JULY 2021

Midyear outlook: Guarding for inflation and searching for quality

INVESTMENT INSTITUTE
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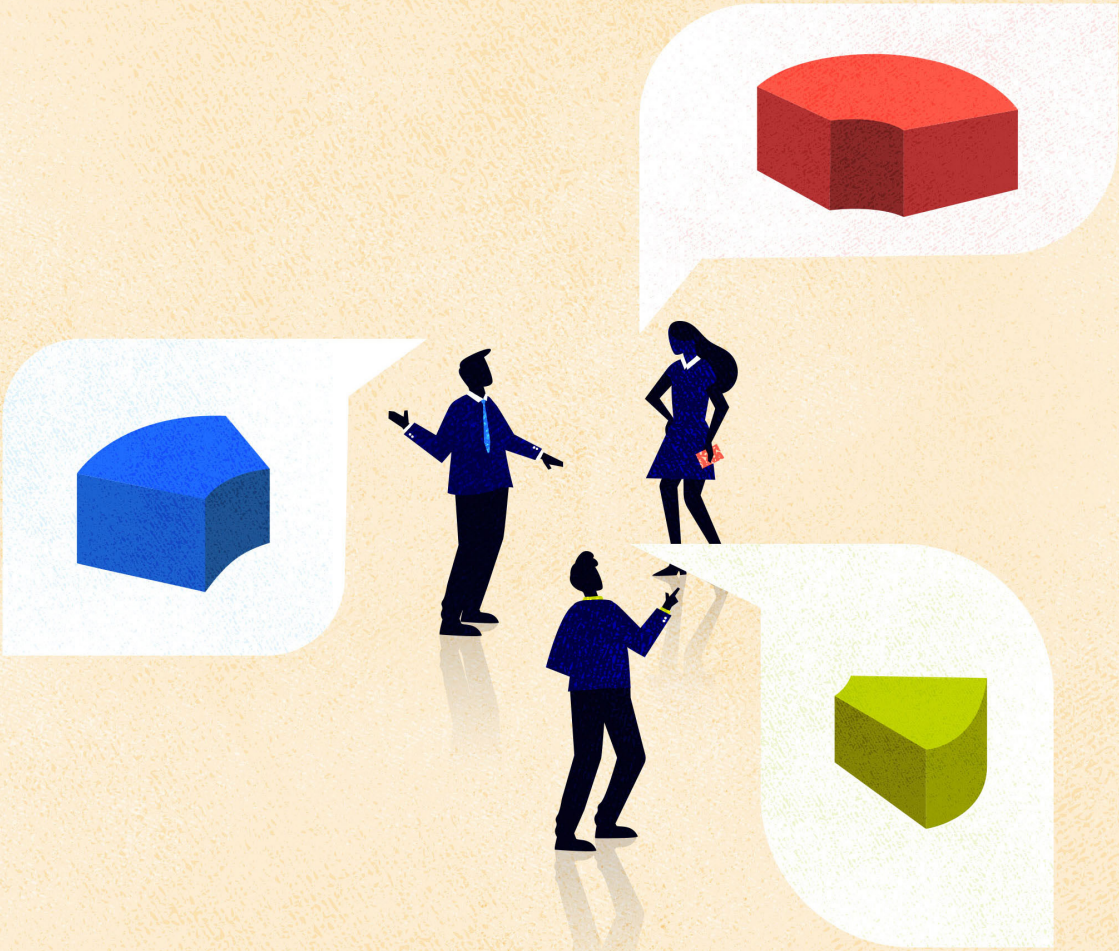
GLOBAL INVESTMENT OUTLOOK



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Introduction

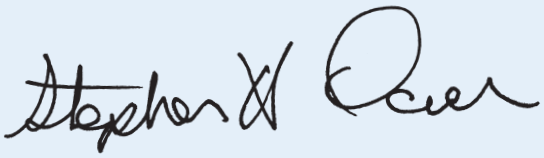
Stephen Dover, CFA
Chief Market Strategist
Franklin Templeton
Investment Institute

In this issue, we focus on our market and investment views for the second half of the year and examine the uneven global recovery from COVID-19. Emerging COVID-19 variants are adding new economic headwinds in parts of the world, while other countries are sharply rebounding amid vaccination rollouts and heavy fiscal and monetary support. Combining this backdrop with supply chain frictions leads to an intriguing second half of 2021.

Our latest outlook highlights some of our specialist investment managers across the globe and across asset classes. Key views across the asset categories include:

- The remainder of 2021 will likely prove challenging with potential key themes of guarding for inflation, searching for income, seeking quality companies as well as looking beyond stocks and bonds.
- Fixed income activity cannot avoid looking out for inflation and income. The opportunities across corporate credit markets will be selective and uneven, and we believe active management will be important. Investors should consider sector, duration and quality rotation.
- Equity discussions converge on "quality" with investors across styles and market capitalization ranges believing the "junk trade" is over and quality is the priority beyond structured definitions of growth and value. Different managers offer different definitions of quality companies, helping investors navigate the market while analyzing supply chain disruptions, economic cycles and growth.
- Real estate takes us directly to the impacts of inflation. The straightforward mechanism of raising rents under improving economic conditions allows properties to adapt to economic supply and demand. This mechanism makes commercial real estate particularly interesting in the second half of this year.
- Infrastructure has regional catalysts and a big nod to sustainable investing and environmental, social and governance (ESG). Significant initiatives around the world are driven from social and government motivations that will allow infrastructure to have diversification benefits beyond the value of the investment. These benefits will be longer term than the second half of 2021.

These observations should resonate with the conversations you are having about the markets. Each manager featured provides their perspective in more depth. I think you'll find their views beneficial as they come from their work in positioning their portfolios.



Inflation drives need for active fixed income

4 **Brian Kloss, JD, CPA, Brandywine Global**

We expect the remainder of 2021 will be challenging. Returns will be harder to come by, but should still be positive, in our view. Overall, we are constructive on corporate credit, especially the shorter end of the curve. Pro-cyclical sectors, such as commodities, basic materials and health care technology, provide interesting opportunities. We believe active management will be key, as the opportunities across corporate credit markets will be selective and uneven. Investors will need to use all the tools in their toolkits, including sector, duration and quality rotation.

5 **Nicholas Hardingham, CFA, Franklin Templeton Fixed Income**

We maintain our bullish view on emerging market debt as an asset class and favor hard-currency emerging markets over local-currency emerging markets, with most of the local rates still trading at historic lows and real rates either negative or extremely low. With interest rates expected to rise in 2022, we do not see the value in adding longer-duration holdings without attractive levels of spread to compensate, and therefore retain our bias for high-yield versus investment-grade issuers.

Quality, quality, quality remains central to equities

7 **Jonathan Curtis, Franklin Equity Group**

Recent volatility aside, we believe technology enjoys powerful secular and cyclical tailwinds which are positive for the long term and near term. We believe the sector is likely to grow much faster than inflation, has pricing power (owing to its leverage to productivity), is asset light and will enjoy deflationary tailwinds as knowledge workers take advantage of more flexible work arrangements to relocate to lower-cost regions.

8 **Alan Bartlett, Templeton Global Equity Group**

Our idea of "compound value" is rooted in the belief that value arises from the union of multiple elements, which can include price, quality, growth and changes/events through time. Looking across the globe, we currently like European equities, as the eurozone is one of cheapest global regions and home to leading industrials and consumer companies with upside to reopening and post-pandemic recovery. We also find Japan attractive, as companies are restructuring and improving balance sheets, and driving a focus to improve return on equity.

9 **Zehrid Osmani, Martin Currie**

We focus on specific stock characteristics rather than regional assessments, but at the geographic level, we happen to find more upside potential in equities in Europe and emerging markets rather than in the US equity market. In terms of sectors, US President Joe Biden's infrastructure spending program has the potential to significantly boost the economic momentum in the United States, thus potentially shaping a long positive industrial cycle with positive implications both for the US and global economic outlook.

11 **Manraj Sekhon, CFA, Franklin Templeton Emerging Markets Equity**

Emerging market (EM) equities have continued their ascent so far this year, though the pace has moderated from the momentum of 2020. EMs in general have shown sustained resilience in managing and adapting to COVID-19. It's worth noting the growing divergence between the perceived challenges surrounding these markets and their demonstrated structural strengths. We highlight three key areas that warrant attention—demand, sentiment and inflation.

ESG and inflation may benefit alternatives

Tim Wang, Ph.D., Clarion Partners

13 We believe 2021 marks the beginning of a new real estate market cycle. As demand continues to recover across most markets and property sectors, rising occupancy and higher effective rents should drive higher net operating income, supporting higher dividend and property appreciation. In our view, we believe that real estate—income with growth—ought to be an important part of portfolio allocation strategy given accelerating economic growth and the reflationary environment.

14 **Nick Langley, ClearBridge Investments**

Investors should benefit from global stimulus plans as policymakers agree on aggressive multi-decade carbon reduction targets. This investment will allow infrastructure and utility assets to earn stable and often regulated returns, off capital deployed into such areas as lower-carbon generation, strengthening of electricity grids and lower-carbon fuels such as hydrogen. While there are nuances to how environmental, social and governance efforts will influence different areas of infrastructure, we believe it will pay to have some tactical ability.

Inflation drives need for active fixed income

Although this publication does not focus on macroeconomics, I can't avoid a discussion with portfolio managers where inflation doesn't lead the conversation, followed by the challenges of searching for yield. Our featured outlooks point to the opportunities in developed markets and emerging markets and the need for portfolio managers to deploy the full toolkit—sector, duration, quality rotation and country selection—in the second half of 2021. Watch for our next issue of *Macro Perspectives* in July for our macro economists' latest views.

Global credit outlook: Hedging bets on the recovery

Brian Kloss, JD, CPA
Portfolio Manager
Brandywine Global

We expect the remainder of 2021 will be challenging, but in a different sense than 2020 given the high valuations at the start of this year. Returns will be harder to come by, but should still be positive. We think corporate bond spreads are probably near their tightest but could become even tighter through the balance of 2021 as global growth recovers exponentially. Spreads will widen eventually, given the unprecedented governmental fiscal spending and the increased easing of pandemic restrictions.

However, in the near term, investment-grade bond spreads could see another 20 basis points (bps)[1] of tightening, closing in on the tight pre-2008 levels (see Exhibit 1), and below investment-grade bond spreads could tighten by 50 to 100 bps (see Exhibit 2). Where there are opportunities to pick up some incremental yield in corporate credit, we think this positioning will be well-compensated over the next 12 months. Overall, we are constructive on corporate credit, especially the shorter end of the curve. Pro-cyclical sectors, such as commodities, basic materials and health care technology, provide interesting opportunities, in our view.

We also believe active management will be key in these conditions, as the opportunities across corporate credit markets will be selective and uneven. Investors will need to use all the tools in their toolkits, including sector, duration and quality rotation. While continuous monitoring of the macroeconomic environment will be important, so will

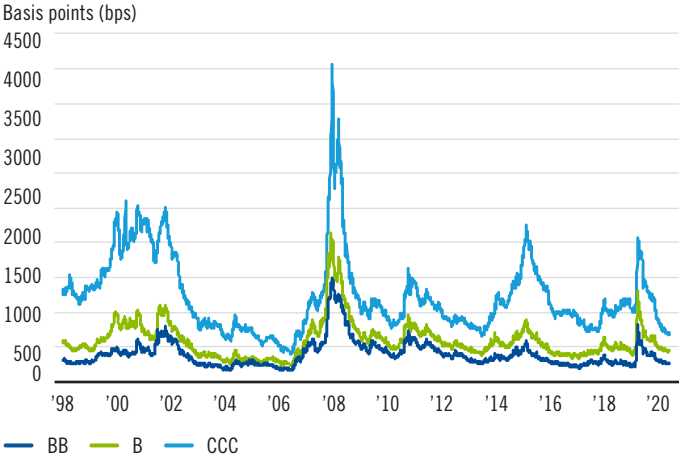
SPREADS ARE CLOSING IN ON THE TIGHT PRE-2008 LEVELS

Exhibit 1: Baa spread
2007–May 31, 2021

Source: Macrobond. See www.franklintempletondatasources.com for additional data provider information.

SECURITY SELECTION CRITICAL IN CORPORATE CREDIT MARKETS

Exhibit 2: Global quality option-adjusted spread (OAS)
1998–May 31, 2021



Source: ICE BofA. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or salescharges. Past performance is not an indicator or guarantee of future results. See www.franklintempletondatasources.com for additional data provider information.

> "While we see opportunities from the global economic recovery, we also are seeking to insulate our portfolios from a potential uptick in inflation. Currently, our sector rotation is geared toward commodities and basic materials with the intent of capitalizing on those sectors poised to benefit from the post-pandemic economic reopening."
>
> **Brian Kloss**

strong underwriting criteria for individual securities given the nuances and small anomalies across the corporate bond spectrum.

Security selection will be particularly important within high yield, where we currently see a bifurcated market. For example, within the CCC rated component of the US High Yield Index, more than half of the securities in this segment yield 6.5% or lower while 14% of the constituents yield 9.5% or higher.[2]

With investors increasingly concerned about the potential for a spike in inflation, the first quarter of this year offered a preview of what could happen. US Treasury yields rose by approximately 75 bps, jarring asset prices significantly during the quarter. If inflation returns for real—and assuming it is the result of stronger economic growth—longer-duration assets will be repriced across the quality spectrum. In this scenario, we would expect more equity-like assets, namely lower-quality assets with shorter maturities and pricing power, to outperform other fixed income segments. The rate curve should initially steepen before the market prices in a policy response from the central bankers.

While we see opportunities from the global economic recovery, we also are seeking to insulate our portfolios from a potential uptick in inflation. Currently, our sector rotation is geared toward commodities and basic materials with the intent of capitalizing on those sectors poised to benefit from the post-pandemic economic reopening.

On the inflation front, we also are focused on those entities that have pricing power as a potential hedge against rising prices. To help cushion our portfolios from potential spikes in interest rates, we are tilted toward securities with shorter maturities or with expectations that the bonds will be called. However, given the speed of the recovery and resulting pressure on central banks to change policies, this positioning may be outdated by as early as midway through the third quarter; that is where flexible guidelines and active rotation will come into play. We will assess the global macroeconomic landscape continuously and reposition accordingly as conditions evolve.

Emerging market recovery is case-by-case

Nicholas Hardingham, CFA
Portfolio Manager
Franklin Templeton Fixed Income

The greater developed market (DM) fiscal and monetary responses and more advanced vaccine rollouts versus emerging markets (EMs) has resulted in a notable 2021 growth differential between the two economies. Stronger growth in the United States and Europe is bringing benefits to EMs via exports and commodity prices, but as growth concerns fade, the market has started to focus on the global rise in inflation in the first half of 2021. Our assessment of this rise in prices across EMs is it will prove temporary and will not lead to sustained increases in inflation, mainly because of the slack still present in many EM economies. Where necessary, EM central banks have transitioned from providing support through the pandemic to tightening policy. However, as is the case with most things related to EMs, the story remains highly differentiated, with inflation risks and expectations varying from country to country.

We maintain our bullish view on EM debt as an asset class, with a number of factors driving its fortunes, including the overall global recovery, rebound in commodity prices, accommodative global liquidity conditions and the further international support for EMs. We anticipate this will result in further spread tightening over the coming months. And with interest rates expected to rise in 2022, we do not see the value in adding longer duration holdings without attractive levels of spread to compensate—therefore we retain our bias for high-yield versus investment-grade issuers.

> “COVID-19 impacted global supply chains, and it is making some companies rethink the stability and complexity of their supply chains going forward. We anticipate an increased focus on domestic or regional components in supply chains over time, in order to avoid the extent of disruption we have recently seen. Countries such as Mexico should benefit from its proximity to the United States, particularly under the current US administration and, as a consequence, some exporters from Asia could potentially see a decline in US demand.”
>
> **Nicholas Hardingham**

Currently, we continue to favor hard currency EMs over local currency EMs, with most of the local rates still trading at historic lows and real rates either negative or extremely low. We expect hard currency EMs will continue to experience intra-EM return differentiation, with idiosyncrasies driving the divergence. Looking further ahead, talk of US policy normalization will likely remain a key driver of EM price action going forward.

EM debt as an asset class is highly diverse, with very different factors driving events in individual countries and companies, requiring a bottom-up approach to assessing value and risk. Ultimately, a deep understanding of an individual government or company's liabilities and revenue is crucial in assessing creditworthiness. In addition, politics remains an important factor to assess within EMs, with COVID-19 causing political polarization in certain countries where poorer communities have felt government support and vaccinations have fallen short of expectations.

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Quality, quality, quality remains central to equities

Our team regularly holds an equity think tank with lead investment officers and researchers across all our specialist investment managers. This collaborative discussion integrates a wide range of philosophies across style boxes and geographic regions. In the latest discussion, a common view was the "junk trade" is over and whether one considers growth or value, large or small, local or global, "quality" was the objective. This discussion led us to four contributions this quarter, each offering you a nuanced view on how they define "quality" and what that means for the second half of 2021.

Digital transformation theme prevails across economic environments

Jonathan Curtis
Portfolio Manager
Franklin Equity Group

Investor preferences have been volatile year-to-date. The technology sector performed well at the beginning of the year, only to face volatility and headwinds as interest rate and inflation expectations increased and investors embraced non-technology companies expected to benefit from a reopening of the global economy.

Despite potential headwinds, and the recent volatility, we are optimistic about the long-term prospects for the technology sector. While there is the potential for short-term market dislocations along the way, we see digital transformation and its relevant subthemes as enduring through an economic recovery. We believe the sector is likely to grow much faster than inflation, has pricing power (owing to its leverage to productivity), is asset light and will enjoy deflationary tailwinds as knowledge workers take advantage of more flexible work arrangements to relocate to lower-cost regions. We have been through periods of interest rate, inflation and even supply chain disruptions before, and we believe the right approach is to capitalize on investors' short-term concerns to add to our highest-conviction positions.

Within the technology sector specifically, supply chain challenges have been significant in the semiconductor industry. We believe this is likely to persist through at least the end of 2021. This will likely lead to higher chip prices in the near term, though we expect pricing to normalize as supply and demand come into balance in 2022.

On the cyclical side, enterprises and consumers spend more on technology when their own prospects are improving. Even as vaccination rates rise and economic conditions return to normal, we believe that the technology-led behaviors developed during the pandemic will be enduring. Simply put, we believe we are at the beginning of what is possible as consumer experiences and businesses digitize, and we foresee a multitude of potential investment opportunities in the years ahead.

While we are global investors and have solid exposure to exciting technology companies headquartered outside the United States, our focus is on each company's end markets. To this point, we like the structural demand for technology-centric infrastructure that we are seeing in the emerging markets.

But when we think about quality, we look for companies with strong and improving competitive positions, sustainable growth drivers, experienced and talented management teams, and financial strength. We also consider the extent to which a company is accounting for the costs it is imposing on the environment and society as well as whether it is well-governed, and incorporating diverse and inclusive stakeholder perspectives.

"While we are global investors and have solid exposure to exciting technology companies headquartered outside the United States, our focus is on each company's end markets."

Jonathan Curtis

Time for compound value

Alan Bartlett
Chief Investment Officer
Templeton Global Equity Group

Global equity markets appear to have largely embraced the inflation narrative, with commodity price- and interest rate-sensitive stocks still leading the rally. However, fixed income markets generally expect rising prices to be transitory, as evidenced by benchmark bond yields well below those implied by current consumer price index (CPI) levels. This disconnect is largely attributable to the consensus belief that CPI will subside once base effects from the COVID-19 crisis roll out of the data. Another possible explanation is simply that central banks have so distorted asset markets that bond prices are no longer market-driven.

On the one hand, we recognize that excessive debt levels and accelerated technological innovation are structurally deflationary; on the other hand, less-efficient supply chains, rising protectionism, regulation and taxation, and demographic patterns that will reduce the supply capacity of the global economy all have the potential to be inflationary in the longer term. Such inflationary pressures may remain hidden in market prices should policymakers continue to pin nominal interest rates below the rate of inflation to suppress borrowing costs and redistribute wealth. That's one reason we remain cautious on financials, which may continue to experience profit pressure if yield curves fail to steepen. Elsewhere, we increased our exposure to cyclicals and stocks at the epicenter of the COVID-19 crisis earlier last year to benefit from the reflationary efforts of governments.

We thought the market was overheated coming into early 2020 and we increased our defensive positioning, which allowed us to perform well during the COVID-19 crash. We added risk and cyclicality later in the year once we understood that global governments were effectively backstopping the financial markets. However, the initial phase of that rebound was mostly a junk rally, and our high-quality positioning prevented us from keeping up with the market during this period, though absolute gains were strong. More recently, we've seen the junk trade begin to falter and the value rally broadening out to higher-quality stocks and different types of value, which has benefited our portfolios. We had a similar experience after the global financial crisis, when we missed the initial rebound because we were reluctant to fill our portfolios with bankruptcy risk. It's a short-term tradeoff, but one that we believe will pay off in the longer term. So far in the second quarter of 2021 we have begun to take gains on some of our cyclical trades. And we've also initiated some new defensive positions in companies in consumer products and health care services.

Looking across the globe, we are generally positive on European equities. The eurozone is one of the cheapest global regions and home to leading industrials and consumer companies with upside to reopening and post-pandemic recovery. The outlook for the European Union is also improving given that it is moving toward the first-ever bond issued by the European Commission and jointly backed by member states. And it is good to see that the eurozone is one of the strongest-performing regions year to date.

We also find Japan attractive for many reasons. The corporate reform initiatives started under former Prime Minister Shinzō Abe have continued under current Prime Minister Yoshihide Suga. Companies are restructuring and improving balance sheets by selling listed assets or buying in minority investments. They are reducing cash through higher dividends and buybacks—all driving the focus to

> "As we look across sectors, many technology companies have simply been too expensive recently for us to be comfortable owning them. Some of these companies are one part of the "double bubble" in markets that we're worried about. Much of what has gone right for these companies—globalization, low interest rates, low tax regimes, liberal regulation, etc.,—now seems to be reversing, but many stocks remain priced for perfection. To us, that's a dangerous combination."
>
> **Alan Bartlett**

LOOKING AT QUALITY AND VALUE THROUGH A DIFFERENT LENS

Reflationary forces in the global economy have supported the value rotation we have seen in the markets this year and was probably overdue after a long period of underperformance and relative undervaluation for the value factor. However, we don't think much about the value factor because our conception of "value" is different than the backward-looking earnings and book multiples that define the value benchmark. Our idea of "compound value" is rooted in the belief that value arises from the union of multiple elements, which can include price, quality, growth, and changes/events through time. This approach relies on a framework for value identification that results in genuine diversification in our team's strategies. We seek to identify five primary types of value:

1. Classic value: where the past is a guide to the future
2. Mispriced growth: where the future will be better than the past
3. Quality: where a longer-term view is appropriate
4. Cashflow: where cash generation is key
5. Discounted assets: where unlocking of asset value drives the thesis

Looking closer at quality, we see quality resulting from a combination of factors. In our view, a quality company has a moat that creates scale and pricing power, resulting in high return on invested capital. The durability of the product/service is multiyear with low risk of obsolescence. The company is led by strong management that executes well and focuses on shareholder returns. The business is predictable enough for investors to make reasonable forecasts without dependence on macro factors (commodity prices, interest rates, inflation).

All of this is irrespective of business valuation, but it is important for us to maintain discipline and pay a fair price to earn above-average returns. Ultimately, quality at a reasonable price reduces investment risk over the long term. As we've mentioned, valuation isn't the only factor we consider—but it is an important factor.

improve return on equity. Private equity usually sells to public markets given higher valuations; in Japan, private equity seeks public companies. A recent example is Toshiba, the target of a private equity firm. Lastly, Japan is the least-correlated country to the MSCI World Index, a helpful characteristic in portfolio construction.

Both Japan and Europe are geared to the global growth cycle and we believe they should continue to perform well as COVID-19 infections decline, economies reopen, and stimulus spending begins to take hold. That said, our diverse exposures in these markets don't tie us to one specific theme or "trade," and we believe our Japanese and European positions can perform well across a range of macro scenarios.

As we look across sectors, many technology companies have simply been too expensive recently for us to be comfortable owning them. Some of these companies are one part of the "double bubble" in markets that we're worried about. Much of what has gone right for these companies—globalization, low interest rates, low tax regimes, liberal regulation, etc.,—now seems to be reversing, but many stocks remain priced for perfection. To us, that's a dangerous combination. Nevertheless, we have done the analytical work on many of these companies and will be ready to buy selectively should pullbacks create better entry points. One area where we have been active within the tech sector in recent years is semiconductors. We've had a range of semiconductor names in our portfolios, which have performed quite well recently given the confluence of COVID-19-related supply bottlenecks and structural demand growth for chips.

Focusing on companies with pricing power amid inflationary forces

Zehrid Osmani
Portfolio Manager
Martin Currie

Quality, or quality growth as we prefer to describe it, to us captures companies that have the potential to generate high and sustainable returns on invested capital with attractive structural growth prospects and a strong environmental, social and governance (ESG) profile. These companies should be able to deliver strong compounding cash flows over the long term, and therefore be able to create value for shareholders no matter what market environment we are in.

The value rotation we have seen recently is typical in the first phase of an

economic cycle, which is a recovery from a recession. During this phase, the market is typically led by value vs. growth, low quality vs. high quality, high risk vs. low risk, and typically also fragile balance sheets vs. strong balance sheets. The point to highlight here is that while every economic cycle can be different from the previous ones, the recovery phase of an economic cycle has typically been a short period that has on average lasted for around six months. Over the next 3–6 months, we believe we are likely to move into the expansion phase of the economic cycle. In this cycle, we expect a broadening of the leadership, and more emphasis being brought back toward stock-picking, with a focus on companies that are able to deliver good earnings growth profiles and steady returns over sustained periods of time, rather than simply based on a sharp rebound from lows—as seen last year at the height of the pandemic.

It is important to bear in mind that inflation could be coming in stronger due to the low base effect of last year, and due to short-term temporary supply-and-demand frictions as economies reopen. Temporary bottlenecks remain in place, contributing to the disruption in supply chains, notably in sectors such as semiconductors and construction. Logistics disruptions have also contributed to intensifying the bottlenecks, which has also fueled some temporary inflation. Wage inflation is typically the largest contributor to sustained inflationary pressures, in our view, and is the measure we are watching to assess any risk of a more sustained inflationary outlook. At this stage, we do not see any major acceleration in wage inflation, apart from a few localized industries. We also believe there is still a strong underlying deflationary current coming from ongoing disruption and technological advancements, such as robotics and automation, that are likely to keep putting downward pressure on wage-inflation trends. As such, in our view, it is important to not draw conclusions too rapidly about the long-term inflation outlook.

> “It is important to bear in mind that inflation could be coming in stronger due to the low base effect of last year, and due to short-term temporary supply-and-demand frictions as economies reopen. Temporary bottlenecks remain in place, contributing to the disruption in supply chains, notably in sectors such as semiconductors and construction.”
>
> **Zehrid Osmani**

In terms of implications for companies, it remains important to focus on companies with pricing power, as these are the companies that can manage the inflationary pressures most successfully, even if those pressures are transitory. For companies with less pricing power, we are expecting some headwinds on the margin front that could initially be masked by the positive impact of operational leverage coming through from what appears to be a much stronger globally synchronized economic recovery.

Investors must consider the potential of a sustained pickup in inflation beyond 2021, which could rapidly shift interest-rate expectations higher. This shift could ultimately weigh on market sentiment and is already becoming a focal point for the broader market, along with some increased volatility.

Economic cycle transitions from recovery to expansion are typically accompanied by a central-bank regime change from a supportive monetary policy phase toward more careful management of liquidity to reduce excesses. Such monetary policy regime shifts typically are met with increased volatility, as the market debates and assesses risks of tightening, pace of tightening and therefore potential risks of policy errors. In such an environment, we want to continue to focus on companies with sustainable business models, solid balance sheets, and structural growth opportunities that are generating high returns. We also look for low disruption risk and strong pricing power in an environment that remains disruptive, and where there is a lack of meaningful inflationary pressures.

We focus on specific stock characteristics rather than regional assessments, but at the geographic level, we happen to find more upside potential in equities in Europe and emerging markets rather than in the US equity market. In terms of sectors, US President Joe Biden’s infrastructure spending program was unveiled at the end of March with an aim to spend over US$2 trillion over eight years. This has the potential to significantly boost the economic momentum in the United States, thus potentially shaping a long positive

industrial cycle with positive implications both for the US and global economic outlook. We believe there is still attraction in stocks with cyclical characteristics that can capture the longer positive economic cycle ahead.

Other sizeable global infrastructure programs are also progressing elsewhere, notably in China and other emerging markets. Therefore, we foresee medium-term opportunities in a post-pandemic recovery in infrastructure spending, with a shift toward:

- Greener infrastructure initiatives as a way to decarbonize economic activity—new energy, more efficient and greener buildings and electric transportation;
- health care infrastructure to upgrade facilities post-pandemic, both through physical and digital upgrades, and;
- accelerating robotics and automation trends, as companies will likely focus on making their manufacturing capacities more robust and their supply chains more resilient

The US FAANG[3] stocks are seeing varying degrees of regulatory and competitive pressures, and for some of them, higher scrutiny in terms of taxation, all of which could potentially have a meaningful impact on their growth prospects, in our view. In general, higher taxation is something we expect as a way to fund some of the increased fiscal spending to combat the pandemic crisis and help boost the economic recovery. So, we think it would be prudent for investors to factor this proactively into their forecasts when analyzing companies, rather than reacting to the news when these get announced.

We look for opportunities across the broad technology ecosystems and in our portfolios, we favor cloud computing, semiconductors and industrial software exposed to increased robotics and automation trends, as well as financial technology. We also have a significant exposure to medical technology given the structural opportunities in health care infrastructure related to aging populations, 21st century diseases, and bespoke health care.

What's next for the emerging market recovery?

Manraj Sekhon, CFA
Chief Investment Officer

Franklin Templeton Emerging Markets Equity

EM equities have continued their ascent so far this year, though the pace has moderated from the momentum of 2020. EMs in general have shown sustained resilience in managing and adapting to COVID-19. It's worth noting the growing divergence between the perceived challenges surrounding these markets and their demonstrated structural strengths. We highlight three key areas that warrant attention—demand, sentiment and inflation.

Demand remains robust

Our meetings with companies across a wide range of industries in EMs have delivered a consistent message—demand remains robust, and the long-term growth drivers are clear. This has been the case even in countries that generated some of the worst COVID-19 headlines in recent months, such as India and Brazil.

India's second COVID-19 wave has extracted a heavy human toll, which has also negatively impacted its economy. While the human casualties are tragic, the country's stock market has weathered the crisis well and is up by more than 60%[4] in the past year, reflecting the underlying dynamism of its economy and companies.

Corporate results have been resilient, and banks' balance sheets have been remarkably sturdy over this period. Many businesses foresee a strong demand revival following the latest outbreak.

Before the pandemic, India's government had already begun tough structural reforms, most notably introducing a goods and services tax and cleaning up the banking sector. These changes, coupled with pro-growth central bank policies, have given us visibility on healthy earnings growth in the coming years.

Across major EMs, technology's role as a key economic engine has only strengthened during the pandemic. Many companies have adapted swiftly to an increasingly contactless world, bringing forward digital transformation to draw consumers and lift productivity. The semiconductor industry is experiencing a cyclical and secular boom as growing digitalization powers a surge in demand, while COVID-19 continues to drive a global supply shortage.

China has also been climbing the technology hardware value chain as it prioritizes innovation and self-sufficiency in its longer-term development plans. Chinese companies that succeeded in their upgrades have won market share globally at a time when COVID-19 hobbled their overseas competitors. We also find innovation-centric businesses in the electric vehicle (EV) and solar energy industries well-positioned for longer-term growth as EV adoption and decarbonization gain momentum around the world.

Shifting sentiment

The healthy demand picture we have seen on the ground contrasts with the soft sentiment that has surrounded EMs amid new COVID-19 outbreaks and slow vaccination progress. We expect this backdrop to set

> “China, a major outperformer in the EM equity universe until February 2021, has fallen behind its peers. Internet heavyweights have been a drag as the Chinese government stepped up its regulatory scrutiny of the industry through antitrust measures and other rules. Major internet players have pledged to increase spending to boost their competitiveness.”
>
> **Manraj Sekhon**

emerging economies up for better performance ahead as vaccination rates and COVID-19 trends improve.

China, a major outperformer in the EM equity universe until February 2021, has fallen behind its peers. Internet heavyweights have been a drag as the Chinese government stepped up its regulatory scrutiny of the industry through antitrust measures and other rules. Major internet players have pledged to increase spending to boost their competitiveness. We view the weakness in these stocks as a short-term pause rather than a longer-term pullback. Crucially, we see the government aiming for the sustainable development of an industry that contributes significantly to the country's economic growth and technological progress. We expect these stocks to resume their momentum as the regulatory pressure recedes and as business investments complete, and we remain constructive about their longer-term potential.

Rising inflation risk?

Inflation concerns in the United States have reemerged as a stimulus-fueled global economy springs back from the depths of the pandemic. Even as we stay true to our bottom-up and stock-driven investment approach, we remain vigilant about possible macroeconomic headwinds.

The recent shift in the US Federal Reserve's (Fed's) tone on inflation reflects the solid demand backdrop that we have observed. The price hikes reflect rising commodity prices, supply bottlenecks, and pent-up demand—an interplay of factors unique to the pandemic. Many EM companies have been measured about passing on higher input costs to customers, recognizing that much of the increase stems from near-term supply disruptions. Efficiency gains and competition among companies have also kept prices in check. Our view is that inflationary pressures will be relatively short-lived.

Conversely, experience suggests that the Fed's messaging around tapering and preparations for such a move are likely to create more market volatility than the actual reduction of bond purchases. The real risk will be abrupt liquidity withdrawal on expectations of rate rises and the end of unprecedented stimulus, which could bring about more market caution.

Our overall outlook for EMs remains positive as they continue to chart a path out of the pandemic, though some risks may impact our medium-term view. That said, short-term air pockets could create longer-term investment opportunities, underpinned by EMs' structural strengths and the competitiveness of their companies.

ESG and inflation may benefit alternatives

Alternatives offer a category of unique possibilities for return, diversification and risk management. This quarter, we highlight real estate, which has both the characteristic of providing income flows as well as a bit more of an automatic stabilizer to interest rates and inflation through property rents. We also wanted to point out infrastructure, which has global momentum with idiosyncratic catalysts in Asia, Europe and the Americas, tends to point at ESG opportunities directly and indirectly.

Recovery, reflation, and reacceleration

Tim Wang, Ph.D.
Head of Investment Research
Clarion Partners

Global economic growth is gaining momentum as the number of daily COVID-19 cases subsides and the vaccination effort begins to pay off. According to Moody's Analytics, six million new jobs are forecasted to be added in the US in 2021 alone, the strongest pace since 1946.[5] Real estate is a derivative of economic expansion, and job growth is the most significant demand driver for commercial space. Consequently, demand and supply fundamentals are improving and have shown encouraging signs of acceleration in recent months, especially in distribution warehouse, rental housing, lab office and infill necessity retail.

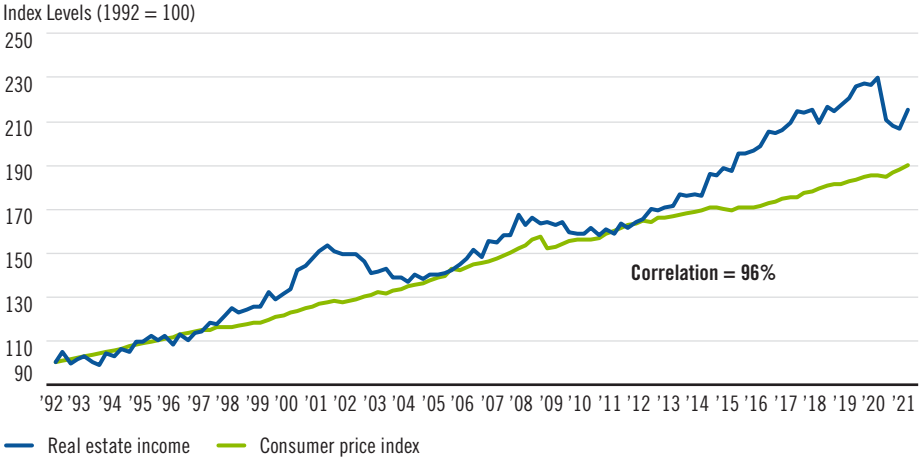
With this synchronized global rebound, robust fiscal and monetary stimulus programs, and strong consumer pent-up demand, one of the potential concerns for investors today is rising inflation. Indeed, the headline Consumer Price Index (CPI) rose 5% year-over-year in May, the fastest pace since August 2008. There is an ongoing debate whether this transitory inflation may eventually become persistent as consumers adjust their long-term inflation expectations. Nonetheless, under such a reflationary environment, asset classes that can hedge against inflation should benefit a mixed-asset investment portfolio.

It is well-documented that real estate has historically been able to at least partially hedge against inflation. As illustrated in the chart below, the correlation between real estate income growth and the CPI Index from 1992 through 2021 is approximately 96%. This strong relationship makes intuitive sense because landlords generally have the ability to raise rents under improving economic conditions, boosting property income and asset appreciation. Apartment operators can adjust annual rents at each renewal, while for longer-term leases for office, industrial or retail properties there are typically built-in periodical rent bumps that are either linked to an inflation index or at a fixed annual rate.

Another characteristic unique to real estate is replacement cost, which is the amount of capital required to replace a property of similar quality using materials and labor that are currently available. Over the past several months, prices of construction

HIGH CORRELATION BETWEEN REAL ESTATE INCOME AND CONSUMER PRICE INDEX

Exhibit 3: Real estate income and consumer price index
1992–March 31, 2021



Sources: CBRE-EA, Bureau of Labor Statistics, Clarion Partners Investment Research.

Note: Real estate income is calculated from the average of the four main property sectors (apartment, industrial, office, and retail) within the NCREIF Property Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not indicative of future results.**

> We believe 2021 marks the beginning of a new real estate market cycle. As demand continues to recover across most markets and property sectors, rising occupancy and higher effective rents should drive higher net operating income, supporting higher dividend and property appreciation."
>
> **Tim Wang**

materials such as lumber, steel and aluminum have surged significantly, leading to substantially higher costs for new development or renovations. Existing properties should benefit from rising replacement costs due to reduced future new supply and thus more room for rent appreciation. This is another facet of real estate's ability to hedge against inflationary pressure.

We believe 2021 marks the beginning of a new real estate market cycle. As demand continues to recover across most markets and property sectors, rising occupancy and higher effective rents should drive higher net operating income, supporting higher dividend and property appreciation. In our view, real estate—income with growth—ought to be an important part of portfolio allocation strategy given accelerating economic growth and the reflationary environment.

Infrastructure will be crucial in global climate efforts

Nick Langley
Portfolio Manager
ClearBridge Investments

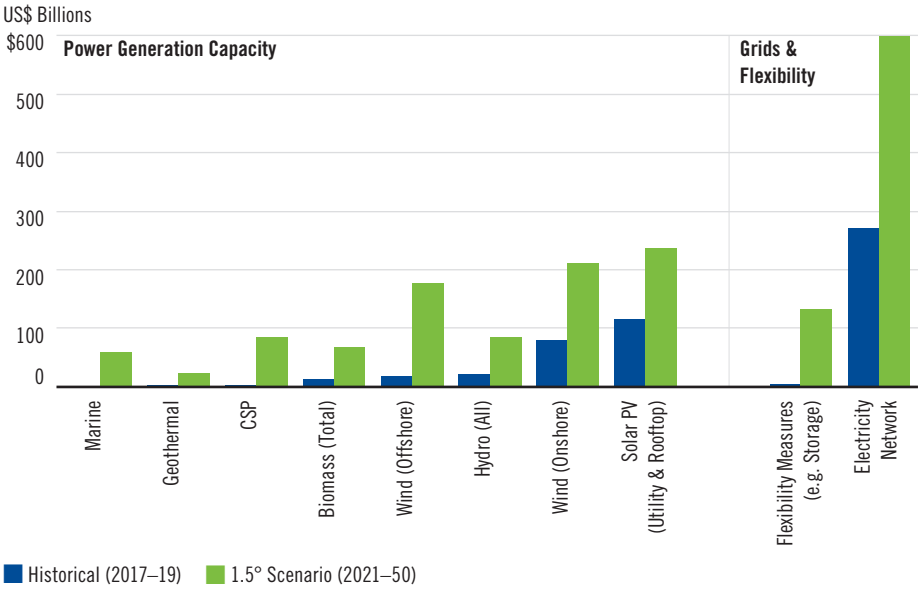
We're focused on listed infrastructure, which is a broad, deep and liquid set of assets around the globe that include regulated assets, such as water, electricity and gas, as well as economically sensitive user- pays assets such as rail, airports, toll roads and telecommunication towers. Attractive characteristics we look for are predictable long-duration cash-flows, inelastic demand for services and low sensitivity to economic and financial market volatility.

We see investment opportunities in all regions of the world, with a preference for those regions where we have the greatest transparency of forward cash flows. Currently, regional exposure is dominated by North America and Western Europe. Opportunities have been dominated by global renewables, gross domestic product-sensitive strategic European infrastructure assets and US utilities with distinct catalysts.

The global investment in infrastructure is an important part of the recovery of economies in a post-COVID-19 world. This investment comes not only in the form of spending on traditional infrastructure such as transport and utility networks, but also from spending targeted at decarbonizing the planet. Investors should benefit from global stimulus plans as policymakers agree on aggressive multi-decade carbon reduction targets. This investment will allow infrastructure and utility assets to earn stable and often regulated returns on capital deployed into such areas as lower-carbon electricity generation, electric vehicle charging infrastructure and lower-carbon fuels such as hydrogen.

ENERGY TRANSITION REQUIRES SIGNIFICANT INVESTMENT

Exhibit 4: Power—average annual investments
As of 2021



Source: IRENA World Energy Transitions Outlook 2021. There is no assurance that any estimate, forecast or projection will be realized.

> "New regulations may, for example, shorten the time natural gas spends as a bridge fuel—as the lowest greenhouse gas (GHG) emitter of the fossil fuels and hence a bridge to a world where energy demand is met entirely by renewables. In such a case, pipelines will see less growth and lose value, resulting in potentially stranded—obsolete and unprofitable—assets."
>
> **Nick Langley**

Infrastructure will require substantial investments for the world to advance on ESG and sustainability goals, in particular lowering carbon emissions and mitigating the impacts of climate change. This will only increase as governments continue to ratchet up commitments to net-zero carbon emissions.

Such efforts will affect valuations of infrastructure companies in different ways. New regulations may, for example, shorten the time natural gas spends as a bridge fuel—as the lowest greenhouse gas (GHG) emitter of the fossil fuels and hence a bridge to a world where energy demand is met entirely by renewables. In such a case, pipelines will see less growth and lose value, resulting in potentially stranded—obsolete and unprofitable—assets. It will be important to understand relative value opportunities in the space as a result. We've seen some of this play out recently, although the situation remains highly dynamic. A corollary insight might apply to toll roads, where the growth of autonomous vehicles, rather than requiring many new roads to be built or stranding existing roads, will markedly increase capacity on existing roads, increasing their value.

Regulators are working with listed utilities to implement green policy. Historically, regulators have provided attractive allowed returns, translating high returns on equity for companies into strong equity returns for shareholders. This is key over the long term, in our view.

Meanwhile, we believe railroads should be considered one of the ultimate ESG winners in the transportation industry due to their unique ability to reduce transport-related greenhouse gas emissions. So, there are nuances to how ESG efforts will influence different areas of infrastructure, and it will pay to have some tactical ability, which we feel very good about in the listed infrastructure space.

Endnotes

1. One basis point is equal to 0.01%.
2. Source: ICE BAML as of May 31, 2021. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
3. FAANG stocks refers to Facebook, Amazon, Apple, Netflix, and Alphabet (formerly known as Google)
4. Source: MSCI India Index, in US dollars, over a one-year period, as of June 15, 2021. Indexes 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 results.
5. There is no assurance that any estimate, forecast or projection will be realized.

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Global Investment Outlook allows the Franklin Templeton Investment Institute strategists to highlight manager's views on markets across the firm. The mission of the Investment Institute is to deliver research-driven insights, expert views and industry-leading events for clients and investors globally through the diverse expertise of our autonomous investment groups, select academic partners and our unique global footprint.

Two related Franklin Templeton Thinks publications of note are Allocation Views, produced by Franklin Templeton Investment Solutions, which offers you our best thinking on multi-asset portfolio construction; and, Macro Perspectives, produced by the Investment Institute, featuring economists from across the firm dissecting key macroeconomic themes driving markets.

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Notes

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