure declined over the following weeks, underlining how localized the recent weakness in many EM currencies has been.

The other perceived threat to EMs has been uncertainty about US trade policies, and here some headway appeared to have been made as the United States and Mexico announced a bilateral deal, as part of the Trump administration's efforts to renegotiate the terms of the North American Free Trade Agreement (NAFTA). The deal tightened the rules on Mexico's auto exports to its North American neighbor, though it remained unclear whether Canada, the other NAFTA signatory, would agree to similar terms.

Argentina's economic crisis deepened as its currency experienced another sharp depreciation, forcing the Argentinian central bank to raise interest rates from 45% to 60%. The catalyst for the Argentinian peso's latest slide was an unexpected appeal by President Mauricio Macri to the International Monetary Fund to speed up the disbursement of a US\$50 billion bailout package for the country. The public request from the Argentinian president unnerved investors and led to heavy selling of the peso, which fell around 12% against the US dollar in a single day. The fall meant the Argentinian currency had lost around half of its value versus the dollar since the beginning of 2018.

“ It is noteworthy, in our view, that while concerns have spread to many EMs, they have so far had little effect on the main financial markets in the larger advanced economies. ”

In South Africa, figures showed the country's economy had fallen into recession in 2018's second quarter for the first time since 2009, prompting a further weakening of the South African rand, another currency that has seen significant losses since the beginning of August. In less turbulent circumstances, the news of recession might have prompted a fall in yields in South Africa's sovereign bonds, given the market's steeply positive yield curve and relatively lengthy average maturity. However, the absence of such a reaction underlined the extent of concerns among investors about more fragile countries, which in South Africa's case were further compounded by news headlines that its government could be re-examining the issue of land reform, potentially raising the risk of capital outflows.

As in previous episodes of EM volatility, countries with relatively large current-account deficits—which become more of a burden as a country's currency weakens against the US dollar—were viewed by investors as particularly vulnerable. Along with South Africa, other countries with sizable trade imbalances included India and Indonesia, and the currencies of both were among the worst performers during August and early September. The drop in the Indian rupee to a record low level against the US dollar came despite data showing the country's economy grew during the April–June quarter at its fastest rate in two years. However, currency weakness was not confined solely to EMs. The Australian dollar fell to its lowest point in two years against the US dollar, on concerns about the trade tensions between the United States and China.

It is noteworthy, in our view, that while concerns have spread to many EMs, they have so far had little effect on the main financial markets in the larger advanced economies. This suggests to us that monetary policy at the major central banks remains on track, though clearly there has been a partial breakdown in the

Negative Investor Sentiment Spreads Across EM Currencies

Exhibit 2: MSCI Emerging Market Currency Index
2 January 2017–17 September 2018



Source: Bloomberg.

synchronized growth seen across the global economy around a year ago. The pressure on the currencies of emerging economies to some extent reflects the growth and interest-rate differentials that have arisen since then between the United States and the rest of the world. The other element heightening concerns has been widespread uncertainty about trade. In this regard, a weakening of EM currencies—which for more export-oriented economies could offset any potential imposition of tariffs—would appear logical.

Growing Risks to UK and EU Economies Make Agreement on Brexit Deal More Likely

With trading volumes in European markets dropping off during the summer period, the main influences on sentiment were concerns about the exposure of some European banks to Turkey and further political uncertainty in Italy. Italian benchmark yields rose around 50 basis points during August, as investors reacted nervously to news that the country’s coalition government had begun budget negotiations earlier than previously expected, though volatility was exaggerated by a holiday-related lack of liquidity. Tensions fell in early September after Italian policymakers sought to reassure the European Union (EU) about their commitment to reducing the country’s high level of public debt, rather than challenging the EU’s fiscal rules by increasing spending.

In the latest sign of the impact of populism on European politics, results from Sweden’s elections showed a surge in support among voters for the anti-immigration Sweden Democrats at the expense of the more established moderate parties. Though the populist party seemed likely to remain excluded from any governing coalition, its rise echoed similar electoral voting patterns in many other European countries. Sweden has been governed by minority coalitions since 2010, and concerns over a continued lack of direction on economic reforms have contributed to the weakness of the Swedish krona, one of the worst-performing currencies among the G10 countries so far this year. The country’s central bank has also received some criticism, as it has consistently held back from raising interest rates despite the strength of the Swedish economy, a stance thought to be partly driven by policymakers’ desire to limit any rise in Swedish rates ahead of any similar move by the European Central Bank.

“ We think a failure to reach a negotiated deal could become increasingly problematic for EU member states, as they see how much it could hurt them and not just the UK. ”

Swedish Krona Hurt by Central-Bank Policy and Political Uncertainty

Exhibit 3: Euro vs Swedish Krona
1 January 2018–18 September 2018



Source: Bloomberg.

With only six months until the deadline for the United Kingdom’s (UK’s) exit from the EU, and little sign of common ground on the terms of the UK’s departure, the possibility of the two sides failing to reach an agreement drew closer, an outcome widely anticipated as liable to hurt the economies of both sides. Amid much speculation, one report suggested that Germany—the most influential EU member—might be prepared to accept a less detailed deal in order to avoid such disruption. Bank of England Governor Mark Carney said he would be willing to remain in his post until 2020 to maintain stability during the UK’s departure, but also stated the central bank’s ability to mitigate the shock of a disorderly exit was limited.

We think a failure to reach a negotiated deal could become increasingly problematic for EU member states, as they see how much it could hurt them and not just the UK. Such a scenario would also potentially be seen as a failure for the EU’s lead negotiator, Michel Barnier, whose mandate was not designed to inflict economic punishment on the UK. So, in the near term, we believe there could be more pressure on EU negotiators to come up with a viable deal, probably accompanied by a lot of last-minute brinkmanship, not just between the negotiating parties but also within the main UK political parties.

EUROLAND MACROECONOMIC DATA

FINAL OUTPUT

Gross Domestic Product (GDP) ¹	Q3:17	Q4:17	Q1:18	Q2:18
GDP, Y/Y (%)	2.8	2.7	2.4	2.1
Private Consumption, Y/Y (%)	1.9	1.5	1.6	1.3
Gross Fixed Capital Formation, Y/Y (%)	2.4	2.6	3.4	2.8

ECONOMIC INPUTS¹

	Apr 18	May 18	Jun 18	Jul 18
Retail Sales, Y/Y (%)	1.6	1.7	1.5	1.1
Unemployment Rate (%)	8.4	8.2	8.2	8.2
Industrial Production, Y/Y (%)	1.7	2.6	2.3	-0.1

INFLATION & WAGE PRESSURE

Inflation Indicators ¹	May 18	Jun 18	Jul 18	Aug 18
Consumer Price Index (CPI), Y/Y (%)	1.9	2.0	2.1	2.2
Core CPI, Y/Y (%)	1.1	0.9	1.1	1.0

FINANCIAL MARKETS

	May 18	Jun 18	Jul 18	Aug 18
Dow Jones EURO STOXX				
50 Price Index EUR, Trailing P/E Ratio ²	15.33	15.81	16.41	15.80
ECB Refinance Rate (%) ³	0.00	0.00	0.00	0.00
10-Year Yield—German Bunds (%) ²	0.34	0.30	0.44	0.33

BALANCE OF PAYMENTS^{1,3}

Trade Balance	Mar 18	Apr 18	May 18	Jun 18
Billion Euro	25.59	16.47	16.62	22.51
Current Account Balance	Q3:17	Q4:17	Q1:18	Q2:18
% GDP	4.6	4.6	2.8	2.2

JAPAN MACROECONOMIC DATA

FINAL OUTPUT

Gross Domestic Product (GDP) ⁴	Q3:17	Q4:17	Q1:18	Q2:18
GDP, Q/Q ar (%)	2.3	0.9	-0.9	3.0
Private Consumption, Q/Q ar (%)	0.8	2.1	-1.5	4.5
Fixed Capital Formation, Q/Q ar (%)	5.4	3.5	2.7	12.8

ECONOMIC INPUTS

	Apr 18	May 18	Jun 18	Jul 18
Unemployment Rate (%) ⁵	2.5	2.2	2.4	2.5
Industrial Production, Y/Y (%) ⁶	2.6	4.2	-0.9	2.3
Tertiary Index, Y/Y (%) ⁶	1.2	1.4	0.7	1.0
Corporate Activities	Q3:17	Q4:17	Q1:18	Q2:18
Corporate Profit Growth (%) ⁷	5.5	0.9	0.2	17.9
Tankan Quarterly Survey (Index Level) ⁸	22	25	24	21

INFLATION

Inflation Indicators ⁵	Apr 18	May 18	Jun 18	Jul 18
Consumer Price Index (CPI), Y/Y (%)	0.6	0.7	0.7	0.9
CPI ex Fresh Food, Y/Y (%)	0.7	0.7	0.8	0.8

FINANCIAL MARKETS²

	May 18	Jun 18	Jul 18	Aug 18
Nikkei 225, Trailing P/E Ratio	16.8	16.1	16.3	16.5
3-Month Yield—JGBs (%)	-0.155	-0.136	-0.191	-0.162
10-Year Yield—JGBs (%)	0.040	0.036	0.062	0.107

BALANCE OF PAYMENTS

Monthly Trade Balance ⁷	Apr 18	May 18	Jun 18	Jul 18
Billion Yen	574	-304	821	-1
Current Account Balance ⁹	Q3:17	Q4:17	Q1:18	Q2:18
% GDP	4.0	4.0	4.0	4.0

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

1. Source: © European Union 1995–2018.

2. Source: Bloomberg. P/E ratios of Dow Jones EURO STOXX 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.

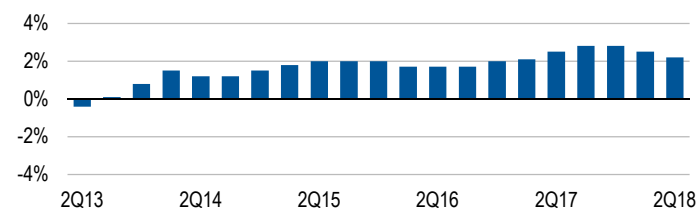
7. Source: Ministry of Finance, Japan.

8. Source: Bank of Japan.

9. Source: Bloomberg Indices.

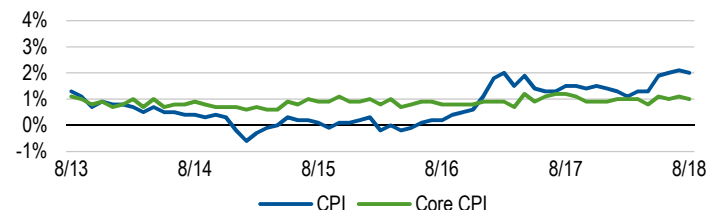
Past performance does not guarantee future results.

Eurozone Real GDP, Y/Y



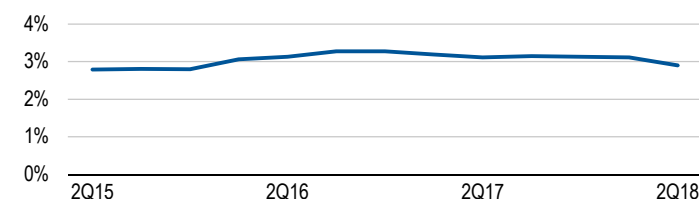
Source: © European Union 1995–2018, as of June 2018.

Consumer Price Index, Y/Y



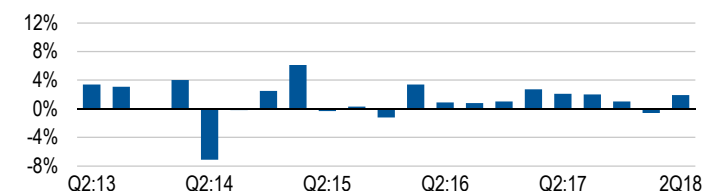
Source: © European Union 1995–2018, as of August 2018.

External Trade Balance, GDP



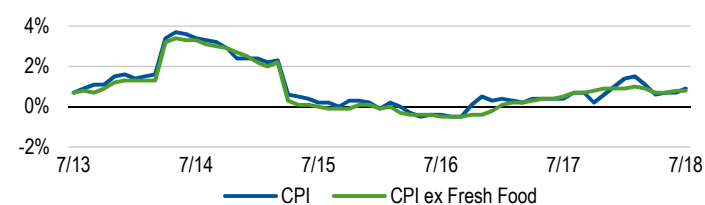
Source: © European Union 1995–2018, as of June 30, 2018.

Japan Real GDP, Q/Q ar



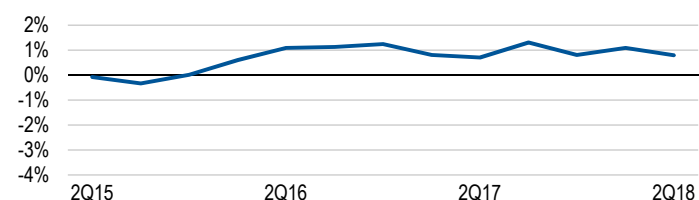
Source: ESRI, Cabinet Office, Government of Japan, as of June 2018.

Consumer Price Index, Y/Y



Source: Ministry of Internal Affairs and Communications, Japan, as of July 2018.

Visible Trade Balance, GDP



Source: Ministry of Finance, Japan and Economic and Social Research Institute, Cabinet Office, Government of Japan, as of June 30, 2018.

US MACROECONOMIC DATA

FINAL OUTPUT

Gross Domestic Product (GDP) ²	Q1:18	Q2:18	Q3:18E ¹	Q4:18E ¹
Q/Q ar (%)	2.2	4.2	3.0	2.8

ECONOMIC INPUTS

CONSUMPTION/FINAL DEMAND

Income/Savings ²	Apr 18	May 18	Jun 18	Jul 18
Consumer Spending, Y/Y (%)	4.5	4.9	5.0	5.2
Personal Income, Y/Y (%)	4.6	4.5	4.8	4.7
Savings Rate (%)	6.9	6.8	6.8	6.7

Employment	May 18	Jun 18	Jul 18	Aug 18
Unemployment Rate (%) ³	3.8	4.0	3.9	3.9
Participation Rate (%) ³	62.7	62.9	62.9	62.7
Nonfarm Payrolls (in Thousands) ³	268	208	147	201
Jobless Claims, 4-Wk Average (in Thousands) ⁴	223	225	215	210

Housing ⁵	Apr 18	May 18	Jun 18	Jul 18
Existing Home Sales (in Millions)	5.45	5.41	5.38	5.34
Y/Y Change (%)	-1.6	-3.4	-2.2	-1.5

INVESTMENT

Corporate Earnings ^{6, 11}	Q1:18	Q2:18	Q3:18E	Q4:18E
Earnings, Y/Y (%)	7.8	24.4	19.9	18.2

Production & Utilization ⁷	May 18	Jun 18	Jul 18	Aug 18
Industrial Production, Y/Y (%)	2.9	3.5	4.0	4.5
Capacity Utilization (%)	77.4	77.8	77.9	78.1

Nonresidential Fixed Investment ²	Q3:17	Q4:17	Q1:18	Q2:18
Y/Y (%)	5.0	6.3	6.7	7.0

INFLATION & PRODUCTIVITY

Inflation Indicators	May 18	Jun 18	Jul 18	Aug 18
Personal Consumption Expenditure (PCE), Y/Y (%) ²	2.2	2.2	2.3	-
Core PCE, Y/Y (%) ²	2.0	1.9	2.0	-
Consumer Price Index (CPI), Y/Y (%) ²	2.8	2.9	2.9	2.7
Core CPI, Y/Y (%) ³	2.2	2.3	2.4	2.2
Producer Price Index (PPI), Y/Y (%) ³	4.1	4.0	4.2	4.6
Core Producer Prices, Y/Y (%) ³	2.2	2.2	2.4	2.4

Productivity ³	Q3:17	Q4:17	Q1:18	Q2:18
Productivity, Q/Q ar (%)	2.3	-0.3	0.3	2.9
Unit Labor Costs, Q/Q ar (%)	2.8	2.3	3.4	-1.0

FINANCIAL MARKETS

Valuation	Jul 18	Aug 18	Sep 18E	Oct 18E
P/E S&P 500 ⁶	20.41	21.00	-	-
Fed Funds Rate ^{7, 8}	2.00	2.00	1.95	2.17

BALANCE OF PAYMENTS

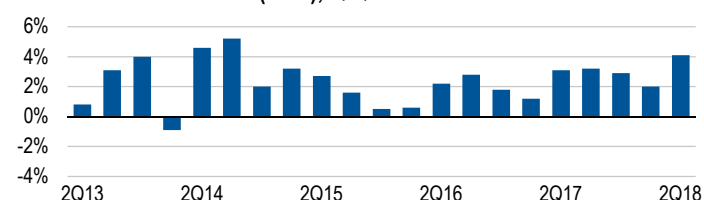
US Monthly Trade Deficit ^{2, 9}	Apr 18	May 18	Jun 18	Jul 18
Billion USD	-45.5	-42.6	-45.7	-50.1
US Current Account Deficit	Q2:17	Q3:17	Q4:17	Q1:18
Quarterly (in USD Billion) ²	-121.8	-103.5	-116.2	-124.1
Annualized (% GDP) ¹⁰	-2.4	-2.3	-2.4	-2.3

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

- Source: Bloomberg Economic Forecasts as of 30/09/18.
- Source: US Bureau of Economic Analysis.
- Source: US Bureau of Labor Statistics.
- Source: US Department of Labor.
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- Source: Standard and Poor's.
- Source: US Federal Reserve. At the 13/06/18 meeting the US Federal Reserve raised the main US interest rate to "a target rate" between 1.75% and 2.00%.
- Source: Chicago Board of Trade (30-Day Federal Funds Futures Rate for August 2018 and September 2018), as of 14/08/18.
- Source: US Census Bureau.
- Source: Bloomberg Indexes.
- Source: Bloomberg calculations are share-weighted y/y. Estimates as of 13/09/18.

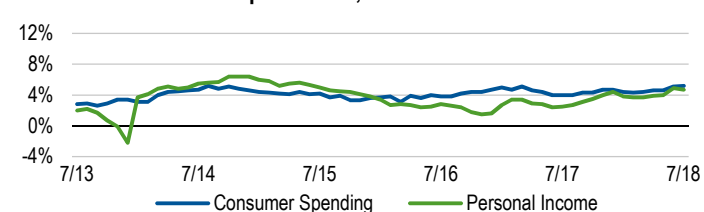
Past performance does not guarantee future results.

Gross Domestic Product (GDP), Q/Q ar



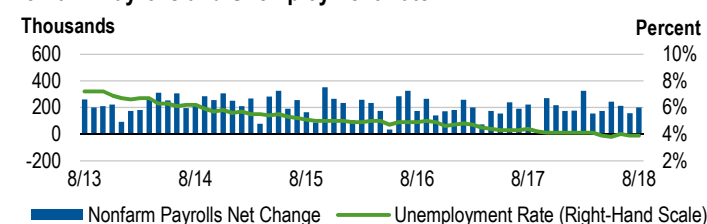
Source: US Bureau of Economic Analysis, as of June 2018.

Personal Income and Expenditures, Y/Y



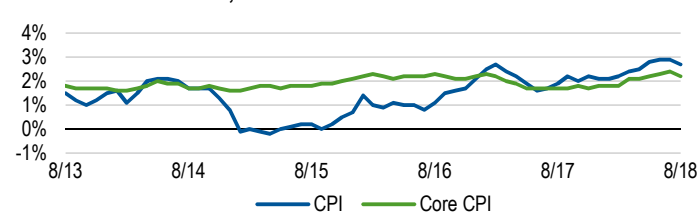
Source: US Bureau of Economic Analysis, as of July 2018.

Nonfarm Payrolls and Unemployment Rate



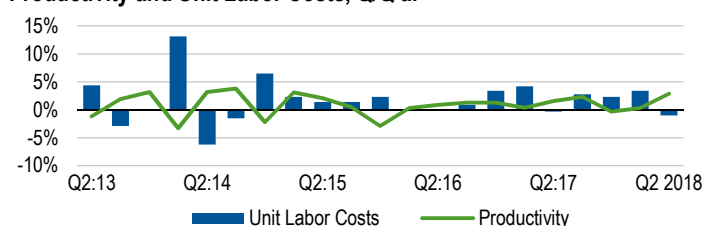
Source: US Bureau of Labor Statistics, as of August 2018. All figures seasonally adjusted.

Consumer Price Index, Y/Y



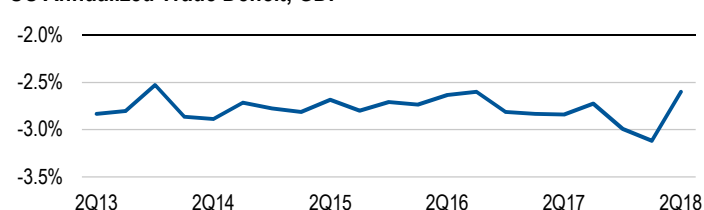
Source: US Bureau of Labor Statistics, as of August 2018.

Productivity and Unit Labor Costs, Q/Q ar



Source: US Bureau of Labor Statistics, as of June 2018.

US Annualized Trade Deficit, GDP



Source: US Census Bureau and US Bureau of Economic Analysis, as of June 2018.

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