FRANKLIN TEMPLETON INVESTMENTS

Global Economic Perspective

MAY 2014

Perspectives from the Franklin Templeton Fixed Income Group


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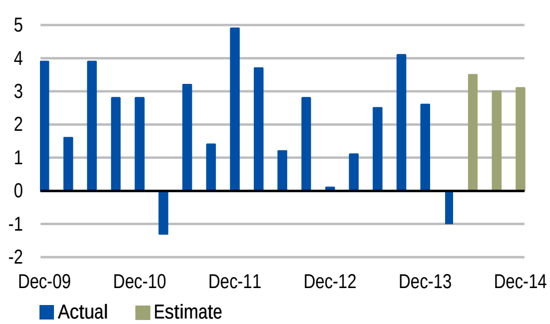
- **US ECONOMY APPEARS TO SHRUG OFF POOR FIRST QUARTER**
- **PREPARING FOR A POTENTIAL RISING-RATE ENVIRONMENT**
- **EUROPEAN OUTLOOK**

US ECONOMY APPEARS TO SHRUG OFF POOR FIRST QUARTER

We believe a substantial improvement in US growth is underway, despite annualised first-quarter 2014 gross domestic product (GDP) growth of -1.0%, well below market expectations. US Federal Reserve (Fed) Chair Janet Yellen struck a notably upbeat tone on prospects for the economy in testimony before Congress in early May, pointing out that the current rebounds in consumer spending, employment and industrial production bode well for growth in the second quarter. Adding to the generally upbeat mood was a recent surge in exports, which has helped reduce the US trade deficit. Yellen did signal her concerns about some recent slowing in the US housing market, while business-equipment spending has also remained somewhat soft, likely reflecting continued caution among US corporations. However, all in all, the US economy is widely expected to accelerate during the second quarter, with questions remaining about how much it would expand and whether the momentum it seems to be gaining can be maintained through to the end of this year.

Chart 1: Real US GDP Growth (%)
Quarter-Over-Quarter
31 December 2009–31 December 2014 Estimate

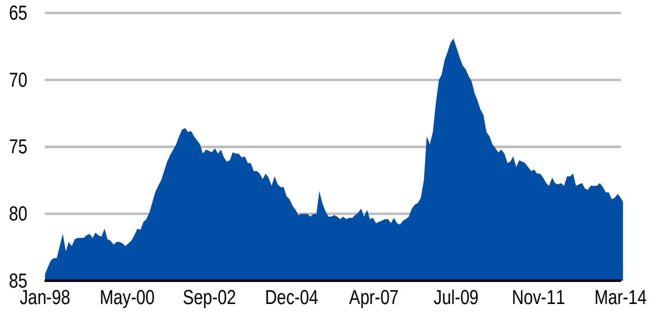


Source: US Bureau of Economic Analysis, Bloomberg, National Bureau of Economic Research, as at 10/05/14. There is no assurance any estimate will be realised.

We believe some months are needed before we know if the US economy is undeniably on a stronger and sustained growth path. Given this relative lack of visibility, we are not surprised that the Fed has been generally hinting that base interest rates will remain low for some time to come—even more so given that the strong jobs report for April (when hiring grew at its fastest pace in more than two years) was tarnished somewhat by statistics showing that the participation rate had fallen again.

Reassurances that base rates will remain low, possibly well into 2015, go a long way to explaining why US government bonds have continued to rally. Toward the end of last year, 10-year Treasury yields rose briefly to 3% as the Fed started to taper its monthly bond purchases. The Fed has been progressively tapering these purchases at every monetary policy meeting since then, thus gradually removing support from bonds. And yet by mid-May, 10-year Treasury yields had fallen to about 2.6%. For some, the continued resilience of Treasuries is puzzling given that the US economy has picked up speed. Some of this rally may be ascribed to the buying of perceived safe-haven securities, driven by the ugly events in eastern Ukraine and lingering fears over China's economic slowdown. US Treasuries also have continued to offer better yields than their Japanese or German counterparts. But much of the decline in yields may be because even as the Fed winds down its bond purchases, market participants do not seem convinced that rates will rise very fast. Furthermore, bond prices may reflect not only uncertainty over the vigour of US growth in the short term, but perhaps also the realisation that the slowdown in the rate of increase in the labour force could lead to softer long-term demand in the economy.

Chart 2: Slack in the US Economy
Available Capacity (%)
January 1998–March 2014



Source: US Bureau of Labor Statistics, as at 04/04/14.

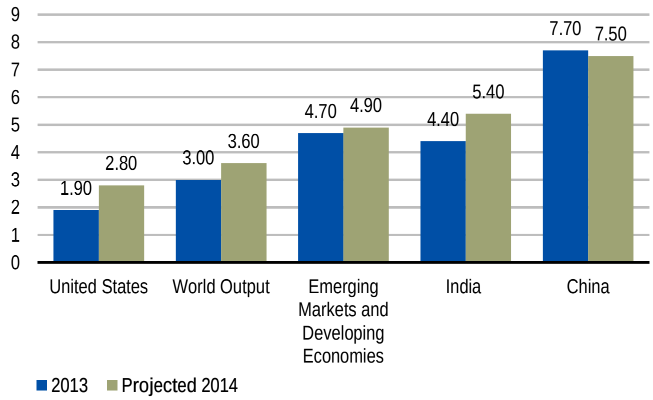
The uncertainty that has benefitted US bond markets was conversely reflected in almost-stagnant US equity markets during March and April, but by mid-May the S&P 500® Index had climbed to a record high. For the moment, uncertainty over the US growth rate and low inflation, coupled with a near-deflationary environment in Europe and lingering investor concerns about China, indicates to us likely continuation of low interest rates. Nonetheless, we continue to believe that a solid US economic recovery could put upward pressure on interest rates. While we think bond markets have been distorted somewhat by massive quantitative easing programmes in Japan and the United Kingdom, as well as in the United States, we believe 10-year Treasury yields should be higher than the expected US growth rate this year (which consensus estimates believe may come in at over 3%). However, even as the Fed continues to taper its asset purchases, prospective monetary easing measures in Europe and Japan may mean a rise in yields would be gradual. Furthermore, we believe any reasonable rise in long-term rates should not derail the US recovery, as any such rise in rates may be a response to a strong economy.

PREPARING FOR A POTENTIAL RISING-RATE ENVIRONMENT

The outlook for the global economic cycle is mostly positive, with the International Monetary Fund (IMF) forecasting global growth of 3.6% for 2014, compared to the 3.0% final outcome for 2013.[1] Although there has been an anticipated slowdown in emerging markets, the IMF sees growth in emerging-market and developing countries picking up this year to 5.1% from 4.7% in 2013.[1] Within the context of this broader theme of growth momentum, we believe Fed tapering, divergence in emerging markets and China's slowdown in growth are the drivers behind the recent period of elevated market volatility.

In line with our unconstrained, global investment strategy, we believe individual countries are likely to continue differentiating themselves from other emerging markets through both robust fundamentals and the ability of policymakers to stay ahead of the curve regarding fiscal, monetary and financial policy. As 2013 confirmed, emerging markets can no longer be treated simply as one, uniform asset class—the performance difference between the best and worst emerging bond markets was over 40 percentage points, according to an analysis of constituent markets in the JP Morgan Government global and emerging-market indexes. After temporary weak performance early this year, currency and bond markets in Asia and Latin America have stabilised in recent months, although the news has not been universally good. While we have seen a rebound in the South Korean won and the Mexican peso, for instance, there have also been recent downgrades of the sovereign debt of Brazil, Venezuela and Argentina.

Chart 3: Global Economic Growth (%)
As at April 2014



Source: *IMF World Economic Outlook,* April 2014. Copyright © 2014. By International Monetary Fund. All Rights Reserved. Annual Percentage Change Projections for 2014.

Despite negative headline news and general investor scepticism toward China, we do not see a hard landing for that country. Recently reported data did reveal issues with overinvestment in certain sectors, decreasing industrial production and increases in non-performing loans within the banking sector, but we believe that these numbers do not reflect the full picture. In fact, the recent deceleration is a welcome and healthy dynamic, in our view. Although China's growth has declined in terms of quantity, we think recent reforms have improved its quality.

As long as China is able to correctly price inputs and move away from state-directed finance, we believe the country can continue to move up the value-added chain. In our view, the new administration of President Xi Jinping is poised to be one of the most transformational governments since that of Deng Xiaoping, who enabled China to embark upon a decade-long reform agenda and move toward a market-driven economy. President Xi has continued to increase competition by opening up China's economy and capital account, while one of the most positive factors of his reform agenda and an indicator of his strength has been his anti-corruption drive. Though there is potential volatility from such wide-ranging reforms, we believe

1. Source: *IMF World Economic Outlook*, April 2014. Copyright © 2014. By International Monetary Fund. All Rights Reserved.

China likely can maintain a steady growth rate for the next one to two years. The underlying driver for this growth is a dramatic acceleration in wages, which we believe should ultimately provide a core anchor for increased consumption. Additionally, we believe China's urbanisation process shows an underlying need for investment despite expected moderation in investment levels over the next decade and slowing growth rates over the next couple of years. There is also some concern regarding the shadow banking system; however, we believe the problems are quite manageable given the size of the economy. The Bank for International Settlements has estimated China's shadow banking is a small percentage of GDP compared to a much larger percentage in Europe. We believe the government has the financial resources to deal with the toxic part of the banking system given its positive net asset position.

Earlier this year, the perceived downturn in China and fears of a global liquidity crisis led to temporary weak performance of emerging-market assets amid a period of heightened volatility. More recently, however, the panic and uncertainty surrounding a potential global liquidity crisis has faded, allowing emerging-market countries with strong fundamentals to differentiate themselves from those with weaker fundamentals in terms of performance. Globally, we are not overly concerned about the effects of Fed tapering given the Bank of Japan's massive amount of quantitative easing. Certain countries, such as Turkey, which have large current account deficits, will likely face pressures, but other countries with current account surpluses and low levels of debt are in good shape, in our view. Interestingly, policymakers in some emerging markets, particularly those in Asia, seem to be starting to feel the effects of Japanese quantitative easing and appear unsure about the appropriate policy response to manage the expected massive capital inflows.

EUROPEAN OUTLOOK

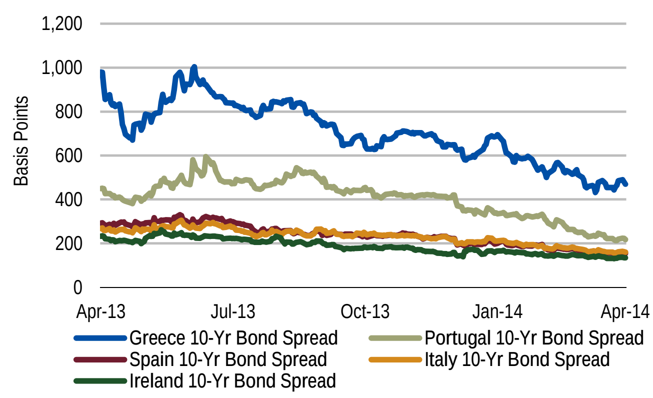
In spite of persistent worries over European deflation and a disappointing first-quarter GDP report (when the eurozone economy grew at a quarter-over-quarter rate of 0.2%), we have seen signs of a broadening of the economic recovery in at least some parts of the region, with domestic consumer spending beginning to pick up on the heels of a noticeable improvement in industrial activity. Two of the continent's biggest economies, those of the UK and Germany, seem to be doing well. The Organisation for Economic Co-operation and Development recently raised its 2014 GDP growth forecast for the United Kingdom to an impressive 3.2%,[2] with improvements in manufacturing showing that Britain's revival may not be limited to an unsustainable housing binge, while Germany's economic ministry has upgraded its growth forecast for the country to 1.8% this year. Reform-shy France has been noticeably trailing in the growth stakes, but the recent appointment of market-friendly Manual Valls as prime minister, together with the unveiling of major government spending cuts and lower social charges for businesses, suggests to us that the French economy could partake in the upswing. Italy—which has also equipped itself with a youthful and reformed-minded prime minister, Matteo Renzi—is also emerging from recession, while the Spanish economy grew at its fastest quarterly pace in six years in the first quarter.

We believe the results of improved data—together with improved state finances and what appears to be the final capitulation of speculators counting on a breakup of the European monetary union—meant that spreads for peripheral European government bonds over German Bunds have continued to fall. But the drop in inflation and inflation expectations has also played a role, in our view, with bond investors generally betting on further action by the European Central Bank (ECB) in the face of possible eurozone deflation to push down bond yields.

In the case of Spain, by mid-May, 10-year government bond yields had fallen to their lowest level ever, well below where they stood even at the start of the monetary union in 1999. Italian bonds told a similar story, with the country's 10-year issues offering yields of below 3% in mid-May. Another milestone was reached when Portugal announced on 4 May that it would make an exit from its three-year bailout without the safety net of a precautionary credit line. Portugal's announcement followed a successful €3 billion five-year bond sale by Greece a month earlier in that country's first foray into the debt markets since its first bailout over four years ago.

Chart 4: 10-Year Government Bond Yield Spreads over German Bonds

1-Year Period Ended 30 April 2014



Source: Bloomberg LP, data as at 30 April 2014. Past performance does not guarantee future results.

However, we believe risk factors persist that the recent fall in bond yields may not be taking fully into account. Already high public debt-to-GDP ratios in most of the crisis-ridden countries have continued to rise or are falling very slowly. According to Eurostat, the ratio for Ireland was almost 124% at the end of

2. Source: OECD, May 2014 Economic Outlook database.

2013, 133% for Italy, 129% for Portugal and 175% for Greece (up from 157% the previous year). To public debt must be added private debt, which is particularly high in Ireland. Since the servicing of their public debt remains high, all these countries will likely have to maintain high primary surpluses, if only to comply with the 3% fiscal deficit threshold imposed by eurozone rules.

Yet, in the context we believe drawn-out structural consolidation and very low inflation, growth is likely to remain relatively weak, making it difficult to bring down debt ratios even if primary surpluses are achieved. While the nominal yield on Greek 10-year bonds had dropped to around 6.2% in mid-May, having gone as high as around 45% in May 2012, this level was still painfully high for a country that the IMF forecasts will grow by only 0.6% this year[1] and that is experiencing deflation (prices fell 1% in 2013, according to Eurostat). And when the drop in prices is taken into account, real (as opposed to nominal) yields throughout southern Europe are actually higher than before the sovereign debt crisis of 2010.

All in all, one can say that low nominal yields and inflation in Greece, Italy and elsewhere reflect economies that are trying to address their structural problems through painful austerity measures that may have steadied investors' nerves, but have also resulted in high unemployment and depressed demand. The poor figure for GDP growth in the first quarter illustrates just how tentative recovery is in much of the eurozone. Output gaps (meaning the difference between actual and potential growth) remain very wide, while lower-than-anticipated inflation means the burden of repayments on households, corporations and governments alike has been rising in real terms. And in reality, investors are still demanding a hefty credit premium to invest in peripheral countries.

Some short-term relief could come if the ECB loosens monetary policy further to combat deflation and weaken the euro, as its president, Mario Draghi, hinted in early May. The ECB may also do something to boost the securitisation market and lending to small- and medium-sized enterprises. Yet, all things considered, although the situation throughout peripheral Europe is markedly better, in our view, prospects continue to be fragile and extremely sensitive to any unforeseen events. But the ECB's forward guidance seems to have reassured markets that short-term rates will remain very low for an extended period, which we believe should be supportive of the European bond market.

Given the rapid changes that can take place in markets and economic conditions, it's often difficult to provide up-to-date materials that address the most current situations. This material is intended to be of general interest only and should not be construed as individual investment advice or an investment recommendation. The views expressed are those of the noted investment manager and the comments, opinions and analysis are rendered as at publication date and may change without notice. The information provided in this material is not intended as a complete analysis of every material fact regarding any country, region or market. ***All investments involve risks, including possible loss of principal.***

Data from third party sources may have been used in the preparation of this material and Franklin Templeton Investments (FTI) has not independently verified, validated or audited such data.

EUROLAND MACROECONOMIC DATA

FINAL OUTPUT				
Gross Domestic Product (GDP)[1]	1Q13	2Q13	3Q13	4Q13
GDP, Y/Y (%)	-1.1	-0.6	-0.3	0.5
Private Consumption, Y/Y (%)	-1.4	-0.8	-0.6	0.1
Gross Fixed Capital Formation, Y/Y (%)	-5.5	-3.6	-2.5	-0.1
ECONOMIC INPUTS[1]				
	DEC 13	JAN 14	FEB 14	MAR 14
Retail Sales, Y/Y (%)	-0.3	0.8	1.0	0.9
Unemployment Rate (%)	11.8	11.8	11.8	11.8
Industrial Production, Y/Y (%)	1.2	1.6	1.7	—
INFLATION & WAGE PRESSURE				
Inflation Indicators[1]	JAN 14	FEB 14	MAR 14	APR 14
Consumer Price Index (CPI), Y/Y (%)	0.8	0.7	0.5	0.7
Core CPI, Y/Y (%)	0.8	1.0	0.7	1.0
FINANCIAL MARKETS				
	JAN 14	FEB 14	MAR 14	APR 14
Dow Jones EURO STOXX 50 Price Index EUR, Trailing P/E Ratio[2]	21.64	22.62	22.52	22.79
ECB Refinance Rate (%)[3]	0.25	0.25	0.25	0.25
10-Year Yield—German Bunds (%)[2]	1.66	1.62	1.57	1.47
BALANCE OF PAYMENTS[1]				
Trade Balance	NOV 13	DEC 13	JAN 14	FEB 14
Billion Euro	17.20	14.11	0.83	13.60
Current Account Balance	4Q12	1Q13	2Q13	3Q13
% GDP	2.6	1.0	2.2	2.2

JAPAN MACROECONOMIC DATA

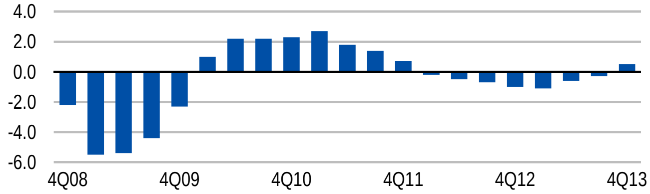
FINAL OUTPUT				
Gross Domestic Product (GDP)[4]	1Q13	2Q13	3Q13	4Q13
GDP, Q/Q ar (%)	4.5	4.1	0.9	0.7
Private Consumption, Q/Q ar (%)	2.2	2.0	1.8	2.6
Fixed Capital Formation, Q/Q ar (%)	-3.7	4.2	0.4	3.0
ECONOMIC INPUTS				
	DEC 13	JAN 14	FEB 14	MAR 14
Unemployment Rate (%)[5]	3.7	3.7	3.6	3.6
Industrial Production, Y/Y (%)[6]	7.2	10.6	7.0	7.0
Tertiary Index, Y/Y (%)[6]	2.2	3.5	2.2	—
Corporate Activities	2Q13	3Q13	4Q13	1Q14
Corporate Profit Growth (%)[7]	24.0	24.1	26.6	—
Tankan Quarterly Survey (index level)[8]	4	12	16	17
INFLATION				
Inflation Indicators[5]	DEC 13	JAN 14	FEB 14	MAR 14
Consumer Price Index (CPI), Y/Y (%)	1.6	1.4	1.5	1.6
CPI ex-Fresh Food, Y/Y (%)	1.3	1.3	1.3	1.3
FINANCIAL MARKETS[2]				
	JAN 14	FEB 14	MAR 14	APR 14
Nikkei 225, Trailing P/E Ratio	20.3	20.1	19.4	18.7
3-Month Yield—JGBs (%)	0.050	0.036	0.030	0.062
10-Year Yield—JGBs (%)	0.622	0.586	0.642	0.627
BALANCE OF PAYMENTS				
Monthly Trade Balance[7]	DEC 13	JAN 14	FEB 14	MAR 14
Billion Yen	-1073	-2345	-533	-1134
Current Account Balance[8]	1Q13	2Q13	3Q13	4Q13
% GDP	0.9	1.0	1.0	0.7

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

1. Source: © European Union 1995–2014.
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 (ESRI), Cabinet Office, Government of Japan.
5. Source: Ministry of Internal Affairs and Communications, Japan.
6. Source: Ministry of Economy, Trade and Industry, Japan.
7. Source: Ministry of Finance, Japan.
8. Source: Bank of Japan.

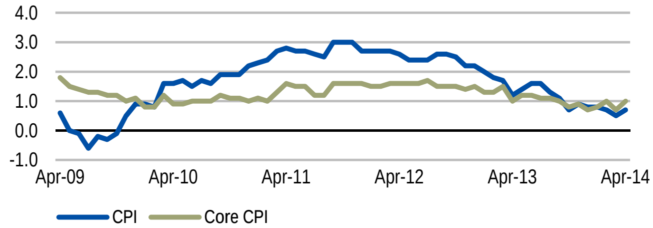
Past performance does not guarantee future results, and results may differ over future time periods.

Eurozone Real GDP, Y/Y (%)



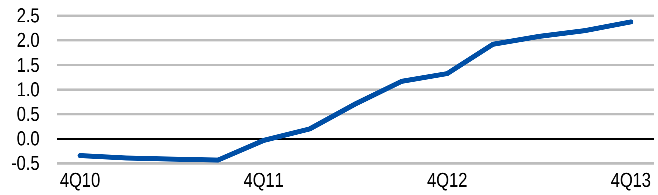
Source: © European Union 1995–2013, as at December 2013.

Consumer Price Index, Y/Y (%)



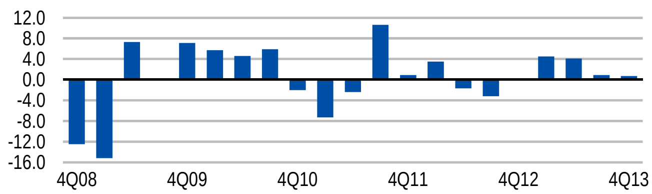
Source: © European Union 1995–2014, as at April 2014.

External Trade Balance, GDP (%)



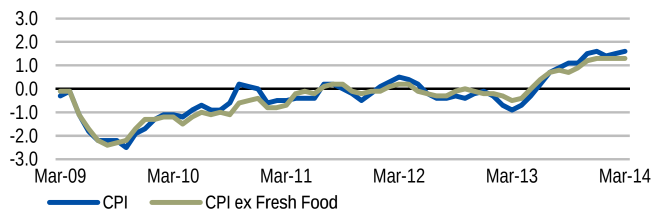
Source: © European Union 1995–2013, as at December 2013.

Japan Real GDP, Q/Q ar (%)



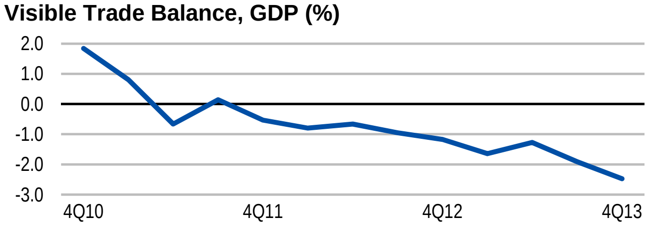
Source: ESRI, Cabinet Office, Government of Japan, as at December 2013.

Consumer Price Index, Y/Y (%)



Source: Ministry of Internal Affairs and Communications, Japan, as at March 2014.

Visible Trade Balance, GDP (%)



Source: Ministry of Finance, Japan and ESRI, Cabinet Office, Government of Japan, as at 31 December 2013.

US MACROECONOMIC DATA

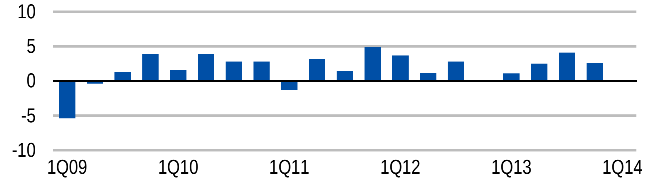
FINAL OUTPUT				
Gross Domestic Product (GDP)[1]	4Q13	1Q14	2Q14E[2]	3Q14E[2]
Q/Q ar (%)	2.6	0.1	3.3	3.0
ECONOMIC INPUTS				
CONSUMPTION/FINAL DEMAND				
Income/Savings[1]	DEC 13	JAN 14	FEB 14	MAR 14
Consumer Spending, Y/Y (%)	3.5	3.5	3.3	4.0
Personal Income, Y/Y (%)	-0.8	4.1	3.2	3.4
Savings Rate (%)	4.1	4.3	4.2	3.8
Employment	JAN 14	FEB 14	MAR 14	APR 14
Unemployment Rate (%)[3]	6.6	6.7	6.7	6.3
Participation Rate (%)[3]	63.0	63.0	63.2	62.8
Nonfarm Payrolls (in thousands)[3]	144	222	203	288
Jobless Claims, 4-wk average (in thousands)[4]	334	337	321	320
Housing[5]	DEC 13	JAN 14	FEB 14	MAR 14
Existing Home Sales (in millions)	4.87	4.62	4.60	4.59
Y/Y Change (%)	-0.2	-5.1	-7.1	-7.5
INVESTMENT				
Corporate Earnings[6]	4Q13E	1Q14E	2Q14E	3Q14E
Earnings, Y/Y (%)	9.0	5.8	6.1	8.5
Production & Utilisation[7]	DEC 13	JAN 14	FEB 14	MAR 14
Industrial Production, Y/Y (%)	3.2	2.9	3.5	3.8
Capacity Utilisation (%)	78.4	78.1	78.8	79.2
Nonresidential Fixed Investment[1]	2Q13	3Q13	4Q13	1Q14
Y/Y (%)	2.4	3.5	2.6	3.2
INFLATION & PRODUCTIVITY				
Inflation Indicators	DEC 13	JAN 14	FEB 14	MAR 14
Personal Consumption Expenditure (PCE), Y/Y (%)[1]	1.2	1.2	0.9	1.1
Core PCE, Y/Y (%)[1]	1.2	1.1	1.1	1.2
Consumer Price Index (CPI), Y/Y (%)[1]	1.5	1.6	1.1	1.5
Core CPI, Y/Y (%)[3]	1.7	1.6	1.6	1.7
Producer Price Index (PPI), Y/Y (%)[3]	1.2	1.5	1.3	1.7
Core Producer Prices, Y/Y (%)[3]	1.4	1.7	1.7	1.7
Productivity[3]	2Q13	3Q13	4Q13	1Q14
Productivity, Q/Q ar (%)	1.8	3.5	2.3	-1.7
Unit Labour Costs, Q/Q ar (%)	2.0	-2.1	-0.4	4.2
FINANCIAL MARKETS				
Valuation	MAR 14	APR 14	MAY 14E	JUN 14E
P/E S&P 500[6]	17.16	17.27	—	—
Fed Funds Rate[7,8]	0.25	0.25	0.09	0.10
BALANCE OF PAYMENTS				
US Monthly Trade Deficit[1,9]	DEC 13	JAN 14	FEB 14	MAR 14
Billion USD	-39.0	-39.3	-41.9	-40.4
US Current Account Deficit	1Q13	2Q13	3Q13	4Q13
Quarterly (in USD billion)[1]	-105.0	-96.8	-96.4	-81.1
Annualised (% GDP)[10]	-2.6	-2.5	-2.4	-2.2

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

1. Source: US Bureau of Economic Analysis, as at 30/04/14.
2. Source: Bloomberg Economic Forecasts, as at 30/04/14.
3. Source: US Bureau of Labor Statistics.
4. Source: US Department of Labor.
5. Source: Copyright National Association of Realtors®. Reprinted with permission.
6. Source: Bloomberg. Corporate Earnings and P/E S&P 500 represented by Bloomberg's calculation of the earnings of S&P 500 Index components, as at 30/04/14. Standard & Poor's®, S&P® and S&P 500® are registered trademarks of Standard & Poor's Financial Services LLC.
7. Source: US Federal Reserve. At the 16 December 2008 meeting, the Federal Reserve cut the main US interest rate to "a target rate" between zero and 0.25%.
8. Source: Chicago Board of Trade (30-Day Federal Funds Futures Rate for May 2014 and June 2014), as at 30/04/14.
9. Source: US Census Bureau.
10. Source: Bloomberg Indexes.

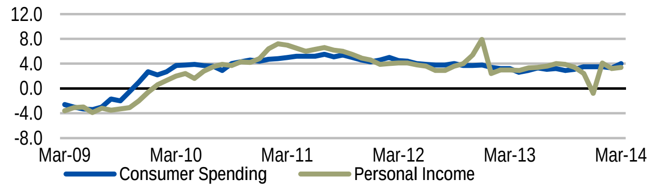
Past performance does not guarantee future results, and results may differ over future time periods.

Gross Domestic Product (GDP), Q/Q ar (%)



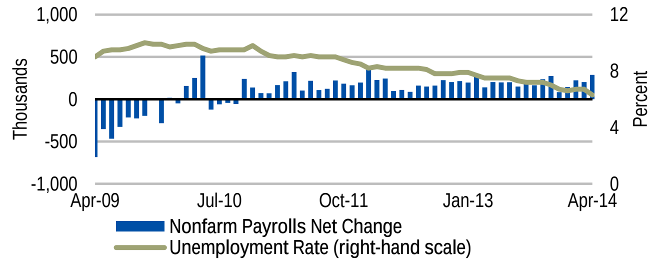
Source: US Bureau of Economic Analysis, as at March 2014.

Personal Income & Expenditures, Y/Y (%)



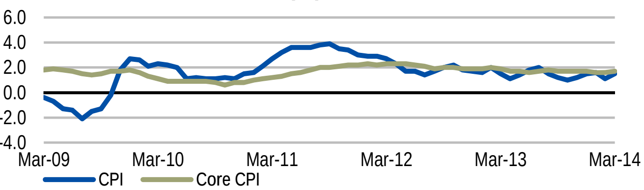
Source: US Bureau of Economic Analysis, as at March 2014.

Nonfarm Payrolls & Unemployment Rate



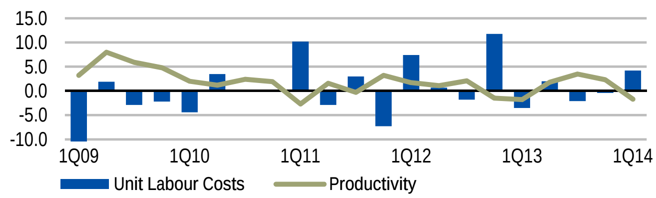
Source: US Bureau of Labor Statistics, as at April 2014. All figures seasonally adjusted.

Consumer Price Index, Y/Y (%)



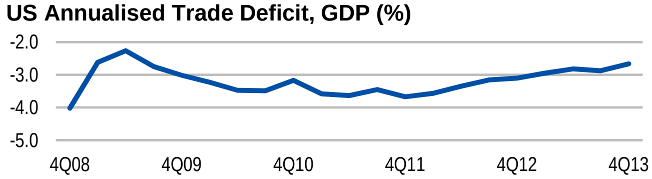
Source: US Bureau of Labor Statistics, as at March 2014.

Productivity & Unit Labour Costs, Q/Q ar (%)



Source: US Bureau of Labor Statistics, as at March 2014.

US Annualised Trade Deficit, GDP (%)



Sources: US Census Bureau and US Bureau of Economic Analysis, as at December 2013.

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