Franklin Templeton Investment Solutions

Allocation Views

A healthy correction

In this issue

Despite a constructive growth outlook, global equity markets stumbled in April. This followed a sustained advance in which investor optimism built on positive price momentum and improving fundamentals may have been fully reflected in market sentiment. After a healthy correction, catalyzed by events in the Middle East, we believe global stocks still have greater performance potential than global bonds, and see us staying the course with an equity preference.

We reflect divergences in monetary policy in our preferences between high-quality fixed income assets. European government bonds have become more attractive and will likely benefit from the commencement of easing cycles.

Macro themes driving our views

Growth is more constructive

Leading economic indicators continue to improve globally, and consumers are remarkably resilient. Recession risks are evolving for some developed economies and are especially low for the United States. However, despite stabilization, global growth levels remain at or below trend.

Inflation risks evolving

Significant progress has been made, although it has been bumpy, and inflation is still above targeted levels. Services inflation remains elevated and is expected to moderate more slowly due to tight labor markets. Goods inflation has already normalized to levels that are low, but commodity price rises may offset this.

Policy easing cycles to begin soon

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

Portfolio positioning themes

Allocation toward risk

An improving macro environment is typically associated with strong markets, which causes us to maintain a tilt toward riskier assets. Policy changes may balance growth and inflation surprises, but the collective mix remains constructive. However, the level of premium discounted in these risky assets remains elevated, even after a healthy correction in equity markets.

A tricky equity landscape

Improving earnings outlooks support our preference for US and emerging market stocks. Increased conviction on Japan, as it is geared to an improving global economy, is offset by caution over European and UK equities, where earnings are starting to come under pressure. China remains a conundrum, where attractive valuations reflect poor fundamentals.

More attractive yields for bonds

Higher yields more recently have been boosting the return potential from global bonds, especially lower-risk government bonds. Easing cycles are likely to begin this year, and we find market expectations generally to be fair. We see value in elevated levels of real yields and retain a longer-duration preference. We also think growth supports the prospects for riskier assets such as bank loans.

Macro themes driving our views

As we discussed in *Allocation Views* last month, we examined whether growth was uniformly positive across the major economies, or whether the process of disinflation would proceed without so much as a bump along the road. We noted that even with these uncertainties, the outlook was still constructive for growth and that this typically supported the outlook for riskier assets, notably equities. As a result, we titled the piece "Staying the course."

Recent growth data in the United States undershot the more elevated expectations that had built up during the first quarter of the year. The continued rapid pace of job creation has supported investor confidence. However, more of the growth in demand is being met from imports, which has tempered this underlying economic strength. And, price rises have been offsetting strong nominal growth (inflation seems to have hit a few bumps in the road recently). As a result, and in line with our expectations, gross domestic product (GDP) growth continues to decelerate toward trend. Meanwhile in Europe, our belief that the worst might be behind us was also validated. The eurozone saw a pickup in activity and is starting to improve from recessionary levels. The revisions to data now show two quarters of contraction in the second half of 2023, confirming a technical recession.

However, the catalysts for financial market wobbles in recent weeks are not linked to growth, in our assessment. They may reflect inflationary concerns, which are behind the change of tone in central bankers' rhetoric, and the rise in bond yields. However, the Middle East was the obvious catalyst for stock market weakness, as tensions between Israel and Iran briefly took the headlines as missiles were fired. We view this as driving a healthy market correction (that we think was overdue), rather than a game-changing moment. Investor sentiment had become excessively optimistic. As momentum slowed, and a catalyst appeared, rational investors reduced exposure—at least for a while.

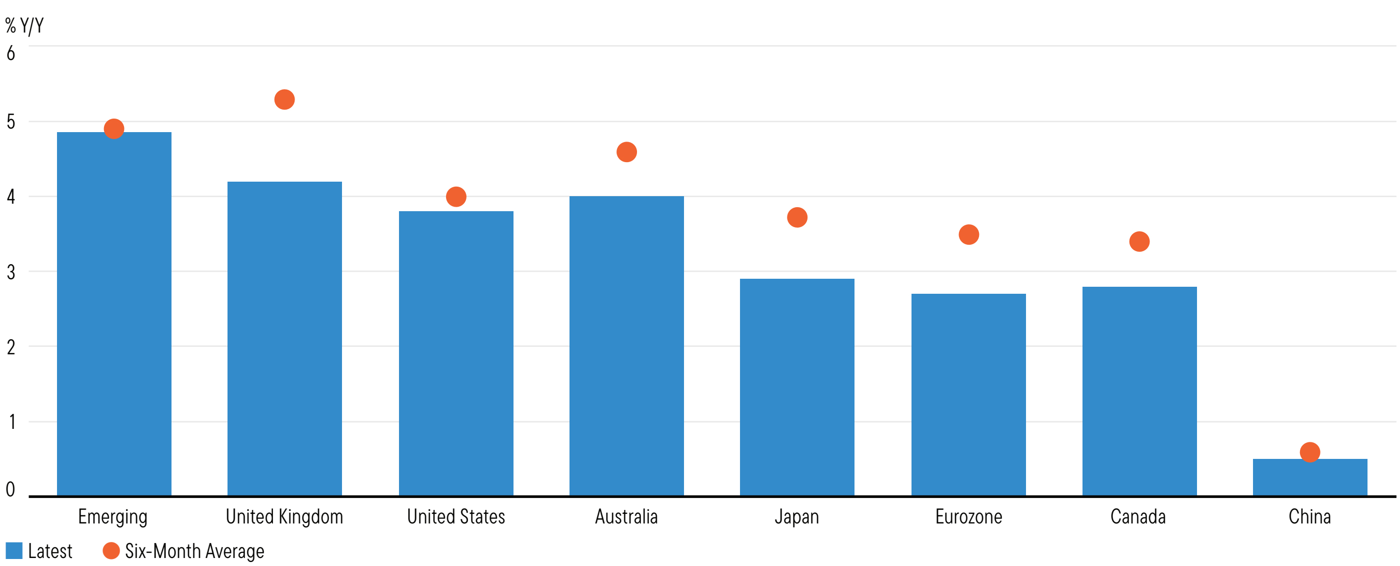
Although we anticipate a further dip in the pace of global growth, possibly to below its trend rate, we take confidence from upticks in leading indicators of activity. Having upgraded our outlook last quarter to show more than just stabilization, our first theme continues to show "**Growth is more constructive.**"

As we note above, the disinflation process has experienced several bumps in the road so far this year. However, when we look at the latest core Consumer Price Index (CPI) inflation compared with the last six months' average, we see progress has been made (see Exhibit 1.) However, it has been

Core CPI Continues to Fall

Exhibit 1: Current CPI Inflation and Six-Month Average, Select Economies

As of April 30, 2024



Sources: BLS, StatCan, Eurostat, ONS, SBJ, ABS, NBS, Dallas Federal Reserve, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com neither smooth nor uniform across economies. The most rapid declines have been in Europe, where activity remains subdued. In the emerging markets, progress has largely stalled. This is positive for China, as it had seen bouts of deflation. In other markets, it has led to a pause in rate-cutting cycles.

Focus has fallen on the United States, where progress might have stalled. We point to mixed messages across components of the Federal Reserve (Fed's) core Personal Consumer Expenditure (PCE) measure. However, we anticipate that the idiosyncratic housing component will continue to drive the overall PCE measure down, even if super-core measures rise.

China's domestic economic troubles and excess manufacturing capacity may see it continue to export a deflationary impulse, which could subdue global traded goods prices. Although rises in commodity prices may offset the decline, and the path will remain bumpy, the description of our inflation outlook remains a modestly constructive one, as our second macro theme reflects "**Inflation risks evolving**."

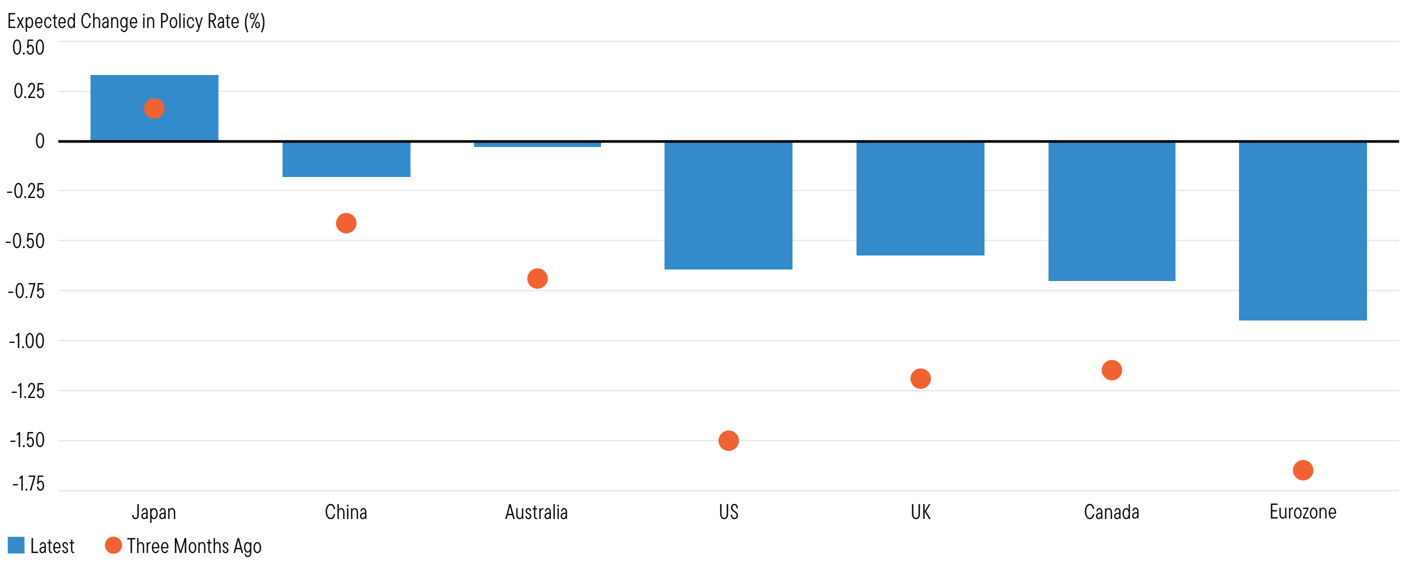
With an evolving view on inflation and greater dispersion across economies, we believe that interest-rate cuts will arrive later in some Western markets. They may be able to balance past economic weakness in Europe but will be delayed further if US inflation surprises to the upside. This makes us cognizant of the policy easing that is priced into markets (see Exhibit 2). The outlook in Asia has shifted to expect no further monetary easing in China and accelerated rate hikes from the Bank of Japan (BoJ). Wage gains in Japan have boosted confidence in a sustained economic expansion, but weakness in the Japanese yen may act as a constraint. The yen has recently accelerated, prompting talk of currency intervention to lean against this move.

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 European Central Bank (ECB) and Fed, which have been pushed back toward the middle or latter part of the year. However, we see greater divergence of outcomes as likely. As the delivery of rate cuts in the West remains relatively close for some economies at least, we emphasize "**Policy easing cycles to begin soon**."

Fewer Rates Cuts Are Now Expected

Exhibit 2: Changes in Market Expectations for Policy Rates Over the Next Year

As of April 30, 2024



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

Portfolio positioning themes

Our macro themes remain supportive of the established tilt toward risk assets even as the inflation environment is more nuanced than it was. Last month, we felt that our constructive view might already have been reflected in the positioning of investors more broadly. Then, we decided that "*Staying the course*" was the best approach. After "*A healthy correction*" this month, which has cleared some of the over-exuberance, we maintain that stance.

Simple measures of equity valuations remain expensive to us, and the recent correction is insufficient to really move the needle. However, the moderation of economic volatility that we foresee has made this less of an impediment to owning such assets, which leaves us with a first portfolio theme that shows an "**Allocation toward risk**" assets.

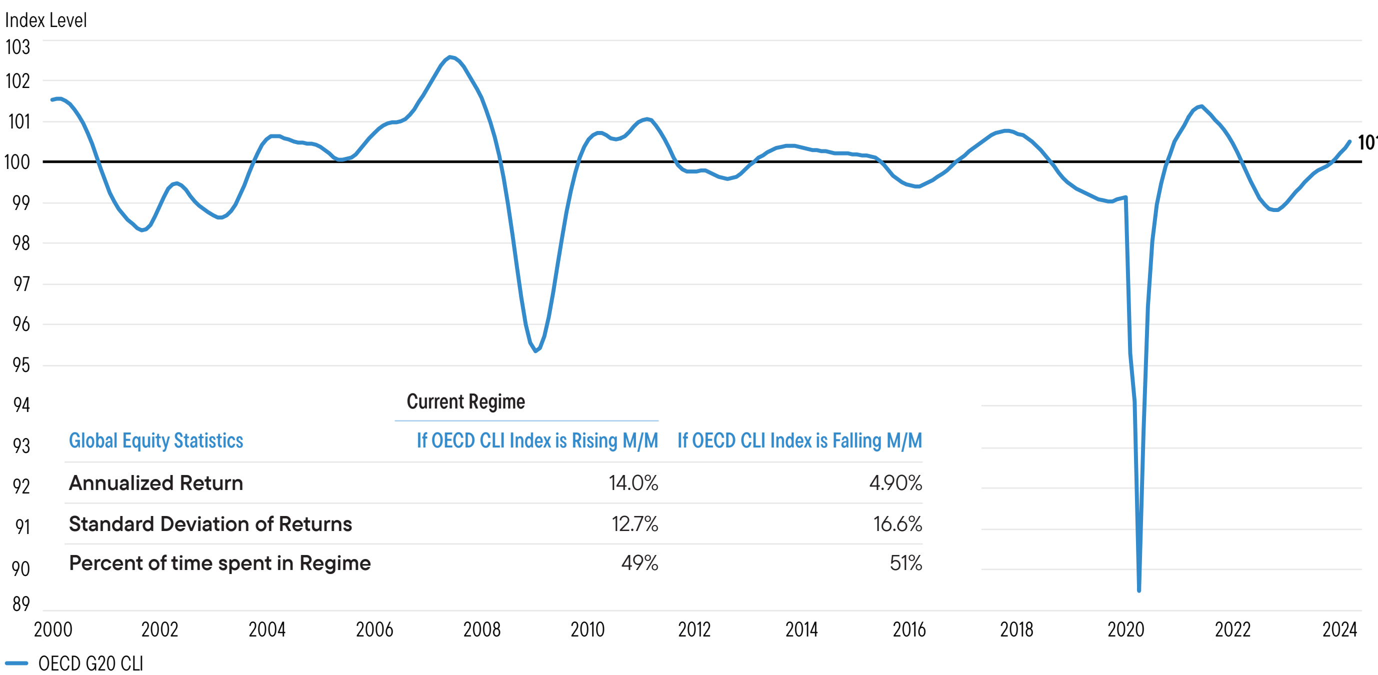
Within equity markets, our views continue to evolve. We still anticipate an improving earnings outlook in the United States and among emerging market companies, and remain relatively optimistic on Japan. Prospects in these cases are geared to an improving global economy, with a nuanced driver in the Japanese yen's weakness. However, among the weaker economies in Europe, we have diversified our positioning with an incrementally less negative view on the eurozone, which is leveraged to global activity. In contrast, the UK equity market has lower sensitivity to these trends and a defensive sector composition.

China remains in a challenging economic position, as the property sector is still weak despite policy easing. Although the stock market has rebounded recently, we retain our neutral stance, reflecting the conundrum of still-attractive

Leading Economic Indicators Are Improving

Exhibit 3: OECD Composite Leading Indicator: G20

As of April 30, 2024



Global Equity Statistics	Current Regime: If OECD CLI Index is Rising M/M	If OECD CLI Index is Falling M/M
Annualized Return	14.0%	4.90%
Standard Deviation of Returns	12.7%	16.6%
Percent of time spent in Regime	49%	51%

Sources: Organisation for Economic Co-operation and Development (OECD), MSCI. **Past performance is not an indicator or a guarantee of future results.** Important data provider notices and terms are available at www.franklintempletondatasources.com. Returns are measured on a monthly frequency using MSCI World Net Return USD Index. The time period of returns is from March 1970 to present day. All returns are forward returns measured using a two-month lag to adjust for the data release. To determine the regimes, we simply compare the month's current value versus the previous month value to determine if it is rising or falling. Standard deviation measures the risk or volatility of an investment's return over a particular time period; the greater the number, the greater the risk. Standard deviation measures the risk or volatility of an investment's return over a particular time period; the greater the number, the greater the risk.

valuations but poor equity fundamentals. Our views across the globe are best summarized in our second portfolio theme, which shows "**A tricky equity landscape**," but one that offers continued opportunities for active managers to exploit.

Bond markets also reflect the same trends and divergences. Japanese government bonds remain our least-favored market, potentially suffering the BoJ's accelerated policy normalization. The level of yields in this market is low, and it is one of the few regions with negative real yields. Where growth remains weaker, we are more confident in the timing of the start of the easing cycle by the ECB and the Bank of Canada. We have increased further our bearishness on Japanese bonds in recent weeks, favoring government bonds in Europe and Canada.

We retain a slightly cautious bias in higher-quality credit, where its defensive characteristics are better expressed through a preference for government bonds. Offsetting this, we are becoming more constructive toward lower-rated corporate bonds, even at what we consider elevated valuations, and extended our preference for US bank loans.

Overall, our final portfolio theme reflects "**More attractive yields for bonds**." Easing cycles are likely to begin soon, supporting a longer duration preference. This cycle will likely support riskier assets as well, including equities, which may fare better than bonds, but both are likely to exceed the return potential of cash deposits.

Allocation settings—May 2024

Pendulum settings reflect cross-asset class views

Risk tier

Asset class	Conviction	Our viewpoint

Risk off/on

- Global growth is more constructive in the developed world as leading indicators continue to improve.
- Risks remain focused on elevated valuation in equities, but disinflation is anticipated to continue.
- We maintain a more optimistic stance toward riskier assets, as policy easing is anticipated to begin soon.

High level allocation tier

Equities

- Improving earnings outlooks support our preference for global equities despite localized margin pressures.
- Longer-term equity fundamentals favor regions with proven earning power and continued corporate resilience.
- We hold a more optimistic stance in global equities relative to bonds after a healthy market correction.

Bonds

- Yields are increasingly attractive, in our assessment, but may already largely discount likely policy easing.
- Corporate bond spreads have declined recently and do not fully reflect the increase in default rates.
- We retain a more cautious view of bonds overall relative to stocks but hold a long duration preference.

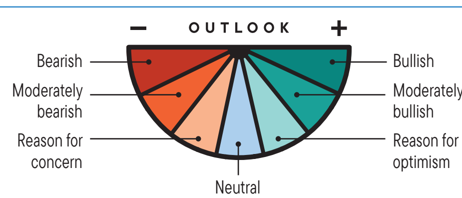
Alternatives

- 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		• Stronger current economic activity and robust corporate earnings support the outlook for US equities. • We retain a more constructive view on the prospects for ongoing earnings growth over the next year. • We have moderate optimism toward this market relative to other regions, despite still-elevated stock market valuations.
Canada		• Growth in Canada faces headwinds from accumulated central-bank rate hikes. • Banking stocks remain under pressure, even with what we consider valuation attractions. • We have maintained a cautious stance on this market in recent months.
Europe ex United Kingdom		• Europe faces headwinds for consumers and businesses as past ECB rate rises feed through the economy. • Corporate earnings results may disappoint, as the lagged effect of wage rises starts to impact profit margins. • As a result, we have continued to move to a slightly less-pronounced but still cautious stance over the medium term.
United Kingdom		• UK economic prospects remain uncertain despite a pickup in business investment. • A low weighting to technology and significant foreign currency earnings offset a generally high dividend yield. • We adopted a more cautious view, reflecting ongoing profit margin headwinds, in 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 other markets, in our view, even after recent gains. • We maintain a more constructive outlook on this market, relative to other countries in the region directly.
Pacific ex Japan		• Overall, this region remains vulnerable due to tensions in relations with China. • A sticky decline for inflation in Australia and still-elevated interest rates may impact consumers. • We hold a more cautious stance on these markets, following divergence relative to China equity markets.
Emerging ex China		• Stronger long-term growth opportunities are offsetting emerging markets' idiosyncratic risks. • Developed market demand should boost earnings, which are not discounted in valuations. • Prospects for currency recovery support us maintaining a more constructive view of emerging markets.

Allocation tier

Asset class	Conviction	Our viewpoint
China		• Property market risks, which have led to an easier policy environment, are holding back China's economy. • 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 this year, but it has maintained its fight against inflation. • Once rate cuts start, we see lower US Treasury yields in a year's time, but more conviction in other markets. • We have diversified some of our greater interest-rate sensitivity away from US government bonds.
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 signaled it is likely to cut soon from peak rate levels, but inflation remains above target. • Given weak demand growth in the European economy, the future path of rates is likely to head lower. • We have increased our modestly constructive stance on this region, having previously reduced exposure.
UK Government Bonds		• The UK economy was confirmed to be 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 maintain a constructive view on this market.
Canada Government Bonds		• The Bank of Canada has moved aggressively amid high inflation and a tight labor market. • The economy is sensitive to changes in interest rates, which have skewed yields lower than those of its peers. • We have boosted our moderately constructive view relative to other global markets.

Allocation tier

Asset class	Conviction	Our viewpoint
Japan Government Bonds		• The BoJ has moved away from negative interest rates but maintained its easy monetary policy stance. • Ending measures used to target low 10-year government bond yields is a step toward policy normalization. • Further monetary policy tightening in the coming quarter reinforces our significant caution towards 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 have continued to moderate our cautious stance toward high-yield bonds, despite narrow spreads. • Reflecting a more optimistic growth outlook, we have increased our tilt towards loans which show less stretched valuations.
Emerging Market Debt		• Emerging market fundamentals are improving and should benefit from a benign global environment. • We are more 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.

WHAT ARE THE RISKS?

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.

Active management does not ensure gains or protect against market declines. Diversification does not guarantee a profit or protect against a loss.

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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