February 2023

Franklin Templeton Investment Solutions

Allocation Views

The mood music changes

The first month of 2023 was quite the contrast to the dismal financial market returns posted last year. We have seen a growing belief form in markets that inflation—the prime driver of last year's pain—has not just peaked but is finally moderating. This has been complemented by optimism relating to China's reopening and economic data in Europe that suggest near-term recession risks have been averted. You might say the "mood music has changed."

As we discussed in last month's Allocation Views, this is perhaps a case of markets having already discounted the likely pause in developed market growth. In addition, the relatively mild winter in Europe, which has led to unusually full reserves of natural gas (and sharply lower prices), can be viewed through an economic lens as one of the more extreme tail risks having been dodged. But has the outlook actually improved noticeably? Or is it just a matter of the phasing of periods of slightly more, or slightly less, sluggish growth. We continue to anticipate that the cumulative effect of monetary policy tightening will have a dampening effect on economic activity. We also believe the consequences of the cost-of-living crisis have not been evaded and that corporate profit margins may have further to fall if wages attempt to catch up with prices. This is likely to see growth slow—not just to below trend levels, but toward a standstill. However, with a more optimistic background, and listening to a happy tune being played by market participants, it would be easy to get carried away and believe that all was well.

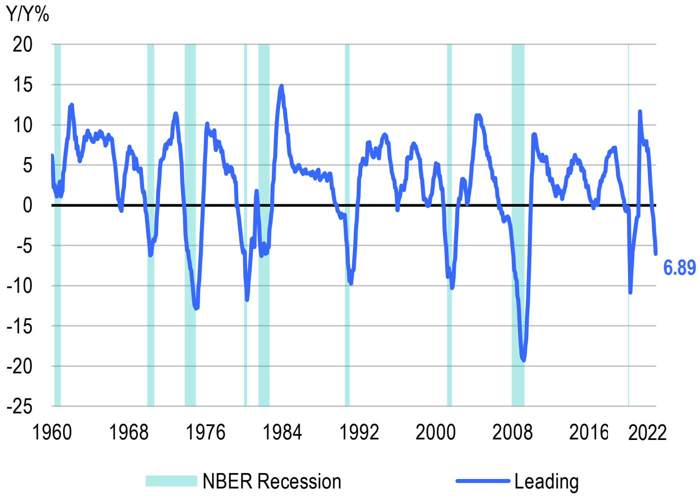
One area where this optimism perhaps sits on more solid foundations is in Asia. The reopening of China's economy and rising demand for regional travel may help to support China's neighbors. The health consequences of a slightly chaotic relaxation in China's COVID restrictions have not been as bad as some might have feared, and the domestic service sector should continue to benefit from the follow through into sustained acceleration in growth. However, the Chinese authorities continue to balance a desire to promote growth with a need to maintain stability. Neither housing market risks nor fears of further regulatory action have gone away. We have seen that the change in tune regarding China's zero-COVID policy has improved the mood of equity investors, especially locally, but we would be less certain that China will drive any appreciable improvement in gross domestic product (GDP) for the rest of the world or lessen the risk of recession in the western developed economies to a meaningful extent.

The trough in economic activity is likely still ahead of us, as leading indicators suggest a period of weak growth (see Exhibit 1), even where current activity has held up reasonably well thus far. If the full impact of ongoing monetary policy tightening remains to be felt, then it is unlikely financial markets can post a sustained rebound at this time. Our analysis remains more certain in the view that headwinds persist; whether this results in a recession is probably less important than the direction of travel. This is reflected in our primary theme that is revised to note that **"Growth Is Below Trend"** and recession risks are high globally, but increasingly bifurcated between East and West.

Leading Indicators Show Growth is Weakening and Below Trend

Exhibit 1: US Conference Board Composite Leading Economic Indicators

As of December 31, 2022



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

Inflation has peaked

Part of the improving sentiment in markets, as we noted above, is due to inflation appearing to have peaked. This is true globally at the headline level, including the direct effects of energy prices. One of the areas that has received particular attention is European natural gas prices (see Exhibit 2), but broader measures of commodities have also reversed substantially all of their gains since the invasion of Ukraine in February 2022. As this round trip in prices recedes into the past, it will provide easy comparisons against which current Consumer Price Index (CPI) levels will be judged. This will result in expectations of an ongoing drop in headline CPI inflation being realized, unless other components rise to offset it.

However, with labor markets tight—especially in the United States, but also in the United Kingdom—wage pressures remain the dominant concern of policymakers. So long as job openings remain elevated and employers struggle to fill vacancies with appropriately skilled applicants, core measures of inflation will be slow to normalize. These pressures are particularly acute in the service sector, where productivity gains can be harder to come by and automation is more problematic. As a result, many central bankers continue to have a laser focus on developments in employment and the labor force. Even as we become more certain that headline inflation has peaked, it is too early to sound the "all clear" from a policymaker's perspective.

Commodity Price Declines Confirm Headline Inflation Peak

Exhibit 2: European Natural Gas Front Month Futures Contract

As of January 31, 2023

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

Although supply-push inflation is reversing, we believe demand destruction will increasingly be the dominant force as the economic cycle slows. These developments reinforce our view that companies will face softer demand, just as the lagged impacts of wage gains and interest-rate rises are felt. A continued drag on profit margins is likely to drive weaker employment trends and a deceleration in core inflation. This will be a catalyst for central bank policy to change, but it is not in place yet. We believe the current focus on inflation and the debate around the rate of policy normalization will be the key determinants of monetary policy actions as the year progresses. However, we do see movement in a more constructive direction and have revised our second theme to reflect **"Inflation Risks Are Now More Balanced."**

Policy remains a headwind

The improved mood of investors can be linked to hopes for a less restrictive path for monetary policy—if not now, then later in the year. However, it seems that central bankers in the developed world remain more concerned about the risks of letting inflation expectations become embedded in the behavior of businesses and consumers than anything else. They have repeated this mantra is recent weeks, even as they recognize that the accumulated tightening across the major developed economies appears to be starting to have some impact. The US Federal Reserve (Fed) slowed the pace of rate hikes to a more normal cadence at its early February meeting and talked optimistically of a disinflationary process that is underway. The Fed indicated it was getting closer to the end of its tightening cycle but did not suggest that it viewed the cycle as "job done." What the Fed did say was that the central bank would be highly data dependent in executing its monetary policy objectives.

This contrasts with the Bank of Japan (BoJ), which is still at the start of this process and yet to make a first move toward more normal interest rates. Still, the Fed's message resonated with comments from the Bank of England (BoE) as that central bank hinted at an imminent pause to rate hikes. And even the European Central Bank (ECB) sounded more circumspect even as it and the BoE continued to hike at a relatively rapid pace. The ECB resisted the temptation to give strong forward guidance beyond stating that it would make decisions on a meeting-by-meeting basis. This was viewed initially as supporting the idea that a peak in rates was approaching. However, we think the more accurate observation is that the lack of guidance, and increased data dependence, will leave financial markets more vulnerable to changes in the interpretation of the economic outlook. It also reinforces our view that policymakers remain laser focused on inflation.

Taken together with the prospects for a continued slimming of central bank balance sheets, expected central bank hikes will moderate negative real rates and sustain restrictive conditions.

Although fiscal policy has responded to energy costs in some countries, especially in Europe, it will be slow to sway dovish in others, leaving it more differentiated across economies. However, the ongoing tilt in global policy is still quite hawkish. Overall, this sees our final theme complete a set of three still quite negative drivers for markets, even as it evolves to downplay the pace of hikes while emphasizing **"Policy to Remain Restrictive"** as we move through 2023.

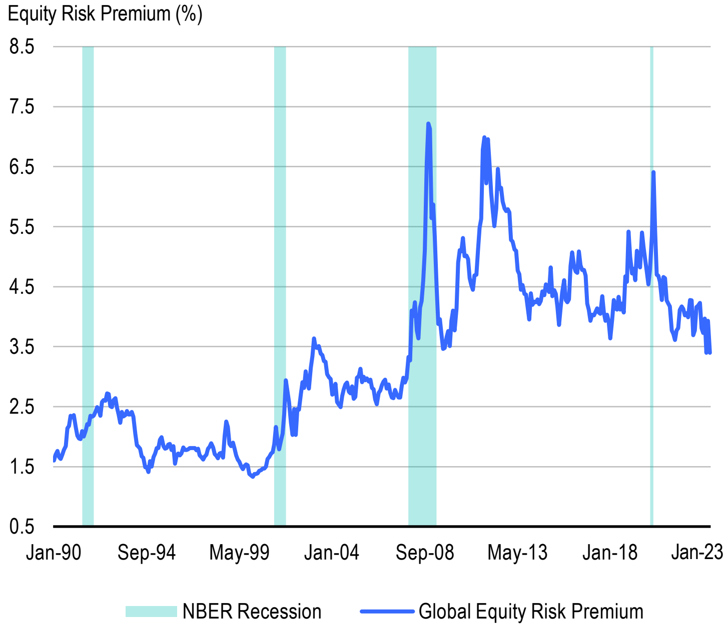
Equity valuations had moderated (the multiples of earnings at which stocks trade fell considerably), but the levels of anticipated earnings per share have yet to decline meaningfully. The more recent improvement in sentiment and recovery in stock prices appear to underplay ongoing concerns around economic growth, inflation and likely policy responses. Investor sentiment may have got ahead of itself and supports us remaining moderately cautious in our view of stocks, rather than becoming bolder.

We entered 2023 with an allocation preference away from stocks, which we have retained in recent months, but over the next few quarters, we anticipate that a nimble investment management style will continue to be required. We are more attracted to the yields available in high-quality government bonds, although they too may have discounted an overly sanguine view about an imminent end to the rate-hike cycle. Although we still see attractive longer-term return potential for stocks and believe they should earn their equity risk premium over time (see Exhibit 3), this premium is not high enough to reflect the uncertainties markets currently face or support an equity preference at this time, in our assessment.

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

Exhibit 3: Global Equity Risk Premium

As of January 31, 2023



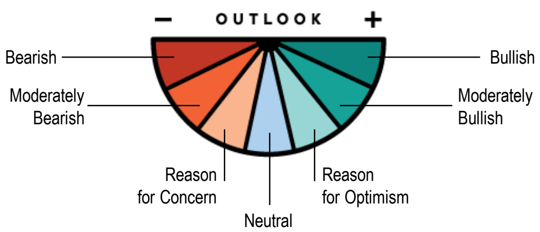
Sources: Bloomberg, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

Allocation settings views—February 2023

Pendulum settings reflect cross-asset class views

Asset Class	Conviction	Our viewpoint
Risk tier **Risk Off/On**		Global growth has slowed to below trend but is stabilizing in the developed world. This is driven by the impact of monetary policy tightening. Despite the ongoing Russia-Ukraine war, peak inflation likely has been passed as goods and commodity prices decline. We maintain a more cautious stance toward riskier assets as recession probabilities remain elevated and some regions may already be in recession.
High level allocation tier		
Equities		In broad terms, global equities require sustained earnings to support current valuations. Earnings expectations generally do not reflect recession and remain vulnerable to ongoing margin pressures. Tightening monetary policy offsets longer-term equity fundamentals that are still relatively supportive. We remain nimble in our level of conviction but continue to reflect reasons for concern in a somewhat defensive stance toward global equities relative to bonds.
Bonds		Long-term valuations are fair, in our assessment, and monetary policy is still expected to tighten further. However, decelerating growth and heightened global uncertainties balance this view. Corporate bond spreads may not fully reflect an anticipated increase from currently low default rates. We have moved to a more constructive view of bonds at the asset allocation level, but favor higher-quality bonds, which reflect the pace of rate hikes that is already discounted.
Alternatives		We see structural attractions in naturally diversifying alternatives such as private assets. High recession probabilities present headwinds to real estate. The benefits commodities may afford through tightness of supply are balanced by the risk of higher interest rates increasing the risk of higher default rates to private credit. We have maintained a neutral view overall, consistent with our longer-term structural allocation.
Cash		The defensive features of cash are complemented by higher yields as short-term US Treasury bills now reflect higher policy rates and no longer present a drag on portfolio yield. Cash can have attractions as a means of diversification and as a complement to the potential attractions of higher-risk asset markets, but we hold a neutral view at this time.

Understanding the Pendulum Graphic



Arrows represent any change since the last month-end.

Asset Class	Conviction	Our viewpoint
Allocation tier		
Equity Regions (Pendulum settings relative to equity asset class broadly)		
United States		Generally healthy US corporate balance sheets may help this market better weather a global slowdown. The outlook is more balanced as profit margins may remain under pressure in the coming quarters. The stock market's attention will likely focus on whether earnings can support current valuations as the remaining interest-rate hikes are delivered and a recession becomes the most likely outcome. We have scaled back our bullish stance but still reflect a relatively constructive view of this market.
Canada		Growth in Canada faces headwinds from high inflation and an aggressive central bank response. However, accumulated interest-rate increases support Canadian banks, although energy producers have faded as a support for the market even as ESG (environmental, social and governance) concerns ease. We have moderated our conviction, even with continuing valuation attractions, and now maintain a neutral view of this market.
Europe ex UK		Europe faces headwinds to consumer and business activity as ECB interest-rate rises continue, while the Russia-Ukraine war, which is entering its second year, remains a drag on confidence. Corporate earnings results may disappoint, and geopolitics pose an ongoing threat to regional equities. We have moderated our bearish stance to reflect the diminished risk of recession, as energy supply concerns for this region and elevated natural gas prices have eased.
United Kingdom		UK economic prospects remain uncertain, dimmed by fiscal and monetary tightening, reflecting trade weakness and significant European revenue exposure. A low weight to technology and significant foreign currency earnings offset the attractions of a high dividend yield. On balance, we have retained a neutral view on this market, reflecting some caution over persistent headwinds.
Japan		Japan appears well placed to benefit from its cyclical economic rebound, due to its sensitivity to China's reopening and from global capital expenditure. Corporate earnings are growing strongly, and equity valuations, particularly on a price-to-book-value basis, remain attractive relative to other markets, in our view. We have maintained our relatively constructive view of this market in recent months.
Pacific ex Japan		Commodity exposure has been supportive for this region overall. However, it remains vulnerable due to tensions in relations with China more broadly. Strong inflation in Australia and higher interest rates are likely to impact consumers. We lowered our conviction level recently and now maintain a neutral stance on these markets broadly, even as we are less cautious on Hong Kong and Singapore, which reflect valuations we regard as somewhat supportive.
Emerging ex China		Stronger long-term growth opportunities are being offset by emerging markets' idiosyncratic risks and exposure to slowing demand from developed market consumers. Local inflation pressures, especially for food-importing nations, have seen central banks continue to increase interest rates. We believe prospects for currency recovery across emerging markets are insufficient to fully offset these other factors, and we have retained a moderately cautious view of these markets.
China		China's economy should benefit from the removal of zero-COVID restrictions. However, the reopening looks "bumpy" and is compounded by remaining property market risks, which have led to an easier policy environment. Trade disputes remain unresolved in the longer term and are a symptom of broader tensions as heightened geopolitical stresses persist. Regulatory concerns that dominated market sentiment are slowly fading, and we have moved to a more constructive view of this market as valuation attractions offset residual risks.
Fixed Income Sectors (Pendulum settings relative to fixed income asset class broadly)		
US Treasuries		The Fed continues to emphasize a more hawkish response to inflation and may prompt further periods of volatility in US Treasuries. However, yields repriced significantly to reflect policy rates moving to restrictive levels, and as growth slows, we anticipate lower yields in a year's time. Having added to interest-rate sensitivity overall in recent months, we have tempered our optimistic view of US government bonds, relative to those of other developed markets, as yields fell.
Inflation-Linked Bonds		The level of inflation discounted in inflation-linked securities has moderated from elevated levels early in 2022. We believe these expectations fairly reflect anticipated longer-term inflation, even as current realized inflation is likely to remain elevated for a while. We have maintained a neutral view of assets that benefit directly from rising prices, such as inflation-linked bonds, as policy tightening reduces the value of their potential risk-mitigating role within a portfolio.

Asset Class	Conviction	Our viewpoint
Allocation tier		
Eurozone Government Bonds (neutral)		The ECB remains concerned by higher inflation levels, and further rate rises still seem likely even as they move into restrictive territory. However, given risks to demand growth in the European economy, the extent of future rate rises is particularly uncertain at this time, but likely to be less than the market currently discounts. We have added marginally to this region but have maintained a broadly neutral stance.
UK Government Bonds		The country's economy is heading for recession, and structural issues persist. Gilts have decoupled from global equivalents at times, reflecting pension fund liquidity issues. Inflation risks remain elevated and have moved the Bank of England to tighten policy sharply, but further rate-hike expectations are moderating. We have moved to a more constructive stance as risks of a policy error are elevated, in our assessment.
Canada Government Bonds		Canada has benefited from commodity price rises, and the Bank of Canada has moved aggressively amid high inflation and a tight labor market. However, the interest rate-sensitive nature of the economy may start to be felt. Canadian bond yields have lagged recent moves up in the United States. We eliminated our cautious stance in recent months and remain neutral, in line with other global markets.
Japan Government Bonds		The BoJ has reiterated its easy monetary policy stance but unexpectedly moved to widen the band it uses to target low 10-year government bond yields. Monetary policy remains stimulative for now, but it is expected to tighten in the next 12 months, and this move has supported the Japanese yen. We have moved to a significantly more cautious stance on this market as the divergence from other developed markets could be quite notable.
Investment Grade		The investment-grade sector has benefited from ample corporate liquidity and earnings levels that make high debt loads more sustainable. Investor confidence was hit by monetary policy tightening, and spreads widened alongside rising Treasury yields. Having eliminated our defensive stance at notably higher yields, and maintained a marginally constructive view in recent months, we have returned to a truly neutral view of higher-quality credit.
High Yield		Corporate earnings continue to support the fundamental attractions of lower-rated fixed income sectors such as loans and high-yield bonds, despite the impact of policy rate rises. We tempered our conviction toward high-yield credit last year following a period of rising volatility and wider spreads. Following a sharp recovery, even as recession risks persist, we have progressively built a more definitively cautious stance toward high-yield bonds and loans overall.
Emerging Market Debt		Emerging market fundamentals remain challenging as foreign demand compounds ongoing domestic weakness and food price inflation. We remain cautious on emerging market hard-currency bonds, as valuations reflect debt servicing concerns, and local-currency bonds are less compelling to us on fears of higher global policy rates. We have recently eliminated a marginally constructive view on China's local bonds and continue to think selective positioning is important.

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