FRANKLIN TEMPLETON INVESTMENTS

Investment Team Update

July 2015

Global Economic Perspective

PERSPECTIVE FROM THE FRANKLIN TEMPLETON FIXED INCOME GROUP®

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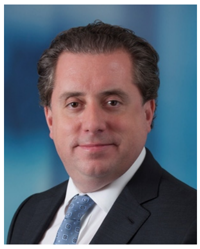

David Zahn

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- China Intervenes to Prop Up Growth and Calm Its Stock Market
- Greek Battle Disguises Continued Eurozone Improvement

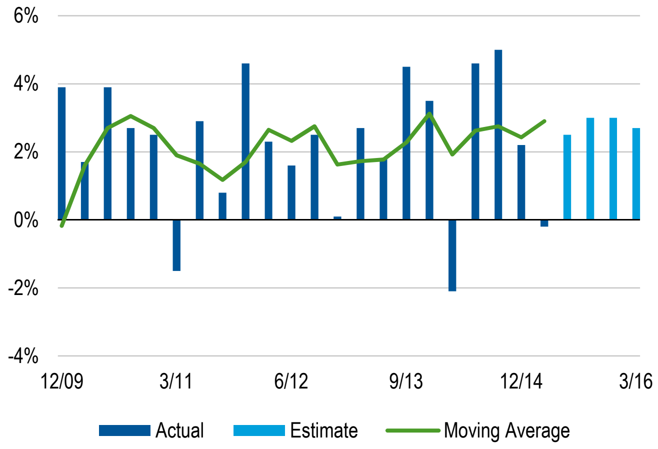
US Likely Inching toward Moderate Interest-Rate Hikes

US Federal Reserve (Fed) Chair Janet Yellen gave the clearest indication yet that the central bank is likely to start raising interest rates later this year when she said in a speech on 10 July that she expected it would be "appropriate at some point later this year to take the first step to raise the federal funds rate and thus begin normalising monetary policy." Yellen re-iterated this view in an appearance before Congress five days later. As usual, the Fed chair has been hedging her bets somewhat, saying she wanted to see further improvement in labour market conditions and greater confidence that inflation would move back up to 2% in the next few years, but, based on current trends, it seems that small, incremental hikes in base interest rates are looming on the horizon.

In our view, any decision on monetary policy normalisation will have to take into account some of what is happening outside of America's borders, including the hazy economic outlook for China, the slowdown in other large emerging markets and the uncertainties that continue to plague the eurozone. Any move toward US monetary policy normalisation would come in spite of an appeal from the International Monetary Fund (IMF) that the country delay raising interest rates until next year. The IMF expressed concerns over the rise in the value of the US dollar, which has gained about 20% against a basket of currencies in the past year and led to a deepening trade deficit. More gains by the dollar—abetted by expectations of rate rises—could leave growth in the United States "significantly debilitated," according to the IMF.

But we believe purely US domestic factors continue to argue in favour of lifting short-term benchmark rates from the "at or close to zero" level where they have been stuck since 2008. Most tellingly, the US nonfarm payroll report for June showed that the US economy has continued to create plentiful jobs, which has led to a fall in the unemployment rate to 5.3%. After the first quarter's negative economic growth, the increase in employment has fed through into some spending indicators and to a real estate recovery, with the S&P/Case-Shiller index of home values in 20 cities rising 4.9% from a year earlier in April. Additionally, car sales have been buoyant for several months. All in all, recent data would seem to confirm the Fed's view that first-quarter 2015 weakness was "transitory" and that the US economy regained its footing in the second quarter, perhaps setting the stage for a more robust second half of the year.

Chart 1: Real US GDP Growth
Quarter-Over-Quarter Change
Q4 2009–Q1 2016 (forecast)

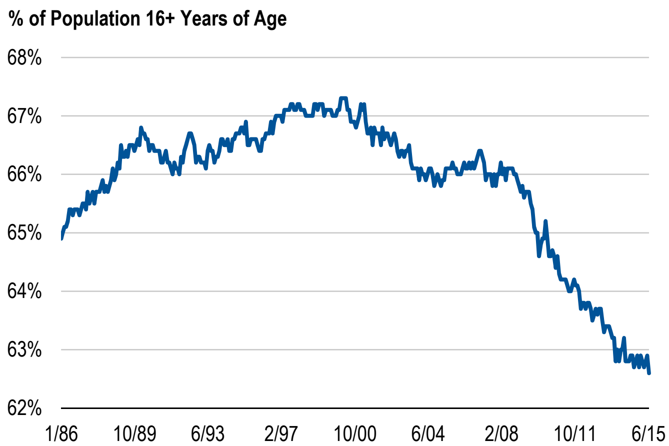


Source: Bureau of Economic Analysis, data through 1Q15; as of 25/6/15. Estimates from Bloomberg survey of 75 economists' forecasts, surveyed from 5/6/15 through 25/6/15; reported on 26/6/15. **There is no assurance that any projection, estimate or forecast will be realised.**

The US economic picture, however, is not entirely unblemished. Productivity gains have been weak, the participation rate (meaning the percentage of the labour force in employment) declined to 62.6% in June—the lowest level since 1977—and hourly wage growth was flat in the same month. In spite of the drop in gasoline prices, consumers have remained cautious, as a 0.3% drop in retail sales in June suggested. Such factors explain the restraint that the Fed has continued to show, even as it leans toward rate rises. Meanwhile, manufacturing output was flat in May and June.

But one can be reasonably sanguine on at least some of these points. The Institute for Supply Management's purchasing managers' index (PMI) showed that US industry has continued to expand, and while weak retail sales betray consumer caution, The Conference Board's consumer confidence index for June was still much higher than a year ago.

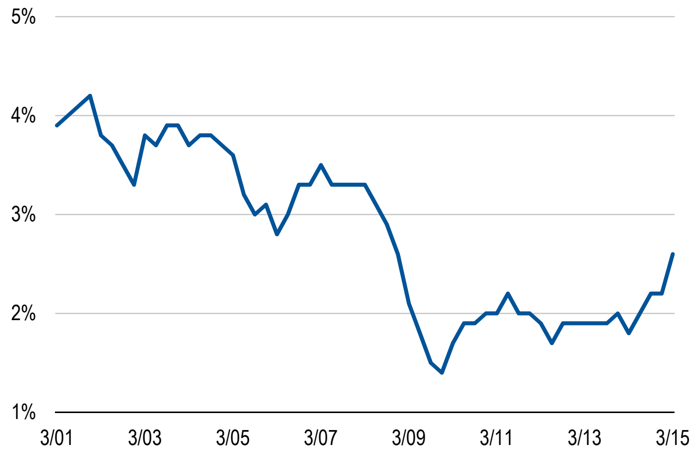
Chart 2: US Labour Force Participation Rate
1 January 1986–30 June 2015



Source: Bureau of Labor Statistics, 2 July 2015. Data through 30 June 2015, includes ages 16+.

However, the lack of growth in hourly earnings is something of a conundrum (average hourly wage growth was flat month-over-month in June and up over the past year by just 2%). The growth in contract employment, automation and crowd sourcing could well be having a negative influence on wage increases and sapping the bargaining power of full-time employees. However, hikes in minimum wages in a number of states and reports that prominent companies are having to offer higher pay to attract workers may start to show up in wage statistics in the months ahead. Meanwhile the employment cost index (ECI)—which is compiled by the Bureau of Labor Statistics on a quarterly basis—suggested relatively solid 2.8% gains in wages in the year to end-March. Many observers expect hourly wages to pick up and become visible in statistics if and when the economy expands.

Chart 3: US Employment Cost Index
Year-Over-Year Change
Q1 2001–Q1 2015



Source: Bureau of Labor Statistics, 30 April 2015.

All in all, the Fed continues to expect inflation to rise gradually toward 2% over the medium term as the labour market improves further and the transitory effects of energy price declines and other factors dissipate, but the pace for hikes in interest rates could well be moderate, as the Fed has been indicating.

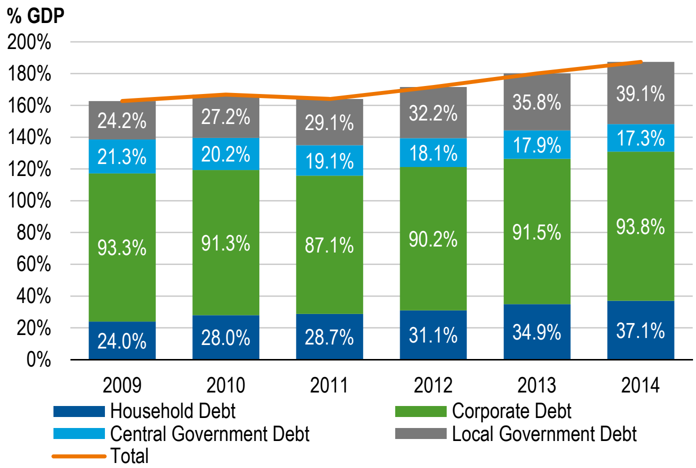
China Intervenes To Prop Up Growth And Calm Its Stock Market

It is generally felt by market observers that the wild, retail-driven speculation on the domestic Chinese stock market has little relation to economic fundamentals. China's domestic stock markets doubled in value in the space of less than a year only to fall by 30% during three weeks in late June through early July, before rising sharply again after central bank intervention. The stock market is just a small part of the Chinese economy, and a previous boom and bust in Chinese equities in 2007–2008 had little impact on consumption, retail sales or industrial production.

Yet jitters on the Chinese stock market have caused unease among many observers because of the potential fallout for the world economy. They have come amid some reports suggesting that even the reduced economic growth figures that the Chinese authorities have been presenting of late have been enhanced by a decline in the cost of imported commodities—which helps the trade balance and hence the ultimate gross domestic product (GDP) figure. This unease has been compounded by the downturn in exports to China (and to Asia in general) that a number of countries have been reporting. Chinese imports slumped by 17.6% in May (year-over-year), according to official data from the General Administration of Customs, and by a further 6.7% in June (year-over-year).

In spite of the Chinese stock market's perceived relative unimportance, the Chinese authorities have pulled out all the stops to ensure that equity volatility does not spill over into the wider economy. The People's Bank of China cut interest rates four times between November and the end of June, with the last of these cuts seen in part as an effort to prop up stock prices. Bank reserve requirements were also cut for similar reasons. Fiscal stimulus has also been introduced. Thus, extra liquidity is flowing through the Chinese economy, which may help stimulate growth not only in China but also in many emerging markets that export to China. Additionally, government spending on infrastructure has helped stabilise industrial activity, and property prices in major cities have started to tick up again after long being in the doldrums. The major shift toward reflationary macroeconomic policy would seem to trump events on the stock market in determining Chinese growth, in our view. China recorded 7% annual growth in the first quarter of 2015 and again in the second, which was slightly better than analysts' forecasts, while measures of monthly activity showed bank lending increasing in June and a rebound in factory orders. The decline in Chinese imports seems to be tapering off, while Chinese exports rose in June, breaking a three-month slide. Chinese GDP growth is well below the double-digit rates the country achieved a decade ago, but with the Chinese economy now considerably bigger than it was then, we remain confident that even with a moderate deceleration in annual growth, the country will continue to contribute significantly to the global economy.

Chart 4: China: Total Debt
2009–2014



Source: National Bureau of Statistics, China; People Bank of China, IMF.

However, the recent sharp gyrations in stock prices may have a number of indirect consequences. Margin lending to buy shares may well decline as humbled investors deleverage, but there is the danger that fresh liquidity will go into different speculative bets—money might again flow into real estate ventures, for example—thus holding out the possibility of fresh problems sometime ahead. The stock market whiplash also poses a credibility problem for the Communist regime, particularly with regard to its economic and financial liberalisation programme, of which the progressive opening of the domestic share market was meant to be a part. Wild swings in the market, just like the authorities' intervention to prop it up, could well delay the development of fully functioning capital markets as an alternative to bank loans. Propping up share prices—as the Chinese authorities have been doing in recent weeks through bans on short selling and feeding cash to brokers to buy shares—represents a distortion in the allocation of capital. However, some observers might remark that the rolling-out of quantitative easing programmes in developed markets over the past six years has also distorted financial markets.

Greek Battle Disguises Continued Eurozone Improvement

After labourious negotiations during the night of 12–13 July, Greece agreed to a third bailout totaling €86 billion—or, more precisely, it reached an agreement on a process to launch negotiations on a new programme of aid from the European Stability Mechanism. Perhaps the most interesting aspect of the bailout agreement is a provision that forces the Greeks to transfer up to €50 billion of state assets to a new fund to recapitalise Greek banks, reduce debt and make new investments.

But Greece has received two previous bailouts since 2010 that have failed to provide a definitive fiscal cure. With little by way of investment or industry, and with generally poor demographics, Greece's overall economic viability remains in doubt, as does its capacity to carry through the drastic reforms that its creditors have exacted as the price for a third bailout, especially as resistance hardens to the measures and onerous oversight insisted upon by the international lenders. Reforms will have to be meticulous and excruciating for Greece to stand any chance of eventually paying its own way, but it is by no means certain that after five years of austerity and a 25% drop in the size of the economy, another severe dose of the same will solve Greece's long-term problems.

In the circumstances, one might seriously question Greece's ability to pay back any of its existing debt (about €320 billion), never mind yet another bailout. The IMF, skeptical of the plan outlined on 13 July and somewhat removed from European sensibilities over the issue of debt relief for Greece, has pressed for more precise details on how the new plan will stabilise Greek finances in the short term as well as over the long run, and it has called for "dramatic" measures to lighten Greece's debt burden.

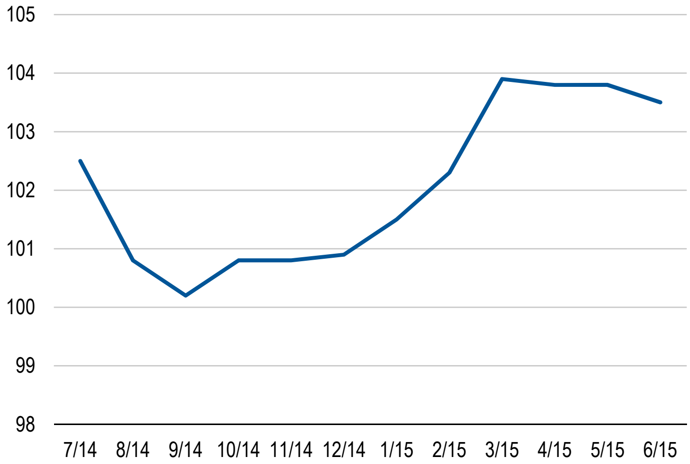
Yet on the question of restructuring the country's debt or cancelling it altogether, the summit agreement is somewhat (and potentially purposefully) vague. "Nominal haircuts" on Greece's debt "cannot be undertaken," it says, but "longer grace and payment" periods might be considered.

Overall, while Europe has avoided "Grexit" (meaning a Greek exit of the currency bloc) in the immediate term, the Greek economy remains in intensive care. It is, of course, possible that the agreement on a third bailout clears all the hurdles placed before it and that the shock therapy to which Greece is being subjected quickly sparks an upsurge in confidence among international investors and Greeks themselves. But that might be a tall order. Unless business confidence and recovery can be fostered in the coming months, the country may continue to face a highly uncertain economic and political outlook, even should the radical left government of Prime Minister Alexis Tsipras manage to survive its own internal contradictions.

Nobody has come out of the Greek crisis shouting victory. Since Tsipras came to power in January, tempers have flared, insults have been hurled, a rift has appeared between a generally more conciliatory France and a less pliant Germany, and the idea that the European "union" is a solid entity in which solidarity between countries can be taken for granted has taken a serious hit. The threat of Grexit seems likely to reverberate through the European Union for some time yet. The impasse that Greece's radical left government has found itself in could either sharpen or dull electoral appetite for a change to the traditional centre-left/centre-right divide that dominates European politics. In this regard, Spain's general election in November will provide a useful indicator of the spread of populism in European politics. Meanwhile, countries such as Poland and the Czech Republic that are supposed to adopt the euro in the years ahead might now have second thoughts. And the imbroglio surrounding Greece will undoubtedly be used by those campaigning for the United Kingdom's exit from the European Union in a referendum to be held in 2017.

European bond markets initially welcomed the deal made at the July summit, although the narrowing of spreads for peripheral bonds over German Bunds was relatively muted, perhaps signalling a measure of scepticism among investors about the ability of the eurozone to survive in the absence of a formal mechanism that ensures the sharing of liabilities among member states. But the widening in spreads at the height of this most recent crisis was also very mild when compared with the 2010–2012 period, suggesting European markets remain fairly sanguine about the state of the region's economy. Indeed, with the exception of Greece, the European economy has continued to motor along. Sentiment continues to be cushioned by European Central Bank (ECB) bond-buying and subdued energy prices.

Chart 5: Eurozone Economic Sentiment Indicator
July 2014–June 2015



Source: European Commission, 29 June 2015. (Readings above 100 signify improving sentiment).

The banking system has been strengthened, fiscal policy is broadly neutral, and the euro remains weak, helping exports. The ECB's latest quarterly banking survey showed that, with ECB support, banks are easing credit standards for loans to enterprises—an encouraging sign, as the chronic weakness in loan activity has been blamed for the absence of any meaningful recovery in the eurozone. In a similar vein, the Markit composite eurozone PMI, which combines measures of manufacturing and services activity, has continued to indicate healthy expansion, rising in June to its highest level in four years, while the European Commission's Economic Sentiment Indicator continues to show that European consumers and businesses remain upbeat about prospects.

EUROLAND MACROECONOMIC DATA

FINAL OUTPUT				
Gross Domestic Product (GDP)[1]	**2Q14**	**3Q14**	**4Q14**	**1Q15**
GDP, Y/Y (%)	0.8	0.8	0.9	1.0
Private Consumption, Y/Y (%)	0.8	1.0	1.5	1.7
Gross Fixed Capital Formation, Y/Y (%)	1.2	0.6	0.5	0.8
ECONOMIC INPUTS[1]				
	Feb 15	**Mar 15**	**Apr 15**	**May 15**
Retail Sales, Y/Y (%)	2.4	1.8	2.7	2.4
Unemployment Rate (%)	11.2	11.2	11.1	11.1
Industrial Production, Y/Y (%)	1.9	2.1	0.8	—
INFLATION & WAGE PRESSURE				
Inflation Indicators[1]	**Mar 15**	**Apr 15**	**May 15**	**Jun 15**
Consumer Price Index (CPI), Y/Y (%)	-0.1	0.0	0.3	0.2
Core CPI, Y/Y (%)	0.6	0.6	0.9	0.8
FINANCIAL MARKETS				
	Mar 15	**Apr 15**	**May 15**	**Jun 15**
Dow Jones EURO STOXX 50 Price Index EUR, Trailing P/E Ratio[2]	21.20	20.73	20.47	19.63
ECB Refinance Rate (%)[3]	0.05	0.05	0.05	0.05
10-Year Yield—German Bunds (%)[2]	0.18	0.37	0.49	0.76
BALANCE OF PAYMENTS[1, 3]				
Trade Balance	**Jan 15**	**Feb 15**	**Mar 15**	**Apr 15**
Billion Euro	7.95	21.21	22.97	24.94
Current Account Balance	**2Q14**	**3Q14**	**4Q14**	**1Q15**
% GDP	1.3	2.6	3.3	2.1

JAPAN MACROECONOMIC DATA

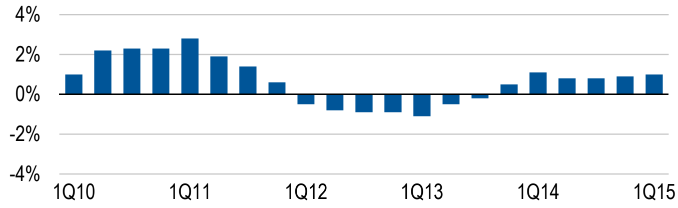
FINAL OUTPUT				
Gross Domestic Product (GDP)[4]	**2Q14**	**3Q14**	**4Q14**	**1Q15**
GDP, Q/Q ar (%)	-6.8	-2.0	1.2	3.9
Private Consumption, Q/Q ar (%)	-14.0	-3.4	0.0	6.4
Fixed Capital Formation, Q/Q ar (%)	-17.9	0.3	1.0	11.0
ECONOMIC INPUTS				
	Feb 15	**Mar 15**	**Apr 15**	**May 15**
Unemployment Rate (%)[5]	3.5	3.4	3.3	3.3
Industrial Production, Y/Y (%)[6]	-2.0	-1.7	0.1	-3.9
Tertiary Index, Y/Y (%)[6]	-1.2	-2.5	1.3	—
Corporate Activities	**2Q14**	**3Q14**	**4Q14**	**1Q15**
Corporate Profit Growth (%)[7]	4.5	7.6	11.6	0.4
Tankan Quarterly Survey (index level)[8]	12	13	12	12
INFLATION				
Inflation Indicators[5]	**Feb 15**	**Mar 15**	**Apr 15**	**May 15**
Consumer Price Index (CPI), Y/Y (%)	2.2	2.3	0.6	0.5
CPI ex-Fresh Food, Y/Y (%)	2.0	2.2	0.3	0.1
FINANCIAL MARKETS[2]				
	Mar 15	**Apr 15**	**May 15**	**Jun 15**
Nikkei 225, Trailing P/E Ratio	21.7	22.1	23.2	22.8
3-Month Yield—JGBs (%)	0.005	-0.003	0.003	0.000
10-Year Yield—JGBs (%)	0.405	0.342	0.394	0.465
BALANCE OF PAYMENTS				
Monthly Trade Balance[7]	**Feb 15**	**Mar 15**	**Apr 15**	**May 15**
Billion Yen	-146	671	-146	-47
Current Account Balance[9]	**2Q14**	**3Q14**	**4Q14**	**1Q15**
% GDP	-0.1	-0.1	0.5	1.6

Abbreviations: Q/Q ar: Quarter-over-quarter annualised rate. Y/Y: Year-over-year.

1. Source: © European Union 1995–2015.
2. Source: Bloomberg. P/E ratios of Dow Jones EURO STOXX 50 Price Index and Nikkei-225 Stock Average as calculated by Bloomberg.
3. Source: European Central Bank.
4. Source: Economic and Social Research Institute, Cabinet Office, Government of Japan.
5. Source: Ministry of Internal Affairs & Communication, Japan.
6. Source: Ministry of Economy, Trade and Industry, Japan.
7. Source: Ministry of Finance, Japan.
8. Source: Bank of Japan.
9. Source: Bloomberg Indexes.

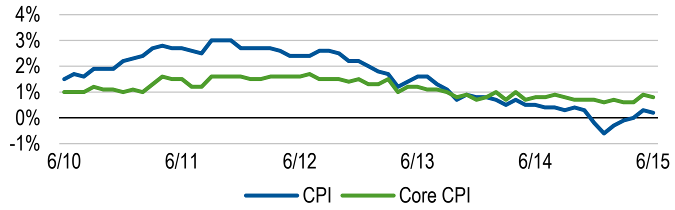
Past performance does not guarantee future results.

Eurozone Real GDP, Y/Y



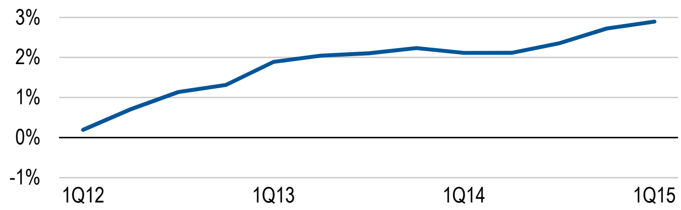
Source: © European Union 1995–2015, as at March 2015.

Consumer Price Index, Y/Y



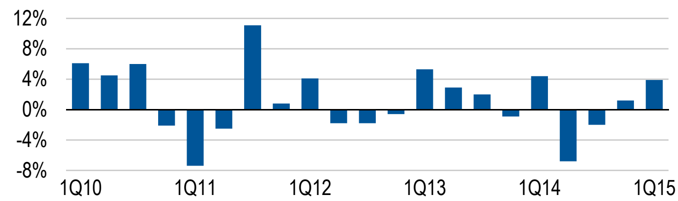
Source: © European Union 1995–2015, as at June 2015.

External Trade Balance, GDP



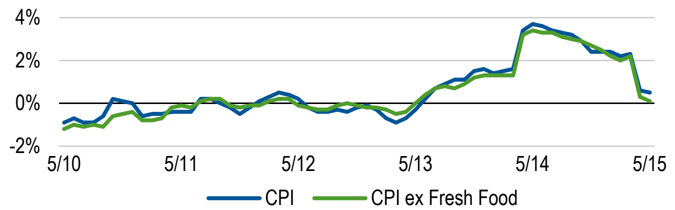
Source: © European Union 1995–2015, as at March 2015.

Japan Real GDP, Q/Q ar



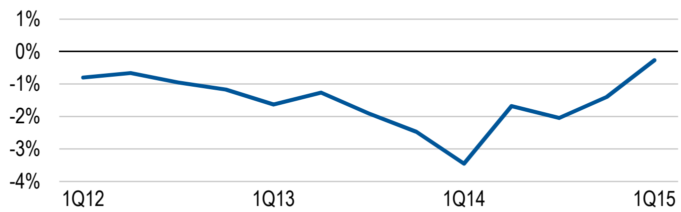
Source: ESRI, Cabinet Office, Government of Japan, as at March 2015.

Consumer Price Index, Y/Y



Source: Ministry of Internal Affairs and Communications, Japan, as at May 2015.

Visible Trade Balance, GDP



Source: Ministry of Finance, Japan and Economic and Social Research Institute, Cabinet Office, Government of Japan, as at 31/3/15.

US MACROECONOMIC DATA

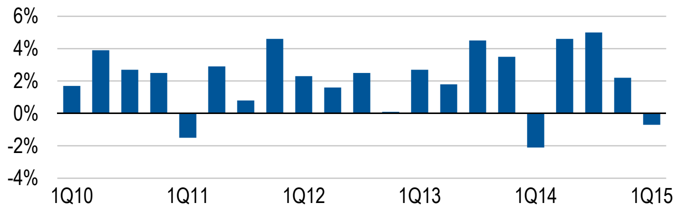
FINAL OUTPUT				
Gross Domestic Product (GDP)[2]	**4Q14**	**1Q15**	**2Q15E[1]**	**3Q15E[1]**
Q/Q ar (%)	2.2	-0.2	2.7	3.0
ECONOMIC INPUTS				
CONSUMPTION/FINAL DEMAND				
Income/Savings[2]	**Feb 15**	**Mar 15**	**Apr 15**	**May 15**
Consumer Spending, Y/Y (%)	3.3	3.2	3.1	3.6
Personal Income, Y/Y (%)	4.6	4.0	4.2	4.4
Savings Rate (%)	5.7	5.1	5.4	5.1
Employment	**Mar 15**	**Apr 15**	**May 15**	**Jun 15**
Unemployment Rate (%)[3]	5.5	5.4	5.5	5.3
Participation Rate (%)[3]	62.7	62.8	62.9	62.6
Nonfarm Payrolls (in thousands)[3]	119	187	254	223
Jobless Claims, 4-wk average (in thousands)[4]	285	284	275	275
Housing[5]	**Feb 15**	**Mar 15**	**Apr 15**	**May 15**
Existing Home Sales (in millions)	4.89	5.21	5.09	5.35
Y/Y Change (%)	4.9	10.9	7.2	9.2
INVESTMENT				
Corporate Earnings[6, 11]	**1Q15**	**2Q15E**	**3Q15E**	**4Q15E**
Earnings, Y/Y (%)	0.7	-7.3	-3.3	3.4
Production & Utilisation[7]	**Mar 15**	**Apr 15**	**May 15**	**Jun 15**
Industrial Production, Y/Y (%)	2.6	2.0	1.4	1.5
Capacity Utilisation (%)	78.8	78.3	78.1	78.4
Nonresidential Fixed Investment[2]	**2Q14**	**3Q14**	**4Q14**	**1Q15**
Y/Y (%)	6.8	7.6	6.2	5.2
INFLATION & PRODUCTIVITY				
Inflation Indicators	**Mar 15**	**Apr 15**	**May 15**	**Jun 15**
Personal Consumption Expenditure (PCE), Y/Y (%)[2]	0.3	0.2	0.2	—
Core PCE, Y/Y (%)[2]	1.4	1.3	1.2	—
Consumer Price Index (CPI), Y/Y (%)[2]	-0.1	-0.2	0.0	—
Core CPI, Y/Y (%)[3]	1.8	1.8	1.7	—
Producer Price Index (PPI), Y/Y (%)[3]	-3.2	-4.4	-3.0	-2.6
Core Producer Prices, Y/Y (%)[3]	2.0	2.0	2.0	2.3
Productivity[3]	**2Q14**	**3Q14**	**4Q14**	**1Q15**
Productivity, Q/Q ar (%)	2.9	3.9	-2.1	-3.1
Unit Labour Costs, Q/Q ar (%)	-3.7	-1.0	5.6	6.7
FINANCIAL MARKETS				
Valuation	**May 15**	**Jun 15**	**Jul 15E**	**Aug 15E**
P/E S&P 500[6]	18.58	18.20	—	—
Fed Funds Rate[7, 8]	0.25	0.25	0.14	0.14
BALANCE OF PAYMENTS				
US Monthly Trade Deficit[2, 9]	**Feb 15**	**Mar 15**	**Apr 15**	**May 15**
Billion USD	-37.2	-50.6	-40.7	-41.9
US Current Account Deficit	**2Q14**	**3Q14**	**4Q14**	**1Q15**
Quarterly (in USD billion)[2]	-92.0	-97.9	-103.1	-113.3
Annualised (% GDP)[10]	-2.1	-2.1	-2.2	-2.3

Abbreviations: Q/Q ar: Quarter-over-quarter annualised rate. Y/Y: Year-over-year. E: Estimate.

1. Source: Bloomberg Economic Forecasts, as of 30/06/15.
2. Source: Bureau of Economic Analysis.
3. Source: Bureau of Labor Statistics.
4. Source: Department of Labor.
5. Source: Copyright National Association of REALTORS®. Reprinted with permission.
6. Source: Standard and Poor's.
7. Source: Federal Reserve. At the 16 December 2008 meeting the Federal Reserve cut the main US interest rate to "a target rate" between 0.00% and 0.25%.
8. Source: Chicago Board of Trade (30-Day Federal Funds Futures Rate for June and July 2015), as of 30/06/15.
9. Source: US Census Bureau.
10. Source: Bloomberg Indexes.
11. Source: Bloomberg calculations are share-weighted year-over-year. Estimates as of 30/06/15.

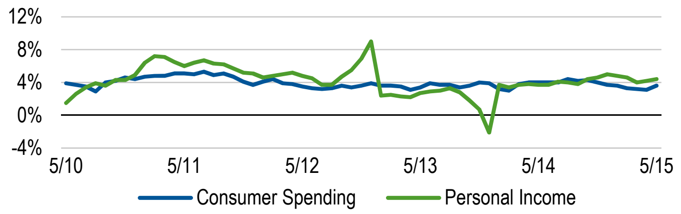
Past performance does not guarantee future results.

Gross Domestic Product (GDP), Q/Q ar



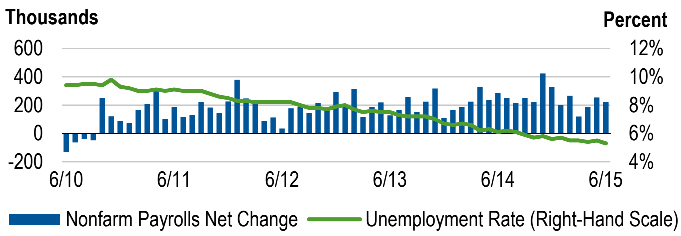
Source: Bureau of Economic Analysis, as at March 2015.

Personal Income & Expenditures, Y/Y



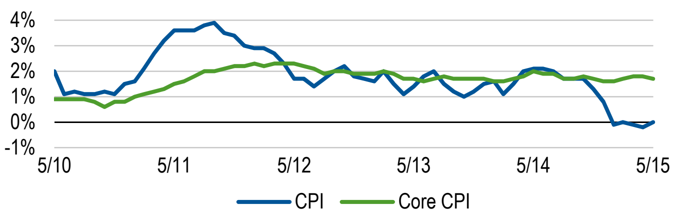
Source: Bureau of Economic Analysis, as at May 2015.

Nonfarm Payrolls & Unemployment Rate



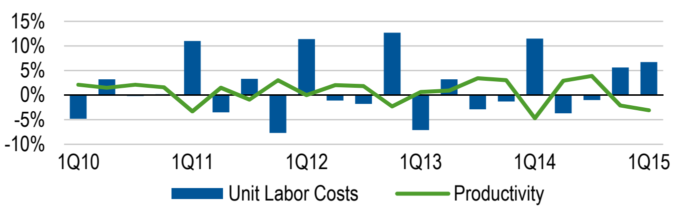
Source: Bureau of Labor Statistics, as at June 2015. All figures seasonally adjusted.

Consumer Price Index, Y/Y



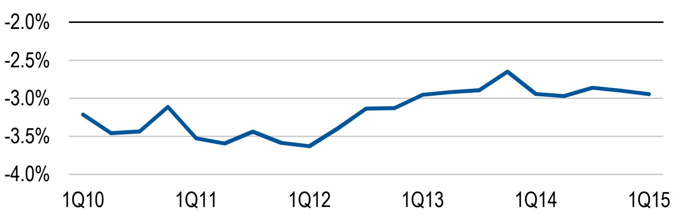
Source: Bureau of Labor Statistics, as at May 2015.

Productivity & Unit Labour Costs, Q/Q ar



Source: Bureau of Labor Statistics, as at March 2015.

US Annualised Trade Deficit, GDP



Source: Census Bureau and Bureau of Economic Analysis, as at March 2015.

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