December 2023

Franklin Templeton Investment Solutions

Allocation Views

Stabilization might be enough

In this issue

The themes we discuss at our Annual Investment Symposium guide our research process. Over a longer-term horizon, we believe global stocks have greater performance potential than global bonds, despite slightly slower growth expectations. With interest rates starting from elevated levels, overall return expectations from all fixed income assets have become more attractive than has been the case in recent years.

We need to recognize that our longer-term outlook will not be reached along a smooth path but take encouragement from the improved momentum in stock prices. Growth stabilization and declining inflation may be enough to justify the elevated valuations of equities.

Major themes driving our views

Growth is stabilizing

Recession risks are moderating for some developed economies, and the outlook is stabilizing. Lagged effects of monetary policy and tight lending standards remain a risk to economic activity. We expect the disparity between manufacturing and services growth to narrow.

Inflation risks are now more balanced

Inflation is still well above target levels, but goods deflation remains in place, and core inflation is moderating across developed markets. Sticky services inflation is expected to be balanced by demand destruction as the lagged effects of slower economic growth are felt.

Policy to remain restrictive

Central banks are likely at peak rates, and are more data dependent, but will likely continue to sustain restrictive conditions. They maintain a primary focus on inflation, and most are accepting the consequences to growth. Policymakers remain prepared to address evolving crises and maintain financial stability.

Practical positioning

Nimble management still required

The level of premium discounted in risk assets does not appear overly generous, but the declining level of uncertainty that we foresee makes this less of an impediment to owning such assets. We maintain our nimble investment management style and have increased our conviction toward equities.

Bond yields have declined recently

Our longer-term analysis shows that the return potential from global bonds, especially lower-risk government bonds, has improved. This supports our preference for longer duration assets, which has been maintained in recent months despite the sharp decline in yields more recently.

Opportunities in alternative assets

Maintaining a diversified portfolio of risk premia, in addition to the traditional benefits of a balanced portfolio between stocks and bonds, is the most likely path toward stable potential returns, in our view.. We are attracted to naturally diversifying “alternatives” such as private assets, which offer the potential to earn an incremental return linked to their relative illiquidity.

Major themes driving our views

Thoughts for 2024 and beyond

As we head toward a new year, we tend to reflect on what happened in the past year and try to learn from these experiences. The sense of growing economic confidence, or at least sufficient stability to allow markets to focus on corporate fundamentals, has supported risk assets in recent weeks. This has been built on hopes that the process of disinflation is sufficiently well established to allow the main developed market central banks to halt their rate hiking cycles. We were surprised by how resilient consumers have been in 2023, despite the bout of higher inflation and the consequent tightening of monetary policy. Reflecting on the reasons that we saw "storm clouds on the horizon" as we entered the year, most seem less clearly applicable for 2024.

We saw the nervous investment environment that characterized 2023's third-quarter reverse course in November—delivering sharply lower US Treasury yields and buoyant stock markets. This was driven by softer economic activity in the United States, which along with rapid disinflation seen globally, prompted market expectation that the US Federal Reserve (Fed) might soon consider easing monetary policy. With increased confidence that global growth was showing signs of stabilization, we had taken advantage of a period of asset market weakness to eliminate our moderately cautious view of equities, as discussed in Allocation Views last month. We find encouragement in a positive shift in the momentum of stock prices and have now shifted to a modestly optimistic allocation stance overall at the cross-asset level.

Longer-term drivers of growth

At our Annual Investment Symposium in November, we debated the longer-term themes that impact our analysis of the global economy. The Franklin Templeton Investment Solutions (FTIS) team engaged in collaborative dialogue with senior leaders from across Franklin Templeton's wide range of specialist investment managers.

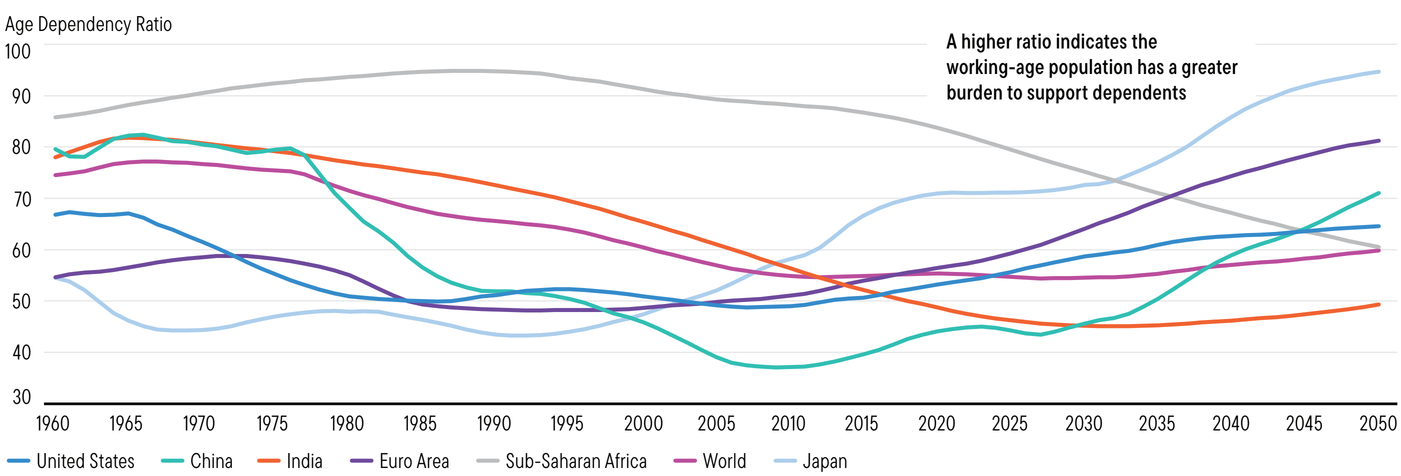
We discussed a range of secular themes that ultimately feed into our views on growth and inflation. This year we focused on the role that artificial intelligence (AI) might play and explored the brave new world of higher interest rates. We elaborate on our views of these trends below, how they impact our macroeconomic outlook, and consequently our longer-term expectations for financial markets. For a more detailed review of the symposium discussions, please see our *Investment Symposium* paper.

In summary, an aging demographic, with rising age-dependency ratio, presents a small but persistent headwind to global growth (see Exhibit 1). This is already evident in Japan

The Ratio of Working-Age Population (As a % of the Total Population) Will Shrink Over the Coming Decades

Exhibit 1: Age-Dependency Ratio, World Bank Projections

January 1960-January 2050E



Sources: World Bank, Macrobond. E= estimate. There is no assurance that any estimate, forecast or projection will be realized. Important data provider notices and terms available at www.franklintempletondatasources.com.

and the eurozone and is following a similar trajectory in China. An acceleration in the adoption of new technology, notably in AI, may provide an offset. As it is rolled out across knowledge industries, we expect that AI will change the way work gets done and boost productivity. Together with other structural trends, including energy security and progress toward a renewable energy transition, this likely drives a capital investment cycle, and supports longer-term growth. Less-supportive fiscal policy in the years ahead may be a partial offset, along with central banks that wish to normalize the size of their balance sheets (see Exhibit 2 below), but likely remain responsive to negative growth shocks or signs of financial instability.

Taking all of this into account, we expect most developed markets to experience trend growth over the upcoming decade. One key exception is China, where we see sustained weaker growth than in the recent past.

Returning to the shorter term, China faces ongoing weakness in the local property market and an unwillingness of policy-makers to stimulate the broad economy due to high levels of debt. Recent changes to public financing arrangements have yet to show sustained progress, and we see this policy dilemma as likely to persist.

In summary, we see recession risks moderating in some developed economies, led by the United States, but still anticipate a period of below-trend growth to continue into 2024. Risks related to the lagged effects of monetary policy and tight bank lending standards temper our optimism.

Inflation has been the most pressing theme in the last few years, given its impact on consumers, businesses, and markets. Although it has dominated the discussion in our Investment Symposium in recent years, it was a little less prominent this year.

The ongoing resilience of consumer demand—as well as the service sector of the economy more broadly relative to manufacturing (which has been weak)—is expected to wane. However, our growth theme continues to show "**Growth Is Stabilizing**" even as recession risks remain somewhat elevated globally.

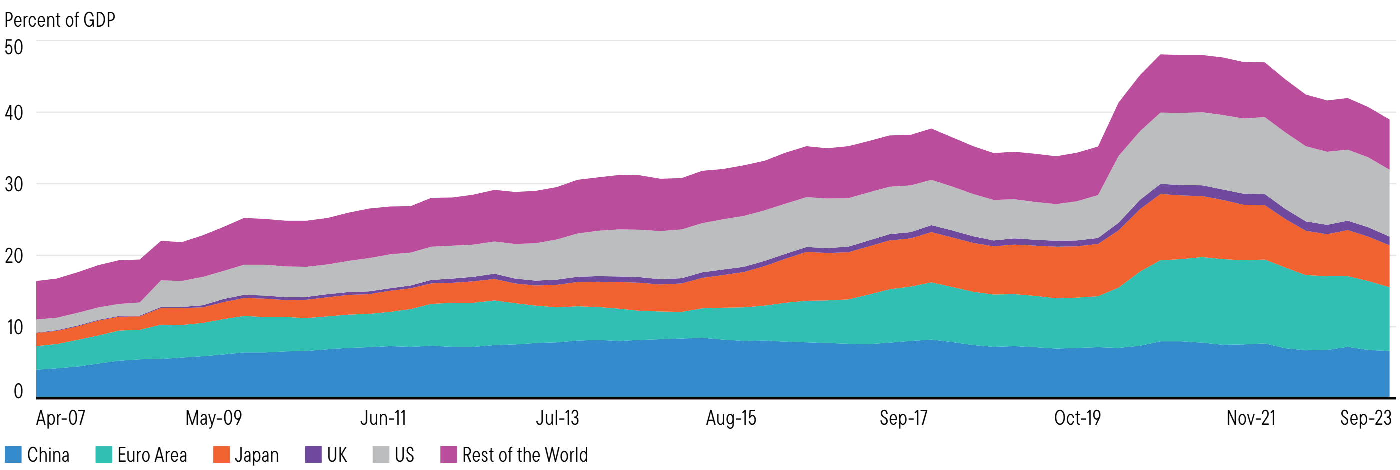
Inflation continues to normalize

Inflation has been the most pressing theme in the last few years, given its impact on consumers, businesses, and markets. Although it has dominated the discussion in our Investment Symposium in recent years, it was a little less prominent this year. Inflation has a direct impact on consumer behavior, and people's expectations for future price rises are a big driver of central-bank actions. Perhaps the reason this topic received less attention is that broad measures of inflation expectations have remained well-anchored, as currently reported inflation has retreated from decades

Quantitative Tightening Has a Way to Go

Exhibit 2: Central-Bank Assets

As of September 30, 2023

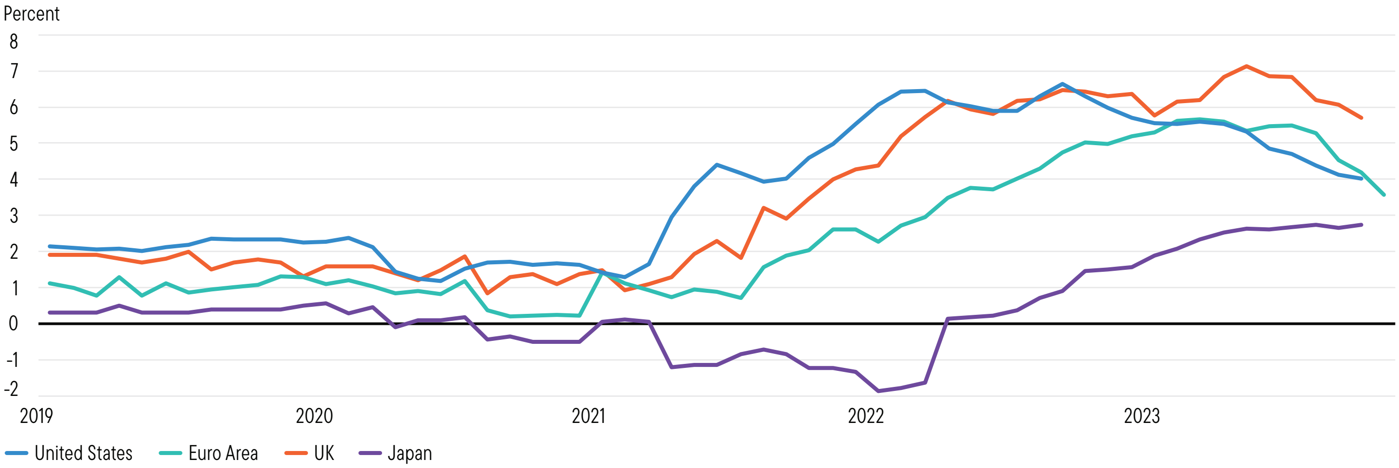


Sources: Reserve Bank of Australia, BCB Community Bank, Statistics Canada, People's Bank of China, Central Bank of Denmark, European Central Bank, Central Bank of Ireland, Reserve Bank of India, Bank of Japan, Bank Negara Indonesia.

Core Inflation Moderates Globally

Exhibit 3: Core CPI Across Regions

As of September 30, 2023



Sources: Bureau of Labor Statistics, Eurostat, ONS, SBJ, Macrobond. **Past performance is not an indicator or a guarantee of future results**. Important data provider notices and terms available at www.franklintempletondatasources.com

high levels over the past year. When we look out over the longer-term horizon, we believe that global inflation will continue to moderate from current levels, but its pace and end point remain uncertain. These are the main themes that we discussed at the symposium.

Central banks' resolve to keep inflation expectations anchored appears to have been maintained even in the face of scares in the banking system earlier in 2023. The reorientation of supply chains may contribute to increased goods prices in the medium term and investment in energy transition likely increases goods price volatility. Despite this, and some of the elements of current inflation, such as housing costs proving somewhat sticky, we do not anticipate that inflation will run far above central-bank targets on a sustained basis. The rapid adoption of AI, as we discussed above, is likely to have positive supply side effects and drive prices down around the world.

As we look for the path to sustained lower inflation, we are continuing to see signs of an easing in stubbornly tight labor markets, notably in the United States. Goods deflation and lower headline inflation may help to moderate wage demands and tame inflation more generally.

Turning to today, we have seen inflation fall faster than anticipated in many parts of the world, especially in Europe where growth has been weaker, adding to the attractions of bonds generally and longer-duration assets in particular. The pace of core disinflation (see Exhibit 3) now seems less likely to be impeded by oil price volatility than it did in October. The rise in energy prices that occurred in early stages of the conflict in Gaza and Israel has been fully reversed as other regional powers have not become actively involved. Neither have we seen any notable reduction in the physical supply of oil.

As we look for the path to sustained lower inflation, we are continuing to see signs of an easing in stubbornly tight labor markets, notably in the United States. Goods deflation and lower headline inflation may help to moderate wage demands and tame inflation more generally. Although some components of core services inflation may be slower to decline, this broad balance of forces saw us change the description of our inflation outlook earlier this year to a somewhat more constructive one, as our second theme reflects "**Inflation Risks Are Now More Balanced**."

Policy on hold for key central banks

In the longer term, monetary policy is the key governor of the relationship between growth and inflation, and with anticipated inflation remaining above central-bank targets, this will keep policy tight in the near term. While we continue to see good reasons for slightly higher levels of inflation in the years ahead, it seems unlikely that inflation will run far above central-bank targets on a sustained basis. Ultimately, in the long term, inflation is a policy choice. Governments and central banks have the tools to combat inflation, but it may be more broadly acceptable to tolerate slightly higher inflation to avoid deeper hits to growth and higher unemployment. This assumption may already start to be reflected in markets, which have moved to discount a pivot to lower rates as early as the first half of 2024.

Slower inflation in the European region has allowed the European Central Bank (ECB) and the Bank of England (BoE) to follow the lead of the Fed in taking a pause from rate hikes. Although they too do not wish to declare a premature victory over inflation, the narrative has changed to how long they will maintain monetary policy at its currently restrictive level. More recently, many monetary policymakers that were previously among the most hawkish voices at their respective institutions have expressed optimism over the progress that has been made, and started to build the case for lower rates, should disinflation continue at its recent pace.

Even as the Fed and other Western central banks are likely at peak rates, policy in Japan and China is following divergent paths. With inflation likely to ease further through the early part of next year, but stay above targeted levels, it seems likely that policy will be highly data-dependent. Overall, this sees our policy theme as a headwind for financial markets, even as it has evolved to downplay the likelihood of any further rate hikes, while emphasizing "**Policy to Remain Restrictive**" even as we move into 2024.

Practical positioning

We incorporate the longer-term themes discussed at our Annual Investment Symposium into our research process, helping to set the direction for our portfolios and their strategic benchmarks.

Over this longer-term horizon, we believe riskier assets, such as global stocks and corporate bonds, have greater performance potential than global government bonds, despite slightly slower global growth. A marginal decline in global inflation expectations offers support. With global interest rates starting from elevated levels and expected to normalize, overall return expectations from all fixed income assets have become significantly more attractive than has been the case in recent years. Earnings growth and yield will likely drive equity returns, with minor support from some valuation uplift that is likely to occur over our 10-year horizon. The risk premium contained within corporate bond yields has tightened but appears to be adequate compensation for the likely level of default risk across the business cycle.

However, in managing portfolios today, we cannot just focus on the higher prospective returns that our long-term expectations highlight. We also need to reflect on more immediate economic dynamics and valuation anomalies that drive shorter-term market moves. Uncertainty over the level of activity and the continued path of inflation normalization leave the outlook somewhat uncertain. This is why "*stabilization might be enough*" is the title of our current edition of Allocation Views. After a year in which the consensus wrongly expected a premature end to the current economic expansion globally, markets are understandably looking for greater clarity on whether these fears might return in the months ahead. We need to recognize that our longer-term outlook will not be reached along a smooth path but take encouragement from the improved momentum in stock prices in recent weeks.

Stronger pricing power has supported corporate earnings, and disinflation may have helped stave off the widely anticipated recession. Earnings expectations plateaued in the early part of this year but are now seen recovering, and recent earnings releases have exceeded market expectations, especially in the United States. However, they remain exposed to ongoing margin pressures, especially where real wage growth continues to feed through. Despite this, developed market valuations, based on price-to-earnings (P/E) ratios, have risen above their historical averages. We believe that stabilization in the outlook for sales growth may be enough to offset any deterioration in margins, justifying elevated valuations.

The level of premium discounted in risk assets does not appear overly generous, but the declining level of uncertainty that we foresee makes this less of an impediment to owning such assets. Reflecting the signs of stabilization, we maintain our nimble investment management style, and have increased our conviction toward equities. We focus on the prospective longer-term return potential for stocks and believe they should earn their equity risk premium over time (see Exhibit 4).

Bond yields have declined recently

One of the notable features of our longer-term analysis is that the return potential from global bonds, including lower-risk government bonds, has improved. This reflects the fact that having seen policy rates rise very sharply over the past two years, the starting level for all government yields has increased. We believe that most developed market central banks, and many in emerging economies, have already reached a terminal policy rate that is somewhat restrictive. Our near-term macroeconomic assumptions call for below-trend growth and only slightly elevated inflation, and we will likely see official interest rates start to be cut in 2024 and normalize in the early part of our long-term horizon.

Once the current restrictive policy environment starts to moderate, it is likely that high-quality bonds will again exhibit more of a risk-dampening effect. Until then, we believe government bonds make a more compelling case than they have for many years.

This supports our current view, which has been maintained in recent months despite the sharp decline in yields more recently, to take a greater total interest-rate exposure and express a preference for longer duration assets.

Once the current restrictive policy environment starts to moderate, it is likely that high-quality bonds will again exhibit more of a risk-dampening effect. Until then, we believe government bonds make a more compelling case than they have for many years. We hold a less constructive view of bonds at the asset allocation level, preferring the return potential of stocks. Investment-grade corporate bond spreads appear somewhat less attractive and generally below their historic average. Given our macroeconomic outlook, the risk premium contained within corporate bond yields seems to be adequate compensation for the likely level of default risk over a full business cycle. However, following a rebound in the valuations of lower-rated corporate and emerging market

Global Equity Valuations Remain Elevated but Not an Impediment to Investment

Exhibit 4: Global Equity Risk Premium

As of December 1, 2023

Sources: Bloomberg, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

hard-currency bonds, we maintain a more cautious stance toward high-yield bonds overall. This reflects valuation more than our outlook for economic activity and the persistence of generally sound corporate debt fundamentals.

Opportunities in alternative assets

We believe that maintaining a diversified portfolio of risk premia in addition to the traditional benefits of a balanced portfolio between stocks and bonds is the most likely path toward stable potential returns. We also believe that active management of this asset mix can enhance potential return and manage the level of total portfolio risk that is taken.

If the assumed benefits of diversification that high-quality bonds and other assets intend to provide disappear, even temporarily, as was the case in the “sell everything” market of 2022, then only the perceived safe haven of cash can offer protection. High inflation represents the primary reason for rising correlations and dominated growth fluctuations in dictating the performance of both stocks and bonds in this period. However, in the longer term, it is hard to make a case for a strategic allocation to cash. Short-term US Treasury bill yields now reflect peak policy rates and no longer present a drag on portfolio yield. Cash has appeal as a means of diversification but is less compelling to us than the potential attractions of fixed income markets, and we maintain a neutral view at this time.

Private assets may be a beneficial addition to multi-asset portfolios from several perspectives: They can offer a higher return potential, may include an illiquidity premium and provide access to a broad array of heterogenous investments.

Our long-term private-asset expectations reflect both bottom-up estimates and top-down models. These identify public asset proxies with common economic risks and growth sensitivities, with necessary adjustments to account for the idiosyncrasies that these private assets may have over their respective proxies, including the impact of their cost of financing. Bottom-up models use a build-up approach to estimating market implied discount rates based on prevailing fundamental data and forward-looking assumptions.

US private real estate continues to face a headwind, albeit improved from last year’s assumptions, due to ongoing lags in appraisal-based valuation adjustments. Unlike its public market counterparts, appraisal-based private real estate has still yet to fully re-price to reflect an environment with negative leverage (financing rates exceeding capitalization rates) and low transaction activity. In contrast, our assumptions for private credit and private equity show a meaningful return premium on offer over public markets.

We review the underlying assumptions for each of these components of longer-term prospective return on an annual basis. We update correlation assumptions and cross-reference between asset classes to calculate an appropriate strategic allocation. However, as “alternatives” are fundamentally buy-and-hold investments, we do not express shorter-term tactical preferences, but maintain our longer-term structural allocation to these assets.

Allocation settings—December 2023

Pendulum settings reflect cross-asset class views

Risk tier

Asset class | Conviction | Our viewpoint

Risk off/on

Global growth is stabilizing in the developed world. Risks remain focused on the lagged effects of monetary policy tightening, but inflation has moderated, and we anticipate this move to continue. We have taken a more constructive stance toward riskier assets, as recession probabilities have declined in some economies.

High level allocation tier

Equities

In broad terms, global equities have emerged from recent earnings pressures with continued corporate resilience. Longer-term equity fundamentals are still relatively supportive. We have adopted a more optimistic stance in global equities relative to bonds as momentum has improved but remain nimble to change direction if needed.

Bonds

Long-term valuations are attractive, in our assessment, fully reflecting monetary policy that is likely at a peak. Corporate bond spreads have declined recently and may not fully reflect the anticipated increase from currently low default rates. We have taken a more cautious view of bonds overall, relative to stocks, but still find government bond yields attractive.

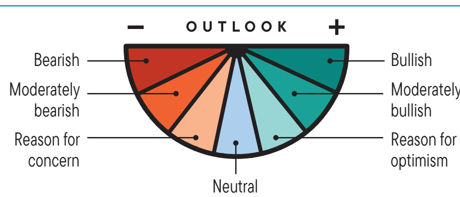
Alternatives

We see structural attractions in naturally diversifying alternatives such as private assets. Continuing structural changes to demand present headwinds to real estate. Also, among alternatives, the benefits commodities may afford through tightness of supply are balanced by softening demand. We have maintained a neutral view overall, consistent with our longer-term structural allocation.

Cash

The defensive features of cash are complemented by, what we believe are, attractive yields as short-term US Treasury bills now reflect peak policy rates and no longer present a drag on portfolio yield. Cash has appeal as a means of diversification but is less compelling to us than the potential attractions of fixed income markets, and we maintain a neutral view at this time.

Understanding the pendulum graphic



Arrows represent any change since the last quarter end.

Allocation tier

Asset class | **Conviction** | **Our viewpoint**

Equity regions: Pendulum settings relative to equity asset class broadly

United States

Stronger current economic activity and robust corporate earnings support the outlook for US equities. Despite the stock market's valuations remaining elevated, we have upgraded our view to reflect some optimism toward this market relative to other regions.

Canada

Growth in Canada faces headwinds from accumulated central bank hikes and energy prices that have faded as a tailwind. Banking stocks remain under pressure, and we have maintained a moderately cautious stance on this market in recent months, even with continuing valuation attractions.

Europe ex United Kingdom

Europe faces headwinds for consumer and business activity as ECB interest-rate rises continue to feed through to the economy. Corporate earnings results may disappoint, as the lagged effect of increased wages starts to impact profit margins. As a result, in recent months we have extended further our medium-term cautious stance.

United Kingdom

UK economic prospects remain uncertain, despite a pickup in business investment. A low weight to technology and significant foreign currency earnings offset the attractions of a generally high dividend yield. On balance, we have retained a neutral view of this market, reflecting some caution over anticipated profit margin headwinds.

Japan

Japan faces weaker foreign demand hitting manufacturing exports, as real-term wage declines hit domestic consumption. Equity valuations remain attractive relative to other markets, in our view. However, we have maintained a neutral stance on this market in recent months, preferring opportunities in other countries in the region directly.

Pacific ex Japan

Overall, this region remains vulnerable due to tensions in relations with China. Strong inflation in Australia and higher interest rates are likely to impact consumers. However, we have maintained a neutral stance on these markets broadly, as we are less cautious on Hong Kong and Singapore, which reflect valuations we regard as somewhat supportive.

Emerging ex China

Stronger long-term growth opportunities are offsetting emerging markets' idiosyncratic risks and highly cyclical nature. Developed market demand should boost earnings, which are not discounted in valuations. Prospects for currency recovery further support us maintaining a notably more constructive view of emerging markets at this time.

Allocation tier

Asset class	Conviction	Our viewpoint
China		Ongoing property market risks, which have led to an easier policy environment, are holding back China's economy. Trade disputes remain unresolved in the longer term and are a symptom of broader tensions as heightened 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

US Treasuries		The Fed has likely reached a peak policy rate, but it has maintained its ongoing fight against inflation. US Treasury yields reflect policy rates gradually easing in 2024. Once rate cuts start, and with tight credit conditions continuing to be felt, we anticipate lower bond yields in a year's time. We maintain greater interest-rate sensitivity to US government bonds.
Inflation-Linked Bonds		The level of inflation discounted in inflation-linked securities fairly reflect anticipated longer-term inflation. We have maintained a neutral view of assets that benefit directly from rising prices, such as inflation-linked bonds, as tight policy reduces the value of their potential risk-mitigating role within a portfolio.
Eurozone Government Bonds		The ECB remains concerned by persistently high inflation, but has signaled it is close to peak rate levels. Given weak demand growth in the European economy, the future path of rates is likely to head lower. We have progressively added exposure to this region and in recent months have maintained a more constructive stance on these markets.
UK Government Bonds		The economy is still at risk of recession and inflation risks are now moderating. BoE policy, having tightened sharply, will likely continue to restrict activity. We believe the peak in rates has been reached and, after some stronger gains, have moderated slightly our constructive stance on this market in recent months.
Canada Government Bonds		The Bank of Canada has moved aggressively amid high inflation and a tight labor market. The interest rate-sensitive nature of the economy is now being felt, skewing yields lower than those of developed market peers. We maintain a moderately constructive view relative to other global markets.
Japan Government Bonds		The Bank of Japan (BoJ) has maintained its easy monetary policy stance, despite adjustments to the band used to target low 10-year government bond yields. However, monetary policy may begin to tighten in the coming quarters. We hold a more cautious stance on this market as the divergence from other developed markets remains quite notable.

Allocation tier

Asset class	Conviction	Our viewpoint
Investment Grade		The investment-grade sector has benefited from ample corporate liquidity and earnings levels that make high debt loads more sustainable. At current elevated yield levels, this market is more attractive to some investors, even though yield spreads appear less generous, in our analysis. We maintain a truly neutral stance toward higher-quality credit.
High Yield		Corporate earnings have supported the fundamental attractions of lower-rated fixed income sectors such as loans and high-yield bonds. We have retained a cautious stance toward high-yield bonds, as financial conditions tightened, but recently added marginally to loans at attractive yields, which capture elevated policy rates.
Emerging Market Debt		Emerging market fundamentals may be improving as foreign and domestic demand stabilize. However, we remain neutral on emerging market bonds overall, as valuations are near historical lows. Local-currency bonds are more compelling to us as domestic monetary policy is starting to pivot toward easier conditions. We remain more cautious on China's local bonds, as we believe selective positioning is especially important in these markets.

Allocation Views

Our research process monitors a consistent set of objective indicators and screens them to identify signals that help our analysts to make better recommendations. By doing this we aim to filter out the daily noise to reveal the underlying trend.

Our macro-economic research group aims to challenge the consensus forecasts for growth and inflation by digging deeper into the data. Just as important, we aim not to be swayed unduly by topics that are dominating current market debate.

Editorial review

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Notes

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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.

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.

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.

Active management does not ensure gains or protect against market declines.

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