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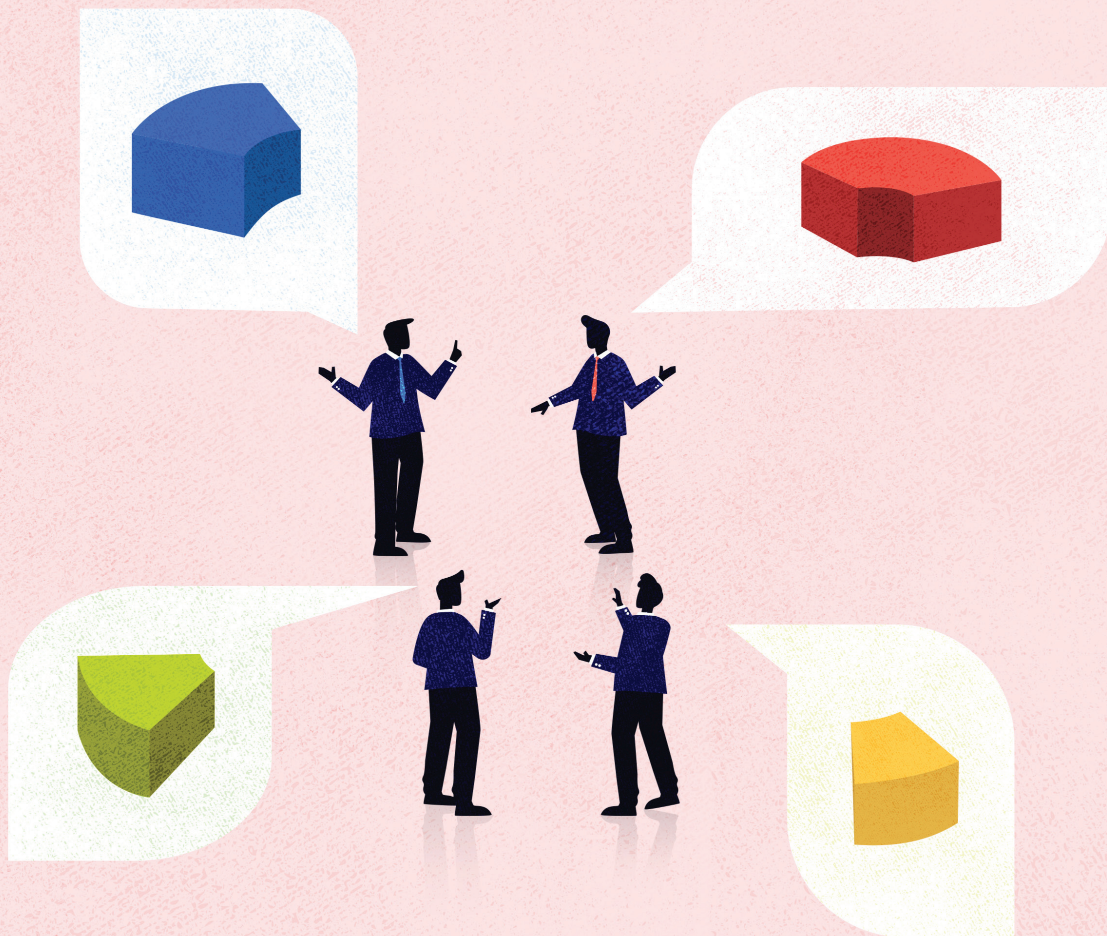
Institute | Global Investment Outlook

Franklin Templeton Thinks™

September 2022

Actively selecting opportunity in uncertain times



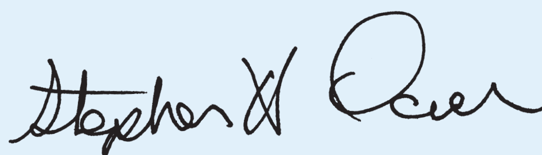
Introduction

Stephen Dover, CFA
Chief Market Strategist
Franklin Templeton Institute

The current state of the global economic landscape has led to flat or inverted yield curves in most government bond markets, US dollar strength, diminishing central bank support for financial markets, elevated price volatility across most asset classes and higher commodity prices. Considering this backdrop, our investment teams shared with me how this impacts their current outlook:

- "Most opportunities for income generation are in the fixed income space right now, but we are mindful of attractive opportunities in equity sectors that have suffered steep price depreciation in recent drawdowns—such as financials and information technology."
  Ed Perks, Franklin Income Investors*
- "As growth and inflation moderate and the risks surrounding central bank policy become more balanced, so too should the market environment for fixed income investors...Lower volatility could also lead investors to reengage in fixed income spread sectors, especially given current valuations."
  Kurt Halvorson, Western Asset
- "Given the general fundamental strength of muni issuers, we feel comfortable taking on incremental credit risk. So far this year, the sizable changes in yields have been the main driver of performance for the muni sector ... We believe credit selection will become even more critical as we progress through this market cycle."
  Ben Barber, Franklin Templeton Fixed Income
- "From a bottom-up perspective, our focus is on stocks where dominant market positions or 'self-help' initiatives (such as overhead reduction plans) can support earnings growth despite a more challenging economic backdrop. Additionally, companies with meaningful capital return programs, either through dividends or large share buybacks, are likely to fare better."
  Scott Glasser, ClearBridge
- "The biggest opportunities in emerging markets remain the structural themes we have positioned portfolios to take advantage of: the greening and electrification of transport, and digitization and premiumization in the consumer sector."
  Manraj Sekhon, Franklin Templeton Emerging Markets Equity
- "In our view, there is significant value in specific local-currency emerging markets. Those pricing for high inflation and rate hikes provide attractive risk-adjusted yields and should benefit when domestic inflation eventually peaks and begins to moderate."
  Michael Hasenstab, Templeton Global Macro
- "Over the next few years, we believe three main factors will drive greater industrial space requirements and higher rents: supply chain disruption and inventory rebuilding, the continued e-commerce boom, and higher construction and replacement costs."
  Tim Wang, Clarion Partners

The consistent themes that emerged throughout these conversations were increased opportunities across the credit and duration spectrums within fixed income, a potentially favorable environment for the banking sector globally, and supply/demand factors leading toward a closer look at commodity sectors. For more detailed insights, please read our full Global Investment Outlook.



*Franklin Income Investors formed on October 1, 2022.

Conditions underpinning capital markets

Many of the outcomes emerging in the next year will be driven by the changed global economic outlook. A combination of factors, ranging from pandemic-related supply disruptions to global conflict, impaired the manufacture, distribution and allocation of many goods and services in product and labor markets. Combined with a burst of economic activity underpinned by economic reopening as well as unprecedented fiscal and monetary stimulus, insufficient supply relative to demand has boosted price and wage inflation, necessitating an aggressive tightening of monetary policies in most major and many smaller economies worldwide.

This has led to five key changes in the conditions underpinning capital markets:

1. Flat or inverted yield curves across most government bond markets
2. A stronger US dollar
3. Elevated price volatility in most asset classes
4. Diminishing central bank support for financial markets, including in terms of lower liquidity and higher interest rates
5. Elevated commodity prices

Let's take a deeper look at the implications of these current conditions and what they might signal for the future performance path of major asset classes, including the potential impact on profitability, risk premiums and valuations.

Is the yield curve inversion predicting a recession?

Yield curve inversion has followed from the pursuit of tighter monetary policies, now underway in most developed and emerging economies. As central banks hike short-term interest rates, expectations for weaker future growth and lower inflation tend to push short-term interest rates above longer-term yields, producing a downward-sloping, or inverted, yield curve. Given the duration of expected monetary policy tightening, a function of today's unusually high inflation, there is a risk that yield curves will remain flat or inverted for most of the next 12 months.

Inverted yield curves can have profound impacts on asset returns and portfolio performance. For fixed income investors, when yields on less price-sensitive notes exceed those on

> **"For equity investors, an inverted yield curve typically leads to a preference for quality, stable earnings and growth styles relative to more cyclical or value baskets of stocks. That is true for several reasons. First, in relative terms, companies with sound future prospects (e.g., growth or consumer staples stocks) enjoy a relative improvement in the discounting of their profits relative to shorter-duration cyclical stocks. Second, inverted yield curves typically presage economic slowdowns or even recessions, which creates more profits uncertainty or even scarcity."**

riskier bonds, most will likely shorten the duration of their fixed income holdings, particularly among government securities. This also creates an expanding opportunity set within shorter-duration high-yield and floating-rate debt. At the same time, because yields on the longer-duration end of the maturity curve have also risen, but not as quickly as at the short end, we believe there are opportunities to increase the quality of fixed income portfolios and achieve capital appreciation by investing in longer-duration US Treasuries and investment-grade corporate debt.

For equity investors, an inverted yield curve typically leads to a preference for quality, stable earnings and growth styles relative to more cyclical or value baskets of stocks. That is true for several reasons. First, in relative terms, companies with sound future prospects (e.g., growth or consumer staples stocks) enjoy a relative improvement in the discounting of their profits relative to shorter-duration cyclical stocks. Second, inverted yield curves typically presage economic slowdowns or even recessions, which creates more profits uncertainty or even scarcity. Therefore, investors tend to flock to stocks whose business models are better able to withstand

adverse economic conditions. At the same time, because this is the general market consensus, some value-oriented sectors remain attractive to us based on specifics related to their particular businesses. For example, financials are much better capitalized relative to the period prior to the 2007/2008 global financial crisis but are being valued on recession fears.

US dollar strength—global opportunity?

Rising short-term interest rates due to US Federal Reserve (Fed) tightening have propelled the US dollar higher against most other developed and emerging currencies. Other factors have underpinned US dollar appreciation, including geopolitical uncertainty, high oil prices, and weak economic activity in China and other emerging economies.

There are three key implications for asset returns with a strong US dollar. First, a strong US currency tends to force countries exposed to imports from the United States to hike interest rates to curb inflation pressures. That pressure is particularly pronounced for emerging economies. The resulting combination—rising interest rates and weakening domestic currencies—acted as a drag on local-currency emerging market (EM) debt securities.

Second, a strong US dollar tends to lower US inflation as it makes imports cheaper, thus creating weaker US economic activity due to reduced production. This reinforces the inversion of yield curves.

Third, a strong US dollar redistributes corporate earnings for larger-capitalization multinational firms. US firms with sizable earnings from overseas have seen those profits dwindle when translated back into a strong US dollar, whereas European, Japanese and EM multinationals are reporting windfall gains on their US dollar earnings when translated back into their weaker national currencies.

What does this mean going forward? From a fixed income perspective, valuations could reach levels that indicate EM sovereign bonds are becoming more attractive relative to developed market options, particularly in countries that remain ahead of the United States in their interest-rate cycles.

On the equity side, valuations outside the United States may become more attractive on a relative basis. Coupled with earnings expectations that remain elevated in the United States, regions such as Europe may offer opportunities because the issues centered around the war in Ukraine have already been discounted.

Elevated volatility—an opportunity for skillful investment?

Unsurprisingly, when central banks tighten aggressively, price volatility tends to rise across all asset classes. Already underway, that process is likely to endure.

In fixed income markets, volatility jumps because inflation-fighting central bankers can no longer confidently guide investors about their future policies. "Data dependency" replaces "forward guidance" and given the uncertain linkages between supply and demand fundamentals driving today's inflation, no central banker can confidently communicate where interest rates will be in three, six or 12 months. Accordingly, short-term interest rates and bond yields are likely to gyrate more significantly than was the case when central banks were targeting "zero" interest rates.

In addition, fixed income investors may become more troubled by the shift from "quantitative easing" to "quantitative tightening," i.e., the reduction and reversal of central bank asset purchases. Against the backdrop of huge increases in government and private sector indebtedness, the removal of central banks as bond buyers will likely continue to increase fixed income volatility.

Tighter monetary policies increase economic and earnings risk. Fed Chairman Jerome Powell stated that some "pain" may be unavoidable. A more uncertain earnings outlook will increase the volatility of equity prices.

Lastly, a growing divergence of monetary policy—some central banks are tightening aggressively (e.g., the Fed and the Bank of England), others more slowly (e.g., the European Central Bank) or not at all (the Bank of Japan)—will likely drive an interest-rate "wedge" between domestic yields across countries, creating conditions for larger exchange-rate moves. The US dollar's advance this year is the prime manifestation of how monetary policy divergence also creates greater exchange rate volatility.

This volatility inherently creates more idiosyncratic opportunities and the ability for active managers to add alpha. While it may seem like we are advocating for all sectors, asset classes and regions, the fundamental message is that the current conditions create a better environment for utilizing skill to achieve excess returns, both from active asset allocation and thoughtful investment selection.

> **“While the Fed has not completely forsworn its commitment to the proper function of financial markets, the ‘Fed put’ clearly now has a much lower strike price, shifting market risk away from the central bank and back to investors. ”**

Less supportive central banks—more risk for investors

A commitment to fight inflation implies a reduced willingness to fight other risks such as a recession. That matters to investors, who for at least a quarter century have counted on significant liquidity, low interest rates and timely interventions from central banks when markets have significantly weakened. That has made investors more willing to take risks, which is one reason why both stock and bond valuations have soared in recent decades.

Less supportive central banks create more risk. As noted, that is evident in volatility. But risk is also rising for investors who previously counted on a “Greenspan,” “Bernanke,” “Yellen” or “Powell” put option—a helping hand in terms of lower interest rates and added liquidity if markets tumbled. While the Fed has not completely forsworn its commitment to the proper function of financial markets, the ‘Fed put’ clearly now has a much lower strike price, shifting market risk away from the central bank and back to investors.

For investors concerned about this particular risk, the municipal (muni) bond market may offer a specific opportunity considering that fiscal budgets are in surplus, which has led to upgrades from the ratings agencies. We believe taxable equivalent yields are attractive relative to other corners of the fixed income market, and investors have not yet flocked to the asset class, providing some runway for flows to support positive returns.

Additionally, another opportunity may be in private commercial (and more specifically industrial) real estate, where the fundamental dynamics of e-commerce-related warehouses, in particular, may provide opportunity for strong returns. Rising construction costs and higher interest rates are likely reducing the ability to add supply, while continued demand allows any cost increases to be passed through to customers.

Elevated commodity prices

Typically, higher interest rates, a stronger US dollar and weaker growth would erode commodity prices. That may occur for some commodities, particularly those that are most cyclical, such as industrial metals. But supply side factors are also important, including the squeeze on global energy, food and fertilizer prices resulting from Russia’s invasion of Ukraine. Supplies of crude oil and natural gas, globally, remain very tight. Hydrocarbon production is increasing in the United States, but slowly, while few producers in the Organization of the Petroleum Exporting Countries (OPEC) or elsewhere have much spare capacity. In food markets, adverse weather conditions are also wreaking havoc on crop yields. Given these conditions, many commodity prices, particularly for food and energy, are unlikely to recede significantly from current levels based solely on weaker global growth.

This leads to a variety of options across the sub-sectors within the energy space, including mid-stream, downstream and upstream operators. From a fixed income perspective, investment-grade energy bond valuations are attractive relative to recent history. In addition, a large proportion of energy companies were funded through private credit in times of industry stress, particularly during recent periods of lower energy prices. These are other sources of opportunity for investors, providing capital appreciation, higher income and lower volatility in exchange for illiquidity.

Summary and conclusions

Inverted yield curves, US dollar strength, higher volatility, less supportive monetary policies and high commodity prices are a troublesome and challenging cocktail for investors more accustomed to low interest rates, predictability, central bank “puts” and low energy prices.

Yet despair cannot be the strategy of the investor, least of all the long-term investor. Opportunities exist in all market outcomes, and today’s is no different. In our view, today’s environment favors active investors, who look beyond broad stock or bond market performance to identify potential winners. Reaching up and down the capital structure to find the best candidates within asset allocations and including alternatives strategies and asset classes to optimize these allocations is particularly effective today, in our view.

Following are the specific comments from our specialist investment managers highlighting their views.

Income investing: A broad opportunity set remains key

Given rising interest rates and inflation, the opportunity set has certainly expanded over the past few months for income-oriented investors. Ed Perks of Franklin Income Investors, opines on what he views as the optimal mix of equity and fixed income to achieve income within today's environment—and where he's finding opportunities.

Ed Perks, CFA
Chief Investment Officer and Portfolio Manager
Franklin Income Investors

Stephen: Considering your shift from a heavy equity to a more marginally overweight relative to your benchmark in 2022, what are your current thoughts on the balance between equities and fixed income—and about optimizing income generation?

Ed: We believe a broad opportunity set remains key to successful income investing. We have a long-term objective to maintain exposure to fixed income and equities at roughly 50/50, although we can flex that ratio to any extent in pursuit of stable, reliable income streams for our investors. In March 2021, our income portfolio allocations were close to 75% total equity against 25% fixed income. Looking back at recent history, the only other time we were close to these extremes was after the global financial crisis, when we allocated around 70% to fixed income and 30% to equities.

Investment opportunities within broad fixed income markets have changed drastically during the past few quarters against a backdrop of high inflation and tighter monetary policy, allowing us to add back to fixed income and take advantage of rising yields. As a result, we are now back to close to an equal split between the two asset classes within our portfolios, with a slight preference for fixed income. The way we went about altering that allocation was crucial to performance and income management. We started to moderate equity exposure throughout the third and fourth quarters of 2021 as valuations moved higher, initially selling down growth stocks, then selling our defensive stocks as prices became more attractive. We were uncomfortable moving that exposure directly into fixed income as monetary policy clearly needed to normalize. Instead, we added to cash and short-duration US Treasuries, creating easily accessible liquid assets ready to be deployed opportunistically into fixed income as interest rates rose and spreads widened.

> **"Most opportunities for income generation are in the fixed income space right now, but we are mindful of attractive opportunities in equity sectors that have suffered steep price depreciation in recent drawdowns—such as financials and information technology."**

As a result, in the current market environment, we believe we are well placed to take advantage of a broad set of income- generating opportunities within the fixed income asset class. We can now incorporate longer-duration US Treasuries into our portfolios given the steep rise in yields. Yields have risen in investment-grade corporate debt securities, meaning we are able to improve the quality of our debt profile while still achieving healthy levels of income. Having said that, we are comfortable leveraging our extensive bottom-up research process to invest opportunistically in high-yield bonds, floating-rate term loans and private credit to enhance portfolio income.

Most opportunities for income generation are in the fixed income space right now, but we are mindful of attractive opportunities in equity sectors that have suffered steep price depreciation in recent drawdowns—such as financials and information technology. We actively look across a given company's entire capital structure to assess a range of different securities that might deliver income and manage the overall risk profile of the portfolio. This could include dividend-paying common stocks and preferred stocks into convertibles or other equity-linked instruments that really broaden our opportunity set.

Stephen: How are you thinking about the role and use of alternatives today?

Ed: The ability to use alternative investments to derive income from all areas of the equity markets delivers a more robust portfolio, in our view, as it relates to the consistency and stability of income distribution and capital appreciation over the long term.

If our portfolio management team identifies an attractive equity opportunity, we can then custom build the characteristics of a security that we would like to invest in, using derivatives if necessary. These types of securities provide effective exposure to an underlying common stock in a way that imparts lower volatility on the portfolio than direct investment in that stock. This is a key element of equity investing during periods of elevated volatility such as the one we are currently experiencing.

Stephen: And how are you thinking about risk management in light of the current environment?

Ed: Our macro outlook for both the economy and markets plays a more prominent role in risk management during volatile environments. We manage overall portfolio construction in the context of interest-rate risk, equity market risk and credit risk. Current macro trends have elevated all of these in prominence, particularly interest-rate risk. We have also learned there are other risks that are harder to plan for, including policy risk and geopolitical risk. We believe that flexibility, alongside nimble, proactive portfolio management, can allow us to navigate these risks effectively, using our extensive research expertise to stay ahead of the curve.

Equity: Coping with challenging times

Global equity volatility continues amid inflation, rising interest rates, and ongoing supply chain issues. While corporate earnings reflect this challenging environment, our investment teams see the market at a possible inflection point, and a potential earnings trough may be forthcoming. Scott Glasser of ClearBridge offers his view of the US market and sectors that look attractive, while Franklin Templeton Emerging Markets Equity's Manraj Sekhon explores opportunities in emerging markets.

High-quality dividend payers can rebut inflation pressures

Scott Glasser
Chief Investment Officer and Portfolio Manager
ClearBridge

Stephen: How are you thinking about equities, with particular emphasis on the impact of a more hawkish Fed on valuations as well as earnings expectations over the next 12 months relative to today?

Scott: The bear market appears to be following the course that we were concerned about in May. After the S&P 500 Index's sharp initial selloff (–23%) as the Fed began its tightening cycle, stocks rallied meaningfully (+18.3% from June 16 to August 16) on hopes of an economic soft landing and pivot towards lower interest rates in 2023.[1] However, sentiment soured in mid-August, with stocks taking another leg down as the Fed asserted rates will stay high amidst persistent inflationary pressures even if, as Fed Chair Jerome Powell said in Jackson Hole, this causes "some pain to households and businesses." This pattern is consistent with the last two significant bear markets (2008/2009 and 2001/2002), as each included at least one period with a significant rally before making a final low. We believe the probabilities favor a return to mid-June, or potentially lower, levels before a bottom is established.

While the tightening liquidity environment—as measured by rising interest rates, higher commodity prices, a strong US dollar and wider credit spreads—caused valuation multiples to contract during the initial selloff, falling profits are likely to drive the next stage of the downturn. From a macro perspective, we believe the Institute for Supply Management (ISM) Purchasing Managers' Index (PMI) remains the best way to forecast corporate profit trends and, unfortunately, PMIs continue to decline, with S&P 500 profits likely to follow and turn negative over the next six months, in our view.

> **“From a bottom-up perspective, our focus is on stocks where dominant market positions or ‘self-help’ initiatives—such as overhead reduction plans—can support earnings growth despite a more challenging economic backdrop. Additionally, companies with meaningful capital return programs, either through dividends or large share buybacks, are likely to fare better.”**

Ironically, higher prices for goods and services are the very reason that earnings have held up to date, helping cushion margins and profits as companies pushed up prices to offset cost pressures.

Stephen: Where are you seeing opportunities today, given this backdrop?

Scott: We continue to favor more defensive industries like pharmaceuticals and insurance. From a bottom-up perspective, our focus is on stocks where dominant market positions or “self-help” initiatives—such as overhead reduction plans—can support earnings growth despite a more challenging economic backdrop. Additionally, companies with meaningful capital return programs, either through dividends or large share buybacks, are likely to fare better.

While the technology sector, as well as other longer-duration growth companies, were the first and hardest hit in this selloff, many of these companies have already absorbed a lot of the pain from multiple compression. The combination of price flexibility, advantageous margin structures and strong secular growth drivers should allow for profit growth to hold up better than their more cyclical peers.

We are watching the banking sector as a valuable barometer for assessing the depth of an economic slowdown and potential US recession. While the current environment is good for banks given higher interest rates, steady loan demand and benign credit, future investment performance will be driven by investor perception of the breadth and depth of an impending credit cycle and the magnitude of losses for the industry.

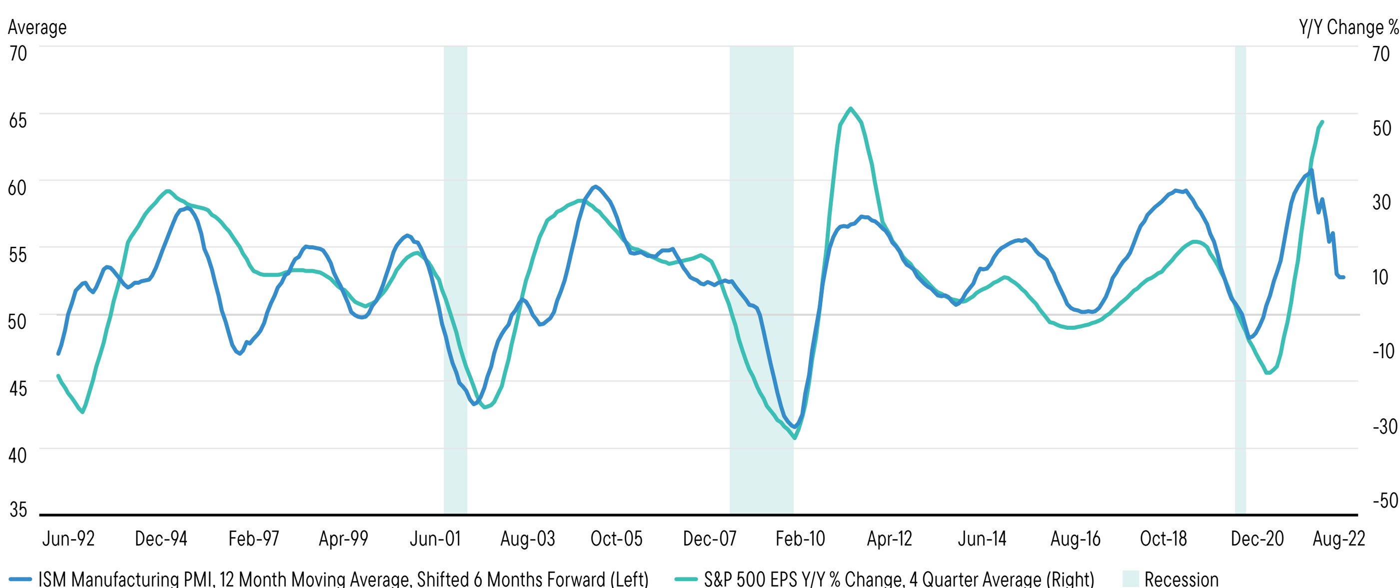
Stephen: Which sectors or areas of the market are you less sanguine about, and what risks in general are you watching?

Scott: One sector likely to remain under pressure is consumer discretionary. We have witnessed major earnings warnings out of several large retailers and companies supporting

Manufacturing a Leading Indicator of Earnings

Exhibit 1: ISM Manufacturing PMI and S&P 500 Index Earnings per Share

June 30, 1992–Aug 31, 2022



Sources: FactSet, ISM, Standard & Poor’s. Past performance is not an indicator or a guarantee of future results. Data as of August 31, 2022, latest available as of September 19, 2022.

e-commerce that have caused their stocks to derate. Many were hit by the double whammy of a consumer pivot toward everyday items—such as grocery and fuel—creating bloated inventory in higher-margin products such as electronics. Meanwhile, cost pressures remain unrelenting, and we are seemingly at a point where incremental price increases cause demand destruction.

Market breadth statistics and corporate bond spreads are key indicators that we continue to watch. The recent rally was dominated by defensive sectors. Yes, technology and discretionary stocks outperformed in the June–August rally, but so did utilities and real estate. To make a durable bottom, we need to see stock prices decline to a level where investors are willing to add risk and duration to their portfolios, and for market breadth to expand to include small- and mid-capitalization companies. Bond spreads are high and trending toward recession, but are not there yet, in our view.

It's important to remember that the market is a discounting mechanism and will make its bottom before earnings and the economy trough. Stocks continue to react aggressively to earnings misses or lowered guidance, indicating that investors are struggling to discount an appropriate level of future profits. Given such volatility, rather than trying to project near-term earnings trends, we believe it's better to look out two to three years and make investment decisions based on the longer-term, sustainable growth rates of companies.

Interest rates, COVID-19 policy in China drive emerging markets outlook

Manraj Sekhon
Chief Investment Officer
Franklin Templeton Emerging Markets Equity

Stephen: What's your market outlook for the coming six months?

Manraj: EMs are going through a period of adjustment due to slower developed market (DM) growth, rising interest rates and changes in the regulatory environment. In combination with China's zero-COVID policy and Russia's war in Ukraine, the outlook is challenging. Nevertheless, these are cyclical trends, which we expect to eventually turn more constructive. Once the uncertainty clears, we expect investors to refocus on the resilience of EMs during COVID-19 and their structural drivers. These include: urbanization and a rising middle class, effective monetary and fiscal policies, along with low leverage of household, corporate and government balance sheets.

Stephen: Let's outline some of the main investment issues you are focused on for the next 6–12 months, starting with the US federal (fed) funds rate and its impact on emerging markets.

Manraj: Investor expectations of a peak in the fed funds rate in early 2023 have been dashed by recent inflation data and Fed guidance. We believe the long-run estimate of the fed funds rate, the neutral rate, is of more importance to long-term investors as this level is used in financial models. It also has implications for investor assessment of fair value in equity markets. Members of the Fed Board and Fed bank presidents' current view on the neutral rate is 2.3%–3%.[2] Investors expect this to increase, potentially to 4%, and the fed funds rate to peak in 2023.

Long-duration technology and health care companies in EMs are feeling the negative effect of higher interest rates. Banks are beneficiaries of the trend for higher rates as they witness a faster repricing of their assets/loans compared to their liabilities/deposits. While there are concerns over the impact of slower growth on credit quality, banks in India and the Association of Southeast Asian Nations (ASEAN) were prudent in raising their provisioning levels during the COVID-19 pandemic. These banks could release these provisions given credit quality has held up better than expected.

Stephen: What are the consequences of China's zero-COVID policy into 2023?

Manraj: The absence of an exit road map from China's zero-COVID policy is resulting in a more cautious stance by companies toward investment. Consumer demand remains fragile, as reflected in slow growth in retail sales. However, we believe these uncertainties have largely been reflected in the 27% decline in the MSCI China Index thru September 21, 2022.[3] We would caution against turning overly negative on China as we approach the 20th National Congress in mid-October. Xi Jinping's reappointment for a third term as president could result in a rebalancing of the dual policy focusing on growth and zero-COVID, in favor of growth.

Stephen: What is the outlook for EM corporate earnings in 2023?

Manraj: EM consensus earnings expectations in 2023 are for 6% growth.[4] We note that earnings are currently being revised downwards due to recession risk in DMs. However, the headline rate of growth masks divergent trends across regions within EMs. Asia is displaying resilient growth of 8%, led by India.[5] Earnings in China are expected to post

double-digit growth in 2023, and policy easing could provide a further boost. We expect earnings in Latin America to be revised up, driven by growth in domestic demand as well as potential China policy easing that could benefit commodity producers. Brazil is witnessing significant consensus earnings upgrades for 2023, which should see its forecast contraction in earnings next year reduce.

Stephen: Where are the opportunities in EMs?

Manraj: The biggest opportunities in EMs remain in the structural themes we have positioned portfolios to take advantage of: the greening and electrification of transport, and digitization and premiumization in the consumer sector.

Economies with a greater focus on domestic demand are likely to be more resilient if there is a recession in DMs. These markets include India, and in particular Indian banks, which are benefiting from a post-COVID-19 recovery. India also stands out as a clear beneficiary of multinational companies' China+1 strategy. This strategy sees businesses adding an additional manufacturing base to the existing one in China. The recent announcement of a US$20 billion semiconductor factory in the Indian state of Gujarat reflects this trend.

We favor Brazil, which is benefiting from improving domestic demand, as well as Indonesia in Southeast Asia, where we are positive on companies in the consumer discretionary sector. We also see some value in consumer sectors in selected markets in the Middle East, where consumption is benefiting from a spillover from high energy prices.

Stephen: Where are the risks in EMs?

Manraj: Companies we speak to are highlighting weak order visibility, which we believe is due to high inventory levels in the United States. There is evidence that the surge in demand for semiconductors, particularly from auto manufacturers, has been satisfied and is contributing to this weakness. They also cite a sharp drop in shipping rates; while good news for costs, it also signals weakness in demand. A continuation of China's zero-COVID-19 policy into 2023 would maintain downward pressure on corporate earnings as would a deterioration in the Russian war against Ukraine. Awareness of these risks does not prevent us from utilizing our on-the-ground network of analysts to identify quality businesses trading at what we believe to be attractive valuations.

Fixed income: Inflation moderation needed for stability

Volatility hit fixed income markets this year as central banks turned toward more aggressive tightening. Kurt Halvorson, portfolio manager with Western Asset, and Ben Barber, Franklin Templeton Fixed Income's director of municipal bonds, discuss how this impacted their areas of expertise within the credit markets. Kurt sees the environment for fixed income investors improving with stability and continues to position for a post-COVID "reopening trade," while Ben favors adding duration, and feels comfortable taking on incremental credit risk in his portfolios.

Kurt Halvorson, CFA
Portfolio Manager
Western Asset

Stephen: How does the current environment impact your overall investment positioning, with particular emphasis on credit?

Kurt: The key to an improved tone and more stability in fixed income markets is a moderation in inflation. Our base case is that the supply chains will slowly begin to normalize. We believe this trend, combined with the Fed and other major central banks around the world tightening monetary policy, along with declining real incomes slowing consumption, eventually should help inflation moderate.

Generally, as growth and inflation moderate and the risks surrounding central bank policy become more balanced, so too should the market environment for fixed income investors. Not only may the rise in government yields abate, but lower

> **“…as growth and inflation moderate and the risks surrounding central bank policy become more balanced, so too should the market environment for fixed income investors. Not only may the rise in government yields abate, but lower volatility could also lead investors to reengage in fixed income spread sectors, especially given current valuations.”**

volatility could also lead investors to reengage in fixed income spread sectors, especially given current valuations. If, indeed, inflation can subside as quickly as the markets are currently anticipating (primarily via forward-looking indicators), it is likely that bond yields will continue to stabilize and could even move lower. We believe this could set the stage for an exceptional investment opportunity across spread sectors in the second half of the year. Given the sharp rise in interest rates and widening of spreads in corporate credit (especially investment-grade), structured product and EM sectors, we believe now is the time to take advantage of these opportunities. Fixed income provides attractive alternatives to other sectors, in our view, and should provide diversification.

Stephen: Where do you see opportunities across the sectors/segments that you invest in?

Kurt: We continue to position for a “reopening trade” and to identify potential rising stars, should volatility decline and growth slow only slightly. Within specific sectors, since 2016, investment-grade energy company managements have acted conservatively, lowered cost structures, improved cash flow, delevered their balance sheets, extended maturity runways and improved liquidity. Capital budgets remain conservative and shareholder returns are derived from excess free cash flow. Given the sector’s continued focus on cost reduction and greater capital discipline even in the face of higher commodity prices, this is an area we would highlight.

The US banking sector also looks to be in robust shape given the high level of cautious oversight from regulators. Recent repricing made valuations more appealing as corporate fundamentals remain strong, in our view. We believe further ratings upgrades are likely still ahead.

We also believe fundamentals in European investment-grade credit are strong but may deteriorate from here as a growth slowdown becomes more likely. Exposure to Russian gas is a current concern, with particular focus on German industrial and utility credits. Bank balance sheets remain in strong shape with higher rates supportive of profitability. Yields have reached multi-year highs in euro-denominated investment-grade credit, and investment-grade spreads look attractive to us on both a historical and also a cross-currency-adjusted basis.

Stephen: Where do you see risks across the sectors/segments that you invest in?

Kurt: The war in Ukraine still poses massive geopolitical uncertainty. The potential for energy rationing in key eurozone economies is a prominent risk. If the Russian supply of energy is cut off to Europe, that could cause tremendous difficulty for economic output across the region, particularly Germany, and could push headline inflation in the eurozone into double digits. In the United States, if the Fed’s hiking regimen is more aggressive than expected, we see an increased probability of a recession. In the United Kingdom, we believe that the Bank of England’s hiking cycle is likely to run out of steam sooner rather than later, as inflation and fiscal pressures weaken household demand.

In EMs, the unevenness of pandemic recovery across regions and countries has led to a greater emphasis on idiosyncratic risks. We continue to believe investment-grade and crossover-rated EM sovereigns are attractive from a carry standpoint, while vigilance is warranted on lower-rated countries given the pandemic’s impact on sovereign credit quality. EM growth challenges, heightened geopolitical risks and Fed tightening are historically not supportive of EM currencies. In addition, inflation concerns continue to be a dominant theme for central banks. The aggressive approach to monetary tightening over the past year does provide some counterbalance, reflected in the higher cost of carry across local markets. By region, Asia stands to benefit given a resumption of global trade activities, while the currencies of weaker countries remain vulnerable to market swings.

Municipal bonds: Attractive valuations and improving technicals

Ben Barber, CFA
Director, Municipal Bonds
Franklin Templeton Fixed Income

Stephen: What is your outlook for muni bonds and what are you watching closely to see early signs of shifts in the environment?

Ben: In our view, the muni bond market will continue to be pressured by multi-decade high inflation and the Fed's monetary response, which have driven longer-term fixed income yields much higher year-to-date. Although, conditions have modestly improved more recently, we still believe muni bond market volatility will remain elevated amid continued monetary policy tightening. If we were to see yields stabilize, lower volatility could potentially be supportive to the muni market. While investors are beginning to take notice of what we regard as attractive valuations and the tax-free income potential of the asset class, we have yet to see broad-based improvement in demand, which we believe is necessary for performance to stabilize and drive a potential rebound in the asset class.

Stephen: What have been the key drivers of current muni markets?

Ben: We tend to look at the three major components of the muni market: technical, fundamental and valuation factors.

As the year has progressed, technical conditions in the market have improved for tax-exempt investors, yet outflows from muni bond mutual funds persist. Given the retail nature of the market, these fund flows represent the majority source of demand for the asset class and are a key driver of performance. But other factors, including a typical lull in new issuance and heavy coupon and principal payments associated with the summer months, have limited supply in the market, which has to some extent blunted the lack of demand.

> "Coming off record fiscal surpluses and a very positive budgeting season, fundamentals across the muni market are generally stable. We are seeing municipalities put prudent budget measures into place, which, in some cases, are resulting in rating agency upgrades."

Historically, the market tends to see heavier new issue supply in September, October and early November, and this can provide investors with new opportunities to put cash balances to work, which we believe will be welcomed by the market.

Coming off record fiscal surpluses and a very positive budgeting season, fundamentals across the muni market are generally stable. We are seeing municipalities put prudent budget measures into place, which, in some cases, are resulting in rating agency upgrades. However, there are some sectors, such as certain transportation and health care segments, that remain challenged in the current economic environment. As part of our ongoing credit research process, we continue to monitor the impact of a wide range of factors—such as rising interest rates, inflation, the end of federal COVID-related aid, as well as labor market and wage concerns—on muni issuers' financial conditions. Understanding credit fundamentals will continue to play a critical role in portfolio positioning as we move through the economic cycle.

Valuations of longer-maturity muni bonds remain reasonable, in our view, while the shorter-maturity issues are relatively more expensive compared to US Treasuries (USTs). A common metric used for measuring the relative value of munis is the ratio of muni-to-UST yields. The 10-year ratio ended August at 82%, while the 30-year ratio ended 102%.[6] Historically, these ratios have averaged in the high 80% to low 90% range.[7] For those investors able to take advantage of tax-exempt returns, muni taxable-equivalent yields remain attractive compared to other fixed income products, in our view. Considering the lower default characteristics and higher after-tax income currently available, we believe the muni bond sector remains a strong option for investors as part of their fixed income allocation.

Stephen: Given this environment, how have you been positioning muni portfolios?

Ben: In general, we tend to maintain a more neutral interest-rate risk positioning as measured by portfolio duration. As muni yields have moved higher, we have been looking to potentially add duration to our portfolios.

Given the general fundamental strength of muni issuers, we feel comfortable taking on incremental credit risk in the portfolios. So far this year, the sizable changes in yields have been the main driver of performance for the muni sector, overshadowing credit selection. While the fundamentals generally remain strong, we believe credit selection will become even more critical as we progress through this market cycle.

Global macro: Finding opportunities amid global tightening

Global macro investors are finding the policy response to inflationary pressures is not uniform across the globe. Michael Hasenstab from Templeton Global Macro highlights how EM central banks stayed ahead of the curve by maintaining already high rates or hiking rates ahead of DMs. They see value in specific local-currency emerging markets—particularly in Asia—that are already priced for inflation, and could benefit when it begins to moderate.

Michael Hasenstab, Ph.D.
Chief Investment Officer
Templeton Global Macro

Stephen: How do you see the current environment in light of your strategy, particularly currency and interest-rate trends?

Michael: In our view, the strong US dollar rally since mid-2021 that took the greenback to two-decade highs against some currencies may be running out of steam. A still-negative real interest rate in the United States, combined with twin deficits and slower economic growth, could lead to a break in the recent broad US dollar strength against certain currencies. We think the US dollar is at historically stretched levels.

The global monetary policy tightening cycle continues to press forward as inflation pressures broaden. While some DM central banks moved more aggressively in recent months to tighten policy, it's likely interest rates will have to remain higher given low starting policy rates and persistent, above-target inflation.

> "In our view, there is significant value in specific local-currency EMs. Those that have already priced for high inflation and rate hikes provide attractive risk-adjusted yields and should benefit when domestic inflation eventually peaks and begins to moderate."

Many DM sovereign bonds are thus likely to face continued headwinds. Certain EMs that have been able to stay ahead of the curve by maintaining already-high rates or hiking rates ahead of others—such as areas of Latin America—should be in a stronger position to weather the global tightening cycle. By contrast, other EMs appear more vulnerable to persistent inflation and weaker fundamentals. Heterogeneity in fundamental conditions and monetary policy should create relative valuation opportunities amongst countries.

Stephen: Where are you seeing opportunities—and why?

Michael: Given our view on the US dollar, we see opportunities in non-US dollar assets—both among DMs and EMs. In our view, there is significant value in specific local-currency EMs. Those that have already priced for high inflation and rate hikes provide attractive risk-adjusted yields and should benefit when domestic inflation eventually peaks and begins to moderate.

On a regional basis, areas of Asia continue to stand out from the EM pack. Though growth is slowing as elsewhere, emerging Asia is still projected to have some of the strongest growth rates in the world in 2022 and 2023. After much of the region endured economic headwinds from reinstating lockdowns in the second half of 2021, several countries reopened their economies and pivoted toward a policy stance of "living with COVID." These reopenings should provide a substantial boost for domestic economies, as well as external trade. China's gradual easing of its zero-COVID policy is likely to continue after the 20th National Congress meeting in October. The effect on economic activity will have positive spillover effects for its regional neighbors, too.

Additionally, several countries have large current account surpluses, low fiscal deficits, low levels of debt, and relatively normalized interest rates compared with the low rates in many advanced economies. Furthermore, many of the growth drivers in the region are aligned with trending sectors such as pharmaceuticals, digitalization, big data and high tech, notably in places like South Korea and Singapore. Looking ahead, we expect Asia to remain an important driver for global growth.

We also have identified additional risk-adjusted value in areas of Latin America where high commodity prices should continue to support export revenue, and where several central banks aggressively raised interest rates to confront inflation, support their currencies and maintain policy credibility. These dynamics are creating highly compelling risk-adjusted yields in specific countries.

Stephen: What potential risks or areas of concern do you see?

Michael: Structural risks associated with massive fiscal spending and excessive monetary accommodation remain a medium- to longer-term concern in several countries. Debt levels increased significantly in the last couple of years in just about every country. Additionally, financial market over-reliance on extraordinary monetary accommodation creates the preconditions for potential financial market disruptions as policy rates normalize. Certainly, we anticipate episodes of volatility as the world transitions from the massive fiscal stimulus and monetary accommodation of the last couple years. A significant risk to the outlook is a "Volcker moment," where the Fed feels compelled to raise rates very sharply to deal with sticky, high inflation.

Alternatives: Trends and opportunities in private real estate

In an environment where stocks and bonds are struggling, one could argue the case for alternatives has never been greater. Tim Wang, head of investment research at Clarion Partners, outlines the trends he sees in private real estate—and why industrial property looks particularly compelling.

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

Stephen: Why is commercial real estate attractive to you today—particularly industrial property—and why?

Tim: US industrial property has continued to be the best-performing commercial real estate (CRE) sector amidst historically robust demand and historically low vacancy. Institutional-quality industrial investments have significantly outpaced the overall NCREIF (National Council of Real Estate Investment Fiduciaries) Property Index (NPI) since 2011, as well as the other core CRE property types over recent years.[8] The enduring strength of the sector has been extraordinary, driven by the ongoing rise in US consumer spending, omnichannel expansion and expanding global trade. Clarion Partners' short- and long-term outlook for the sector is positive given structural transformations in both global supply chains and last-mile distribution.

Over the next few years, we believe three main factors will drive greater industrial space requirements and higher rents: supply chain disruption and inventory rebuilding, the continued e-commerce boom, and higher construction and replacement costs. The ongoing expansion of e-commerce logistics is by far the largest secular tailwind for industrial demand. E-commerce users typically utilize three times more warehouse space than traditional retailers, augmenting the demand for warehouse and distribution space. Clarion Partners anticipates that tenant demand for industrial property—in particular, modern Class A facilities—will be so strong, amidst limited new supply, that landlords will be able to sustain and escalate rent levels.

Stephen: In addition to the population shift from North to South in the United States, what are other trends you are seeing? What are the best opportunities related to these trends?

Tim: The onset of the COVID-19 pandemic largely accelerated many location changes that began before March 2020. Nationwide, some migratory patterns related to American industry and demographic shifts became more pronounced by type of region, metro and location—some areas experienced unprecedented booms, while others reported sizeable declines. Clarion Partners' analysis indicates that post-pandemic US relocation activity showed four main trends:

1. Out-migration from large “blue” states
2. Stronger growth in certain small/mid-sized cities
3. Relocations to many Sunbelt markets
4. A move to the suburbs

The exodus from a handful of large cities is a notable contrast from a decade ago, when urban cores in most gateway markets were growing, then bolstered by the rising popularity of urban living and a decades-long boom in immigration.

Clarion Partners believes that CRE investors should prepare investment strategies expecting more de-densification in the future. In addition, strategic CRE capital allocators should increasingly focus on high-growth locations with thriving industries, steady in-migration, and pro-business policies for greater return potential. Prudent real estate investing may depend more than ever before on understanding where Americans want and are able to live, work and play post-pandemic.

Stephen: What are the biggest risks to your view/positioning, and why?

Tim: While we believe that hybrid work arrangements are likely to stay, recent migration patterns might be partially revised if return-to-office (RTO) gains momentum. Current US physical office occupancy levels are still on average 50% below pre-COVID-19 levels.[9] Such uncertainty will likely impact the pace of recovery in large commercial business districts across the country.

There has also been an unprecedented surge in US construction costs over the past 18 months. Subsequently, CRE development and renovation costs have risen significantly. Higher construction costs will negatively impact project timelines and budgets for the 1.4 billion square feet of warehouse space planned over the next five years.[10] However, Clarion Partners believes that developers can pass on higher costs to future tenants in the form of higher rents given the robust demand conditions.

Endnotes

1. Source: FactSet. Federal Reserve tightening began on March 17, 2022. 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 a guarantee of future results.
2. Source: US Federal Reserve Summary of Economic Projections, September 21, 2022.
3. Sources: MSCI, Bloomberg. 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 a guarantee of future results. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI. Important data provider notices and terms available at www.franklintempletondatasources.com.
4. There is no assurance any estimate, forecast or projection will be realized.
5. Source: Bloomberg, September 2022.
6. Source: Bloomberg.
7. Source: Bloomberg.
8. 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 a guarantee of future results.
9. Source: Kastle Systems. May 2022.
10. Source: CBRE-EA, Clarion Partners Investment Research. Q3 2021.

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Global Investment Outlook allows the Franklin Templeton Institute strategists to highlight manager's views on markets across the firm. Our mission is to provide our clients with research that meets their needs and concerns. We do this by listening, understanding, and then harnessing the resources of our firm to answer the challenge. We organize around areas of exploration to develop distinct insights and their practical applications.

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 Institute, featuring economists from across the firm dissecting key macroeco-nomic themes driving markets.

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