REFLECTIONS ON GROWING ECONOMIES AND FADING STIMULUS

2018 Global Investment Outlook

OPTIMISM AND SELECTIVITY IN 2018

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2018 OUTLOOK: *"We're expecting a return to normal volatility in financial markets in 2018, the kind that we think is best-suited to a nimble, tactical approach toward portfolio construction."*

We regard 2018 as a critical juncture for global financial markets and economies. Ten years on from the global financial crisis (GFC) of 2007–2009, the response of key central banks to it—namely the massive printing of money through quantitative easing (QE) programs—has supported, in broad terms, an environment of synchronized global growth and resilient corporate profitability. It has also accomplished its goal of guiding many investors into riskier financial assets. Stock market gauges across developed and emerging markets have recovered significantly since the depths of the GFC; in the United States, for example, we've experienced the country's second-longest bull market on record, and bond markets across the globe have likewise posted impressive gains. At the same time, the march higher in US and global equity indexes has seen implied volatility fall to multi-year—and in some cases multi-decade—lows.

However, the US Federal Reserve (Fed) is now shifting toward a monetary-tightening phase as it gradually raises interest rates and unwinds its balance sheet, and certain other central banks may likewise begin to do so in the year ahead. We will see how the extended influence of QE on financial markets evolves as its gradual removal gathers strength. Various global political situations also have the power to ratchet up volatility. Overall, we face the coming year with a balanced assessment of the opportunities and potential headwinds, and this furthers our conviction that a nimble and tactical approach to multi-asset investing is the best posture to navigate this uncertain outlook.

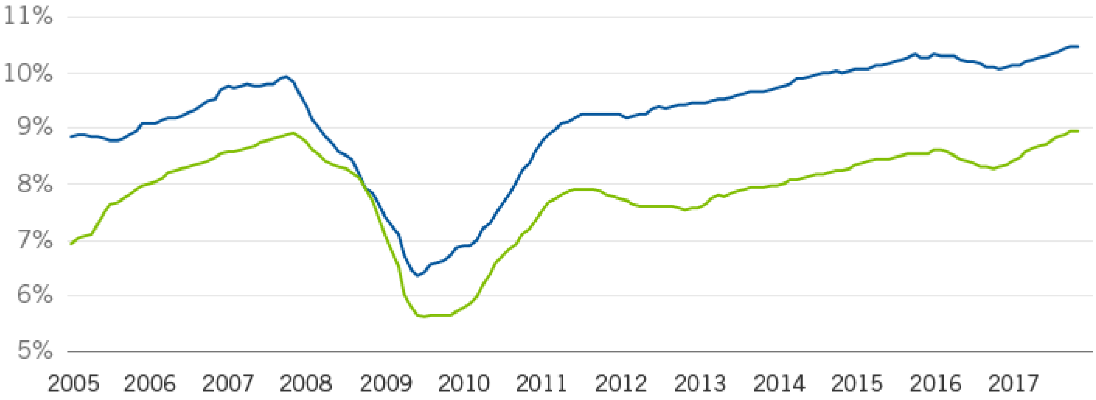
Synchronized Global Growth with Scope to Persist

After a slow-burning but sustained recovery, the global economy has largely repaired the damage of the GFC and the ensuing recession. In October 2017, the International Monetary Fund (IMF) lifted its forecasts for global growth and employment in 2017 and 2018. The IMF expects all G20 countries[1] to grow in 2017—the first such synchronized expansion since 2010. We believe the ongoing global economic recovery has the potential to continue for a few more years at least. Global trade has picked up since the latter half of 2016, and it could accelerate marginally over the next couple of years.

The extended period of generally low interest rates globally has also supported corporate profit margins that were still improving in late 2017. The sustainability of corporate profits has been the foundation for rising global equity markets in 2017. Though US corporations have demonstrated a generally subdued approach toward capital spending since the GFC, we believe many companies are now more focused on positive capital allocation decision making and policies. The lack of significant investment to date has likely dampened excesses that might contribute to economic challenges, and an acceleration in business investment could give economic growth a second wind by, for example, reviving productivity growth.

Corporate Profit Resiliency amid Low Interest Rates

Net Income Margins, United States and Worldwide
January 1, 2005 -November 1, 2017



S&P 500 Index

MSCI World Index

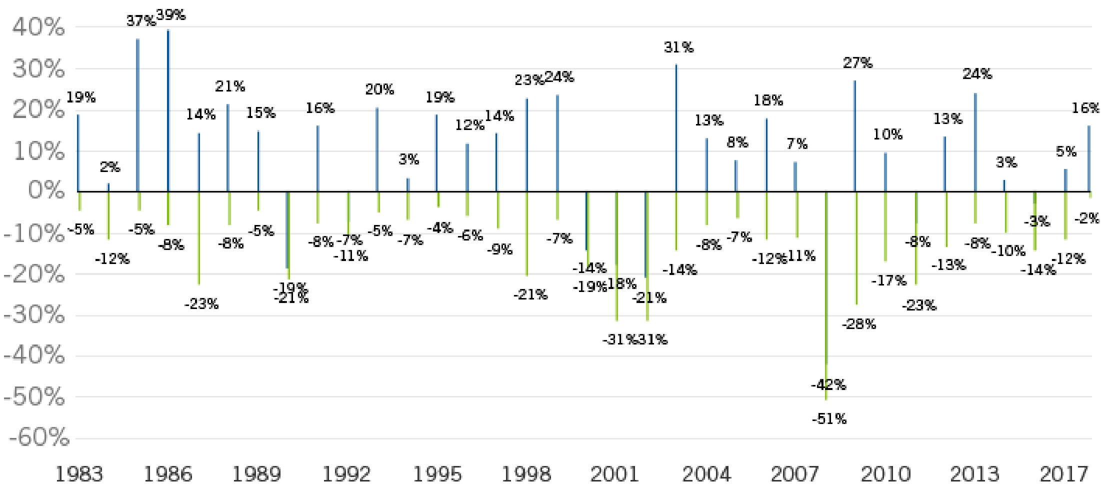
Source: Thomson Reuters Datastream. Indexes are unmanaged and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. **Past performance does not guarantee future results.**

Potential Return of Normal Volatility as Extraordinary Support Measures Are Removed

This backdrop leads us to believe the normalizing of monetary policy in 2018 could mean a return to normal market volatility. Many investors seem to expect that reversing QE will have little impact, if any. We disagree, though we think the Fed has signaled its policy intentions clearly enough that a disorderly debt-market decline similar to 2013's "taper tantrum" appears unlikely. However, we see greater potential for volatility in 2018, simply 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.

Global Equity Market Volatility in 2017 Has Been Abnormally Low

MSCI World Index, Returns and Drawdowns
December 31, 1983 -October 31, 2017



Calendar Year Return

Largest Drawdown

Source: MSCI. A drawdown is the peak-to-trough decline during a specific period on the index. A drawdown is usually quoted as the percentage between the peak and the subsequent trough. Those tracking the entity measure from the time a retrenchment begins to when it reaches a new high. **Past performance does not guarantee future results.**

Any resurgence in market volatility could also be driven by various geopolitical factors. The US political environment remains a challenge, and several of the pro-growth economic policies touted by the current presidential administration have been slow to develop. With tax policy maneuvering alongside Fed balance-sheet unwinding on the horizon, US equities may become more prone to volatility and sector rotation. Nonetheless, we still see potential for eventual US corporate tax reform, which may smooth the way for repatriation of corporate profits. This, in turn, could encourage US companies to reinvest more of their profits domestically based on favorable tax treatment of future earnings. It would also be supportive of higher future US economic and earnings growth.

Elsewhere, the latest push for Catalonian independence in Spain was a reminder that Europe's economic recovery is not necessarily synonymous with political tranquility, and thus faces potential future disruption. Similarly, geopolitical outliers such as North Korea could linger as a source of uncertainty and headline risk. With that in mind, we think investors should consider preparing for rising volatility following an unusually quiet period for global financial markets.

We Think 2018 Calls for a Selective Approach to Multi-Asset Investing

Given that central bank monetary policy is set to provide incrementally less support for a wide range of risk assets as financial markets evolve in 2018, we think this is a time to be agile in our portfolios and adapt to changes that may be coming. For all of our multi-asset portfolios, their construction begins with our longer-term capital market expectations. However, we also leverage the knowledge and expertise that exists in the Franklin Templeton investment teams to drive tactical moves.

Based on the teams' fundamental research, we believe our multi-asset portfolios will likely be best served by being tilted 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. Heading into 2018, valuations appeared stretched in certain pockets of the global equity markets but not in others, and we have continued to find compelling ideas across sectors. In particular, we are most interested in stocks that appear currently undervalued relative to long-term business fundamentals. We also favor stocks that offer some degree of counter-cyclical or contrarian defensive characteristics should the central bank-fueled bull market eventually run out of steam. In our view, corporate earnings and cash flow generation will matter most for the performance potential of global equities going forward. Moreover, we believe rising rates globally should increase the opportunity set for investors.

In terms of fixed income, we remain cautious regarding developed-market government bonds and retain our bias toward short duration to help us navigate some of the risks of this market environment. A combination of improving growth and favorable 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. Ultra-low interest rates and massive bond-buying by central banks have pushed down financing costs for corporate borrowers that have raised money in the world's bond markets. While corporate credit conditions appeared healthy as we headed toward 2018, we also think potential shifts in these markets could cause problems for investors holding bonds that are more susceptible to price declines or defaults should credit conditions turn. Essentially, our efforts within fixed income markets are now more tilted toward deemphasizing asset allocation risk in favor of more idiosyncratic risk exposures, with targeted and concentrated exposures to specific government and corporate bond opportunities.

1. The G20 (Group of 20) is an international forum for the governments and central bank governors from Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, the Russian Federation, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, the United States and the European Union.