

WHAT FRANKLIN TEMPLETON THINKS...

About Volatility

December 17, 2018

There's a New Regime in Town: Its Name Is Higher Volatility

We expect a return to long-term, historical volatility norms, as market ups and downs may allow active managers opportunities to add value.

- Driving this, in our opinion, is the ongoing removal of the decade-long stimulative effects of global central banks. Like the Fed in the US, they added fixed income assets to their balance sheets (keeping interest rates on government bonds lower than they might otherwise have risen to) in an effort to jump-start global economies after the financial crisis. This encouraged investors to shift into relatively higher-risk assets such as corporate bonds and stocks.
- The extended period of quantitative easing (QE) described above likely dampened market volatility in recent years; we believe an increase in volatility reflects normalization in markets, particularly given the late stage of the current business cycle.
- Risks from geopolitical situations, trade uncertainty, and domestic affairs, which had been somewhat allayed by the stimulative efforts, now may demonstrate a greater ability to impact markets.
- Selectivity in risk exposures will be more important in our view, as broad market levels have not been cheap, but the global economy holds the potential to continue moving positively in 2019.

Brrrrexit: Chances of a “hard” Brexit rise, which could leave the UK out in the cold (or seeking a warm re-embrace)

One of the geopolitical risks playing out in real time now has the potential to disrupt UK markets

- Recent challenges in the UK parliament reflect growing uncertainty regarding the future of the UK's departure from the European Union.
- As a result, the risk of a hard Brexit—where the UK leaves the EU single market and EU Customs Union without any trade deal in place, has increased. This scenario would likely mean higher tariffs on British exports to EU countries.
- The possibility of a second referendum has now also increased; that outcome could allow the UK to remain in the EU.
- **Outcomes:** Markets appear likely to remain skittish, but worst-case scenarios may already be priced into some UK market sectors such as financial services and construction. Gilts (UK government bonds) appear likely to rally, while the currency (pound) may fall further. Active management may help navigate the uncertainty.

Very *Interesting*...The Long and Short of Rates and Inflation

- We expect the Fed to continue raising the Fed funds rate toward the neutral rate (the short-term real interest rate consistent with the economy maintaining full employment and price stability) in 2019.
- US Treasuries face rising rate pressures:
 - **Higher Supply**—A US fiscal deficit that may reach 5% of GDP (gross domestic product) due to increased spending from the current Administration, reduced revenue due to tax cuts, and ongoing mandatory spending.
 - **Lower Demand**—Both the Fed, as it unwinds QE, and foreign governments are buying less.
 - **Inflation Potential**—So far tame, inflation has the potential to surprise on the upside.
- Our central assumption is that inflation is likely to remain subdued, but the risks to that view are to the upside.
 - GDP growth is solid—the economy still has momentum, despite the unusually long economic expansion.
 - Unemployment is at the lowest level in almost 50 years.¹
 - Wage growth has not accelerated, but that risk remains.

1. Source: Bureau of Labor Statistics. Data through Nov.30, 2018.

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FRANKLIN TEMPLETON
INVESTMENTS

Franklin Templeton Distributors, Inc.
One Franklin Parkway
San Mateo, CA 94403-1906
(800) DIAL BEN® /342-5236
franklintempleton.com