FRANKLIN TEMPLETON

March 2020

Perspective from Templeton Global Equity Group

Coronavirus: Volatility and Opportunity Update

Following up on our earlier piece, *Coronavirus: Volatility & Opportunity*, here we offer additional insight into market conditions and details about portfolio and research actions we are taking.

Update & Outlook

Global stock markets experienced historic volatility in recent trading days, with investors selling virtually everything, including perceived safe haven investments. The US dollar was a notable exception; demand for dollars has far exceeded supply, causing severe liquidity issues in the corporate bond market. During the most acute episodes of market stress, long-dated US Treasuries have sold off with the equity market in a reversal of their traditional relationship. The market for mortgage-backed securities has frozen up and exchange-traded funds started pricing at significant discounts to net asset value. The US Federal Reserve was forced to intervene on a massive scale in order to provide liquidity, effectively cutting rates to zero and restarting quantitative easing. If anyone doubted how serious this is, they surely don't anymore. Our base case scenario is that a global recession is now inevitable. We do not believe monetary policy can meaningfully stimulate growth. Fiscal proclamations may sound impressive, but it takes time for projects to be shovel-ready. In short, the world has changed.

Our view is that in recent years, stock markets became overly focused on momentum and lost their grounding in fundamentals. Analysts in their thirties have grown up in a world where capital is essentially free and the mere possibility of a "disruptive" idea has been enough to command exorbitant valuations. The average age of an analyst on our team is 46. We have seen cycles. Another beneficiary of momentum throughout this cycle has been private equity. Inevitably, industry advocates will argue that the volatility in public markets shows how superior private markets are. But we have been deeply concerned about private capital markets for a while now. Despite the excesses in public markets, the mispricing of assets in private markets has arguably been worse.

We are laser focused on navigating the short-term environment for our clients. Downside mitigation is critical, and we have attempted to build more resilient portfolios in recent quarters to prepare for the unexpected. But most important is trying to figure out how the world is going to look tomorrow. We believe we are prepared for this challenging scenario. We restructured our research team over a year ago in order to promote the importance of regional research. This feels timely in a world where companies are going to look much more closely at their global supply chains. We expect to see an acceleration in the regionalization of business. Corporate tax and where it is paid will become a huge issue. The social contract between governments, corporations and citizens is going to evolve. This was already happening, with corporations under increasing pressure to play a broader role in society in order to deal with social and environmental issues. But looking forward, we expect to see the pendulum swing further back toward workers, reducing corporate profitability in some industries. Health care is obviously going to become an even bigger focus for governments around the world, with the reality check that you get what you pay for. Geopolitics in general will get far more interesting in a world where all problems cannot be solved by printing money. Governments will compete with each other on fiscal spending, though their priorities will be different. Currencies are likely to get more volatile.

We have a team of 35 analysts and portfolio managers that are located across eight offices globally. This means we are used to communicating with each other by phone or video conference. Many on our team have been working from home over the last month. We have a robust management structure and exceptional operational resources to draw upon. We are absolutely committed to being effective stewards of your capital regardless of the background situation. And awful as the coronavirus is, it will inevitably create opportunities for the brave.

As previously discussed, we have built a large "reserve list" of stocks over the last nine months. We have carried out extensive due diligence on each of these companies and built proprietary models for them. We have ensured our research list is well diversified by geography and industry, and not just focused on traditional cyclical value stocks.

The opportunities we see currently fall into one of four baskets:

1. **Eye of the storm:** These are companies whose operating businesses are directly impacted by the concerns surrounding the coronavirus. The potential opportunities here include—but are not limited to—cruise ships, hotels and airlines. We had already built models on a number of these companies over the last six months, but have been updating our numbers and expanding our coverage. Within this basket, we are especially sensitive to credit risk.

2. **Cyclicals:** With rising odds of an impending recession comes the realization that certain cyclical stocks will likely get oversold. We must determine which cyclicals are likely to survive the crisis and come out better-positioned in the long run. Like "eye of the storm" stocks, these opportunities will require in-depth credit analysis and the fortitude to buy at moments of maximum pessimism.

3. **Quality:** Our view is that this period of market turmoil is unlikely to subside until quality stocks get de-rated along with the rest of the broader equity complex. We believe many investors have unrealistic expectations for the earnings resilience of their favored quality companies in a recessionary environment. As reality dawns, we expect to get opportunities to buy companies we consider world-class at bargain levels.

4. **Growth:** Growth opportunities will include—but are not limited to—technology and consumer stocks, which we have long been wary of due to a lack of reasonably priced opportunities. Many sectors and regions offer growth opportunities underpinned by good structural demand trends that have simply been outside of our reach valuation-wise. All of our sector analysts have been tasked with re-assessing higher growth companies, and we are finally beginning to get a number of these stocks onto the reserve list and into our portfolios.

Our aim is to emerge from this downturn with what we regard as an attractively diversified portfolio of value opportunities. We will be brave where valuations warrant and seek to balance exposures appropriately. Thorough credit and liquidity analysis are essential in taking calculated risks. Led by our senior banking analyst, we are keeping a close watch on credit markets generally while also stress-testing the balance sheets of current holdings and reserve list stocks under different scenarios. This involves a comprehensive understanding of liquidity ratios, debt covenants, banking relationships, and more generally, credit conditions and overall corporate capital structures.

We do not pretend to know exactly how this situation plays out. It is a highly fluid, global crisis with few comparable historical precedents. However, we do know that after a prolonged period of difficulty and frustration for value-oriented investors, we are now seeing the type of dislocations that can create genuine long-term opportunities. We believe we are prepared to take advantage of volatility and uncertainty and hope to repay the faith you have shown in us with exceptional performance potential over the coming years. We will continue to provide timely updates and thoughts as this situation evolves.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors. To the extent a strategy focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a strategy that invests in a wider variety of countries, regions, industries, sectors or investments. The price and yield of a MBS will be affected by interest rate movements and mortgage prepayments. During periods of declining interest rates, principal prepayments tend to increase as borrowers refinance their mortgages at lower rates; therefore MBS investors may be forced to reinvest returned principal at lower interest rates, reducing income. Bond prices generally move in the opposite direction of interest rates. A MBS may be affected by borrowers that fail to make interest payments and repay principal when due. Changes in the financial strength of a MBS or in a MBS's credit rating may affect its value. Currency rates may fluctuate significantly over short periods of time and can reduce returns. Investing in the natural resources sector involves special risks, including increased susceptibility to adverse economic and regulatory developments affecting the sector—prices of such securities can be volatile, particularly over the short term.

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