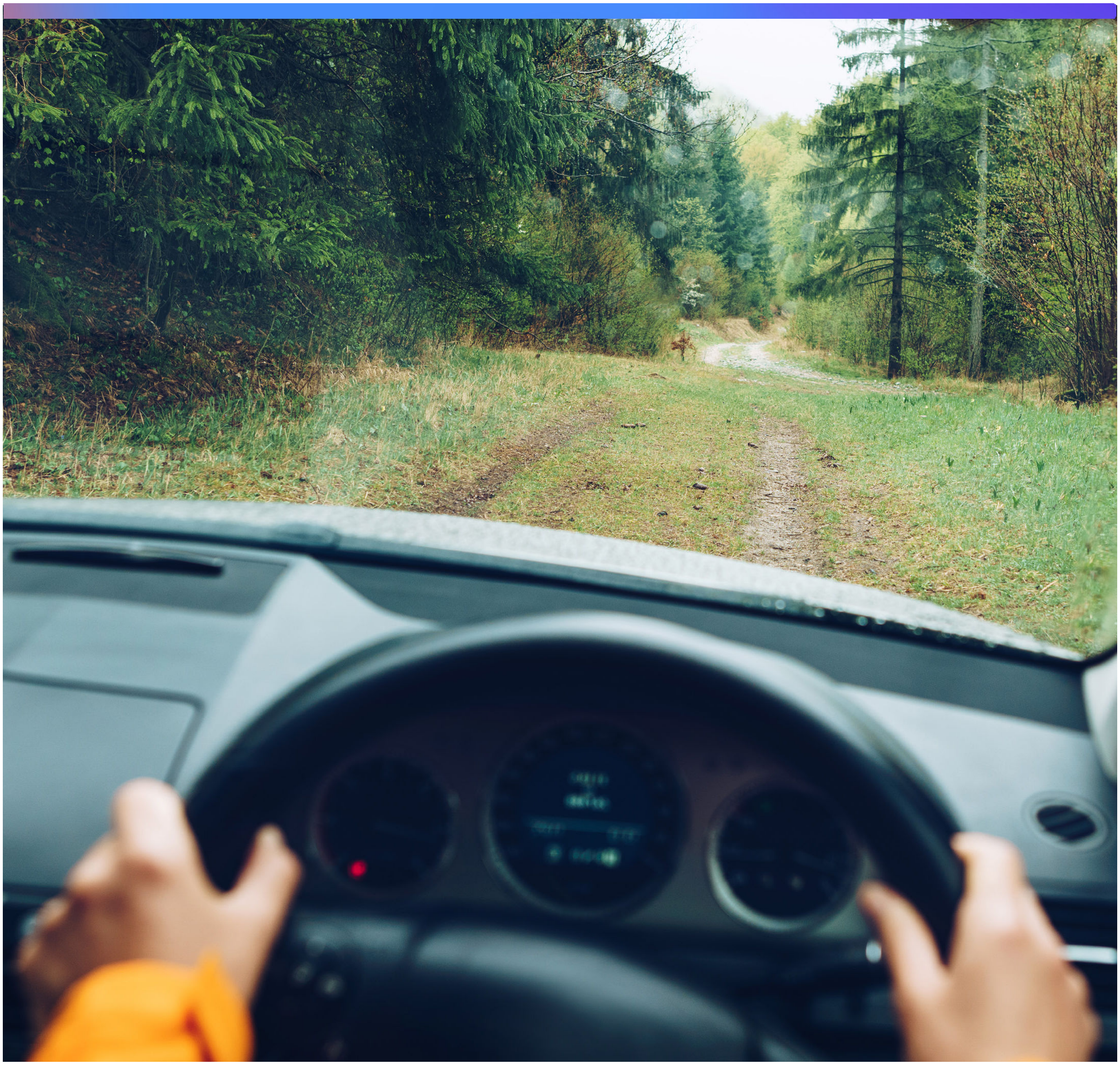
FRANKLIN TEMPLETON

August 2024

Franklin Templeton Investment Solutions

Allocation Views

It's tricky



In this issue

Despite a constructive growth outlook, global equity markets remain in a fragile state. Even with an ongoing disinflationary process and likely rate cuts, rising volatility suggests this is not the time to take aggressive positions in portfolios. Although we believe global stocks still have greater performance potential than global bonds, we maintain the neutral asset allocation stance.

We see persistent divergences in monetary policy and reflect this in our preferences among high-quality bonds. Across asset classes and sectors, we see markets fully discounting the good news that is needed to justify elevated valuations presenting us with a "tricky" investment environment.

Macro themes driving our views

Growth is constructive

- Leading economic indicators suggest continued global growth.
- Recession risks have passed for some developed economies and are low especially for the United States.
- Despite stabilization, growth levels remain at or below trend.

Inflation risks are more balanced

- Significant progress has been made, although it has been bumpy, and inflation is still above targeted levels.
- Elevated services inflation is expected to moderate more slowly due to tight labor markets.
- Core goods inflation has already normalized, but freight cost rises may offset this.

Divergent policy cycles

- More central banks are likely to start cutting rates soon, but with a greater divergence of outcomes likely.
- Inflation progress allows policymakers leeway to balance growth and inflation objectives.
- Central banks remain cautious and will seek data that confirms disinflation before acting.

Portfolio positioning themes

Balance of risks across assets

- A constructive macro environment is typically associated with strong markets, which would support a tilt toward riskier assets.
- However, the level of premium discounted in risky assets remains elevated, and extended sentiment leads to fragile equity markets.
- Policy changes may offset growth and inflation surprises, and the collective mix is more balanced.

A changing equity landscape

- Diminished conviction on the growth outlook for Europe ex UK stocks sees us trim our optimism toward this region.
- The emerging markets remain our preferred region as they are geared to an improving global economy.
- We are marginally less cautious over UK equities but continue to find Canada and Pacific ex Japan less appealing on valuation grounds.
- China remains the most volatile equity market, but policy is more supportive.

Attractive yields for bonds

- Lower yields more recently diminish the return potential from global bonds, causing us to reduce our longer-duration preference in government bonds.
- Easing cycles are likely to begin this year for Western economies, and we find market expectations to be fair.
- Sustained growth supports some optimism toward riskier assets such as high-yield corporate bonds, which we now prefer over bank loans.
- We see value in elevated levels of real yields balanced by continued volatility.

Macro themes driving our views

Recent moves in financial markets have had us casting an eye back to historical precedents where extreme concentration and narrow equity leadership occurred. It's not just those of us old enough to reminisce about the 1980s hip-hop legend RUN-DMC that are singing the iconic track, "It's Tricky." We are not suggesting that a market crash like the one that occurred in 1987—the year that song was released—is in the cards, or even a dramatic move. But we do worry that extended sentiment can lead to fragile equity markets. As a result, we maintain a neutral allocation to riskier assets, and still find the defensive characteristics of developed market government bonds attractive.

As we have noted in recent issues of "Allocation Views," the stock market rally this year has become less healthy, even as fundamentals remained supportive. As a result, we were not surprised to see some rotation into assets that had lagged the rally. Over the last month, this was most prominent in smaller companies, which might benefit from lower interest rates. Our main macro themes remain broadly constructive, even as we anticipate the pace of growth to slow in the United States and the labor market to soften. And perhaps they will not rebound as sharply in Europe as was hoped. Leading indicators have moderated but suggest reasonable growth.

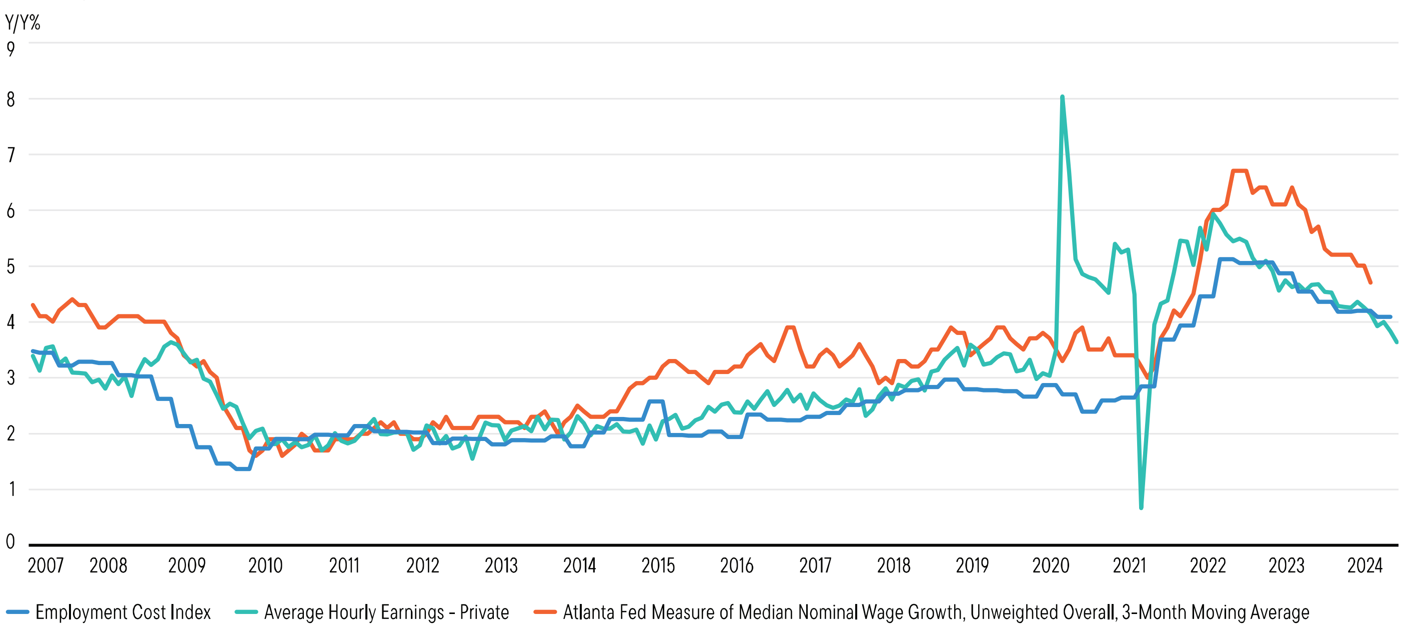
However, we retain the more measured description in our first theme adopted last month, which still shows **"growth is constructive."**

Investors have recently focused less on inflation fears and a bit more on earnings expectations, which have become elevated for a few world-leading artificial intelligence (AI) companies. Even if these lofty levels are realized, it seems that a lot of the good news may be fully discounted in current prices. Is the same perhaps true for broader measures of consumer price inflation. The sharp declines in energy costs late last year will soon drop out of annual comparisons, making further progress toward inflation targets less likely and may see at least a temporary resurgence.

We continue to believe the disinflationary process is intact but expect bumpy progress. We are analyzing developments in freight rates. Freight rates may offset otherwise very subdued global traded goods prices, which reflect a surge in exports from China. The recent easing of employment costs in the United States and softer labor markets in other countries give optimism over future inflation developments. However, we retain our somewhat cautious outlook, as our second macro theme reflects **"inflation risks are more balanced."**

Exhibit 1: US Wage Growth

As of July 1, 2024



Sources: US Bureau of Labor Statistics. Federal Reserve Bank of Atlanta (Atlanta Fed), National Federation of Independent Business, Macronbond. Important data provider notices and terms available at www.franklintempletondatasources.com.

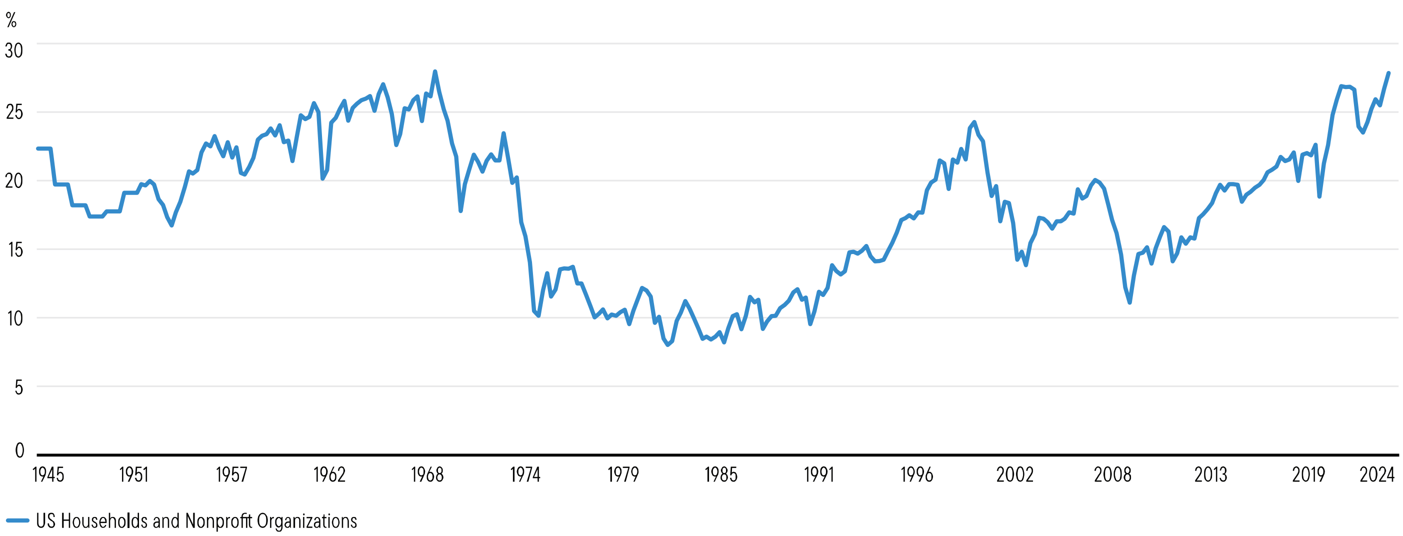
This outlook for inflation is allowing additional central banks to follow the European Central Bank's (ECB's) lead in starting to cut rates. We expect this move to continue and extend to the US Federal Reserve (Fed) in the coming months. However, the expectation of a succession of rate cuts is a further example of where the good news is perhaps fully in the price. Indeed, we have seen expectations build beyond the point that bonds discount just a normalization of monetary policy, verging on pricing a harder landing than we anticipate.

Central banks remain cautious, seeking confirmation of disinflation before acting, but we see the direction of travel as clear. We broadly agree with the market's anticipated timing of the first cuts from the Fed and for further rate hikes from the Bank of Japan (BoJ). Even as the delivery of cuts in the West remains relatively close for more economies, we continue to emphasize **"divergent policy cycles."**

Portfolio positioning themes

Exhibit 2: US Households Own a Lot of Equities

Data As of First Quarter 2024



Source: Federal Reserve. Equities directly held as a % of total financial assets.

Our macro themes had softened earlier this year but are not expected to deteriorate from here. Rather, we reflect on a fragile equity market, still-elevated valuations and extended sentiment. These give concern that our constructive view of fundamentals might already be fully reflected in the positioning of investors. This holds back our enthusiasm for riskier assets and our first portfolio theme shows **"a balance of risks across assets."**

A rise in market volatility from previously subdued levels makes our observation last month about "the calm before the storm" feel even more worrisome. However, the extent of any further market correction will likely be dependent on corporate earnings developments more than the persistence of elevated valuations. Equity risk premiums for global and US equities remain close to their weakest since 2007 (see Exhibit 3), but as always, offer little guidance for near-term market moves.

Exhibit 3: Equity Risk Premium Across Regions

As of July 24, 2024

Sources: Refinitiv, Franklin Templeton Investment Solutions. As of July 24, 2024. The MSCI ACWI Index captures large- and mid-cap representation across 23 developed markets and 24 emerging market 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.** Important data provider notices and terms available at www.franklintempletondatasources.com.

Within equity markets, our views continue to evolve. As growth momentum in Europe remains unconvincing, our preference for markets with proven earnings power and corporate resilience sees us moderate our optimism toward this region. Similarly, the typical defensiveness of stocks in the United Kingdom has more appeal in an uncertain environment. While US equities also tend to offer a safe haven in times of stress, the valuation arguments temper our enthusiasm to only a marginal preference to this market.

Forthcoming rate cuts in the United States may see the dollar weaken, boosting the potential for emerging markets to realize their value. However, headwinds in China seem likely to persist despite recent policy announcements, seeing us favor other developing economies. Our views across the globe are encapsulated in our second portfolio theme, which reflects **"a changing equity landscape."**

Fixed income markets are reflecting a more benign inflationary environment and the prospect of a developing rate-cutting cycle. While this is typically good for fixed-coupon bonds, it tends to lessen the enthusiasm of investors for floating-rate bank loans. Although the outlook for credit more broadly remains supportive, valuations are stretched, and we scale back modestly our preference for sub-investment grade debt as we rotate from loans into high-yield bonds.

Similar forces saw shorter-dated instruments driving the recent fall in governing bond yields, leading to a steepening of the yield curve. As this typically persists through the first rate cut, we have moved to focus more of our investments on shorter-dated bonds. Also, as US Treasury yields have fallen, the return potential of this market has diminished. As such, we see better prospects in markets such as the United Kingdom, where rate cuts look to begin shortly. Overall, our final portfolio theme has moderated a little but still reflects **"attractive yields for bonds."**

Allocation settings views—August 2024

Pendulum settings reflect cross-asset-class views

Risk tier

Asset class | Conviction | Our viewpoint

Risk off/on

- Global growth remains constructive in the developed world as leading indicators suggest continued expansion.
- We maintain a neutral stance toward riskier assets and have trimmed exposure to lower-rated corporate credit.
- Risks remain focused on elevated valuation in equities, and extended sentiment that leads to fragile markets.

High level allocation tier

Equities

- Improving earnings expectations support the outlook for global equities despite localized margin pressures.
- Longer-term equity fundamentals favor regions with proven earning power and continued corporate resilience.
- We retain a neutral view of global equities on elevated tech earnings expectations and positioning which remains somewhat stretched.

Bonds

- Yields are less attractive, in our assessment, and may already largely discount likely policy easing.
- Corporate bond spreads remain low but offer adequate compensation for default risk given macro backdrop.
- We hold a neutral view of bonds overall relative to stocks but moderated our long-duration preference.

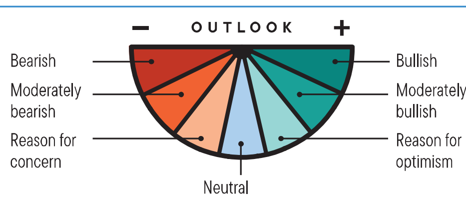
Alternatives

- We see structural attractions in naturally diversifying alternatives, such as private assets.
- Continuing changes to usage and demand present headwinds to real estate.
- We have maintained a neutral view overall, consistent with our longer-term structural allocation.

Cash

- Defensive features of cash are complemented by attractive yields for short-term US Treasury bills.
- Peak policy rates are still available and no longer present a drag on portfolio yield.
- Cash has appeal as a means of diversification, but we maintain a neutral view at this time.

Understanding the pendulum graphic



Arrows represent any change since the last month end.

Allocation tier

Asset class	Conviction	Our viewpoint

Equity regions: Pendulum settings relative to equity asset class broadly

United States

- Strong current economic activity and robust corporate fundamentals support the outlook for US equities.
- We retain a more constructive view on the prospects for ongoing earnings growth over the next year.
- But, we retain a minimal tilt toward this market relative to other regions, reflecting elevated stock market valuations and extreme earnings expectation for AI companies.

Canada

- Growth in Canada faces headwinds from past central bank rate hikes, though cuts have now begun.
- Banking stocks remain under pressure, even with what we consider to be attractive valuations.
- We retain a moderately cautious stance on this market despite global cyclical improvement.

Europe ex United Kingdom

- Easier monetary policy from the ECB and Swiss National Bank, and stabilizing business confidence, support the economy.
- We have diminished confidence in corporate earnings troughing, as the lagged effect of wage increases pass through to profit margins.
- As a result, we have moderated the extent of our optimism toward these markets

United Kingdom

- UK economic prospects remain uncertain despite a pickup in activity and business investment.
- A low weighting to technology and significant foreign currency earnings offset a generally high dividend yield.
- We trim our cautious view, reflecting what is typically a market with defensive sector composition.

Japan

- Japan is starting to see real-term wage gains, which may boost domestic consumption.
- Equity valuations remain attractive relative to history, in our view, but less appealing than other markets.
- We hold a neutral outlook on this market, favoring other countries in the region directly.

Pacific ex Japan

- Overall, this region is vulnerable due to tensions in relations with China.
- A sticky decline for inflation in Australia and still-elevated interest rates may impact consumers.
- We retain our cautious stance on these markets, where valuations are less appealing.

Allocation tier

Asset class	Conviction	Our viewpoint
Emerging ex China		• Stronger long-term growth opportunities are offsetting emerging markets' weaker current earnings. • Developed-market demand should boost growth, which is not discounted in valuations. • Conviction in this view has diminished, and we have moderated the constructive view of emerging markets in recent months.
China		• Property market risks are holding back China's economy, despite recent policy measures from the Third Plenum. • Trade disputes remain unresolved and are a symptom of broader tensions as geopolitical stresses persist. • We retain a neutral stance to reflect growth risks, despite the valuation attractions of this market.

Fixed income sectors: Pendulum settings relative to fixed income asset class broadly

Asset class	Conviction	Our viewpoint
US Treasuries		• The Fed is likely to start cutting its policy rate later this year, but these moves are now fully anticipated by the market. • Once rate cuts start, we anticipate lower US Treasury yields in a year's time but hold greater conviction in other markets. • We are neutral duration sensitivity to US interest rates and prefer other markets offering better value.
Inflation-Linked Bonds		• The level of inflation discounted in inflation-linked securities fairly reflects anticipated longer-term inflation. • Tight monetary policy reduces the value of these assets' potential risk-mitigating role within a portfolio. • We have maintained a neutral view of assets that benefit from rising prices, such as inflation-linked bonds.
Eurozone Government Bonds		• The ECB has started to cut from peak rate levels, even with inflation currently above target. • Given still-weak demand growth in the European economy, the future path of rates is likely to head lower. • We add to our more constructive stance on this region having trimmed exposure last month.
UK Government Bonds		• The UK economy is recovering, having been in recession last year, and inflation risks are moderating. • Bank of England policy will likely continue to restrict activity, even as rates are cut. • We believe the pace of cuts may be faster than anticipated and build our positive view of this market.

Allocation tier

Asset class	Conviction	Our viewpoint
Canada Government Bonds		• The Bank of Canada moved aggressively to address inflation and has now started to cut rates. • The economy is sensitive to changes in interest rates, which have skewed yields lower than those of its peers. • We added to our moderately constructive view relative to other global markets this month.
Japan Government Bonds		• The BoJ has moved away from negative interest rates but maintained its easy monetary policy stance. • Reducing purchases of government bonds in the months ahead is a likely step toward policy normalization. • Further monetary policy tightening is largely anticipated, but we maintain our significant caution toward this market.
Investment Grade		• The investment-grade sector has benefited from earnings levels that make high debt loads more sustainable. • At recent elevated yields, this market was more attractive to some investors, driving yield spreads lower. • We retain a slightly cautious bias in higher-quality credit, preferring government bonds' defensive features.
High Yield and Loans		• Corporate earnings have supported the fundamental attractions of lower-rated fixed income, including loans. • We continue to build a more confident stance toward high-yield bonds, despite narrow spreads. • Reflecting likely cuts in cash rates, we eliminated a tilt toward loans, which have benefited from higher yields.
Emerging Market Debt		• Emerging market fundamentals are improving and should benefit from a benign global environment. • We remain marginally constructive toward local-currency bonds as domestic monetary policy has further to ease. • We remain neutral on emerging market bonds overall but are more cautious on China's local bonds.

Allocation Views

At **Franklin Templeton Investment Solutions (FTIS)**, we translate a wide variety of investor goals into portfolios powered by Franklin Templeton's best thinking around the globe. We serve a variety of institutional clients, ranging from sovereign wealth funds to public and private pension plans in addition to retail multi-asset clients around the world.

The hallmark of our approach is a central forum—the Investment Strategy and Research Committee (ISRC)—which generates a top-down view across asset classes and regions. Furthermore, it connects and synthesizes the bottom-up sector and regional insights of the global investment teams at Franklin Templeton. The ISRC also calibrates firmwide views with original analysis from our dedicated teams, which include both fundamental and quantitative research professionals.

FTIS actively engages with clients in an ongoing, collaborative partnership, to understand each client's particular needs and then to draw from our extensive global resources and capabilities to meet those goals. These portfolios are built, managed and monitored in the framework established by the ISRC, and undergo rigorous tests under multiple scenarios and market regimes.

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All investments involve risks, including possible loss of principal.

Equity securities are subject to price fluctuation and possible loss of principal.

Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. **Low-rated, high-yield bonds** are subject to greater price volatility, illiquidity and possibility of default.

The allocation of assets among different strategies, asset classes and investments may not prove beneficial or produce the desired results. To the extent a strategy invests in companies in **a specific country or region,** it may experience greater volatility than a strategy that is more broadly diversified geographically.

Commodity-related investments are subject to additional risks such as commodity index volatility, investor speculation, interest rates, weather, tax and regulatory developments.

International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. The government's participation in the economy is still high and, therefore, **investments in China** will be subject to larger regulatory risk levels compared to many other countries.

Investing in privately held companies presents certain challenges and involves 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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