FRANKLIN TEMPLETON | Institute

December 2022

Franklin Templeton Investment Solutions

Allocation Views

Storm clouds on the horizon

In this issue

The themes we discuss at our Annual Investment Symposium guide our research process. Over a longer-term horizon, we believe global stocks have greater performance potential than global bonds, despite slightly slower growth expectations. With interest rates starting from relatively elevated levels in developed markets, overall return expectations from all fixed income assets have become more attractive than has been the case in recent years.

We recognize that our longer-term outlook will not be reached along a smooth path and that maintaining a diversified portfolio of risk premia, in addition to the traditional benefits of a balanced portfolio between stocks and bonds, should be the most likely path toward stable potential returns.

Major themes driving our views

Growth is slowing to below trend

Growth momentum is decelerating, and the risks are skewed to the downside, accentuated by the impact of policy tightening and a squeeze on real incomes. Leading indicators of growth suggest further weakness to come, even where current activity levels have held up reasonably well. Recession risks are meaningful and rising across developed economies.

A challenging inflation environment

Inflation remains well above targeted levels. Supply pressures have boosted inflation, but signs of a peak are in place despite the challenge of commodity shocks and the ongoing Russia-Ukraine war. These supply concerns are being balanced by demand destruction as the economic cycle slows.

Policy to remain restrictive

Most central banks have adopted a singular focus on inflation and are accepting the consequences for growth. Fiscal policy is responding to energy costs in some economies but will be slow to sway dovish in others. Expected central bank hikes will moderate negative real rates and sustain restrictive conditions.

Practical positioning

Nimble management still required

Having started to trim our allocation preference for equities at the start of this year, we retain a more cautious view of stocks. We continue to believe that a nimble investment style remains appropriate and have recently established an allocation preference away from equities. The levels of anticipated earnings per share remain close to their peak, which underplays concerns around economic growth.

Bond valuations have improved

Our longer-term analysis shows that the return potential from global bonds, including lower-risk government bonds, has improved. Once the current policy-tightening environment starts to moderate, it is likely that government bonds will again exhibit more of a risk-dampening effect. Until then, we believe bonds still make a more compelling case than they have for many years.

Opportunities in alternative assets

We are attracted to naturally diversifying “alternatives” such as private assets, which offer the potential to earn an incremental return linked to their relative illiquidity. These assets reflect trends in public markets, notably a higher risk-free rate environment. Private credit and private equity also include a healthy prospective return premium over public markets.

Major themes driving our views

Thoughts for 2023 and beyond

Some things haven't changed—the COVID-19 pandemic is still with us, but at least the West has moved past worrying about every new variant that comes along and appears to pose an additional threat. Even in China, where lockdowns and restrictions have continued throughout the year, it appears that changes to its zero-COVID approach are afoot. This may remove the last major economic headwind from the pandemic. However, the much-anticipated reopening rebound in the rest of the world has been overtaken by the Russia-Ukraine war, which appears to be no closer to resolution, and the inflationary consequences of energy insecurity. Economic optimism has been sapped by these issues and the consequent tightening of monetary policy across most of the developed world. Reflecting on the reasons that we were "still looking on the bright side" as we entered 2022, most are no longer applicable for 2023.

Economic momentum has deteriorated. Strong growth in gross domestic product (GDP), fueled by government spending plans and financed with cheap money, has been replaced by widespread pessimism. The probability of a recession over the next year is now meaningful and rising globally, with risks most evident in Europe. Indicators of economic growth continue to point to a notable slowdown (see Exhibit 1), and risks remain still firmly skewed to the downside, accentuated by the lagged impact of monetary policy that is likely to remain restrictive until inflation risks are tamed.

Financial markets have been undermined in 2022 by this pessimistic turn. Equity markets corrected sharply, following a period of strong appreciation from pandemic-induced lows. They joined a correlated move in government bond yields and credit spreads to create a "sell everything" environment. This was driven by the aggressive policy tightening cycle adopted by many developed market central banks in response to multi-decade high levels of inflation.

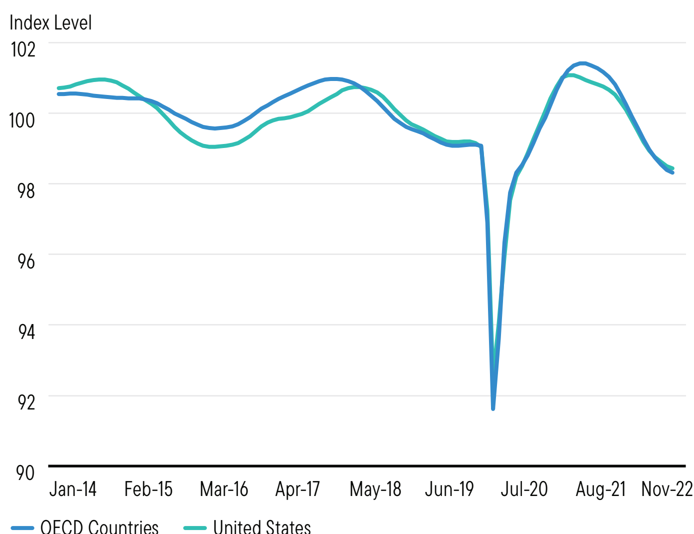
Longer-term drivers of growth

At our Annual Investment Symposium in October, we debated the longer-term themes that impact our analysis of the global economy. The Franklin Templeton Investment Solutions

Indicators of Growth Momentum Show Ongoing Slowdown

Exhibit 1: OECD Composite Leading Indicator

As of November 30, 2022



Sources: OECD, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

(FTIS) team engaged in collaborative dialogue with senior leaders from across Franklin Templeton's wide range of specialist investment managers.

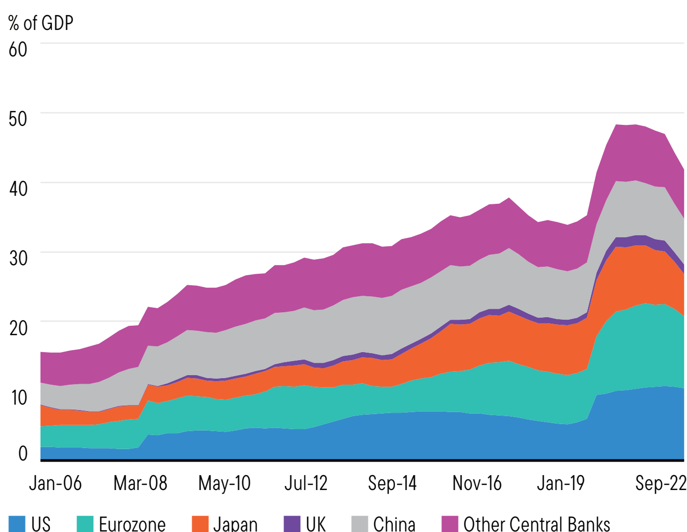
We discussed a range of secular themes that ultimately feed into our views on growth and inflation. This was complemented by a parallel theme of "future threats to human existence," which combined geopolitical with sustainability issues. We explore our views on these trends below, how they impact our macroeconomic outlook, and consequently our longer-term expectations for financial markets. For a more detailed review of the symposium discussions, please see our *Investment Symposium* paper.

In summary, the crises of the last few years have seen an interruption of the process of globalization—a reaction to geopolitical stress and the desire to ensure security of supply. These include the balance between energy security and progress toward a renewable energy transition. These types of changes seem to suggest that the resilience of global growth going forward may be challenged or, at least, desynchronized by region. To some extent this is offset by the potential for improved productivity on the back of rapid

Quantitative Tightening is Just Beginning

Exhibit 2: Central Bank Assets

As of September 30, 2022



Sources: Reserve Bank of Australia, BCB Community Bank, Statistics Canada, People's Bank of China, Central Bank of Denmark, European Central Bank, Central Bank of Ireland, Reserve Bank of India, Bank of Japan, Bank Negara Indonesia. Important data provider notices and terms available at www.franklintempletondatasources.com.

technological innovation. The positive impact of technology likely offsets the fracturing of global supply chains due to geopolitical stress, but the balance point may continue to shift over time. Overall, we expect productivity growth rates to rise to their long-run average, which is higher than the level seen in the most recent cycle, but to fall short of what many would hope for.

We expect fiscal spending, particularly in areas such as green infrastructure, to provide tailwinds for years to come. Both the United States and the eurozone, among others, have fiscal agendas that are geared toward decarbonization. However, debt burdens remain elevated and are leading to increased uncertainty about whether governments will be able to effectively react when the next calamity hits. The rise of political polarization within countries or regions may also place another hurdle in the path of fiscal support. Similarly, the extent to which global central banks are willing to halt the early stages of quantitative tightening (i.e., the normalization of their balance sheets) (see Exhibit 2) and again act as a shock-absorber for debt markets remains to be seen. For now, as monetary policy normalizes and balance sheets contract, debt levels and changes in who holds large chunks of them will be a modest drag on activity levels.

Returning to the shorter term, we see a squeeze on real incomes stunting consumption growth as we move into 2023, even as households continue to take advantage of their generally strong financial positions. Although we are not in one yet, we believe the probability of a recession over the next year is now elevated globally. This is important for our outlook for risk assets, as our analysis suggests that markets usually trough around the same time as the macroeconomic data—within a few months of each other. Markets can and do recover before the end of a recession, but it seems unlikely that they would trough before its onset.

The trough in economic activity is likely still ahead of us, as leading indicators suggest, even if current activity has held up reasonably well. If the full impact of ongoing monetary policy tightening remains to be felt, then it is unlikely that financial markets can post a sustained rebound at this time. We believe the recent improvement in risk-asset sentiment remains more likely to be merely a bear-market rally than a new bull run. Our analysis remains more certain in the view that activity continues to moderate, reflected in our primary theme that concludes **"Growth Is Slowing to Below Trend."**

Inflation

When we look out over a longer-term horizon, the most pressing theme impacting consumers, businesses and markets is inflation. It has grown to dominate the discussion in our investment symposium in recent years and did so again this year. Inflation has a direct impact on consumer behavior, and expectations for future price rises are a big driver of central bank actions. We believe global inflation is close to its cyclical peak and will moderate from current levels, but we anticipate some longer-lasting impact on trend levels of inflation.

However, we believe that medium-term inflation expectations remain well anchored and broadly compatible with central banks' established definitions of price stability. Technological innovation, as we discussed under the growth heading, is driving prices down around the world. Today's growth in debt, and the management of accumulated central bank balance sheets, will limit future demand.

The investment needed to facilitate a green transition should not be underestimated, given the scale of non-renewable energy sources that are still being used in 2022 (see Exhibit 3) and the imperative to speed up their elimination. This together with structurally tight labor markets, which could lead to wage inflation being slow to normalize, may lead to some element of inflation proving to be sticky. In addition, geopolitical tensions persist, particularly between the United States and China, and this is likely to drive some of the more lasting changes in supply chains and may lead to higher prices.

However, we believe that medium-term inflation expectations remain well anchored and broadly compatible with central banks' established definitions of price stability. Technological innovation, as we discussed under the growth heading, is driving prices down around the world. Today's growth in debt, and the management of accumulated central bank balance sheets (as we showed in Exhibit 2), will limit future demand. Disinflationary forces have changed, and their role may be diminished today, but they remain powerful factors keeping a lid on inflationary pressures.

Turning to today, we have seen a clear separation between the paths for goods and services inflation. The acute supply bottlenecks that dominated financial market debate late last year also peaked at that time (see Exhibit 4). As supply-chain pressures continued to ease, and the process of economic reopening saw demand shift—from goods back to services that were harder to consume during the pandemic—the forces of inflation also changed.

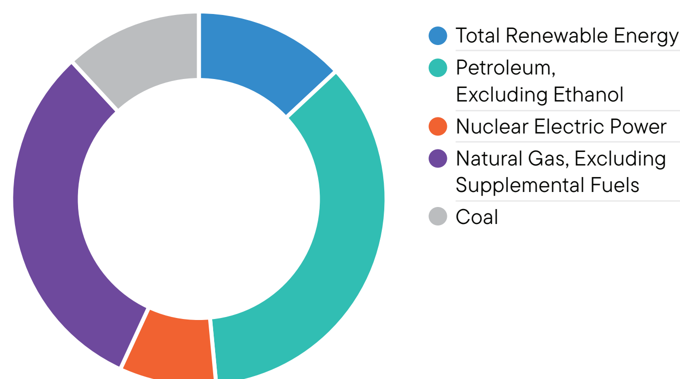
With labor markets tight—especially in the United States, but also in the United Kingdom—wage pressures remain a notable concern to policymakers. So long as job openings remain elevated and employers struggle to fill vacancies with appropriately skilled applicants, broad measures of inflation will be slow to normalize. These pressures are particularly acute in the service sector, where productivity gains can be harder to come by and automation is more problematic. As a result, central bankers continue to have a laser focus on developments in employment and the labor force.

Although supply-push inflation had driven headline figures higher in the post-COVID world, and is now reversing, we believe demand destruction will increasingly be the dominant force as the economic cycle slows. These developments make it more likely that the peak of global inflation is in place, even if it is undoubtedly also a sign of the pain that still-elevated prices are exerting on consumers globally. This is a necessary first condition for central bank policy to change, but it is not sufficient. It does not lessen the current focus on inflation and the debate around the pace of policy normalization, which will be a key determinant of monetary policy actions in the year ahead. Even as inflation eases, we will probably see the trend rate of price gains remain a little more elevated than we have seen in past business cycles. Accordingly, our second theme continues to reflect **"A Challenging Inflation Environment."**

Green Energy is a Major Initiative for Most Developed Markets Over the Long-term

Exhibit 3: Energy Consumption by Source

As of July 31, 2022



Source: Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

Bottlenecks Have Been Easing Consistently

Exhibit 4: Global supply chain pressure index

As of November 30, 2022

Source: Federal Reserve Bank of New York, Macrobond. The Global Supply Chain Pressure Index (GSCPI) tracks the state of global supply chains using data from the transportation and manufacturing sectors. The Index contains 27 variables related to cross-border transportation costs, supplier delivery times, order backlogs and inventories. Important data provider notices and terms available at www.franklintempletondatasources.com.

Taken together with the prospects for a slimming of central bank balance sheets, expected central bank hikes will moderate negative real rates and sustain restrictive conditions. Although fiscal policy is responding to energy costs in some countries, especially in Europe, it will be slow to sway dovish in others, leaving it more differentiated across economies. However, the anticipated shift in global policy is still quite hawkish.

Policy

The key observation from our symposium about central bank policy objectives is that their resolve to keep inflation expectations anchored appears to have been stiffened by the period of uncomfortably high inflation during the last two years. Previous discussions about targeting average levels of inflation, or incorporating medium-term forecasts into the process, have been downplayed. These factors have not gone away, but they have been overtaken by a singular focus on fighting inflation (often described as US Federal Reserve [Fed] Chair Jerome Powell channeling one of his predecessors, Paul Volker). This has been accompanied by a willingness to accept the collateral damage caused by higher-than-anticipated interest rates, in the form of slower growth and potentially higher unemployment, in the years ahead. This clarification of objectives has gone some way to moderating market-observed levels of inflation expectations.

Despite what we view as a clear re-statement of policy imperative by central banks, markets have again been quick to discount a pivot toward easier monetary policy in the year ahead. The first signs of inflation peaking have fueled a continued bear-market rally in stocks and the riskier parts of the bond market. With the major central banks all confirming that they are indeed likely to slow the pace of future rate hikes (though they protest that this is not in any way the same as confirming the market view that easing is just around the corner), government bonds have also joined the “feel good” party.

Taken together with the prospects for a slimming of central bank balance sheets, expected central bank hikes will moderate negative real rates and sustain restrictive conditions. Although fiscal policy is responding to energy costs in some countries, especially in Europe, it will be slow to sway dovish in others, leaving it more differentiated across economies. However, the anticipated shift in global policy is still quite hawkish. Overall, this sees our final theme complete a set of three unambiguously negative drivers for markets, even as it evolves to downplay the pace of hikes but emphasize **“Policy to Remain Restrictive”** as we move through 2023.

Practical positioning

Nimble management still required

We incorporate the longer-term themes discussed at our Annual Investment Symposium into our research process, helping to set the direction for our portfolios and their strategic benchmarks.

Over this longer-term horizon, we believe riskier assets, such as global stocks and corporate bonds, have greater performance potential than global government bonds, despite slightly slower global growth and a marginal increase to global inflation expectations. With global interest rates starting from relatively elevated levels and expected to rise a little further before normalizing, overall return expectations from all fixed income assets have become more attractive to us than has been the case in recent years. Equity returns will likely be driven by earnings growth and yield, supported by some valuation uplift but offset by margin normalization that is likely to occur over our 10-year horizon. The risk premium contained within corporate bond yields appears to be more than adequate compensation for the likely level of default risk across the business cycle.

However, in managing portfolios today, we cannot focus only on the "brighter times ahead" that our long-term expectations highlight. We also need to reflect on more immediate economic concerns and the dynamics that drive shorter-term market moves. Uncertainty over policy responses and the continued path of inflation normalization leave the outlook especially uncertain. This is why "storm clouds on the horizon" is the title of our current edition of Allocation Views. As we progress toward a premature end to the current economic expansion globally, markets are understandably looking to discount the bad news that might occur in the months ahead. Even as we look to the next expansion, we need to recognize that our longer-term outlook will not be reached along a smooth path.

Equity valuations have moderated (the multiples of earnings at which stocks trade have fallen considerably), but the levels of anticipated earnings per share remain close to their peak. This appears to ignore ongoing concerns around economic growth, inflation and likely policy responses that continue to weigh on investor sentiment and to support us remaining more cautious in our view of stocks, rather than becoming bolder.

We moved to trim our top-level allocation preference for equities at the start of 2022 and took advantage of the ebbs and flows of sentiment that occurred during its early months to progressively temper our optimistic view back to neutral in April. Over the next few quarters, we anticipate that a nimble investment management style will continue to be required, and we look for assets that offer some protection if a less favorable scenario were to be realized. We have more recently moved to establish an allocation preference away from stocks, which we have retained this month as we do not see a sustained rally at this stage. We are more attracted to the yields available in high-quality corporate and government bonds. Although we still see attractive longer-term return potential for stocks and believe they should earn their equity risk premium over time (see Exhibit 5), we struggle to find a strong argument supporting an equity preference at this time.

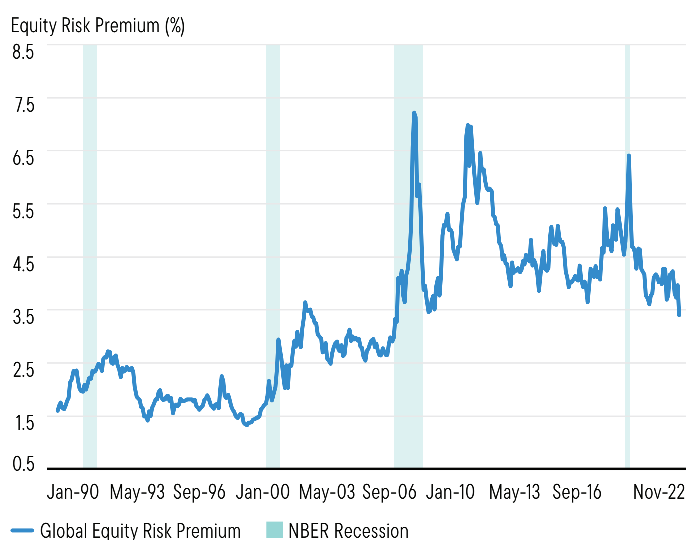
Bond valuations have improved

One of the notable features of our longer-term analysis is that the return potential from global bonds, including lower-risk government bonds, has improved. This reflects the fact that

We Believe Global Equity Valuations Are Not Cheap Enough Relative to Current Higher Bond Yields

Exhibit 5: Global Equity Risk Premium

As of November 30, 2022



Sources: Bloomberg, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

We believe that maintaining a diversified portfolio of risk premia in addition to the traditional benefits of a balanced portfolio between stocks and bonds is the most likely path toward stable potential returns. We also believe that active management of this asset mix can enhance potential return and manage the level of total portfolio risk that is taken.

having seen policy rates rise quite sharply over the past year, the starting level for all government yields has increased. The combination of slowing growth and still elevated inflation will likely drive many central banks to quickly reach a terminal policy rate that is somewhat restrictive, before normalizing official interest rates in the early part of our long-term horizon. This supports our current view, which has been built up in recent months, to take a greater total interest-rate exposure and express some preference for longer duration assets.

Once the current policy-tightening environment starts to moderate, it is likely that government bonds will again exhibit more of a risk-dampening effect. Until then, we believe bonds still make a more compelling case than they have for many years. We hold a constructive view of bonds at the asset allocation level, established recently at notably higher yields, reflecting the pace of rate hikes that is already discounted. Investment-grade corporate bond spreads have also risen and largely reflect an anticipated increase from currently low default rates. However, following a rebound in the valuations of lower-rated corporate and emerging market hard-currency bonds, we have adopted a more cautious stance toward high-yield bonds and loans overall. This reflects our outlook for economic activity and comes despite the persistence of generally sound corporate debt fundamentals.

Opportunities in alternative assets

We believe that maintaining a diversified portfolio of risk premia in addition to the traditional benefits of a balanced portfolio between stocks and bonds is the most likely path toward stable potential returns. We also believe that active management of this asset mix can enhance potential return and manage the level of total portfolio risk that is taken.

If the assumed benefits of diversification that high-quality bonds and other assets intend to provide disappear, even temporarily, then only the perceived safe haven of cash can offer protection. However, in the longer term, it is hard to make a case for a strategic allocation to cash, and even harder to time a tactical move in it, especially when yields are low, as was the case at the start of 2022. In addition, the defensive features of cash are diminished in a challenging inflation environment. Short-term US Treasury bill yields have responded to Fed tightening and now reflect higher policy rates, but ample liquidity continues to drag on the available yield. Cash can have attractions as a means of diversification and as a complement to the potential attractions of higher-risk asset markets, but it is rarely more than a temporary bolt hole for multi-asset investors.

Private assets may be a beneficial addition to multi-asset portfolios from several perspectives: they can offer a higher return potential, may include an illiquidity premium and provide access to a broad array of heterogenous investments. Our long-term private asset expectations reflect the impact of asset pricing trends in public markets, most notably a higher risk-free rate environment, noted above. However, private real estate faces a headwind due to relatively low starting appraisal-based capitalization rates. Unlike its public market counterparts, private real estate has yet to re-price to reflect an environment with higher funding costs and low transaction activity. In contrast, our assumptions for private credit and private equity show a healthy return premium on offer over public markets.

We review the underlying assumptions for each of these components of longer-term prospective return on an annual basis. We update correlation assumptions and cross-reference between asset classes to calculate an appropriate strategic allocation. However, as "alternatives" are fundamentally buy-and-hold investments, we do not express shorter-term tactical preferences, but maintain our longer-term structural allocation to these assets.

Allocation settings—December 2022

Pendulum settings reflect cross-asset class views

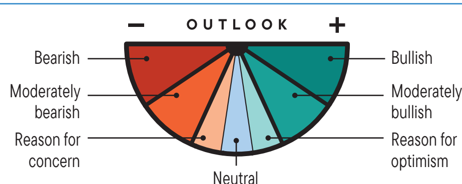
Risk tier

Asset class	Conviction	Our viewpoint
Risk off/on		Global growth is slowing to below trend, and risks remain skewed to the downside, accentuated by the impact of monetary policy tightening. This complicates continuing supply pressures, including the ongoing Russia-Ukraine war, in boosting inflation. We adopted a neutral stance toward riskier assets earlier in the year, even as corporate fundamentals remained generally strong. Last quarter we moved to a more cautious view as recession fears have risen.

High level allocation tier

Equities		In broad terms, global equities require continued earnings growth to offset any further normalization of valuations. Earnings expectations remain elevated and vulnerable to downgrades. Tightening monetary policy has led to a rise in volatility, which offsets longer-term equity fundamentals that are still relatively supportive. We remain nimble in our level of conviction but continue to reflect mounting reasons for concern in a more defensive stance toward global equities relative to bonds.
Bonds		Long-term valuations are fair, in our assessment, and monetary policy is still expected to tighten sharply. However, decelerating growth and heightened global uncertainties balance this view. Corporate bond spreads have risen sharply and largely reflect an anticipated increase from currently low default rates. We have moved to a more constructive view of bonds at the asset allocation level, at notably higher yields, reflecting the pace of rate hikes that is already discounted.
Alternatives		We see structural attractions in naturally diversifying alternatives such as private assets. Economic expansion supports demand for real estate, and the gradual post-COVID normalization of work and activities has materially reduced risk for this asset class. The benefits commodities may afford through tightness of supply are balanced by the risk of higher interest rates to private credit. We have maintained a neutral view overall, consistent with our longer-term structural allocation.
Cash		The defensive features of cash are diminished in a challenging inflation environment. Short-term US Treasury bill yields now reflect higher policy rates, but ample liquidity continues to drag on portfolio yield. Cash can have attractions as a means of diversification and as a complement to the potential attractions of higher-risk asset markets, but we hold a neutral view at this time.

Understanding the pendulum graphic



Arrows represent any change since the last quarter end.

Allocation tier

Asset class	Conviction	Our viewpoint
Equity regions: Pendulum settings relative to equity asset class broadly		
United States		Generally healthy US consumer and corporate balance sheets may help this market better weather a global slowdown. The outlook is more balanced as profit margins may come under pressure in the coming quarters. The stock market's attention will likely focus on whether valuations decline further as anticipated interest-rate hikes are delivered and fears of recession mount. We have built a more definitive bullish stance to reflect our relatively constructive view of this market.
Canada		Growth in Canada faces headwinds from high inflation and an aggressive central bank response. However, ongoing interest-rate increases may support Canadian banks, although energy producers have faded as a support for the market even as ESG (environmental, social and governance) concerns ease. We have moderated our conviction, even with continuing valuation attractions, and now maintain a neutral view of this market.
Europe ex United Kingdom		Europe faces headwinds to consumer and business activity due to higher energy prices and a hit to confidence because of the Russia-Ukraine war. Corporate earnings results may disappoint, and geopolitics pose an ongoing threat to regional equities. As European Central Bank (ECB) interest-rate rises continue, we have maintained our more definitive bearish stance to reflect the risk of recession among growing reasons for concern regarding this region.
United Kingdom		UK economic prospects remain particularly uncertain, reflecting trade weakness and significant European revenue exposure. A low weight to technology and significant foreign currency earnings offset the attractions of a high dividend yield. On balance, we have retained a neutral view on this market, reflecting some caution over persistent headwinds.
Japan		Japan appears well placed to benefit from its cyclical economic rebound and from sensitivity to an eventual China reopening and global capital expenditure. Corporate earnings are growing strongly, and equity valuations, particularly on a price-to-book-value basis, remain attractive relative to other markets, in our view. We modestly increased our more constructive view of this market.
Pacific ex Japan		Higher commodity prices have been supportive for this region overall. However, it remains vulnerable due to tensions in relations with China more broadly. Strong inflation in Australia and higher interest rates are likely to impact consumers. We lowered our conviction level recently and now maintain a neutral stance on these markets broadly, even as we are less cautious on Hong Kong and Singapore, which reflect valuations we regard as somewhat supportive.
Emerging ex China		Stronger long-term growth is being offset by emerging markets' idiosyncratic risks and exposure to slowing demand from developed market consumers. Local inflation pressures, especially for food-importing nations, may see central banks continue to increase interest rates. Prospects for currency recovery across emerging markets are insufficient to fully offset these other factors, and we have retained a moderately cautious view of these markets.

Allocation tier

Asset class	Conviction	Our viewpoint
China		China's economy has slowed, compounded by property market weakness and residual COVID-19 concerns, but this has led to an easier policy environment. Trade disputes remain unresolved in the longer term and are a symptom of broader tensions as heightened geopolitical stresses persist. However, regulatory concerns that dominated market sentiment are slow to fade, and we have returned to a neutral view as valuation attractions are an insufficient offset to these risks.

Fixed income sectors: Pendulum settings relative to fixed income asset class broadly

Asset class	Conviction	Our viewpoint
US Treasuries		The Fed continues to emphasize a more hawkish response to inflation and may prompt further periods of volatility in US Treasuries. However, yields have repriced significantly to reflect policy rates moving to restrictive levels, and as growth slows, we anticipate lower yields in a year's time. This prompted us to add to interest-rate sensitivity overall last month and establish a moderately optimistic view of US government bonds relative to those of other developed markets.
Inflation-Linked Bonds		The level of inflation discounted in inflation-linked securities has moderated from elevated levels earlier this year. We believe these expectations fairly reflect anticipated longer-term inflation, even as current realized inflation is likely to remain elevated for a while. We have maintained a neutral view of assets that benefit directly from rising prices, such as inflation-linked bonds, as policy tightening reduces the value of their potential risk-mitigating role within a portfolio.
Eurozone Government Bonds		The ECB remains concerned by higher inflation levels, and a series of rate rises still seems likely after it began hiking rates in July. However, given risks to demand growth in the European economy, the extent of rate rises is particularly uncertain at this time. The ECB can ramp up support for peripheral markets if the transmission of monetary policy is imperiled. We have maintained a neutral stance on this region.
UK Government Bonds		We believe the country's economy is heading for recession, and structural issues persist. Gilts have decoupled from global equivalents at times, reflecting pension fund liquidity issues. Inflation risks remain elevated and have moved the Bank of England to tighten policy sharply, but further rate-hike expectations may already be fully discounted. We have maintained a neutral stance as risks of a policy error have increased, in our assessment.
Canada Government Bonds		Canada has benefited from commodity price rises, and the Bank of Canada has moved aggressively amid high inflation and a tight labor market. However, the interest rate-sensitive nature of the economy may start to be felt. Canadian bond yields have lagged recent moves up in the United States, and shorter maturity bonds already largely discount likely rate moves. We eliminated our cautious stance in recent months and remain neutral, in line with other global markets.
Japan Government Bonds		The Bank of Japan has reiterated its monetary policy stance, which targets low 10-year government bond yields, and policy remains supportive. We believe this market's low sensitivity to global yields is likely to continue, despite being tested recently, making it somewhat more attractive to us in the case of higher global yields. However, we maintain an overall neutral position.

Allocation tier

Asset class	Conviction	Our viewpoint
Investment Grade	− OUTLOOK +	The investment-grade sector has benefited from ample corporate liquidity and earnings levels that make high debt loads more sustainable. Investor confidence has been hit by monetary policy tightening and valuations that did not offer significant protection against rising Treasury yields. However, after a move wider in spreads and at notably higher yields, we eliminated our defensive stance and have maintained a marginally constructive view overall.
High Yield	− OUTLOOK +	Corporate earnings continue to support the fundamental attractions of lower-rated fixed income sectors such as loans and high-yield bonds, despite the impact of policy rate rises. Ample liquidity had led to elevated valuations, but following a period of rising volatility and wider spreads, we tempered our conviction toward high-yield credit earlier this year. Following a sharp recovery, even as recession risks persist, we adopted a more definitively cautious stance toward high-yield bonds and loans overall.
Emerging Market Debt	− OUTLOOK +	Emerging market fundamentals remain challenging as foreign demand compounds ongoing domestic weakness and food price inflation. We have become progressively more cautious on emerging market hard-currency bonds, as valuations reflect debt servicing concerns, and local-currency bonds are less compelling to us on fears of higher global policy rates. We have retained a more constructive view on China's local bonds but continue to think selective positioning is important.

Franklin Templeton Thinks: Allocation Views

Our research process monitors a consistent set of objective indicators and screens them to identify signals that help our analysts to make better recommendations. By doing this we aim to filter out the daily noise to reveal the underlying trend.

Our macro-economic research group aims to challenge the consensus forecasts for growth and inflation by digging deeper into the data. Just as important, we aim not to be swayed unduly by topics that are dominating current market debate.

Editorial review

Wylie Tollette, CFA
Chief Investment Officer

Franklin Templeton
Investment Solutions

Gene Podkaminer, CFA
Head of Research

Franklin Templeton
Investment Solutions

Stephanie Chan, CFA
Senior Research Analyst

Michael Dayan, CFA
Head of Portfolio Analysis

Mike Greenberg, CFA, CAIA
Portfolio Manager

Dominik Hoffmann
Senior Research Analyst

Matthias Hoppe
Portfolio Manager

Richard Hsu, CFA
Portfolio Manager, Research Analyst

Michael Kerwin, CFA
Senior Research Analyst

Laurence Linklater
Senior Research Analyst

Melissa Mayorga
Senior Research Analyst

Chris Ratkovsky, CFA
Senior Research Analyst

Miles Sampson, CFA
Senior Research Analyst

Chandra Seethamraju, Ph.D.
Head of Quantitative Strategies

Kent Shepherd, CFA, CIC
Senior Institutional Portfolio Manager

Kim Strand, CFA
Head of Fundamental Research and ESG Integration

Ian Westley
Research Analyst

Notes

WHAT ARE THE RISKS?

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