FRANKLIN TEMPLETON | Institute

September 2023

Global Investment Outlook

A broadening opportunity set

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Introduction

Stephen Dover, CFA
Chief Market Strategist,
Head of the Franklin Templeton Institute

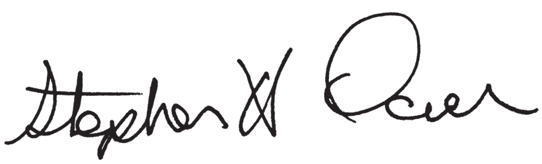
During the summer season, markets have defied expectations—performing well in the face of economic challenges. As autumn's chill starts to settle in, the question for investors is whether the investment climate will likewise begin to turn bleak.

In this Global Investment Outlook, we've asked our leading investment teams to provide a visual example and a few talking points on the investment opportunities they are most focused on today. Many of our highlighted investment opportunities from mid-2023 remain in place as we look toward year-end, with some subtle tilts. Here are the ideas we would focus on:

- Today, we see a much broader opportunity set across asset classes and regions.
- Fixed income has returned as an effective diversifier, justifying an increasing allocation in a balanced portfolio and extending duration beyond cash.
- Within the equities space, investors may want to consider moving beyond the "Magnificent Seven" US technology names. Mid-cap and small-cap businesses offer more potential for innovation and disruption than large-cap businesses. In addition, defensive equities with more resilient earnings streams may be poised to rebound as they have become more attractively valued relative to more economically sensitive sectors.
- Facing both structural and cyclical headwinds, the US office sector has dominated negative headlines in recent months. We see opportunity in other property sectors such as industrial warehouse, self-storage, residential housing and life sciences.

- Specific to fixed income:
  - Within the credit space, attractive yields across various maturities and instruments offer the most compelling income opportunities we have seen in 15 years.
  - There is an opportunity to rotate from quality dividend-paying companies into higher-quality fixed income, picking up substantial yield from lower-risk assets.
  - Agency mortgage-backed securities are offering similar yields to investment-grade bonds but with less credit risk and lower duration risk. For the first time in 20 years, mortgage bonds have a higher yield than stocks.
  - The current US Treasury yield curve inversion is pricing in substantial monetary policy loosening amid a weakening economy, but not all our teams agree on the timing of the first US interest-rate cut.
  - There is more reason to be optimistic about Japan than there has been in years, and the Japanese yen is looking significantly undervalued to us.

In what follows, the Franklin Templeton Institute provides our analysis of today's investment climate and the opportunities we see.



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Will the good times persist?

As memories of summer holidays fade, investors' focus now shifts to the outlook for the final months of 2023.

During the first three quarters of this year, global equity markets benefited from falling inflation and diminishing recession fears. Investors also shrugged off three consecutive quarterly reports of falling corporate profits, anticipating better earnings to come. The most disruptive forms of geopolitical risk failed to materialize, reinforcing the supportive backdrop.

But can the good times continue? By and large, we think so. But investors are also in a race against time. Below, we explain our thinking and offer our conclusions for opportunities over the final months of 2023.

Debt has been a tailwind

By virtue of structural changes in corporate finance, the corporate sector has thus far been sheltered from the harshest impacts of what has otherwise been an aggressive series of Federal Reserve (Fed) rate hikes since early 2022.

The reason why they have been able to survive these hikes is mostly because companies have increased the maturity of their debt and have converted more of their borrowing into fixed-rate obligations. Accordingly, despite the sharp rise in interest rates over the past two years, company debt servicing costs have not yet risen as much.

The fact that profits have been shielded from the impacts of monetary tightening helps explain continued company interest in hiring. It also points to a positive feedback loop between profits, employment and demand that, while not sustainable forever, has helped to support US economic growth.

Most listed companies have also taken advantage of an inverted yield curve, with short-term interest rates above long-term rates. Companies with high cash balances (based on resilient earnings as well as prudent capital spending) are enjoying higher interest revenues by parking their money in short-dated notes, but low interest costs having locked in lower rates via longer-term borrowing. The corporate sector is, in sum, playing an inverted yield curve to its benefit.

The fact that profits have been shielded from the impacts of monetary tightening helps explain continued company interest in hiring. It also points to a positive feedback loop between profits, employment and demand that, while not sustainable forever, has helped to support US economic growth.

The result is a more resilient corporate sector that is better able to manage through tightening cycles. This resilience of earnings and growth has another key implication for investors—namely reduced default risk. Credit risk is more nuanced. Individual defaults remain possible, and some will be unavoidable. But barring a freezing up of lending markets, according to our analysis, overall corporate default rates are likely to be lower in this cycle than in prior ones.

Interest rates must fall soon

This sanguine state of affairs cannot continue indefinitely. New borrowers and those needing to roll over existing debt will face the harsh reality of higher interest rates. In that sense, hopes for "soft landings" for the economy and corporate profits require that interest rates come down, preferably sooner rather than later.

The good news is that most measures of inflation—goods prices, shelter costs and wages—have peaked and have been declining. Falling inflation means that central banks will not likely need to engage in additional aggressive interest-rate hikes. But if higher interest expense and recession are to be avoided, falling interest rates must soon follow welcome declines in inflation. Otherwise, an eventual increase in interest expense will eat into both consumer spending and corporate profits, potentially putting the expansion at risk to a corrosive increase in debt servicing.

For now, and probably for the remainder of 2023, the resilience of the US economy is likely to remain untested. Rising interest expense will exert an inexorable but nevertheless gradual impact on the economy. This is not about a "cliff event." But it is nevertheless true that the longer borrowing costs along the yield curve remain elevated, the greater the probability of a harder landing and a renewed profits recession. Investors expecting a soft landing for the economy are, to mix the metaphors, in a race against time.

Investment opportunities remain abundant

What does this mean for the investment outlook over the remainder of 2023?

We anticipate that the incoming data on growth, inflation and corporate profits will remain largely benign, allowing equity and corporate bond markets to continue to advance, albeit in moderate fashion given that much good news is already discounted.

Accordingly, many of our investment conclusions from mid-2023 remain in place for the remainder of the year. Attractive yields across various maturities and credit instruments offer the most compelling income opportunities we have seen in 15 years. And, as disinflation continues, downside risks for higher-grade issuers (e.g., government and investment-grade corporate borrowers) will likely be contained. The risk/reward ratio, in other words, favors extending duration, even into high-quality corporate bonds. A likely slowing of economic activity and further declines in inflation should boost bond prices (and lower bond yields), offering investors the extra opportunity for price appreciation in addition to income. Moreover, with inflation now moving decisively below nominal yields, real returns have also become attractive to us.

Peaking and then falling US market rates of interest also suggest that the US dollar is near its cyclical peak. Typically, modest dollar depreciation offers a positive environment for emerging market local currency debt. As emerging currencies and bond markets rally, emerging equities typically also outperform. Commodity prices also typically firm up.

The biggest unknown for the emerging complex remains China's economy. Recent efforts to stabilize China's credit and property markets are encouraging, but the policy steps thus far appear aimed at moderating risk, rather than ramping up growth. Chinese corporate profits and equity performance are therefore likely to lag those of other emerging markets.

In sum, as the end of summer gives way to autumn's chill, the investment outlook remains fairly sunny to us. While investors may be tempted to "fade" the positive recent returns in 2023, in our view, fundamentals and valuations continue to point toward favorable risk/reward dynamics.

Peaking market rates of interest also typically bode well for longer-duration equities, including select growth sectors. Even after the 2023 mini boom in artificial intelligence investing, a combination of growth stocks and companies with more stable sources of earnings (i.e., those cushioned from slowing economic activity) appear likely to outperform more cyclical sectors and styles.

Finally, and perhaps most importantly, the outlook over the remainder of this year (and into 2024) appears favorable for balanced portfolios. The big reason is falling inflation risk, which typically produces positive returns in both bonds and stocks. But even if stocks falter on fears that earnings may disappoint as the economy slows, we believe high-quality fixed income components should provide offsetting positive returns, boosting the overall stability of balanced portfolios. For investors nursing their 2022 wounds of joint stock and bond bear markets, we believe the outlook over the coming few months should offer greater reassurance.

In sum, as the end of summer gives way to autumn's chill, the investment outlook remains fairly sunny to us. While investors may be tempted to "fade" the positive recent returns in 2023, in our view, fundamentals and valuations continue to point toward favorable risk/reward dynamics.

Here is where we see the greatest potential investment opportunities:

Movement out of cash

Many investors have understandably parked cash in money market funds yielding over 5%; we believe it is also opportune to move some holdings further out the US Treasury yield curve. The prospect of peak policy rates, further declines in US inflation and some slowing of growth are likely to push long-term yields lower into 2024, boosting returns on safe, longer-duration fixed income holdings. As we point out below, taking duration risk also typically improves portfolio diversification.

Investment-grade credit
The highest-quality areas of the credit market have become more attractive. Bond yields are now comparable to the S&P 500 earnings yield for the first time in at least 20 years.

Generally high-quality, short duration
When broadly looking at higher-quality credit, the default risk premiums are sufficiently attractive to compensate investors, even with some probable slowing of economic activity. Accordingly, within credit markets, we broadly prefer higher-quality, shorter-duration holdings and see opportunities in mortgage-backed securities.

Selected long-duration bonds
The case for higher-quality, long-duration bonds has improved as a likely peak in interest rates arrives sooner rather than later. A decline in rates could provide more capital appreciation to the more interest-rate sensitive longer-duration bonds.

High-quality high yield
High-yield bonds with stronger ratings profiles due to better fundamentals look to be a potential total return opportunity. High-yield debt has a shorter duration profile than other parts of the fixed income market, while at the same time providing equity-like total return potential.

Emerging market debt
Another opportunity, which we also noted at the beginning of this year, exists in emerging market local currency debt. Attractive yields (double-digit in some cases), coupled with potential US dollar weakness, offer an opportunity to enjoy equity-like returns, but without the degree of downgrade or default risk we see in some US high-yield credit markets.

US equities
We continue to see opportunities in selected growth-oriented sectors (especially outside the largest few companies). We believe investors should expand their horizons beyond the "Magnificent Seven" big cap stocks to include attractively valued, quality mid- and small-capitalization growth businesses.

Defensive sectors in the S&P 500 Index including consumer staples, health care, utilities, and real estate have lagged cyclicals in this year's equity rally, reaching a gap between that demands attention.

Non-US equities
We believe it's prudent to consider opening or establishing larger positions in non-US markets. We are more optimistic about Japan's equity market than we have been in years, and the Japanese yen is looking significantly undervalued to us. We generally favor emerging markets outside of China. China's rising debt in the real estate sector is offsetting rapid growth and market share gains in industries we favor, including electric transportation, technology and pharmaceuticals. While we remain optimistic on the long-term potential for Chinese growth, we also acknowledge its growing pains as new policies to address the debt overhang are rolled out.

Historic opportunity in private credit
With rates still elevated relative to recent history, private credit will likely pick up a larger share of the loan market from regional banks. Given these dynamics, private credit managers can more easily negotiate favorable pricing, terms and covenants.

Commercial real estate is down but not out
Sentiment around commercial real estate remains largely negative due primarily to weakness in the office segment. We see opportunity across industrial warehouse, self-storage, residential housing and life sciences real estate. Because of the shifting macro, demographic and disruptive themes, we believe sector allocation and market selection strategies are critical to potential outperformance.

Incorporating absolute return can help smooth returns
Hedged strategies across a variety of asset classes can help reduce volatility of a multi-asset portfolio. In the event of a weaker-than-expected economic environment, non-correlated return streams can provide an effective portfolio diversifier to reduce downside risk.

Balanced portfolios
With inflation rolling over, we believe that the classic diversification benefit of fixed income has largely returned, with the traditional 60/40 investment strategy working again.

Exhibits: Opportunities for the fourth quarter of 2023

We gave our investment teams the challenge to provide the exhibit that best suggests opportunities for the rest of 2023. It is important to understand the specialty perspective to appreciate the points made. We hope you find this both interesting and useful.

Multi-asset income perspective

Contributor

Ed Perks, CFA

Chief Investment Officer

Franklin Income Investors

Rising Bond Yields Now Comparable to S&P 500 Earnings Yield

S&P 500 Earnings Yield and Bloomberg US Aggregate Yield

September 6, 2013–September 8, 2023 (Daily)

Sources: FactSet, S&P Dow Indices, Bloomberg Indices. The Bloomberg US Aggregate Bond Index measures the performance of the investment-grade, US dollar-denominated, fixed-rate taxable bond market. 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.** Important data provider notices and terms available at www.franklintempletondatasources.com.

- When we look back to the post-financial-crisis era and the onset of quantitative easing, the distortion placed in fixed income markets was challenging for income investors.
- As recently as the first half of 2022, many dividend-paying stocks had higher yields than either benchmark 10-year US Treasuries or investment-grade corporate bonds. As the year progressed, that dynamic reversed, with high-quality fixed income assets increasingly offering a substantial income premium to dividend stocks.
- The yield to worst on the Bloomberg US Aggregate Index now sits above 5%, broadly matching the earnings yield on the S&P 500 Index.
- The lagged effect of previous interest-rate increases has recently begun to put pressure on earnings, while continued hawkish rhetoric from the Fed has helped support fixed income yields, eliminating the yield gap between the two asset classes.
- The opportunity to rotate from quality dividend-paying companies into higher-quality fixed income, picking up substantial yield from lower risk assets, is where we have had a significant reallocation taking place on a year-over-year basis.
- The backdrop of higher-for-longer rates and a gradual slowing in the economy, with a reduced and more limited environment for companies to push through price increases, may pose some risk for markets going forward.
- Today, we see a much broader opportunity set and have several different levers to access the most attractive opportunities for income, while also generating potential opportunities for longer-term capital appreciation.

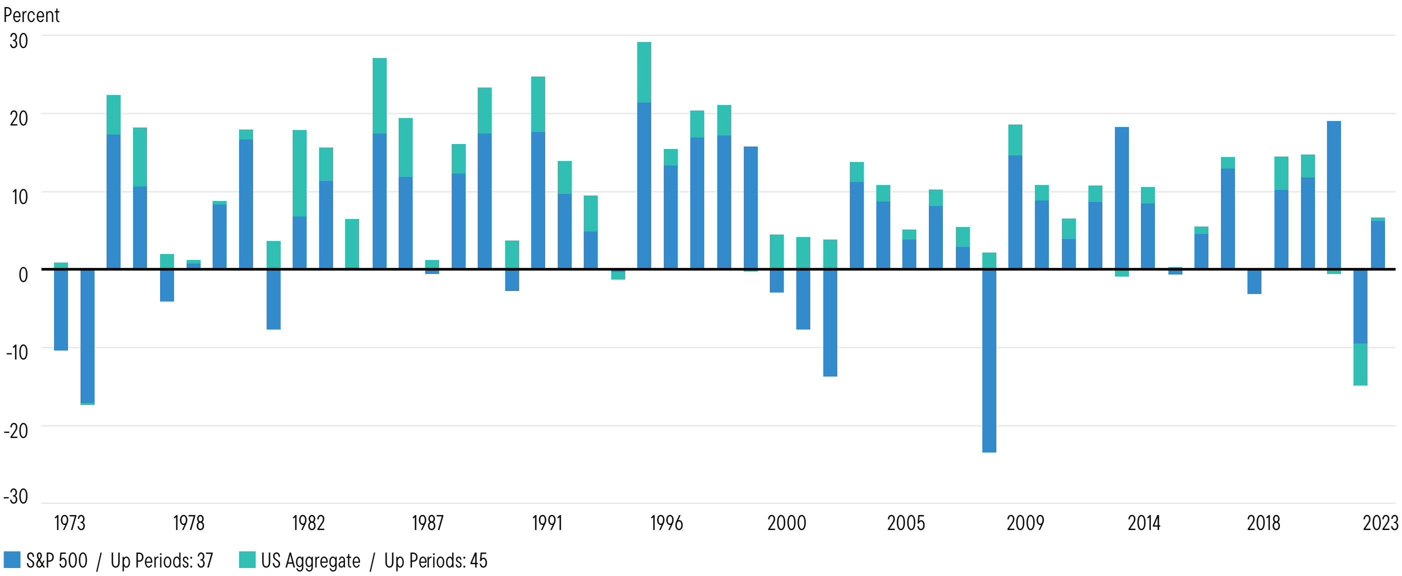
Fixed income perspective

Contributor
Western Asset

Diversification Benefits: Traditional Correlations Are Back

US Aggregate Bond Index vs. S&P 500 Index Returns

December 31, 1973–December 31, 2022



Source: Bloomberg. As of December 31, 2022. The Bloomberg US Aggregate Bond Index measures the performance of the investment-grade, US dollar-denominated, fixed-rate taxable bond market. 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.**

- With inflation rolling over, we believe that the classic diversification benefit of fixed income has largely returned, with the traditional 60/40 investment strategy working again.
- While the post-COVID inflation crisis has proven to be an outlier in many respects, this graphic serves as a reminder of how resilient and reliable the diversification benefits of fixed income has been over the long term, and the number of positive return periods shown above demonstrate the benefit of 40% fixed income in a balanced portfolio.
- We are painfully aware that markets are not linear and there are setbacks. Case in point: The Treasury market performance in August 2023 that resulted in more positive correlations between stocks and bonds. However, we firmly believe that over the long run, bonds will behave like bonds again, and the negative correlation should ultimately revert to its historical relationship.

Fixed income perspective

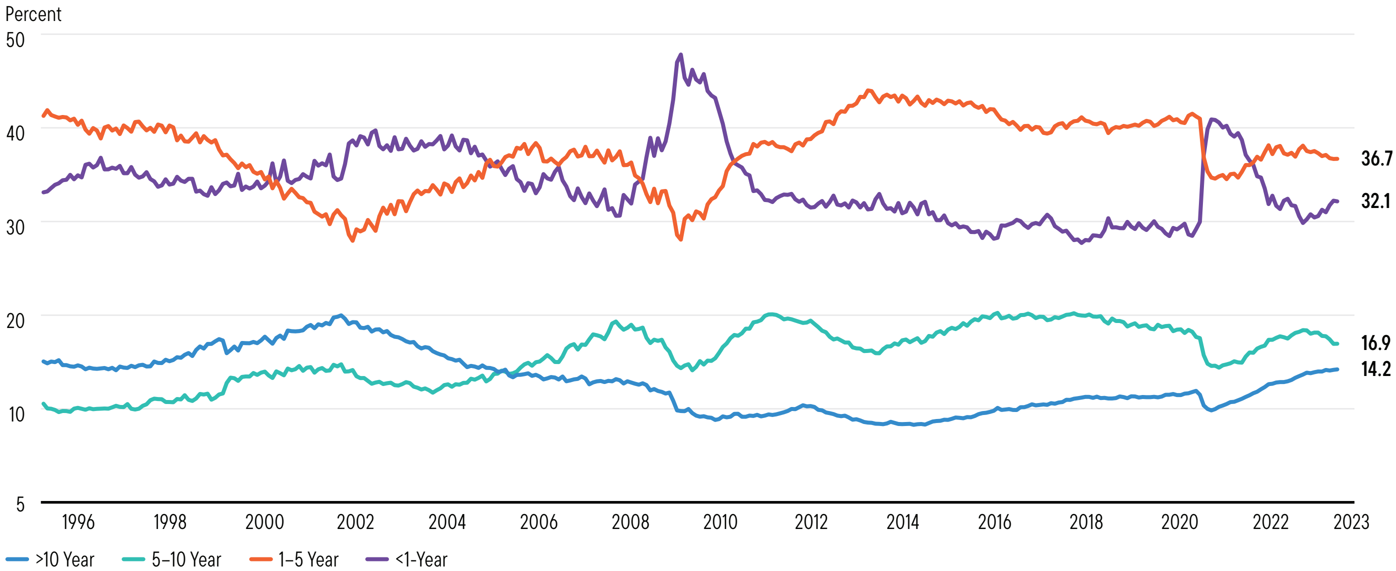
Contributor

Franklin Templeton
Fixed Income

Maturity Distribution of US Debt

Percent Total Public Debt

1996–March 31, 2023



Sources: Franklin Templeton Income Research, US Department of Treasury, Macrobond. Data as of March, 31, 2023.

Key takeaways

- We believe that the global economy will continue to slow, with gross domestic product (GDP) growth remaining below trend through 2024, but we no longer project a technical recession in the United States or the euro area.
- Inflation will likely continue to occupy central banks as they maintain their restrictive monetary stances, but the effects of tighter monetary policy will take time to work through the economy.
- We still feel intermediate- and longer-term government bond yields will increase, but we are more constructive on shorter-term rates.

US economic outlook

- In September, we saw a steady increase in US Treasury yields, with the benchmark 10-year yield moving to an intraday high of 4.55%, the highest level since October 2007.[1] Although these yields approached our previous projections, we have increased our expectations due to a number of factors, including better-than-expected economic growth, persistent inflation, and unfavorable technical conditions in the market. High budget deficits fuel US Treasury supply, which will test the market's appetite for bonds.

Investment implications

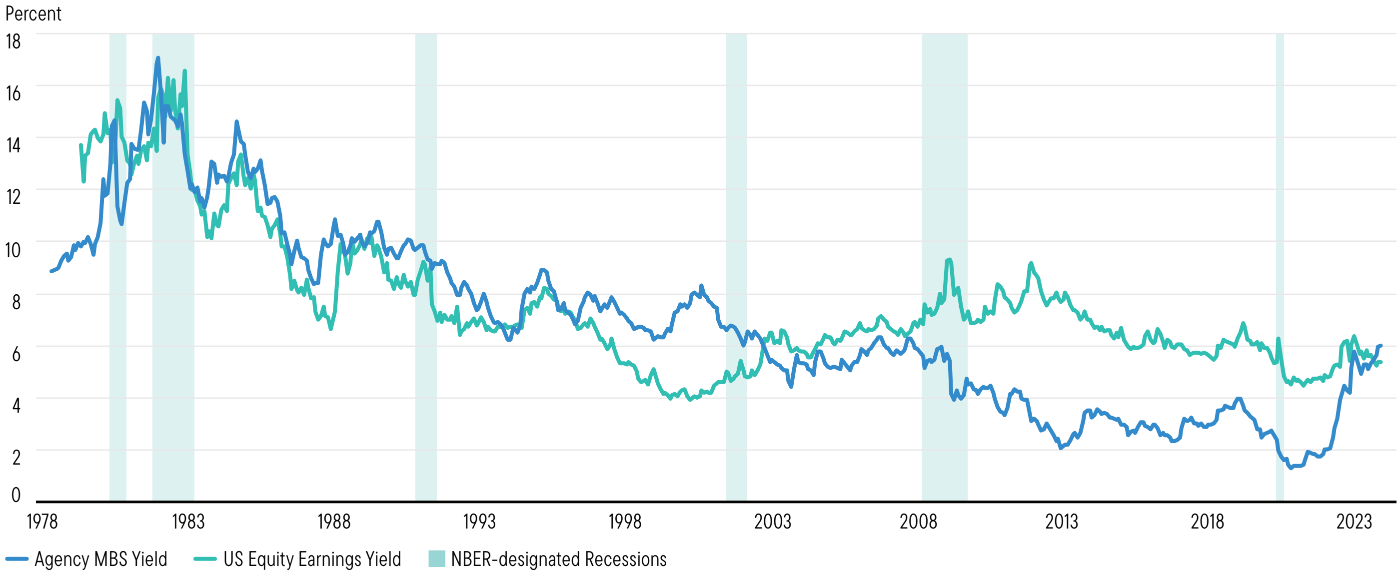
- The market will need to absorb the additional anticipated Treasury supply. Foreign investors have been quite active in buying Treasuries due to their relatively high yields versus those in Europe and especially Japan, but as these central banks move their policy rates higher while the Fed is reaching its terminal rate, this differential will lessen and foreign demand will soften.
- Our view is that the current yield curve inversion is pricing in a substantial loosening of monetary policies due to a weakening economy, which is inconsistent with our current Fed outlook that calls for the potential of additional rate hikes and no cuts until at least the third quarter of next year. However, at current levels, US Treasury yields appear relatively attractive to us, especially on the shorter end of the curve. Longer-term yields are still too low, in our assessment. We feel somewhat comfortable with durations to be like that of benchmarks, but we continue to maintain a steepening bias in our positioning as we look for yields to rise on the longer end of the yield curve.
- As for fixed income spread sectors, we feel spreads have moved too far, pricing in a near-perfect economic landing without any major worries over issuers' fundamental positions. While most fixed income spread sectors appear to us to be fairly valued, at best, we do see some pockets of opportunities.

Fixed income perspective

Contributor
Paul Mielczarski
Head of Global Macro Strategy
Brandywine Global

Why We Like US Fixed Income

US Equity Earnings Yield vs. Agency Mortgage Bond Yield
January 31, 1978–September 12, 2023



Sources: Brandywine Global, Bloomberg (© 2023, Bloomberg Finance LP), Macrobond (© 2023) US equity is represented by the S&P 500. Agency MBS is represented by the Bloomberg US Mortgage-Backed Securities (MBS) Index, which tracks fixed-rate agency mortgage-backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). As of September 12, 2023. 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.**

At the start of the year, many investors predicted 2023 would be the year of the bond. Instead, while fixed income returns have been barely positive, US equities have delivered double-digit returns. Stocks have benefited from conservative investor positioning at the end of 2022, a resilient US economy, and the expectation of an AI-led investment boom.

Going forward, we believe there is a compelling case for being long US fixed income over equities:

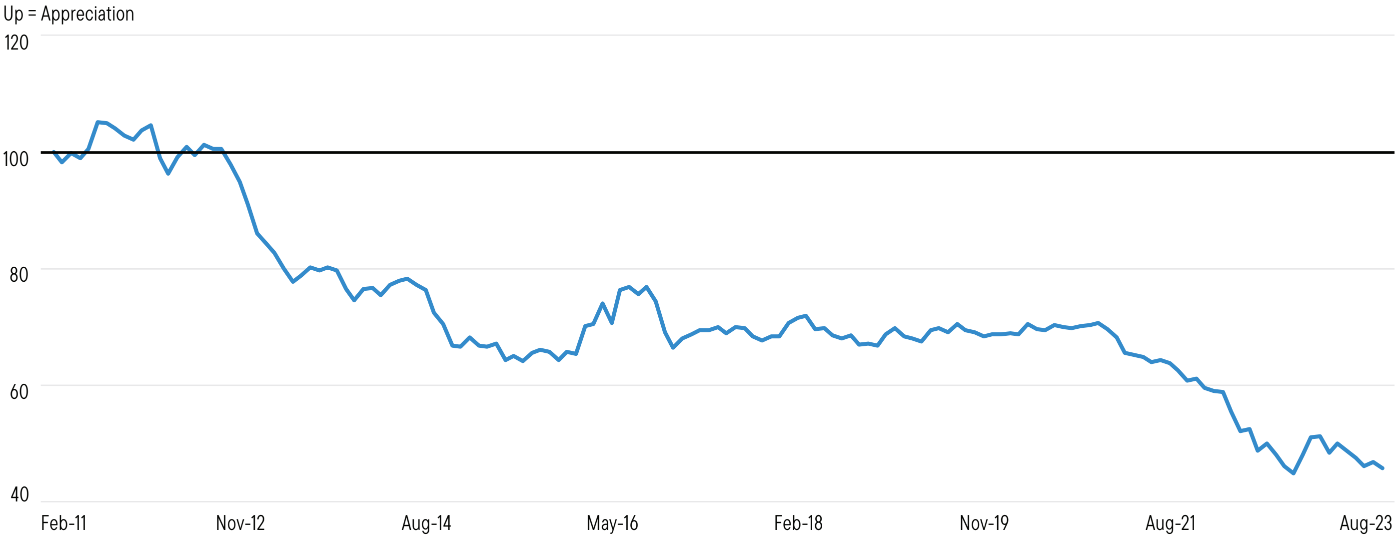
- The Fed is likely done raising interest rates, and the focus will shift to an easing cycle. Core inflation momentum is converging toward the Fed's 2% target. The labor market is rebalancing rapidly, due to lower labor demand and strong labor force growth, which should lead to lower wage growth. Global growth is rolling over, led by China and Europe. While US growth has been resilient so far, we expect growth to slow as monetary policy lags kick in.
- We believe there is a compelling valuation case for being long US fixed income over equities overall. However, our preference is for agency mortgage-backed securities, which offer similar yields to investment-grade bonds but with no credit risk and lower duration risk. The chart above compares the forward-looking US equity earnings yield with the yield on agency mortgage-backed securities (MBS). For the first time in 20 years, mortgage bonds have a higher yield than stocks.
- Lower volatility over equities also supports the case for bonds. Return volatility of mortgage bonds is roughly 50–75% lower than US equities,[2] making them very attractive, in our view, from a portfolio construction perspective. In the late 1990s, equity yields were significantly below MBS yields, and that episode ended badly for US equity investors. Currently, the ratio of equity returns to MBS returns is well above its long-term norm, something we have not seen since the peak of the equity market bubble in 2000.
- Overall, we believe US fixed income offers investors attractive optionality. In a soft-landing scenario, bonds are likely to generate decent returns, although they may struggle to outperform cash. In a deeper growth slowdown or financial shock, they could significantly outperform equities.

Global fixed income perspective

Contributor
Templeton Global Macro

Japanese Yen Significantly Undervalued

Change in Real Bilateral Exchange Rate Since 2011: Japanese Yen vs. US Dollar
February 28, 2011–August 31, 2023



Source: Bloomberg, data as of August 31, 2023. Most recent data available.

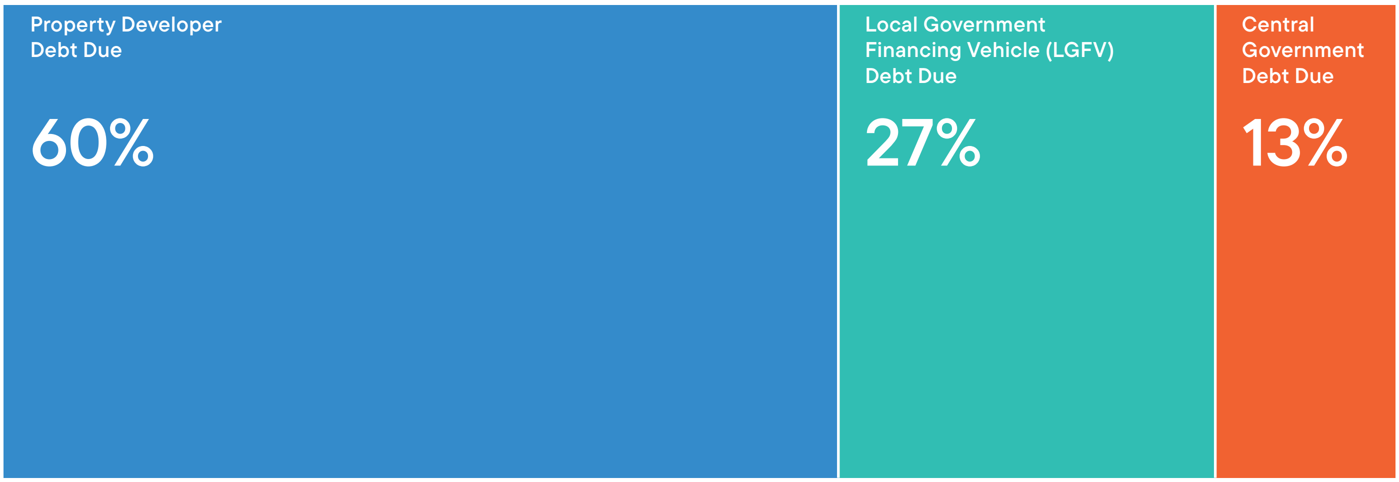
- In our view, Asian currencies in general remain significantly undervalued against the US dollar (USD)—and the Japanese yen (JPY) especially so. We anticipate that a combination of factors is likely to meaningfully reverse the weaker JPY trend of the past couple of decades.
- Despite some pullback over the past year, we still consider the USD overvalued against a range of both developed and emerging currencies. We expect a correction to take place as US interest rates peak and US GDP growth slows, so that interest rate and growth differentials should move in favor of other currencies against the USD.
- In Japan specifically, we believe that the low growth and inflation trends of the past few decades are reversing, solidifying these general USD trends in favor of the JPY in particular.
- The tight labor market in Japan as well as evidence of changes in wage- and price-setting behavior lead us to expect that the current relatively high levels of inflation (over 3% for headline and over 4% excluding fresh food and energy) will be more sustainable than they have been in the past. In particular, in our view, we are seeing the beginning of a self-reinforcing cycle where consumer willingness to accept higher prices means corporates are more comfortable in granting higher wage increases, as their confidence about being able to recoup increased input costs improves. Higher wage increases in turn increase consumer income and propel more spending.
- We anticipate that more sustainable inflation at or above the 2% inflation target will lead the Bank of Japan to policy normalization in due course, thus shifting the interest-rate differential—for the first time in over a decade—more in favor of the JPY.
- We are also more optimistic about growth in Japan than we have been for some years. This is due to a range of factors including the positive effects of post-COVID reopening in the shorter term, as well as corporate governance reforms leading to more structural improvements as companies are incentivized to invest more and reconstruct their balance sheets to become more efficient. In addition, we believe that Japan is well placed to benefit from global reshoring trends, due to its highly developed robotics capacity, relatively cheap cost of labor compared to its international peers, and its uniquely favorable combination of location and geopolitical alliances. For example, Japan maintains a close military and political alliance with the United States and enjoys the robust security guarantees which accompany that relationship, combined with a geo-strategic location that can harness the economic benefits of being located in Asia.

Global equity perspective

Contributor
Manraj Sekhon
Chief Investment Officer
Templeton Global Investments

China's Debt Pains

China Debt Repayments
2023



Sources: IMF WEO, April 2023. Bloomberg, August 30, 2023.

China's economy is becoming more bifurcated. Rising debt in the real estate sector is offsetting rapid growth and market share gains in industries we favor, including electric transportation, technology and pharmaceuticals. While we remain optimistic on the long-term potential for Chinese growth, we also acknowledge its growing pains as new policies to address the debt overhang are rolled out.

Chinese equities have underperformed the MSCI All Country World Index by 20% year to date.[3] Investor concern over the rising tide of indebtedness has been the primary driver of underperformance. It is estimated that CNY12.7 trillion/US$1.7 trillion property-developer debt will need to be refinanced in 2023.[4]

Policymakers have pursued a limited, reactive and piecemeal approach thus far, focused on addressing weakness in demand for property. There are valid concerns on the supply of liquidity to developers to support project completions.

The Chinese economic policy framework is in transition. The new leadership team under President Xi Jinping is developing policies during a time of stress for the economy. Investors are seeking more clarity on how the policies fit together into a cohesive long-term plan.

The focus on "Common Prosperity" implies that a big-bang stimulus similar to 2009 is unlikely. This further increases the emphasis on the need for a clear plan to address property developer debt. Some form of burden sharing between banks, central government and the private sector is likely. Until this is clarified, investor confidence will likely remain fragile.

Chinese policymakers' reluctance to pursue a more broad-based policy response reflects concerns the economy has become too reliant on real estate. Quick-fix solutions would cause a setback in the strategic policy decision to shift the economy's focus toward higher value-added growth. The transition to a more sustainable growth path is proving to be painful and will take time. Unanticipated consequences are possible, and the transition is not without risks. We believe equity market valuations will remain depressed in the short term, reflecting these uncertainties.

Equity perspective

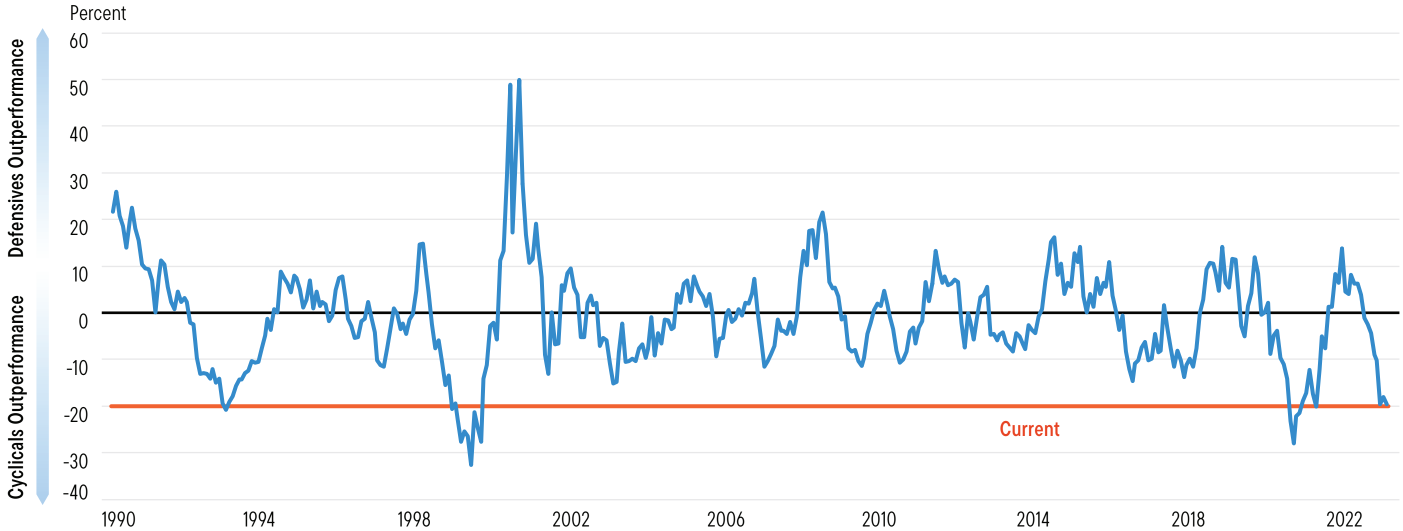
Contributor

Scott Glasser
Chief Investment Officer and Portfolio Manager
ClearBridge Investments

Defensives Look Poised for a Snapback

Defensives vs. Cyclicals: Year-over-Year Change

1990–2022



Sources: S&P Global and Bloomberg. Note: Defensives are Consumer Staples, Health Care, Utilities and Real Estate; Cyclicals are Energy, Materials, Industrials, Consumer Discretionary, Financials, Technology, and Communication Services; Sectors are Equal Weighted Monthly. As of August 31, 2023. **Past performance is not an indicator or a guarantee of future results.**

- Defensive sectors in the S&P 500 Index including consumer staples, health care, utilities, and real estate have lagged their cyclical brethren in this year's equity rally, reaching a gap between that demands attention. Defensives are currently experiencing their fourth worst stretch relative to cyclicals since 1990.
- The underperformance of utilities, which have trailed the S&P 500 by 28.8% year-to-date, is particularly notable. If this holds through year-end, it would be the sector's largest underperformance since 1999 (–32.4%). A strong rebound for defensives followed that period as the "dotcom" bubble burst. The rubber band has become so stretched that recession or even a more minor catalyst could flip the equity market leadership script.
- One potential catalyst for such a shift could come from the Fed, which may be nearing completion of its rate hiking cycle. Historically, the 10-year Treasury yield has peaked around the same time the Fed completed its tightening. If this holds, the 10-year Treasury yield could stabilize or decline in the coming year, likely sparking a bout of defensive outperformance relative to cyclicals.
- Equities with defensive characteristics tend to benefit from declining long-term yields to a greater degree than cyclicals. Lower long-bond yields tend to be associated with slower economic growth, causing investors to seek out companies with more resilient earnings profiles and attractive dividend yields, i.e., defensive equities.
- Although there could be some additional downside, the historical underperformance of defensives argues for a reversal in leadership. The period following the late 1990s—which like today witnessed elevated market concentration and a bout of pronounced cyclical leadership—witnessed a sharp reversion in defensive performance. Typically, active managers are rewarded during these periods given their ability to avoid areas of overvaluation and instead focus on portions of the market that have been neglected.

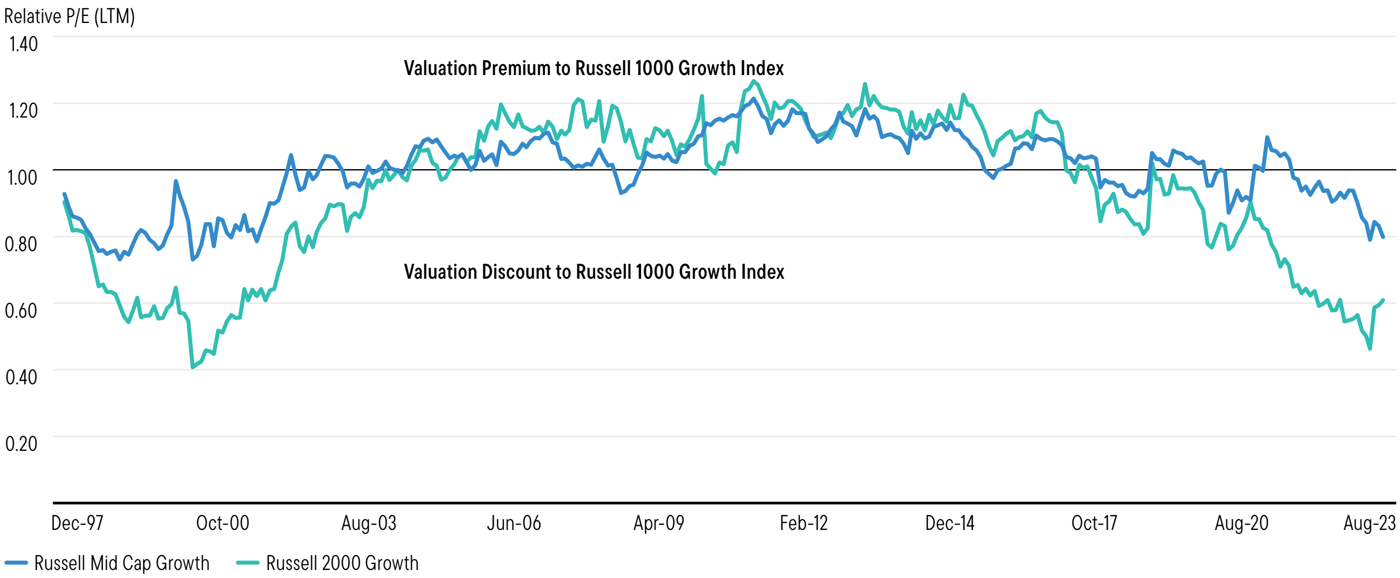
Growth equity perspective

Contributor
Jonathan Curtis
Director of Portfolio Management
Franklin Equity Group

US Equities: Small- and Mid-Cap Growth Relative Valuations to Large Growth Near Historic Lows

Russell Mid Cap Growth and Russell 2000 Growth Last 12 Months (LTM) Price-to-Earnings (P/E) Relative to Russell 1000 Growth

December 31, 1997–August 31, 2023



Source: FactSet. The Russell Mid Cap Growth Index is market capitalization weighted and measures the performance of those Russell Midcap® Index companies with relatively higher price-to-book ratios and higher forecasted growth rates. The Russell 2000 is market capitalization weighted and measures the performance of the approximately 2,000 smallest companies in the Russell 3000 Index. The Russell 1000 Growth Index is market capitalization weighted and measures the performance of those Russell 1000 Index companies with relatively higher price-to-book ratios and higher forecasted growth rates. 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.**

- We believe evidence is mounting that the US economy is in relatively good shape and that the market is entering a new phase of recovery and growth. To capitalize on this opportunity, we believe investors should expand their horizons beyond the "Magnificent Seven" to include attractively valued, quality mid- and small-capitalization growth businesses throughout broader market.
- We are already starting to see signs of this, reflected in a recent broadening of index returns. We think this can continue over the next few quarters as investors gain conviction that inflation is coming under control, the rate cycle is nearing completion, employment remains robust, and COVID perturbations are more manageable.
- We believe mid-cap and small-cap stocks have several advantages that could make them attractive investments in the current environment.
- Mid-cap and small-cap growth stocks are relatively undervalued compared to their large growth counterparts, in our view. As shown above, the P/E multiples for the Russell Mid Cap Growth and Russell 2000 (Small Cap) Growth Indexes are near their lowest levels relative to the Russell 1000 Growth Index.
- Mid-cap and small-cap stocks tend to be more sensitive to the economic cycle. As consumer spending remains robust on the back of good employment and business activity returns to normal, we believe mid-cap and small-cap companies are likely to see stronger revenue and earnings growth than their larger peers.
- Mid-cap and small-cap businesses offer more potential for innovation and disruption than large-cap businesses. They are often nimbler and more adaptable than large-cap companies, allowing them to respond quickly to changing customer preferences, technological trends, and competitive pressures. They may also have more opportunities to expand into new markets, acquire other businesses or become acquisition targets themselves.

Small-cap equity perspective

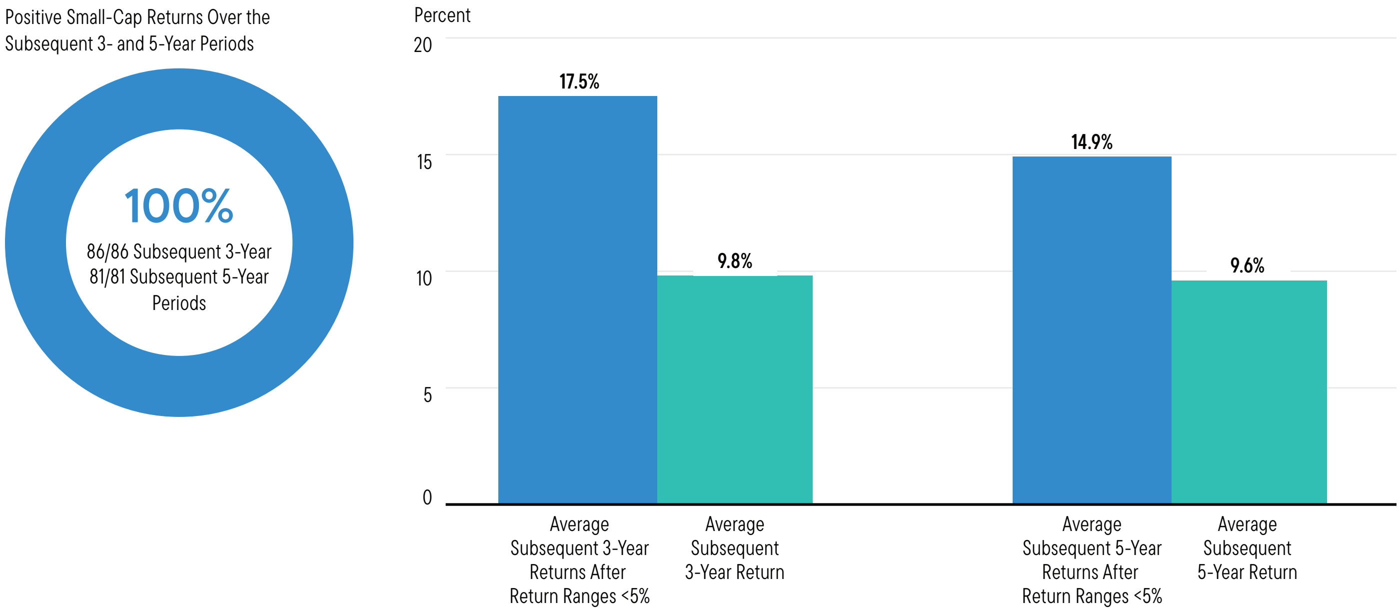
Contributor

Royce Investment Partners

100% of the Time, Positive Three- and Five-Year Returns Have Followed Low Return Markets

Subsequent Average Annualized Three- and Five-Year Performance for the Russell 2000 Following Five-Year Annualized Return Ranges of Less Than 5%

December 31, 1983–June 30, 2023



Source: Russell Investments. The Russell 2000 Index is an index of domestic small-cap stocks that measures the performance of the 2,000 smallest publicly traded US companies in the Russell 3000 Index. 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.**

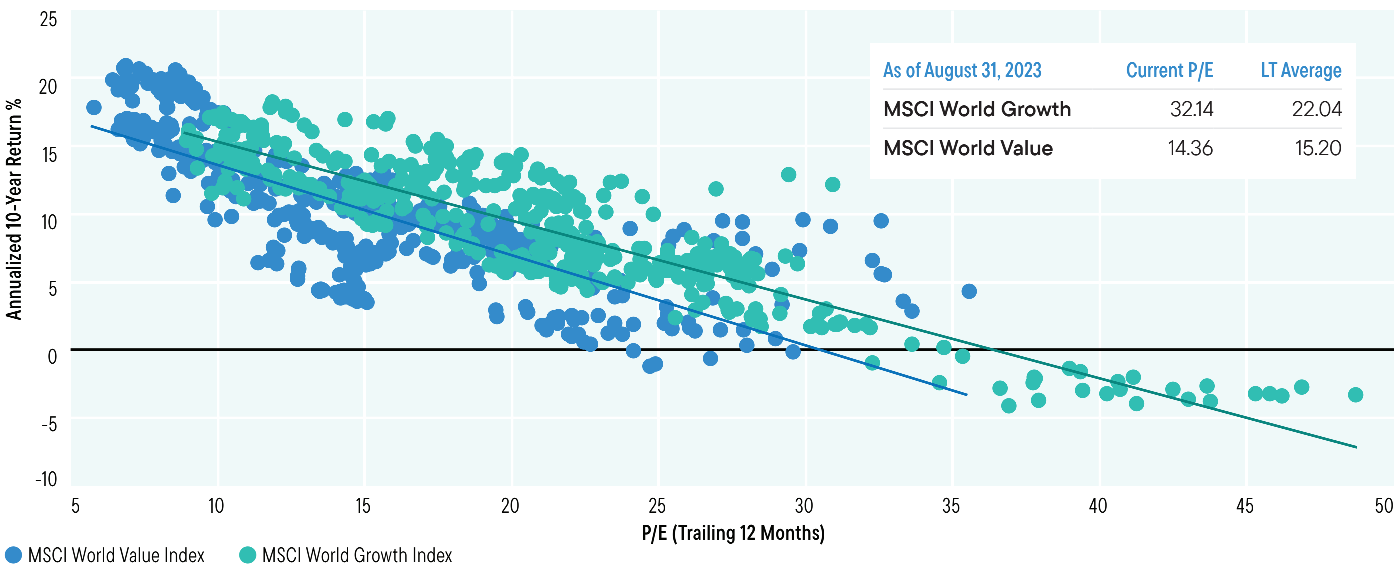
- We believe small-cap stocks look well positioned for strong absolute and relative returns in the coming years.
- Low-return markets have often led to higher-than-average returns for the asset class.
- When three- and five-year annualized returns were 5% or lower, higher-than-average returns followed in 100% of the subsequent three- and five-year periods.
- We think this is therefore a potentially advantageous time to allocate to US small caps.

Value equity perspective

Contributor
Christian Correa, CFA
Chief Investment Officer
Mutual Series

Valuations Matter for Long-Term Returns

MSCI World Growth and Value, Starting P/E Ratio and Subsequent 10-Year Returns
December 31, 1974–August 31, 2023



Sources: FactSet, MSCI. The MSCI World Index captures large and mid-cap representation across 23 developed markets countries. 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.

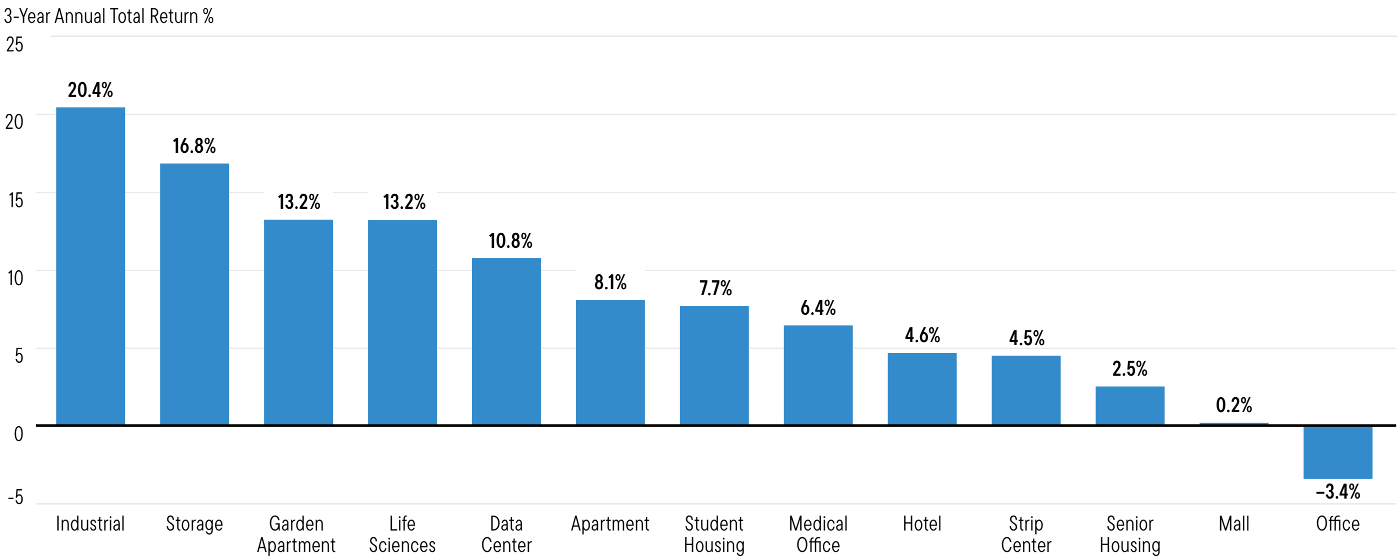
- We believe starting valuation levels have been a strong predictor of subsequent long-term future returns.
- Comparing the trailing P/E multiples for global growth and value and the next 10-year return shows that the lower the P/E, the higher the future return. The evidence that global value stocks can outperform over the longer term looks compelling to us.
- We believe that finding companies with compelling catalysts that can unlock this value and generate solid long-term returns is crucial for separating out appealing value stocks from potential value traps, particularly in uncertain macroeconomic environments.

Real estate perspective

Contributor
Clarion Partners

Commercial Real Estate Investments Are Much More Than the Traditional Office Sector

Three-Year Annualized Total Return by Property Sector
As of Second Quarter 2023



Sources: NCREIF, Clarion Partners Investment Research, second quarter 2023. The NPI Plus Index is a quarterly index tracking the performance of core and alternative property sectors in the US. 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.**

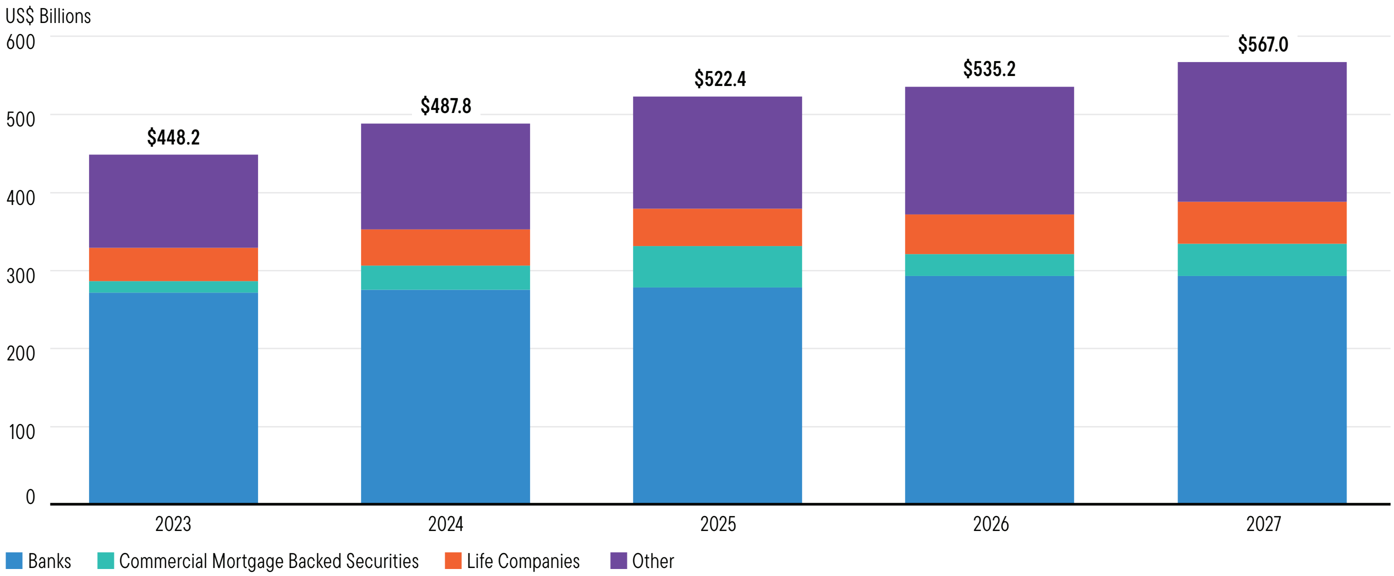
- Facing both structural and cyclical headwinds, the US office sector has dominated negative headlines in recent months.
- However, US commercial real estate consists of much more than the traditional office sector, which accounts for less than 19% of the NPI-Plus Index.
- Many other property sectors such as industrial warehouse, self-storage, residential housing and life sciences have performed well over the past three years.
- Because of the shifting macro, demographic and disruptive themes, we believe sector allocation and market selection strategies are critical to potential outperformance.

Private credit perspective

Contributor
Benefit Street Partners

US Commercial Mortgage Maturities by Lender Type

2023–2027 (forecast)



Source: Trepp. As of August 2023. There is no assurance that any estimate, forecast or projection will be realized.

- Investor sentiment toward commercial real estate (CRE) is weak, given a host of challenges. But we believe all of the pressure points—rising interest rates, a deficiency of debt capital in the face of a steep maturity wall and increasing demand, and even the potential for a surge in defaults—will create opportunities for nimble credit investors.
- We see a bifurcation in CRE among asset classes. There are some broken properties, and possibly even a broken sector in the office market. Otherwise, it's more a case of broken balance sheets, as so many properties are over-levered and/or undercapitalized. Broken balance sheets will no doubt bring some pain to borrowers and some investors; however, they also will likely drive the opportunity set.
- Investors with available capital can position themselves to take advantage of the uncertainty in the CRE market, even during what appears to be a difficult time ahead, by going on offense in the right circumstances. That's especially true for those who can look beyond the short-term volatility and remain focused on the longer-term fundamentals.
- We continue to view newer-vintage multifamily located in primary and secondary markets as having the best credit quality and risk-adjusted returns within CRE credit. In our current view, the historical recession resistance of Class A and B multifamily offers relative insulation from some of the key issues in CRE, as well as long-term secular growth drivers.
- We believe well-positioned investors will be able to lend through this correction and be rewarded when the CRE storm subsides, providing the potential for equity-like returns.

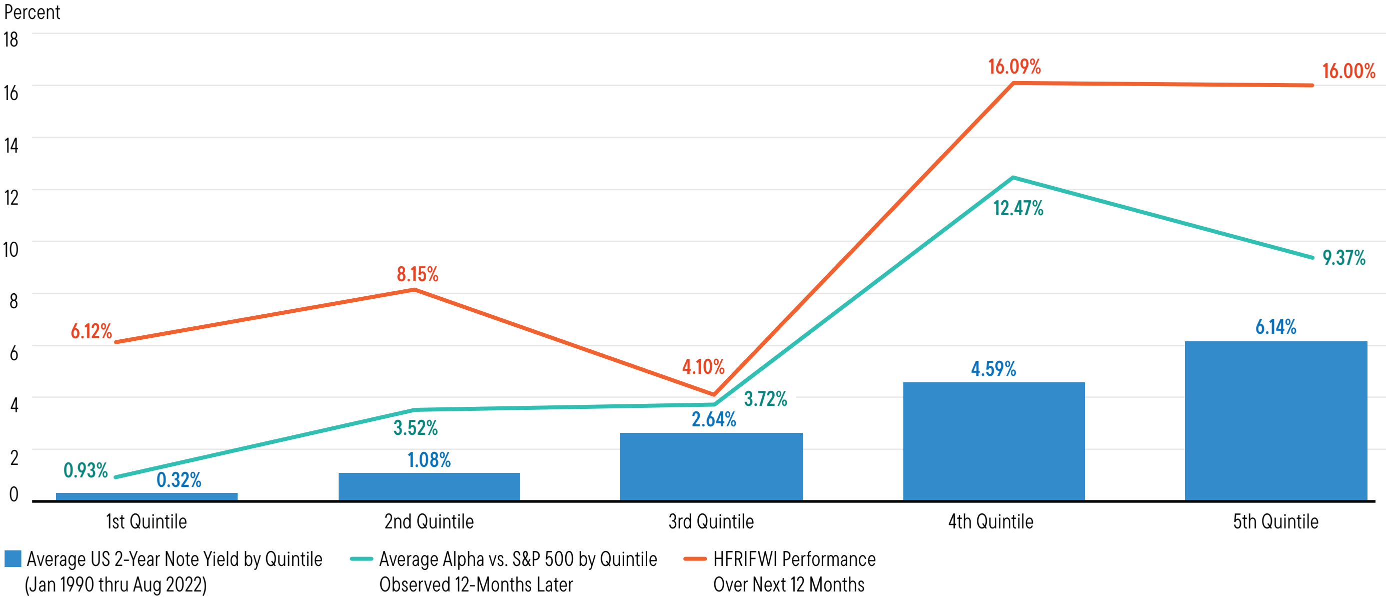
Hedge fund perspective

Contributor
K2 Advisors

Performance of Hedge Funds at Various Interest-Rate Levels

Historically, Higher Yields Benefited Dispersion, Security Selection Alpha and Hedge Fund Performance

January 1, 1990–August 31, 2022



Source: Bloomberg. The HFRI Asset Weighted Composite Index is a global, asset-weighted index comprised of single-manager funds that report to Hedge Fund Research database. 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.** There is no a ssurance that any estimate, forecast or projection will be realized.

- Since 1990, periods of above-average US two-year Treasury note yields have led to above-average forward performance periods for the HFRI Fund Weighted Composite Index, a benchmark for hedge fund investors.
- Higher-than-average interest rates also have benefited security selection alpha as dispersion increases.
- Above-average interest rates impact various companies to varying degrees. Those with high cash holdings may benefit from improved earnings due to interest income. Those with high debt obligations may see fundamental pressures from the higher cost of financing.

Endnotes

1. Source: Bloomberg.
2. Source: Brandywine Global calculations based on publicly available economic data.
3. Source: FactSet. As of September 15, 2023.
4. Source: Bloomberg. “Property is too big to fail, too big to save.” August 30, 2023. There is no assurance that any estimate, forecast or projection will be realized.

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Notes

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To the extent the fund invests in **privately held companies** they present certain challenges and involve incremental risks as opposed to investments in public companies, such as dealing with the lack of available information about these companies as well as their general lack of liquidity.

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