PERSPECTIVES

Global Investment Outlook 2018: Reflections on Growing Economies and Fading Stimulus

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As markets shift away from the recovery era of monetary accommodation amid synchronised global growth, some investors may be wondering where potential opportunities can be found. We present a summary outlook for the year ahead from Franklin Templeton's global macro, fixed income, equity and multi-asset investment teams. They highlight why they think US interest rates look poised to keep heading higher, why global equities may have more room to run and why investors may need to be more selective in the fixed income space.

Global Macro

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Rising US Treasury Yields Present Multiple Risks

- A number of factors are poised to pressure US Treasury yields higher, in our view: the reversal of quantitative easing (QE) as the US Federal Reserve (Fed) unwinds its balance sheet, the exceptional strength in US labour markets, rising wage and inflation pressures, ongoing resiliency in the US economy, and a structural shift toward deregulation by both the Trump administration and potentially a Jerome Powell-led Fed.
- Investors who are not prepared for the shift from the recovery era of monetary accommodation to the expansionary post-QE era may be exposed to significant risks, in our view. We think it is critical not only to defend against current US Treasury risks but to structure portfolios to potentially benefit as rates rise.

Specific Emerging Markets Offer Idiosyncratic Value

- The impact of Fed policy tightening on emerging markets should vary from country to country in the upcoming year.
- It's important to identify countries with idiosyncratic value that may be less correlated to broad-based beta (market) risks. Countries that are more domestically driven and less reliant on global trade often have those idiosyncratic qualities along with inherent resiliencies to global shocks. A select few have already demonstrated that resilience in recent years, notably Indonesia. For others, we believe economic risks are related to the reforms underway within their country, rather than what happens externally, such as in Brazil or Argentina.
- In the major developed economies, we continue to see unattractive bond markets, particularly the low to negative yields in the eurozone and Japan.

We Expect Inflation and US Treasury Yields to Rise in 2018

- As we look ahead in 2018, we expect the reversal of QE, rate hikes and rising inflation pressures in the United States to be among the most impactful factors for global financial markets.

Multi-Sector Fixed Income

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Global Growth Healthy but Many Believe Valuations Look Full

- Overall, we are reasonably optimistic that a positive economic backdrop could remain intact over the coming year.
- At the same time, we cannot ignore the view of many market participants that fixed income markets appeared fully valued on a number of traditional metrics as of late 2017.

Inflation and Monetary Policy Bear Watching

- While persistently high core inflation could spur rates to climb faster than anticipated, we think the more likely scenario is a modest uptick in inflation, particularly over the coming year. We believe inflation has been persistently low as a consequence of several factors, primarily globalisation and technology.
- The Fed's efforts to reduce its balance sheet (even as it continues to hike short-term interest rates) also bear close watching. It is the first time anything of this scale has been attempted.
- We think the Fed and other central banks have done a reasonably good job communicating their intentions to market participants.

A Time for Discrimination

- We believe reasonable risk-adjusted opportunities remain in all corporate sectors, including investment-grade and high-yield bonds, as well as floating-rate bank loans and the housing-related sectors. However, even a buoyant economy has winners and losers, and not all credits within these asset classes will benefit equally.
- As a result, we believe it will be important to differentiate between sectors exposed to some sort of fundamental disruption, such as many retail-related names, versus those that may be undergoing more cyclically dependent shifts, such as many commodity-related credits.
- In short, we believe moving past headlines and focusing on the underlying fundamentals behind specific, individual credits is a sound approach for identifying value in the current bond market climate.

Global Equity

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A "Goldilocks" Macroeconomic Scenario

- The synchronised expansion we have seen around the world during 2017 looks set to continue unimpeded in 2018. After being narrowly driven by a few countries like the United States and China, we have seen the expansion broaden out, with greater participation from Europe, Japan and various emerging markets, suggesting to us that the cycle has further to run.

Better Opportunities outside the United States

- Corporate earnings and relative valuations also to some degree have mirrored where the major economies are in their recoveries as of November 2017. And we believe positive economic and earnings visibility has been behind equity market returns during 2017, a trend that can continue in 2018 so long as earnings growth maintains momentum.

- US earnings have recovered strongly and are now past their prior peaks, but with corporate earnings beginning to show increasing strength outside the United States, we believe an opportunity exists for those stock markets to lead global equities over the coming year.

Growth in Disruptive Companies

- In this environment of modestly rising interest rates and fuller valuations, we believe innovative companies with the potential to disrupt existing industries, including in emerging markets, could fare particularly well.
- We see opportunity not only in disruptive technology companies, but also in companies that are using technology to change entire industries. And unlike during past runs in technology stocks, many of these companies have actual earnings and cash flows that can support reinvestment in their businesses, which in turn makes them less reliant on raising capital in the markets at a time when interest rates are climbing.

Multi-Asset Investing

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Fundamentals in Focus as Central Bank Stimulus Fades

- We regard 2018 as a critical juncture for global financial markets and economies, given that central bank monetary policy is set to provide incrementally less support for a wide range of risk assets.
- We see greater potential for a return to normal levels of volatility, as markets adjust to an environment in which business fundamentals look set to continue powering up, monetary policy will begin powering down, and fiscal policy and economic growth could be increasingly influential as they are taken off “standby” mode.

Increased Selectivity in Multi-Asset Investing, with a Tilt Toward Equities

- We regard equities as fairly attractive compared to more interest rate-sensitive asset classes, given the potential for eventual higher interest rates and the risk this entails for fixed income markets.
- We continue to find compelling ideas across sectors, and are most interested in stocks that appear currently undervalued relative to long-term business fundamentals, and those offering some degree of counter-cyclical or contrarian defensive characteristics.

Cautious about Bonds as the Credit Cycle Evolves

- Within fixed income markets we are now de-emphasising asset allocation risk in favour of more idiosyncratic risk exposures, with targeted and concentrated exposures to specific government and corporate bond opportunities.
- We remain cautious regarding developed-market government bonds and retain our bias toward short duration to help us navigate some of the perceived risks.
- A combination of improving growth and favourable fiscal policies in select emerging markets—along with the prospect for higher yields—presents opportunity in both hard currency and local currency emerging-market debt.

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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. Stocks historically have outperformed other asset classes over the long term, but tend to fluctuate more dramatically over the short term. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. 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. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Changes in the financial strength of a bond issuer or in a bond's credit rating may affect its value. Floating-rate loans and high-yield corporate bonds are rated below investment grade and are subject to greater risk of default, which could result in loss of principal—a risk that may be heightened in a slowing economy.

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