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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 19 September 2018.***

Riding the US LNG Wave: The United States is rapidly expanding its ability to export liquefied natural gas (LNG), as more countries look to embrace cleaner energy. Here, Franklin Equity Group's Matt Adams gives his outlook for US LNG and the possible investment implications.

Then and Now: Mortgage-Backed Securities Post-Financial Crisis: A little over 10 years ago, few people had heard of mortgage-backed securities (MBS). Yet that changed when MBS brought the global financial system to its knees. Today, they're still a pivotal part of the system, with the US Federal Reserve (Fed) the largest holder. Franklin Templeton Fixed Income Group's Paul Varunok explains how MBS fit into the Fed's future plans and gives his outlook for the asset class.

Three Developments in Europe You May Have Missed over the Summer—and One You Didn't: The months of July and August are traditionally a little quieter for markets in Europe as participants take a summer break. But things don't stop completely. As the wheels get back up to speed, David Zahn, Franklin Templeton's Head of European Fixed Income, considers a few developments in Europe over the summer months that might have slipped under the radar.

Riding the US LNG Wave

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Though carbon-based and not listed as a true "clean" energy source, natural gas has long been described as the "bridge fuel" to a cleaner energy future as the world weans itself off highly polluting coal and oil.

In our view, that bridge looks likely to extend well into the next decade, as more countries turn to natural gas in a bid to displace coal as the largest source of power generation. Moreover, long-term LNG supply additions appear to be slowing down after years of underinvestment and few recent project sanctions.

In 2016, natural gas supplied 22% of the world's energy, and its use is growing.[1] As the chart on the next page shows, the International Energy Agency (IEA) projects natural gas to account for 25% of the global energy mix by 2040.

Why Demand for LNG Is Growing

In many parts of the world, constructing pipeline infrastructure to transport natural gas isn't practical, and domestic production of natural gas outside North America is struggling and on the decline in many countries.

That's why we expect to see an increase in demand for LNG as countries pursue more natural gas-driven policies. The natural gas liquefaction process cools, condenses and transforms the gas into a commodity that can be ferried around the world in specialised compression tankers.

We've already seen the number of countries importing LNG rise from 35 in 2015 to 40 last year.[2] In addition, worldwide imports rose 9.9% in 2017, the strongest annual growth rate since 2010.[3]

Meanwhile, LNG supply from new additions has been slowing down and could create a supply deficit in the next decade if LNG demand continues on its current growth trajectory. Since LNG projects require a five-year lead time to develop, global LNG could move into a tighter market for longer time frames before higher prices encourage more investment in new supplies.

The Outlook for US LNG

In the United States, LNG exporters are benefitting from rapid demand growth and the streamlining of federal permits for LNG

plants, export facilities and LNG tanker ships. As at June 2018, many companies said they are finalising investment decisions to build planned US LNG facilities.[4]

Construction has been underway on a wave of US LNG plants along the Gulf of Mexico coast. The first, at Louisiana's Sabine Pass, began shipping LNG in 2016, and Cove Point terminal in Maryland just started this year, while others are scheduled for completion through 2020.[5]

Will Trade Tensions Affect US LNG Exports?

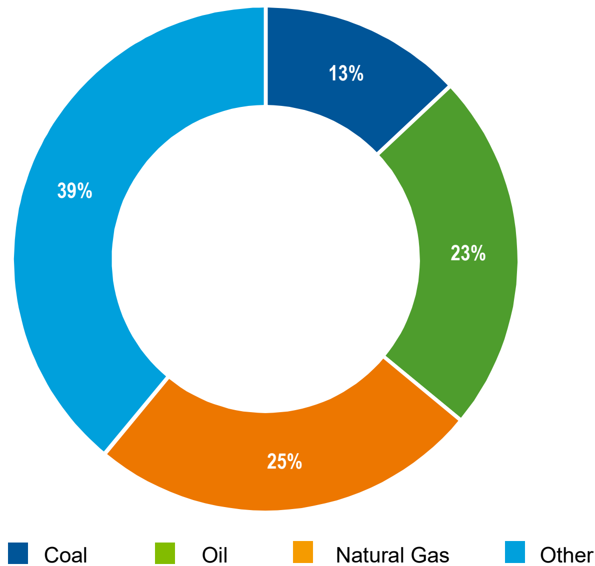
In 2017, China was the third-largest destination for US LNG exports, behind Mexico and South Korea.[6] The country's demand for LNG is expected to continue growing rapidly as the Chinese government moves to limit air and water pollution from the combustion of coal. Coal, which accounts for about a third of global carbon dioxide emissions, currently dominates China's total energy consumption (at about 70%) and electricity production (at nearly 80%).[7]

However, the escalating trade dispute between the US and China casts a shadow over those plans—at least in the short term. In August, China threatened to impose a 25% tariff on US LNG, which, if imposed, could make US LNG more expensive to Chinese buyers.[8] However, given the lack of near-term supply sources which are not already contracted, the US remains a likely supplier of LNG to China, even with a tariff, given the wide spread between US and Chinese prices.

For now, US LNG exports account for a small amount of US natural gas demand, thus there is minimal impact on US natural gas producers. Though if the tariff conflict were to continue for longer, it could eventually diminish one long-term export opportunity for US producers. That said, there appears to be growing opportunity in Europe for US LNG as the continent struggles to balance its demand needs with overdependence on Russian natural gas pipeline supplies.

Projected Global Energy Mix (2040)

Estimated Share of Global Energy Demand



Source: OECD/International Energy Agency, "Outlook for Natural Gas," 2017.
There is no assurance that any forecast, projection or estimate will be realised.

Then and Now: Mortgage-Backed Securities Post-Financial Crisis

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Ten years ago, the United States was in the depths of a financial crisis that is still a sensitive topic for many borrowers who lost their homes and for many investors who saw their portfolios fall as the crisis spread across the globe.

Before the crisis, the United States hadn't experienced a national housing correction in at least four decades.[9] Many groups, including homeowners, mortgage originators and credit rating agencies, seemed to discount the possibility that home prices would fall.

In addition, not much attention had been paid to the risks of subprime lending or the mortgage-backed securities (MBS) backed by subprime loans before the crisis. Then, mortgage delinquencies and foreclosures rose, and home prices and MBS began to fall.

What Are MBS?

MBS are bonds that represent an ownership interest in a pool of residential mortgage loans. Homeowners make mortgage payments which are ultimately pooled each month and then "passed through" to MBS holders in the form of principal and interest cash flows.

MBS are classified as either **agency MBS** or **non-agency MBS**.

Agency MBS are created by one of three government-sponsored agencies: Fannie Mae, Freddie Mac or Ginnie Mae. Ginnie Mae bonds are backed by the full faith and credit of the US government and their credit is comparable to US Treasury securities. Fannie Mae and Freddie Mac bonds aren't US government guaranteed, but they are under conservatorship of the US government and regulated by the Federal Housing Finance Agency (FHFA), a post-financial-crisis created entity.

Within agency MBS, the primary risk to investors is prepayment risk. Typically, when interest rates fall, homeowners refinance their mortgages to secure a lower rate in order to achieve lower monthly payments. As a result of such refinancing events, mortgages are paid off prior to maturity and the MBS investors are confronted with reinvesting that money at a lower prevailing interest rate.

In contrast, **non-agency MBS** are issued by private entities, such as financial institutions. They are not guaranteed by the US government or any of the three government-sponsored agencies, and therefore carry a level of credit risk not present in agency MBS.

Non-agency MBS include the subprime, non-prime and private-label MBS that gained notoriety during the 2008 financial crisis. In the years leading up to the crisis, the non-agency MBS market grew rapidly and the securities provided a way for homebuyers deemed less creditworthy to gain financing.

However, as mortgage delinquencies increased, non-agency MBS fell in value. As mortgage financing leverage was not solely held in the non-agency MBS market, the contagion spread to higher-quality securities, including prime MBS, though the losses were far lower in comparison.

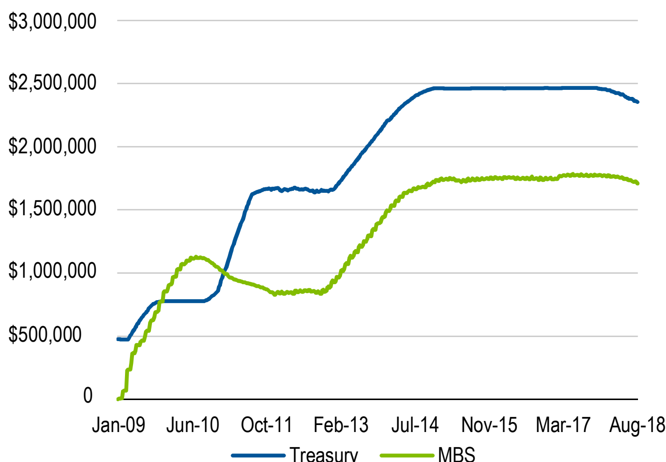
How the Fed Became the Largest Holder of MBS

For decades, Fannie Mae and Freddie Mac were the largest holders of MBS. However, that began to change in 2008, when mortgage lending tightened during the housing crisis. In September of that year, Fannie and Freddie were put in conservatorship and mandated by the FHFA to wind down their private investment portfolios of MBS.

To offset a slowdown in lending and stabilise the housing market, the Fed began its quantitative easing (QE) plan. In November of 2008, the Fed started buying US$600 billion in MBS. Over the following years, the Fed increased its holdings in MBS and US Treasuries, as the chart below shows.

Fed Increased MBS and Treasury Holdings Post-Crisis

Federal Reserve Balance Sheet (USD in Thousands)
14 January 2009–1 August 2018



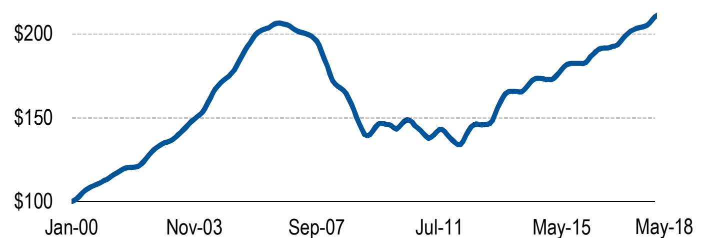
Source: US Federal Reserve, Bloomberg, as at 1 August 2018.

Due to this buying, the yields on MBS and Treasuries fell, which helped put a floor on housing prices by effectively lowering long-term interest rates and thereby making mortgages more affordable for homeowners. Over time, these purchases led the Fed to surpass Fannie and Freddie as the largest owner of US MBS.

In recent years, the US economy has been on an upswing, partly due to home prices that have recovered to pre-crisis levels, as the chart below shows.

US Home Prices Rebound to Pre-Crisis Levels

National Home Prices
Metro Area (USD in Thousands)
31 January 2000–31 May 2018



Source: S&P/Case-Shiller. The S&P CoreLogic Case-Shiller 20-City Composite Home Price NSA Index seeks to measure the value of residential real estate in 20 major US metropolitan areas: Atlanta, Boston, Charlotte, Chicago, Cleveland, Dallas, Denver, Detroit, Las Vegas, Los Angeles, Miami, Minneapolis, New York, Phoenix, Portland, San Diego, San Francisco, Seattle, Tampa and Washington, DC. Indices are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or guarantee of future performance.** This chart is for illustrative purposes only and does not reflect the performance of any Franklin Templeton fund.

The Fed's Plans for its MBS

As the US economy has improved, the Fed has taken steps to normalise its monetary policy. In 2014, the Fed announced the end of QE, when its balance sheet reached about US$4.5 trillion of MBS and Treasuries. Then, in 2017, it began reducing the reinvestment of the principal payments it received for expiring agency MBS when payments exceeded certain levels.

In September 2018, we expect to see about US$6 billion in reinvestment of MBS principal, compared with about US$30 billion a month at the beginning of 2018. And, in October 2018, the Fed has announced that it plans to stop reinvesting the proceeds.

To be clear, the Fed isn't selling MBS; it's allowing its holdings to gradually decline. The Fed currently owns roughly 1/3 of the agency MBS market, worth about US$1.7 trillion. Since the Fed has said it has no plans to sell MBS, we expect the Fed's holdings of MBS to decline about 10% a year due solely to this reduction and eventual end of reinvestment.

Investment Implications

As the Fed stops buying, we expect that will leave a greater supply of MBS for the market to absorb. Now, the question is, who's going to be the marginal buyer of MBS?

US banks, the second-largest contingent of agency MBS ownership, have always been a presence in the market. We believe they'll continue to buy and hold agency MBS due to favourable capital requirements.

Money managers are typically the third-largest owners of MBS. We think mortgage spreads (the spread between mortgage interest rates and Treasury yields) will likely need to move higher to entice money managers to purchase more MBS. That, in general, means prices are likely to fall.

However, our view is buffered by higher interest rates. Higher interest rates typically mean it's less affordable to create new credit for borrowers. In addition, prepayments generally slow when rates rise, so there's less supply for the market to absorb.

So, we think it's kind of a balancing act. We expect spreads might widen marginally but we're not expecting mortgages to sell off drastically. In general, we think they could perform in line with, to slightly better than, US Treasuries. Typically, MBS have higher income than Treasuries, as investors must be compensated for the prepayment risk component; though with only a small portion of the MBS universe currently refinanceable, prepayment risk remains low.

Three Developments in Europe You May Have Missed over the Summer—and One You Didn't

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"Flight to Quality" Pushes Core European Bond Yields to Unrealistic Levels

For a few days in the traditionally quiet mid-August period, concerns about a crisis in Turkey generated feverish headlines and created some volatility in emerging-market assets.

We felt the likely economic fallout was largely confined to Turkey and we regard the knock-on effect on the financial markets and economies of the European Union (EU) as very small.

One or two individual European banks had some exposure to the Turkish lira, but these were generally considered to have more than enough capital to deal with any problem. So the risk of contagion to the European financial sector seems to us negligible.

Investors Adopt Risk-Off Approach

However, noise around the situation in Turkey did trigger a risk-off sentiment amongst some investors, prompting a so-called "flight to quality."

Investors' risk aversion has driven yields in core European bonds down over the past few months. Notably, the 10-year German Bund tumbled to 0.30% in mid-August.

Ultra-low German bond yields don't make sense to us, when you consider the macroeconomic background in the eurozone: core inflation is still near 1%, with headline inflation at around 2%.

The European Central Bank's (ECB's) asset-buying programme looks set to wrap up at the end of the year, which we think should keep a cap on European bond yields. However, we still expect to see the German 10-year yield up at around 0.70% to 0.80% at least, which would still reflect some risk premium built in.

Bank of Japan's Stealth Taper

Potentially one of the most interesting developments for European bond markets over the summer happened well away from Europe—in Japan.

While it appears the ECB will start wrapping up its QE programme at the end of this year, the Bank of Japan (BOJ) will likely be the last major central bank still engaged in asset purchases.

But slowly and without fanfare, even the BOJ has been reducing its purchases over time in what I refer to as a "stealth taper."

BOJ's Asset Purchases Are Falling

The BOJ owns so much of the bond market, it really doesn't need to keep buying as much as it did in the past, but still, the amount of additional QE purchases has been falling.

At its monetary policy meeting in late July, the BOJ announced a small change to its approach. It widened its tolerance for fluctuations in the yield on the 10-year Japanese government bond to 0.20% above or below its 0% target. Previously, the central bank would have stepped in from 0.10% above or below the target.

Widening the range before it steps in means allowing for more volatility, which is something that's been absent from bond markets for some time, and as a consequence more normalisation.

While yield curves globally have seen a flattening trend over the past year, given the coordinated central bank approach we anticipate going forward, we think yield curves could potentially begin to steepen.

Leadership Vacuum in Europe as Italy Prepares a Potentially EU-Baiting Budget

It's become apparent to us over the summer that there's a leadership vacuum at the head of Europe.

Neither French President Emmanuel Macron nor German Chancellor Angela Merkel currently appear strong enough to take a forceful lead of Europe on their own, and so they will need to work together.

Macron has not been able to build the power base that he'd expected. His opinion poll numbers in France are disappointing, and he's not been able to make all the changes domestically he said he wanted.

Merkel has also faced challenges within her ruling coalition in Germany which have left her weakened politically.

Italy's Populist Government to Outline Spending Plans

At the same time, we're gearing up for potential challenges to the EU status quo from the newly formed populist coalition government in Italy.

The Italian government is preparing to unveil its budget for the forthcoming year in September or October. It has previously indicated a willingness to run deficits to spur economic growth, in contravention of EU guidance.

The question is whether Italy will propose a very populist budget that looks to spend lots of money and require deficit spending.

We think the Italian government will tread cautiously. It's seen what's happened to countries such as Turkey when financial markets are spooked. In our view, Italy's leaders will likely recall the volatility that greeted the election success of the two populist parties there.

We'd expect an Italian budget that proposes growing the budget deficit more than the EU would like, but still within what it can comfortably finance.

Brexit: "No Deal" Looks Increasingly Likely, but Would Represent a Failure for Both Sides

What's going on with Brexit? Unfortunately not a lot.

Based on the current state of negotiations, we think the United Kingdom is getting closer to crashing out of the EU without a deal. But significantly, we think the lack of a deal will increasingly become problematic for other EU member states as they see how much it is likely to hurt them, not just the United Kingdom.

We also think a no-deal scenario would be seen as a failure for the EU's lead negotiator, Michel Barnier. His goal was not to eviscerate the United Kingdom, but to come up with a deal that all sides could work with.

If all Barnier does is punish the United Kingdom it's not a successful negotiation in our eyes. If that was the plan, the EU could just have walked away from negotiations.

So in the coming weeks, we think there will be more pressure on Barnier and his team of EU negotiators to come up with a viable deal.

We'd expect a lot of last minute gamesmanship not just between the negotiating parties in Europe but within the political parties in the UK. We're heading towards party conference season, which could decide the future leadership and policy direction of the main political parties in the UK.

There are a lot of moving parts at a time when what's needed is stability.

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. Investing in the natural resources sector involves special risks, including increased susceptibility to adverse economic and regulatory developments affecting the sector. Growth stock prices may fall dramatically if the company fails to meet projections of earnings or revenue; their prices may be more volatile than other securities, particularly over the short term. Smaller companies can be particularly sensitive to changes in economic conditions and have less certain growth prospects than larger, more established companies and can be volatile, especially over the short term. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. The price and yield of a MBS will be affected by interest rate movements and mortgage prepayments. During periods of declining interest rates, principal prepayments tend to increase as borrowers refinance their mortgages at lower rates; therefore MBS investors may be forced to reinvest returned principal at lower interest rates, reducing income. A MBS may be affected by borrowers that fail to make interest payments and repay principal when due. Changes in the financial strength of a MBS or in a MBS's credit rating may affect its value. 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. Current political uncertainty surrounding the European Union (EU) and the financial instability of some countries in the EU may increase market volatility and the economic risk of investing in companies in Europe.

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1. Source: IEA, Market Report Series: Gas 2018.
2. Source: International Group of Liquefied Natural Gas Importers, "The LNG industry, GIIGNL Annual Report 2018."
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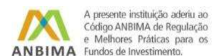

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