FRANKLIN TEMPLETON INVESTMENTS

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Beyond Bulls & Bears Bulletin

INSIGHT FROM FRANKLIN TEMPLETON INVESTMENTS MANAGERS

IN THIS ISSUE: ***The articles in this issue are as at 27 February 2018.***

Italian Election Outlook and Why We Don't See an ECB Rate Hike Before 2020

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Italian Political Uncertainty

Most polls suggest there will be no outright winner in the upcoming Italian general election, due to take place on 4 March. We think the most likely outcome is either a technocrat government or a grand coalition—neither of which we'd expect to have a dramatic impact on bond markets.

However, it could be a different story if one group were to win enough seats to form a government, particularly if that group was the coalition of centre-right parties currently riding high in the polls.

The final opinion polls published ahead of the election suggested the coalition of centre-right parties (that includes the Silvio Berlusconi-led Forza Italia) could win the most seats. In contrast to traditional centre-right dogma, the Berlusconi coalition's manifesto calls for increased spending and a larger Italian budget.

It currently looks unlikely to reach enough seats to win an absolute majority, but if it did creep over the line, that outcome could have negative repercussions on Italian debt. The country's central bank would likely be issuing more government bonds (BTPs) at a time when one of the biggest buyers, the ECB, is scaling back its purchases of government debt.

Modest Volatility and Rising Yields in Europe

Looking more widely, we've seen little evidence so far that contagion from the global equity pullback at the beginning of February has spread into fixed income markets.

In European corporate markets, there's been some modest volatility (more at the index level) and we've seen some spread-widening, but nothing that's overly concerning to us.

European sovereign bond yields are higher this year and have risen a little more quickly than we expected. We felt they would rise in time, but while economic growth has been strong in Europe, inflation remains quite low. However, there are some signs of higher inflation coming through in the data.

ECB President Mario Draghi has indicated that keeping eurozone inflation just below 2% is a long-term target. This implies the ECB could be comfortable with inflation rising above 2% for a short period of time.

So our feeling is the bank's governing council will want to see inflation rising higher before it considers less-accommodative monetary policy.

Our current assumption is that eurozone quantitative easing (QE) will continue into next year and that the ECB will likely aim for its first interest-rate hike in 2020.

However, markets are starting to price in hikes even sooner. That's probably partially because some investors have been expecting yields to increase for quite some time. Understandably, people want to make sure they don't miss out, but we think the market is getting a little bit carried away.

Positive Fundamentals

In general, we think the underlying fundamentals for both investment-grade and high-yield corporate credit in Europe remain positive.

European companies in general appear to have good balance sheets, and borrowing rates are low. At the same time, there's some inflation coming back into the system in Europe, so companies are able to pass through price increases to customers. We see all of this as positive for corporate bonds in the region.

However, we think some valuations on the credit side have become slightly stretched. The widening spreads on the credit side may reflect a normalisation to compensate for some of the risk investors are taking.

While we recognise that the uptick in equity-market volatility may have contributed to the stretched credit valuations, uncertainty over the ECB's monetary policy path seems to also be playing a role. In particular, investors are watching for clues as to the timing and size of the ECB's QE tapering.

The current QE programme is due to expire in September of this year, and we think it's unlikely the ECB would end it abruptly then. So we think an extension, possibly featuring further tapering, is likely. That said, we don't expect the ECB to make an announcement about its tapering plans until at least the summer.

Draghi has indicated any decision on the future of QE would be driven by data. Waiting until the summer would give the central bank policymakers more data to consider. Meanwhile, our analysis suggests other considerations could affect the timing of interest-rate hikes.

The ECB has previously indicated that it wouldn't hike rates immediately after ending the QE asset purchase programme. Assuming the ECB extends the programme into early 2019, a moratorium of six to nine months would take us very close to the end of Draghi's tenure as ECB president.

We think it's likely the ECB would delay an interest-rate hike until the arrival of a new ECB president, which in practical terms pushes the first rate hike into early 2020.

We've been monitoring the ECB's buying habits since it cut the size of its asset-purchasing programme from €60 billion a month to €30 billion a month starting in January 2018. Although the total monthly purchases have halved, the amount of non-government assets bought—including covered bonds or corporates—has dropped only slightly from €10 billion a month to around €8–€9 billion a month.

So, government bonds have felt the bulk of the reduction in purchases. If QE continues into 2019 as we expect, it should likely remain focused on private assets.

Short Bouts of Volatility Likely

We reckon the low volatility in European fixed income markets we've seen over the last 12–18 months is probably behind us.

Although we don't think we're heading into a period of a high volatility, we think investors should accept there will likely be short bouts of it. We consider volatility an opportunity to invest if we see spreads widening on names that we think are solid.

Earnings Growth Underpins our Solid Outlook for European Equities

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In general, looking across Europe as a whole, we don't see much on the horizon to derail our solid fundamental outlook.

Still, because some of these fundamentals—for example, industrial production and purchasing managers' index (PMI) data—are doing so well, it may be hard to see significant improvements this year. On the other hand, we don't see any reason to think they'd slow down.

We think the corporate earnings environment should continue to improve, and that's where we'd be looking to see attractive year-on-year comparisons.

Potential Upside in European Earnings

Europe is only five or six quarters into its earnings recovery since the global financial crisis. That puts it three or four years behind the United States. So our analysis suggests plenty of upside in European corporate earnings.

Provided political risks remain low, we reckon it's likely earnings in Europe will continue to improve. In time that should lead to withdrawal of QE or at least some form of quantitative tightening and ultimately some kind of eurozone interest-rate hike, possibly even in 2019.

The composition of European equity markets tends to be skewed towards financials and energy which are more inflation/bond-sensitive and yield-sensitive companies.

From a sector perspective, energy, materials and financials make up more than a third of the MSCI Europe Index.[1] Many of these companies tend to do well when inflation is rising and bond yields are rising because typically inflation nudges up commodity prices and financial companies tend to profit when the yield curve steepens.

So, a rising interest-rate environment should be positive for European earnings.

Operating Leverage Is a Positive

On the other hand, we don't expect European earnings to hit the highs of 10 years ago, because there is no longer the leverage in the banking system.

Conversely, there is a lot of operating leverage on the corporate side. Thanks to labour reforms in Spain, France and—earlier in

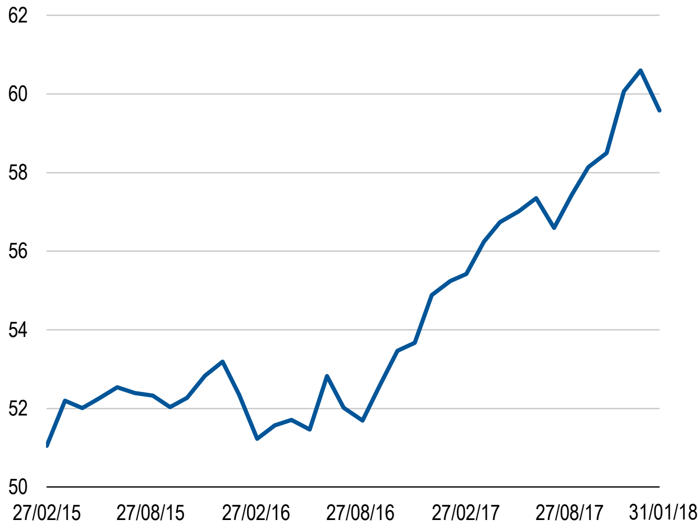
Purchasing Managers' Index Data

Markit Eurozone Services PMI
27/02/2015 through 31/01/2018

Source: FactSet, Markit.
Note: National services data are included for Germany, France, Italy, Spain and the Republic of Ireland.

Purchasing Managers' Index Data

Markit Eurozone Manufacturing PMI
27/02/2015 through 31/01/2018



Source: FactSet, Markit.
Note: National manufacturing data are included for Germany, France, Italy, Spain, the Netherlands, Austria, the Republic of Ireland and Greece.

the decade—Germany, the cost base of European companies is much more flexible. That should mean these companies have a greater capacity to grow earnings through increased profitability.

Significantly, that kind of leverage is not on company balance sheets but is on their profit-and-loss (P&L) accounts. Instead of putting further debt in the banking system and within the corporate world, we believe the upside is that profits will come from lower cost bases and perhaps from charging higher prices.

The US industrial base went through similar changes in the early 2000s and came out much more competitive. Europe is only just starting to go through this.

France and Eastern Europe Offer Potential Opportunities

French President Emmanuel Macron's reform agenda, which encompasses not just labour practices but taxes as well, should present some interesting ideas. As investors we're looking there for opportunities that others in the market are not grasping.

Eastern Europe may prove to be an area of opportunity in the medium term. Recently we've found equities in that region to be very expensive. Corporate governance risks and political risks are higher than elsewhere in Europe, but valuations are higher so we believe it doesn't really make sense to find ideas there; you can find equivalents in core Europe.

However, we expect the United Kingdom's departure from the European Union to leave a considerable hole in the trading bloc's budget, some of which will fall on eastern European member states to fill.

If that were to start to leave budgets in the likes of Poland, the Czech Republic, Hungary or even Austria feeling a little stretched, their equity markets could devalue a little bit. Certainly we'd consider that an opportunity to look for some bargains.

Further out, we're looking at how to play some of the more domestically focused stocks in the United Kingdom.

One consideration at the front of our minds is: "At what point do domestic UK stocks start to look cheap?"

Echoes of the Past

I liken the current attitude to Brexit in the UK to the situation in 2008–2009 when most capital expenditures and corporate investments were put on hold.

It's similar today: Until people know what the post-Brexit rules are, they are postponing investment, hiring and capital-expenditure decisions.

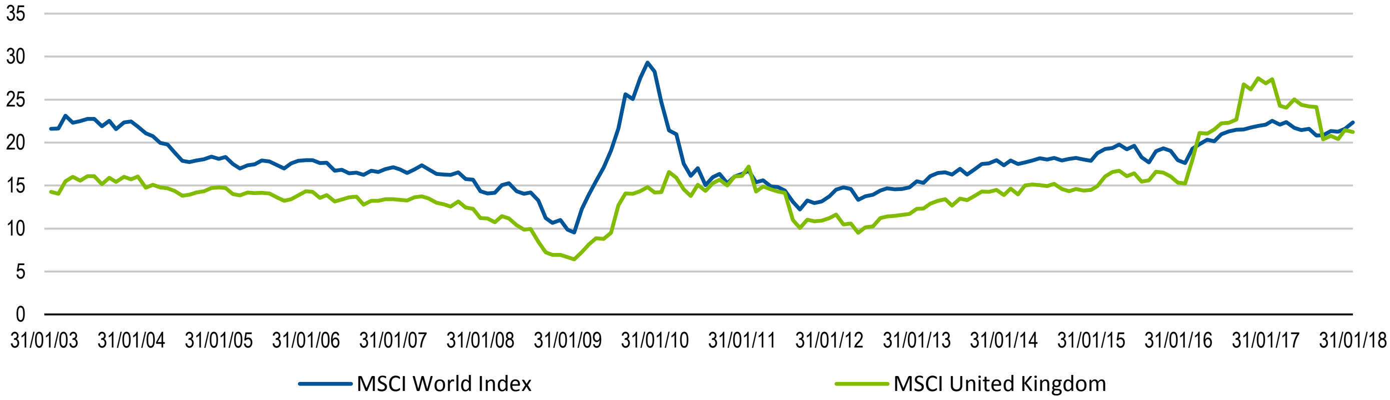
But the supply shock stemming from those decisions has yet to work its way through the economy, and we don't yet know what the implications of that shock will be on demand.

The valuations of many UK domestic stocks are starting to reflect that pessimism. We think prices should eventually revert to the mean; the main question is timing.

So we're aware that it could soon be the moment to find some bargains amongst domestic UK equities.

UK Market: Price to Earnings (P/E)

P/E (LTM): MSCI UK Index versus MSCI World Index
31/01/2003 through 31/01/2018



	31/01/2018	5-yr Avg. P/E	15-yr Avg. P/E	Relative to 5-yr Avg. P/E	Relative to 15-yr Avg. P/E
MSCI United Kingdom	21.2x	18.0x	14.7x	17.9%	44.8%
MSCI World Index	22.3x	19.2x	17.9x	16.3%	24.9%

Price-to-Earnings or P/E (12-mo trailing) represents the share price of a stock, divided by its per-share earnings over the past year. For a portfolio, the value represents a weighted average of the stocks it holds.

Source: FactSet, MSCI. The MSCI UK Index is designed to measure the performance of the large- and mid-cap segments of the UK market. The MSCI World Index captures large- and mid-cap representation across 23 developed-market countries. 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. **Past performance does not guarantee future results.**

Saudi Arabia's Emerging-Market Pursuit

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Global index provider MSCI indicated last year that it was considering Saudi Arabia for an upgrade to its MSCI Emerging Markets Index.[2] If that decision is confirmed later this year, Saudi Arabia could officially become an emerging market in the eyes of the broader investment community when this potential classification change takes effect in 2019.

Our analysis suggests Saudi Arabia's potential upgrade to emerging-market status could prove to be transformative for the Kingdom's stock market. We think the benefits for Saudi Arabia of such a move could be substantial. It could mark a significant long-term opportunity for strong investment returns and asset growth in the Kingdom and in the wider Middle East and North Africa (MENA) region.

Like most emerging-market upgrades, equity markets in the United Arab Emirates (UAE) and Qatar saw an uptick in foreign asset flows in the preceding 12-month period to their gaining official emerging-market status with MSCI, and we believe the same could happen for Saudi stocks.

With approximately US$1.6 trillion in active and passively managed money tracking the MSCI Emerging Markets Index, we'd anticipate the announcement of Saudi's emerging-market status could bring significant foreign investment. We'd expect this fresh flow of capital to potentially trickle to the surrounding markets, too.

From a regional perspective, Saudi Arabia's economic output and its US$450-billion equity market tower over the rest of MENA. If Saudi Arabia were to have a 5% weighting in the index—which would include the proposed initial public offering (IPO) of the state-owned Saudi Aramco oil company—MENA representation in the index could be comparable with other emerging-market countries in the index such as India (8.4%) or Brazil (7.3%).[3]

Recognition for Opening Up Saudi's Markets

In our view, Saudi Arabia's inclusion on MSCI's emerging-market "watch list" for a possible upgrade is recognition of the Kingdom's progress in liberalising its capital markets since May 2015.

The Saudi Capital Markets Authority (CMA) and Saudi Arabia's major stock exchange, the Tadawul, in particular have made efforts to ensure the Kingdom's equity market is compliant with international trading standards.

Developments include introducing a two-day settlement cycle for trades, requirements for cash payments to be made on delivery of shares (delivery versus payment), proper failed trade management, the introduction of short-selling, and securities borrowing and lending facilities.

A New Chapter in the Saudi Story

There are reasons to believe Saudi Arabia's upgrade could come sooner than some commentators first expected. Pakistan's upgrade to emerging-market status in May 2017 came after just one year on the "watch list." We anticipate Saudi Arabia could follow a similar fast pace of index inclusion.

The Kingdom's inclusion will be determined by a MSCI consultation with asset owners, asset managers and those on the sell side.

So far, investor feedback has been positive. We would expect Saudi Arabia's journey through the MSCI process to play out as follows: inclusion in the MSCI Emerging Markets Index to be announced in June 2018, with effective index implementation starting in May 2019.

Given the size of Saudi Arabia's equity market, we would not be surprised to see its inclusion split into two equal phases. For example, for an estimated 5% weighting of the index, 2.5% could be implemented in May 2019, and the remaining 2.5% in August 2019. However, we believe this deadline is subject to investors examining whether it's plausible, given the Saudi market's infrastructure.

For Saudi Arabia, an emerging-market designation may be just the starting point. The Saudi government plans to increase the number of companies listed on its stock market by nearly 50%, from 170 to 250 companies, over the next four years. And there's a robust 80-strong IPO pipeline. These factors lead us to believe that the Kingdom's equity markets are very much in a growth phase. And that, we believe, is a welcome step that could bring recognition to the Kingdom, and the wider MENA region.

What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Value securities may not increase in price as anticipated, or may decline further in value. To the extent a portfolio focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a portfolio that invests in a wider variety of countries, regions, industries, sectors or investments. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets.

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