Allocation Views

Perspective from Franklin Templeton Investment Solutions

October 2022

Strains beginning to show

The last two months have seen short-term correlation between bonds and stocks remain remarkably high. The issues that have concerned financial markets broadly, have worried them all, almost universally. Only the magnitude of the response seems to vary across asset classes. As we discussed in Allocation Views last month, the impact of rising real yields has been felt in equity markets and currencies just as much as in the bond market, which was the epicenter of the move. We expect that these developments will increasingly cascade through the real economy, as yields have continued to rise sharply through the end of September, and they help to explain some of the market turbulence seen in recent weeks.

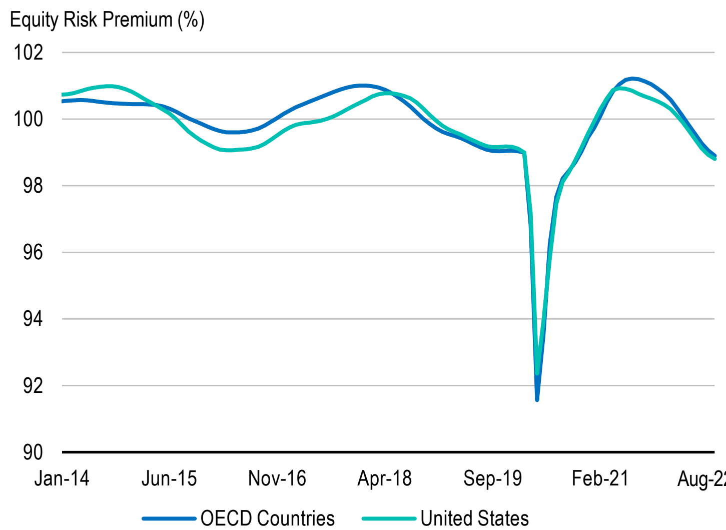
As the impact of the war in Ukraine developed from an energy supply problem into a cost-of-living crisis in much of Europe, we have seen greater differentiation in the fiscal response of governments. Some of the strongest economies, such as Germany, have led the way in attempting to insulate their citizens and businesses from at least some of the direct and indirect impact of the crisis. Others such as the United States have provided less direct support but have released reserves of oil to dampen the market reaction. However, the ability of other, less fiscally secure economies to maintain a similar level of protection as Germany will increase strains within the European Union (EU). The victory for the far-right in Italy's recent general election may complicate relations within the EU still further.

Different strains emerged in the United Kingdom, where the new government of Prime Minister Liz Truss attempted to boost growth by proposing un-funded tax cuts for both consumers and businesses. Taken together with significant, untargeted intervention to offset the rising cost of energy, this prompted a sharp weakening of the currency and a linked rise in government bond (Gilt) yields. The pace of these moves led to a feedback loop of distress in certain parts of the defined benefit pension industry, prompting the Bank of England to intervene in the Gilt market to avoid mounting financial stability risks.

Indicators of Growth Momentum Show Ongoing Slowdown

Exhibit 1: OECD Composite Leading Indicator

As of August 31, 2022



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

Finally, in Japan, the consequences of domestic monetary policy remaining resolutely accommodative, led to an ongoing depreciation of the Japanese yen against the US dollar. The divergent paths of both inflation and interest rates, when compared to the United States, both justified the move and complicated the policy response, in our view. The decision of policymakers to intervene directly in the foreign exchange market, which saw the Bank of Japan buying the local currency in an attempt to at least arrest its depreciation, has provided short-term respite. However, like the Bank of England's purchase of Gilts, neither measure is guaranteed to resolve the market strains that are starting to emerge across the globe. And we wouldn't be surprised to observe additional market dislocations going forward.

Indicators of economic growth momentum point to an ongoing slowdown (see Exhibit 1 above), and risks remain still firmly skewed to the downside, accentuated by policy tightening and China's continuing zero-COVID approach. Increasingly, we see a squeeze on real incomes stunting consumption growth, even as households have taken advantage of their strong financial position. Although we are not in one yet, the probability of a recession over the next year is now meaningful and rising globally, with risks most evident in Europe. Our analysis has grown more certain in the view that activity continues to moderate, reflected in our primary theme that concludes **"Growth Is Slowing to Below Trend."**

This conviction is important for our outlook for risk assets as our analysis suggests that markets usually trough around the same time as the macroeconomic data—within a few months of each other. Markets can and do recover before the end of a recession, but it seems unlikely that they would trough before its onset.

If the trough in economic activity is still ahead of us, and the full impact of ongoing monetary policy tightening remains to be felt, then it is unlikely that financial markets can post a sustained rebound at this time. We believe any recovery in market sentiment, which may again occur given the current degree of pessimism, is more likely to be a bear-market rally than a new bull run.

We moved to trim our top-level allocation preference for equities at the start of this year and took advantage of the ebbs and flows of sentiment that occurred during its early months to progressively temper our optimistic view back to neutral in April. We continue to believe that a nimble investment style remains appropriate, and in July we moved to establish an allocation preference away from stocks, which we have retained as we do not see a sustained rally at this stage.

Equity valuations have moderated (the multiples of earnings at which stocks trade have fallen considerably), but the levels of anticipated earnings per share remain close to their peak. This appears to ignore ongoing concerns around economic growth, inflation and likely policy responses that continue to weigh on investor sentiment and to support us remaining more cautious in our view of stocks, rather than becoming bolder. We are more attracted to the yields available in high-quality corporate and government bonds. Although we still see reasonably attractive longer-term return potential for stocks and believe they could earn their equity risk premium over time (see Exhibit 2), we struggle to find a strong argument supporting an equity preference at this time.

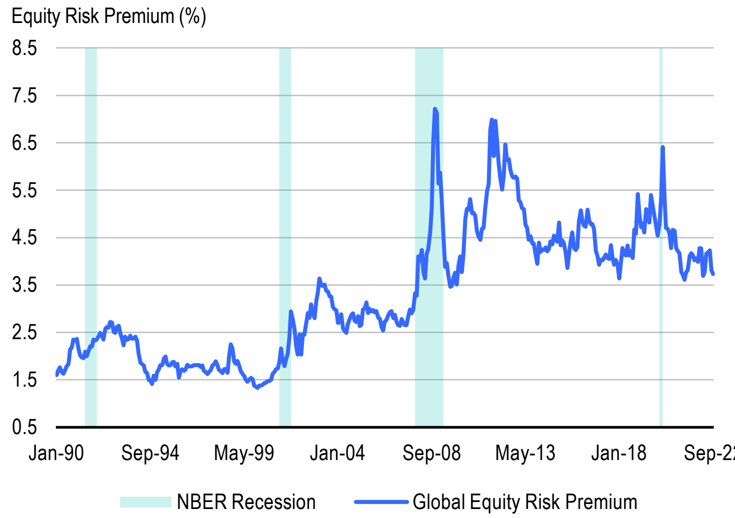
Inflation not yet defeated

In recent months, the drivers of inflation have changed somewhat. Commodity prices have eased, even as the energy crisis remains front and center of the investment debate. Stickier components of inflation, such as housing costs and the feed-through to wage rises, are taking up a bigger share. However, the squeeze on real increases is expected to retard consumption growth and may lessen corporate pricing power. Although supply-push inflation has driven headline figures higher in the post-COVID world, we believe demand destruction will increasingly balance these forces as the economic cycle slows.

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

Exhibit 2: Global Equity Risk Premium

As of September 30, 2022



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These developments make it more likely that the peak of global inflation is in place, even if it is undoubtedly also a sign of the pain that still-elevated prices are exerting on consumers globally. This is a necessary first condition for central bank policy to change, but it is not sufficient. It does not lessen the current focus on inflation and the debate around the pace of policy normalization, which will be a key determinant of monetary policy actions in the months ahead. Even as inflation eases, we will probably see the trend rate of price gains remain a little more elevated than we have seen in past business cycles. Accordingly, our second theme continues to reflect **"A Challenging Inflation Environment."**

Central bank policy has a singular focus

To complete our review of the major themes driving our allocation preferences, the policy environment remains a notable headwind to risk assets. Even as the strains that we note above are having an impact on markets, and prompting unconventional responses from policymakers, it is hard to envisage a broad-based pivot towards easier conditions. Indeed, since the US Federal Reserve's (Fed) symposium at Jackson Hole, in August, it seems that most central banks in the developed world have adopted a singular focus on inflation. They have been increasingly transparent that the battle against inflation must be fought, whatever the collateral damage to growth or employment. Indeed, it seems like they are accepting of the fact that it will require these things to happen to have any meaningful impact on prices.

When we look beyond the short-term rates that central banks control, and out to longer maturity bonds and high-quality corporate debt, we would assume that a return to more normal levels of correlation might occur in the medium term. However, the real yield-driven market environment that we have seen over recent quarters, has lessened these assets' potential diversification attractions, in our assessment. Once the current policy-tightening environment starts to moderate, it is likely that government bonds will again exhibit more of a risk-dampening effect. Until then, we believe bonds do make a more compelling case than they have for many years. Corporate bond spreads have risen sharply and largely reflect an anticipated increase from currently low default rates. We hold a more constructive view of bonds at the asset allocation level, established recently at notably higher yields (see Exhibit 3), reflecting the pace of rate hikes that is already discounted.

Taken together with the prospects for a slimming of central bank balance sheets, expected central bank hikes will moderate negative real rates and quickly move to restrictive conditions. Although fiscal policy is responding 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 anticipated shift in global policy is still quite hawkish. Overall, this sees our final theme complete a set of three unambiguously negative drivers for markets, as it reflects that **"Policy Continues to Tighten Sharply."**

Investment-grade Bonds Offer Notably Higher Yields

Exhibit 3: Yield to worst of US corporate investment-grade bonds
As of September 30, 2022

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

Allocation settings views—October 2022

Pendulum settings reflect cross-asset class views

Asset Class | **Conviction** | **Our viewpoint**

Risk tier

Risk Off/On

Global growth is slowing to below trend, and risks remain skewed to the downside, accentuated by the impact of monetary policy tightening. This complicates continuing supply pressures, including the ongoing war in Ukraine, in boosting inflation. We adopted a neutral stance toward riskier assets earlier in the year, even as corporate fundamentals remained generally strong. Last quarter we moved to a more cautious view as recession fears have risen.

High level allocation tier

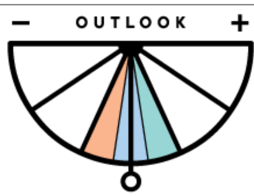
Equities

In broad terms, global equities require continued earnings growth to offset any further normalization of valuations. Earnings expectations remain elevated and vulnerable to downgrades. Tightening monetary policy has led to a rise in volatility, which offsets longer-term equity fundamentals that are still relatively supportive. We remain nimble in our level of conviction but continue to reflect mounting reasons for concern in a more defensive stance toward global equities relative to bonds.

Bonds

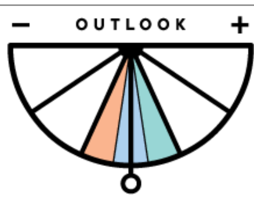
Long-term valuations are fair, in our assessment, and monetary policy is still expected to tighten sharply. However, decelerating growth and heightened global uncertainties balance this view. Corporate bond spreads have risen sharply and largely reflect an anticipated increase from currently low default rates. We have moved to a more constructive view of bonds at the asset allocation level, at notably higher yields, reflecting the pace of rate hikes that is already discounted.

Alternatives



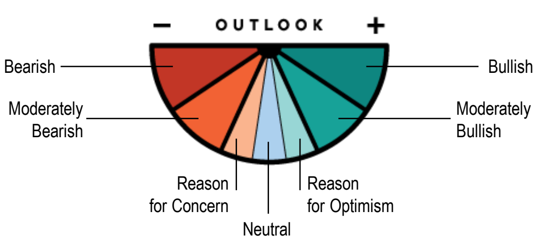
We see structural attractions in naturally diversifying alternatives such as private assets. Economic expansion supports demand for real estate, and the gradual post-COVID normalization of work and activities has materially reduced risk for this asset class. The benefits commodities may afford through tightness of supply are balanced by the risk of higher interest rates to private credit. We maintain a neutral view overall, consistent with our longer-term structural allocation.

Cash



The defensive features of cash are diminished in a challenging inflation environment. Short-term US Treasury bill yields now reflect higher policy rates, but ample liquidity continues to 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.

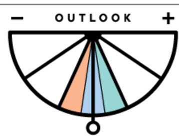
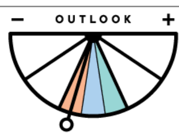
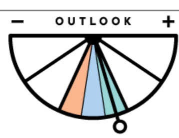
Understanding the Pendulum Graphic



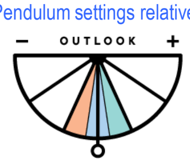
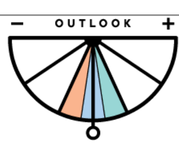
Arrows represent any change since the last month-end.

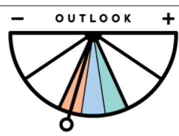
Allocation tier

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

Asset Class	Conviction	Our viewpoint
United States		Generally healthy US consumer and corporate balance sheets may help this market better weather a global slowdown. The outlook is more balanced as profit margins may come under pressure in the coming quarters. The stock market's attention will likely focus on still-elevated valuations and the extent to which interest-rate hikes and fears of recession cause them to decline further. We continue to build a more definitive bullish stance to reflect our relatively constructive view of this market.
Canada		Growth in Canada faces headwinds from high inflation and an aggressive central bank response. However, ongoing interest-rate increases may support Canadian banks, although energy producers have faded as a support for the market even as ESG (environmental, social and governance) concerns ease. We continue to moderate our conviction, but valuation attractions see us retain a marginally constructive view of this market.
Europe ex UK		Europe faces headwinds to consumer and business activity due to higher energy prices and a hit to confidence because of the war in Ukraine. Corporate earnings results may disappoint, and geopolitics pose an ongoing threat to regional equities. As European Central Bank (ECB) interest-rate rises continue, we maintain our more definitive bearish stance to reflect the risk of recession among growing reasons for concern regarding this region.
United Kingdom		UK economic prospects remain particularly uncertain, 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 retain a neutral view on this market, reflecting some caution over persistent headwinds.
Japan		Japan appears well placed to benefit from its cyclical economic rebound and from sensitivity to China reopening and 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 hold a modestly more constructive view of this market.
Pacific ex Japan		Higher commodity prices have been supportive for this region overall. The region remains vulnerable due to tensions in relations with China more broadly. Strong inflation in Australia is leading to higher interest rates. We have lowered our conviction level and maintain a neutral stance on these markets broadly, even as we are less cautious on Hong Kong and Singapore at valuations we regard as somewhat supportive.
Emerging ex China		Stronger long-term growth is being offset by emerging markets' idiosyncratic risks and exposure to slowing demand from developed market consumers. Local inflation pressures, especially for food-importing nations, may see central banks continue to increase interest rates. Prospects for currency recovery across emerging markets are insufficient to fully offset these other factors, and we retain a moderately cautious view of these markets.
China		China's economy has slowed, compounded by property market weakness and residual COVID-19 concerns, but this has 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. However, regulatory risks that dominated market sentiment are fading, and valuation attractions see us maintain a modestly constructive stance on this market.

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

Asset Class	Conviction	Our viewpoint
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 have repriced significantly to reflect policy rates moving quickly to restrictive levels, and risks remain more evenly balanced. This saw us add to interest-rate sensitivity overall, in recent months, and eliminate our moderately cautious view of US government bonds relative to other developed markets.
Inflation-Linked Bonds		The level of inflation discounted in inflation-linked securities has moderated from elevated levels earlier this year. We believe these expectations fairly reflect anticipated longer-term inflation, even as current realized inflation is likely to remain elevated for a while. We maintain 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 a series of rate rises seems likely after it began hiking rates in July. However, given risks to demand growth in the European economy, the extent of rate rises is particularly uncertain at this time. The ECB can ramp up support for peripheral markets if the transmission of monetary policy is imperiled. We maintain a neutral stance on this region.
UK Government Bonds		The country’s economy is heading for recession, and structural issues persist. Gilts have decoupled from global equivalents at times. Inflation risks remain elevated and have moved the Bank of England to tighten policy sharply, but further rate-hike expectations may already be fully discounted. We maintain a neutral stance as risks of a policy error have increased, in our assessment.
Canada Government Bonds		Canada has benefited from commodity price rises, and the Bank of Canada has moved aggressively on high inflation and a tight labor market. However, the interest rate-sensitive nature of the economy may start to be felt. Canadian bond yields are less likely to further exceed moves in the United States, and shorter maturity bonds already largely discount likely rate moves. We eliminated our cautious stance in recent months and remain neutral, in line with other global markets.
Japan Government Bonds		The Bank of Japan has reiterated its monetary policy stance, which targets low 10-year government bond yields, and policy remains supportive, necessitating intervention to support the Japanese yen. We believe this market’s low sensitivity to global yields is likely to continue, despite being tested recently, making it somewhat more attractive to us in the case of higher global yields. However, we maintain an overall neutral position.
Investment Grade		The investment-grade sector has benefited from ample corporate liquidity and earnings levels that make high debt loads more sustainable. Investor confidence has been hit by monetary policy tightening and valuations that did not offer significant protection against rising Treasury yields. However, after a move wider in spreads and at notably higher yields, we eliminated our defensive stance and maintain a marginally constructive view overall.
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. Ample liquidity had led to elevated valuations, but following a period of rising volatility and wider spreads, we tempered our conviction toward high-yield credit earlier this year. Following a sharp recovery, even as recession risks persist, we adopted 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 have become progressively more 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 retain a more constructive view on China’s local bonds but continue to think selective positioning is important.

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