Allocation views

Perspective from Franklin Templeton Investment Solutions

JANUARY 2021

A little more clarity?

As we enter 2021, financial markets appear to be clinging to a more optimistic view of the world than the one we left behind in 2020. Undoubtedly we have reasons to be more hopeful, but it seems that we still have a greater than usual level of uncertainty over a number of factors that are key to how markets react during the coming year.

Focusing on the United States, the political environment is becoming clearer, with the narrowest of victories in the Senate race being confirmed for the Democrats after runoff elections in the state of Georgia. This may open the way for more significant fiscal stimulus to be enacted in the early part of this year, supporting ongoing consumption growth. However, even as the transition to President-elect Joe Biden seems likely to occur on schedule, as legal challenges have fallen away, it is clear that the political landscape is more deeply divided than ever. For now, financial markets have taken this in their stride, but we suspect that US politics may remain a source of continued uncertainty over the months ahead.

Equally, the progress toward authorizing multiple, highly effective vaccines against the coronavirus that causes COVID-19 continues apace. The realization that we have light at the end of the tunnel has been the primary narrative supporting risk assets over the last two months. We share this optimism and remain hopeful that even as the virus mutates and evolves, medical science is likely to be able to keep pace with the challenge. However, the near universal agreement with this positive view leaves scope for any near-term disappointment to hurt investor sentiment. A new element of uncertainty emerges regarding logistics around vaccine distribution, and the willingness of the populace to take it.

Similarly, the re-imposition of harsh lockdowns in many European countries, to avoid health services being overwhelmed in the face of a new, more contagious variant of the virus, is worth noting. The relative lack of concern in markets sits uncomfortably with events that are having such a dramatic impact on populations in these countries and may lead to double-dip recessions in some. We have commented in Allocation Views over the last six months that humanity is very good at adapting to known challenges and learning from prior experience. It is probably the case that markets are right to say, “we know how this story goes” and look through the near-term disruption to a better future. However, it may also reflect fatigue with reading bad news and a degree of complacency over some of these risks.

Taken together, we continue to believe that the deep global recession we saw in 2020 is behind us and a new expansion is well-established. We share the more optimistic expectations of the likely pace of growth, led by near full recovery in China, and as 2021 evolves, especially in the United States. However, the near-term risks from the continued threat of COVID-19 leave us with an outlook that is less clear than usual. As a result, we retain a slightly cautious view, encapsulated in our theme that sees **“Elevated Uncertainty over the Pace of Global Growth.”**

Expectations of a sharp economic rebound are widely discounted in current market levels for risk assets. It is expected to be relatively smooth, but we see the recovery profile as more uneven, especially across geographies. However, we recognize much stronger longer-term return potential for stocks than bonds and believe that they should earn their equity risk premium over time (see Exhibit 1 on the next page). As a result, after stepping to the sidelines toward the end of 2020, following a period of strong global equity market returns, we reinstated our modestly higher conviction toward global equities and increased it further at the end of November. In the longer term, bonds remain more highly valued and equity prospects are attractive relative to them, in our view. Although near-term risks continue to moderate our enthusiasm, we are prepared to maintain a more decisive stance, reflecting longer-term optimism. However, we continue to believe that navigating the challenges presented in the months ahead will require nimble management.

Reflation expectations grow

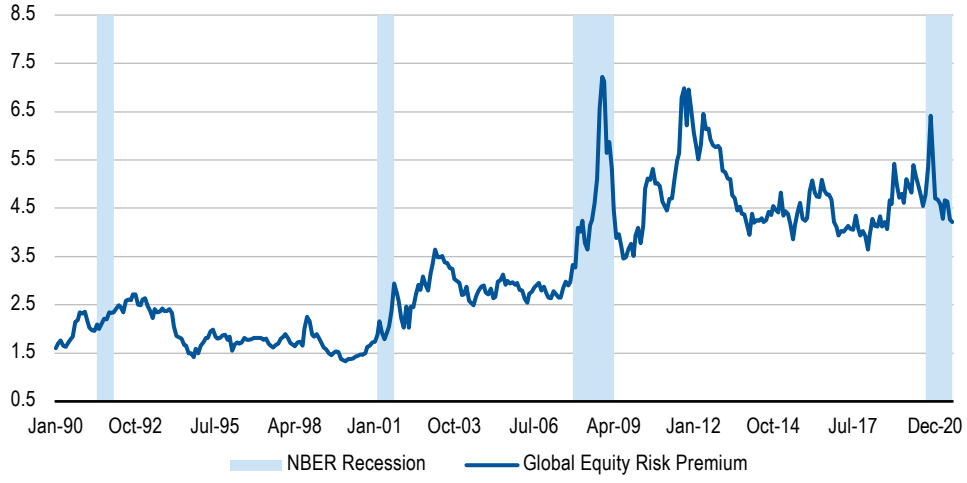
When we look out over a longer-term horizon, one of our stronger convictions remains that inflation will not be a major concern. However, market participants are increasingly concerned that a rebound of

GLOBAL EQUITY VALUATIONS ARE NOT CHEAP, BUT ARE ATTRACTIVE, IN OUR OPINION, RELATIVE TO BONDS IN THE LONGER TERM.

Exhibit 1: Global equity risk premium

As of December 31, 2020

Equity risk premium (%)



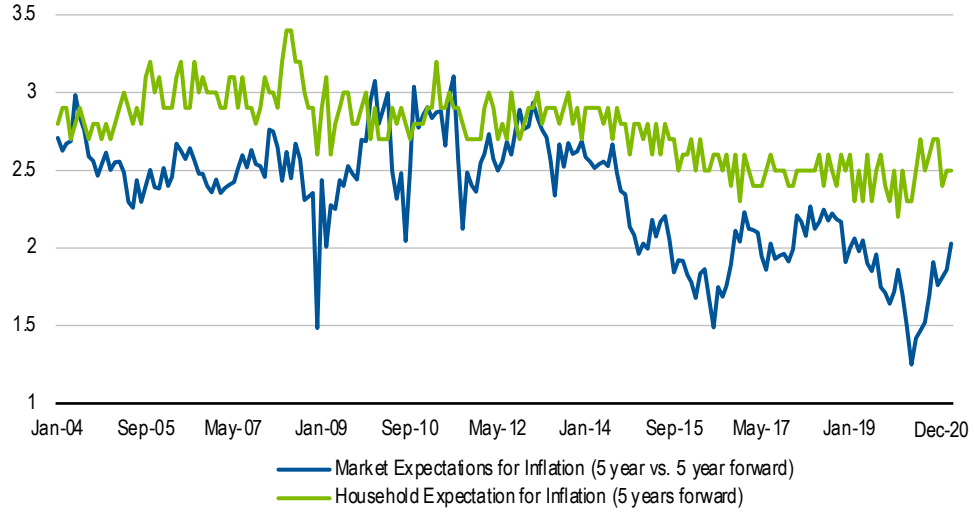
Sources: Franklin Templeton Investment Solutions, Absolute Strategy Research, Macrobond. Important data provider notices and terms at www.franklintempletonresources.com.

US INFLATION EXPECTATIONS HAVE REBOUNDED

Exhibit 2: Household inflation expectations remain higher than market-based levels

As of December 31, 2020

% change



Sources: Franklin Templeton Investment Solutions, Bloomberg, Factset, Macrobond, University of Michigan, St. Louis Fed.

inflation is a risk. It has started to show up in the movements of inflation-protected bonds. It is also evident in a rotation from more defensive sectors of the market to areas that were badly hit by the first lockdown seen last year. Similarly, the level of longer-dated government bond yields has risen, relative to shorter-term bonds, broadly reflecting this optimism over an eventual reflation.

Market-based expectations for inflation have risen. These so-called breakeven inflation rates are derived from the yields of nominal and real return bonds, (where the prospective return on nominal and real return bonds are equal). However, we believe that it is mainly the risk premium for future inflation uncertainty, along with the relative liquidity premium that ebbs and flows with market sentiment, that has returned to more normal levels.

The dislocation that was evident last spring has reversed (see Exhibit 2). The persistent gap in this chart demonstrates a buffer into which breakeven rates can rise before impacting broader expectations. If we look at the post-global financial crisis period, the rise in market levels had little impact on consumer expectations. Without that feed through, it is much less likely that an inflation spiral takes hold. Breakevens have moved higher and are a cleaner reflection of the market's anticipated path for inflation. But they should not be viewed as a sign of problematic inflation in the near term.

More broadly, we continue to believe changes in demand will be the main driver of inflation. A strong recovery likely leads to somewhat higher inflation after a lag. However, we view recent rises in food-price inflation, especially in emerging economies, as transitory. Supply shocks may have lowered productive capacity, but the rise in labor market slack persists and will be much more powerful, in our view. This effect has been felt broadly, including in emerging markets, reinforcing our theme of **"Subdued Inflation Across Economies."**

Policy support remains key for markets

We continue to focus on the need to provide ongoing fiscal support to offset the impact of COVID-19. Renewed stimulus measures have continued to be enacted in many countries, as demand dictates. However, until a large portion of the population has actually been vaccinated, we expect to see a continued threat of shocks to the health care system and broad economy. We are slightly concerned that in both the United States and Europe an element of complacency has set in regarding the rollout of vaccines. Financial markets have taken comfort in the continued provision of ample liquidity by central banks and by the assumption that if things get worse more fiscal support will be forthcoming. While we agree with that assumption, a proactive rather than reactive approach would be more reassuring.

The European Central Bank (ECB) recalibrated its support for the eurozone economy in December. As anticipated, it extended its emergency asset purchase plan, the Pandemic Emergency Purchase Programme (PEPP). It remains a critical element of economic support and may need to be expanded again, even though the ECB argued that the "entirety of the envelope" may not need to be used, in an attempt to sooth concerns of certain member states. We remain optimistic that, like other central banks, the ECB stands ready to do whatever it takes to secure the recovery. As a result, we feel more confident in the prospects for lower-rated, high-yield corporate bonds.

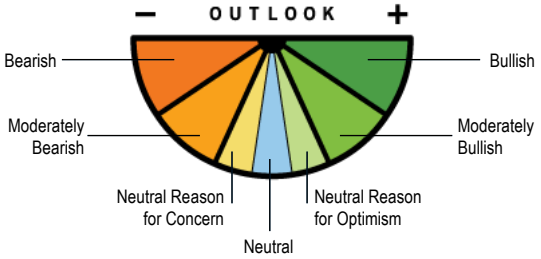
It was the coordinated policy response we saw in 2020 that eased the path through a deep global recession and allowed investors to look ahead to a period of recovery and rebuilding. We remain optimistic that stimulus will be provided when needed, but we are concerned that its delivery will be reactive rather than proactive. Despite this, we retain our final theme of a **"Dovish Bias to Policy."**

Allocation settings views—January 2021

Pendulum settings reflect cross-asset class views

Asset Class	Conviction	Our viewpoint
RISK TIER		
Risk Off/On		We saw a sharp contraction in global growth—which bottomed in 2020's second quarter—and a strong rebound appears to be in place. Our expectation is for moderate inflation and fiscal stimulus to continue, but COVID-19 leads to elevated uncertainty over the pace of global economic recovery. As a result, we retain only a moderately optimistic stance toward riskier assets in the near term. Our view balances lack of clarity on growth with broad policy responses that will continue to be supportive.
HIGH LEVEL ALLOCATION TIER		
Equities		In broad terms, global equities require sustained economic recovery to support elevated valuations, as COVID-19 vaccine delivery holds out great hope for a return to normality. We anticipate plentiful liquidity to continue to support global equities, and longer-term prospects have improved. However, concerns remain about downside risk to capital investment plans. We retain a moderately bullish stance toward global equities over bonds, having reinforced this view last month.
Bonds		Building global recovery and long-term valuations that remain expensive, reflecting low term premiums, contrast with continued easy monetary policy. Corporate bond spreads have become compressed, but the market is supported by central bank purchases. As the COVID-19 and geopolitical backdrop look somewhat clearer in the medium term, we have moved to a moderately bearish view of bonds at the asset allocation level, reflecting valuation concerns.
Alternatives		We believe inflation expectations may continue to normalize from moderate levels, even as overall inflation remains subdued. We see better prospects in naturally diversifying assets such as Treasury Inflation-Protected Securities. We maintain a neutral view overall, reflecting the balance between cyclical reasons for optimism and real estate market concerns that we continue to monitor.
Cash		The defensive features of cash remain modestly attractive to us, despite its drag on portfolio yield. Short-term US Treasury bill yields reflect depressed policy rates rather than greater supply. Cash has attractions as a means of diversification from low-yielding government bonds.

Understanding the Pendulum Graphic



Arrows represent any change since the last quarter-end.

Asset Class	Conviction	Our viewpoint

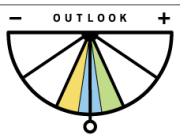
ALLOCATION TIER

Equity Regions (Pendulum settings relative to equity asset class broadly)

United States		Despite COVID-19 headwinds, trend US growth remains stronger than in other developed markets, and substantial technology exposure sustains the market opportunity. The market's attention will likely focus on the strength of the consumer, valuations and whether ongoing fiscal stimulus programs can be expanded to sustain the recovery.
Canada		We see modest opportunities in Canada. Domestic housing concerns and low net interest margins continue to burden Canadian banks. Commodity headwinds have abated but are not really providing support to this market. We maintain our caution, in part reflecting fading fiscal support as COVID concerns continue.
Europe ex UK		Europe continues to require policy stimulus as weak business sentiment persists. The ECB is focusing its efforts on supporting bank lending, but exposure to late-cyclical sectors remains a drag. We maintain a more cautious view, which reflects a lower outlook for earnings and valuations that are no better than neutral relative to history.
United Kingdom		Domestic political tensions remain evident, and uncertainties in UK economic prospects remain. However, this defensive market appears historically cheap so long as corporate profits are not too severely impacted. We reflect these opportunities in a modestly constructive view on this market, tempered by caution over remaining uncertainties.
Japan		Japan appears well-placed to benefit from a cyclical economic rebound, policy continuity despite a new prime minister and a relatively muted COVID-19 impact. Although earnings per share have been weakening relative to peers, equity valuations, particularly on a price-to-book-value basis, remain attractive relative to other markets, in our view. We have extended a more constructive view on this market.
Pacific ex Japan		With banks and related financial companies representing heavier weights in the region, concerns about banks in Australia and Hong Kong persist. The region remains vulnerable due to tensions over Hong Kong and subdued global trade flows. However, with lower interest rates in Australia and at valuations we regard as supportive, we maintain a truly neutral stance.
Emerging ex China		Headwinds to global growth highlight emerging markets' idiosyncratic risks and underlying cyclicality. However, valuations remain attractive to us relative to developed market peers, and return on equity is improving. We continue to reflect near-term market-share concerns, on balance, more than optimism regarding the longer-term structural attractions of emerging markets.
China		China's economy has recovered more quickly from the impact from COVID-19, but heightened geopolitical tensions persist. Trade disputes remain unresolved in the longer term and are a symptom of broader tensions. However, China has a more favorable position when viewed relative to global peers across a number of scenarios. Though valuations remain elevated, we have shifted to a modestly more constructive view of this market.

Fixed Income Sectors (Pendulum settings relative to fixed income asset class broadly)

US Treasuries		The US Federal Reserve (Fed) adopted a new flexible inflation targeting regime last fall and is likely to hold interest rates close to zero for an extended period of time. However, it remains biased to provide more stimulus as needed and to maintain a stable US Treasury yield curve as it moves beyond the crisis-response phase. Stretched valuations and supply dynamics slightly outweigh growth uncertainty and subdued inflation expectations, and we hold a marginally cautious position.
Eurozone Government Bonds		Valuations appear full in the eurozone, where term premiums are the lowest among government bonds. However, in response to growth concerns, the ECB has continued to provide stimulus. The Next Generation EU recovery fund is progressing but still needs to be delivered to support peripheral markets. European yields have recently outperformed US equivalents, and we have moved to eliminate our slightly more constructive position.

Asset Class	Conviction	Our viewpoint
ALLOCATION TIER		
UK Government Bonds		Continued uncertainty over the impact of Brexit was weighing on sentiment before the virus threat increased, and weak productivity growth was holding back activity. The Bank of England has held interest rates close to the lower bound but provided additional stimulus in coordination with extended fiscal stimulus. We remain somewhat cautious overall, in line with other developed markets.
Canada Government Bonds		Canada is vulnerable to a hit in business confidence from recent oil-price volatility. Expectations for the Bank of Canada mirror those for the Fed. Canadian bond yields broadly match those in the United States and are likely to remain closely linked. We remain somewhat cautious overall, in line with other developed markets.
Japan Government Bonds		The Bank of Japan has maintained its monetary policy stance, which targets low 10-year government bond yields. It has also provided guidance that policy will remain stimulative for an “extended period,” with fiscal policy taking a larger role in providing stimulus. We believe low sensitivity to global yields is likely to continue, making this market somewhat more attractive in the case of a stronger global economic recovery. We maintain a relatively more constructive view, but an overall neutral position.
Investment Grade		The investment-grade sector has benefited from robust Fed support. Ample corporate liquidity offsets high leverage and the risk of ongoing defaults. Yield spreads have narrowed as the market has focused on central bank buying. Renewed widening may occur if the recovery slows, but valuations remain supportive in a global context. As such, we maintain a broadly neutral view.
High Yield		The persistent impacts of recession have weighed on the fundamentals for lower-rated fixed income sectors such as high yield. Default rates are easing from above-average levels and the outlook is improving. We have adopted a somewhat more constructive view on this market, reflecting longer-term attractions, balanced by caution over valuations that understate near-term fundamental uncertainties.
Emerging Market Debt		Emerging market fundamentals have been improving in recent months as foreign demand offsets continued domestic weakness. We regard emerging market local-currency bond valuations as supportive and more attractive than hard-currency bonds. Exchange-rate risks in local-currency bonds are balanced, in our view, by attractive relative valuations. We have adopted a more constructive view on these markets, but we continue to think selective positioning is important.
Alternative Assets (Pendulum settings relative to alternatives asset class broadly)		
Inflation-linked bonds		The level of inflation discounted in inflation-linked securities remains modest. We believe that these expectations may continue to normalize, even as overall inflation remains subdued. We retain a more constructive view of assets that benefit directly from rising prices, such as inflation-linked bonds.
Commodities		Risks to economic recovery have created a less supportive environment for broad commodities. However, we believe fiscal stimulus measures and liquidity support should boost growth and demand. Prices remain somewhat depressed, which balances subdued inflation pressures, and sees us retain a more constructive overall view.
Risk Premia		In an environment of slower growth but ample liquidity, we see mixed prospects across asset classes and in market-neutral or naturally diversifying assets. We hold a neutral view of risk premia, reflecting a balance between concerns over the reversal of established trends and the prospect of valuations becoming more attractive.

WHAT ARE THE RISKS?

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