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GLOBAL AND EMERGING-MARKET EQUITY OUTLOOK 2017

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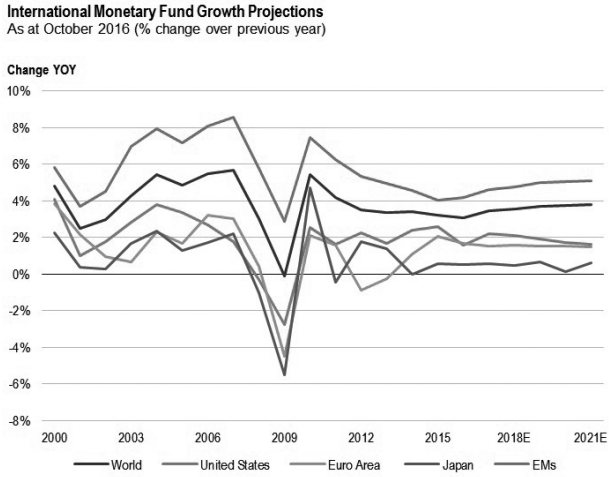
Global Equity Outlook

Subdued Pace of Unsynchronized Global Growth Appears Set to Improve in 2017

Out-of-sync global growth appears apt to continue in 2017, much as we have seen in the past few years. In our view, incremental improvement in global economic output should be supported by a combination of slow-but-steady consumer spending, employment and household formation in the United States, together with improvements in EMs and continued accommodative monetary policies by non- US central banks. Although the US economy technically enters its eighth year of economic expansion in 2017, we believe it is likely to continue to expand modestly in the near term. In our analysis, conditions such as excesses in capital investment or the housing market are not yet in place to foster a conventional investment cycle- driven recession.

While the pace of economic growth may remain relatively subdued, we see reasons for optimism in US and global equity markets in 2017, even as investor uncertainties over commodity prices and upward-trending US interest rates will likely persist. Low global growth may prompt further fiscal stimulus efforts in DMs outside the United States. We also anticipate longer-term economic rebalancing in EMs and structural reforms. Many DMs are contending with disinflationary pressures. Subsiding inflation in EMs leaves room for monetary policy flexibility, in contrast to their developed counterparts, where central banks appear to have exhausted operational tools. In the United States, hints of wage growth, encouraging employment data and an overall build in key inflation gauges have led to growing market sentiment that the Fed is on track to raise interest rates in 2017, though the path is uncertain and will remain data dependent.

Figure 1. Global economic growth has remained tepid but may improve in 2017



Source: FactSet, International Monetary Fund. There is no assurance that any forecast will be realised.

Outside the United States, the path to higher rates is less clear. Global debt levels are at historically high levels as global economic growth has remained tepid. The consensus view appears to be that to bolster growth while also reducing debt, fiscal stimulus should be used to spark inflation along with financial repression to keep real interest rates negative. After years of austerity, ECB President Mario Draghi recently appealed for more expansive budgetary policy.

The quote

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Meanwhile, Japanese policymakers announced a fiscal stimulus package, and the BOJ commenced efforts to engineer a steeper yield curve (i.e., increase the differential between longer-term and shorter-term government bond yields). Even with these policy shifts, the long-term risks to growth due to Brexit and other geopolitical challenges remain to be seen.

EMs also present risks and opportunities, in our view. China's ongoing rebalancing from investment-led to consumption-led growth will likely lead to a continued slowdown in its still-powerful economic engine over the near term as the country manages the transition. Meanwhile, the recession in Latin America might find fresh relief from a mild recovery in commodity prices and generally easier financial conditions. Sanctions have played a role in the collapse of Russia's petro economy and negative gross domestic product (GDP), and Brazil's protracted period of tremendous political upheaval has impacted its economy quite significantly. However, the broader components of EM economies—such as the important developing countries outside China, a list that includes Malaysia, the Philippines and Indonesia—intrigue us. In South America, we think Mexico, Chile and Peru offer a much different and more constructive outlook. And while Russia and Brazil may have been key detractors to global GDP growth in 2016, we are optimistic that these countries could potentially outpace investors' low expectations for growth in 2017.

Global Equity Markets: Caution and Optimism

Amid the persistence of systemic headwinds like low economic growth, high public debt and areas of political uncertainty, as well as an aging US bull market in stocks and elevated equity valuations relative to history in key sectors, it appears the general consensus of equity market investors is that caution seems warranted. Though rising commodity prices and corporate access to credit markets have mitigated some short-term risks, we see the potential for other challenges over the longer term. Contributing to these risks are an unsettled political climate, which makes entrenched problems harder to tackle, some weak financial institutions in DMs, and generally heavy corporate debts in EMs.

In broad terms, global equity valuations in late 2016 appear to be pricing in strong economic and earnings rebounds, while dovish central bank policy seems to be reflected in the prices of many global equities. DM indicators, confidence surveys, financial conditions and profit margins have been mixed in some areas. On the upside, global manufacturing gauges have expanded and earnings breadth has improved. With the uncertainty of the US election behind us and a favorable view toward growth ahead of us, we believe firmly that Franklin Templeton's active management strategy can prove beneficial, and we see the prospects for continued fundamental strength as positive. To this end, we think one of the greatest advantages we can offer is the ability to employ thoughtful, fundamentally rigorous analysis to seek to distinguish between those stocks that appear rightly and wrongly priced for the future, in our analysis.

Although we aim to uncover investment ideas through bottom-up fundamental security analysis, we also bear in mind the top-down considerations likely to drive financial markets over our investment horizon. In an inflationary environment, equities historically have generally fared better than many segments within fixed income markets. Though the prospect of rising rates may pressure prices of bond proxies within equity markets, such as real estate investment trusts, downward volatility may also create buying opportunities for investors with long time horizons. This environment could also be favorable for areas such as financials, resource-oriented and consumer cyclical sectors. Following the results of the US presidential election, support for financials stems from a perception that we might see net interest margins expand and an easing of burdensome regulatory requirements. Within health care, there has been a lot of attention on the potential repeal or replacement of the Affordable Care Act and less pressure from the drug- pricing controversy that dominated investor sentiment in 2016. We see industrials as likely to be the key beneficiaries of potentially higher growth and expanding infrastructure spending. As we move forward, we think a potentially stronger US economy offers a positive dynamic for many other economies and markets, allowing for a potential shift in equity market leadership from the United States to other parts of the world.

Secular Growth Drivers and Capital Allocation

Some may be concerned that profits are typically cyclical and may have already peaked, leading to unsustainable valuations. We think significant secular improvements from globalization, technology and increased productivity have served to drive multi-decade profitability expansion. Though this profitability improvement has on occasion been subject to disruption, we expect it to remain consistent through 2017. As we look at the level of corporate profits and operating margins of companies around the world, we do not see excesses that might portend a pending decline in earnings going forward.

Another area of focus for us relates to corporate capital allocation. We think there is a healthy dynamic between what companies are doing with capital versus the business challenges they are facing. For example, US corporations have increasingly focused on dividends, stock buybacks and capital expenditures in recent years. Merger-and-acquisition activity has remained a focus globally and has shown an accelerating trend in recent years as companies seek strategic drivers of new growth. Many companies have also taken advantage of the low interest-rate environment, extending their debt maturity runways and substantially reducing debt financing

costs. Investing in growth while supporting or growing dividends may ultimately contribute to generating attractive performance potential going forward. For investors searching for yield, we believe these dynamics are likely to continue to favor equities in many parts of the world.

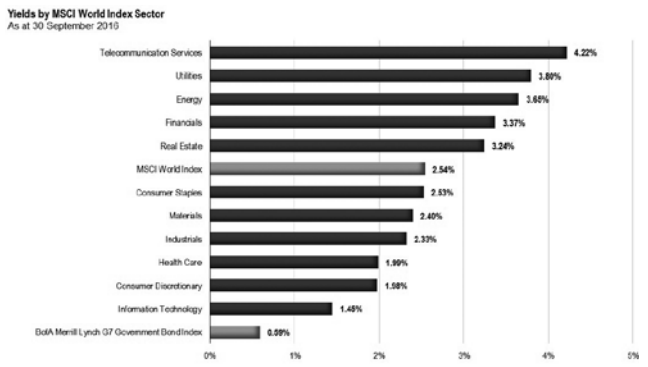
An Object Lesson in Unpredictability

As we reflect on 2016, one of the key themes that emerged was unpredictability. January and February brought negative volatility followed by a swift, albeit narrow, market recovery.

Brexit and the heightened political uncertainty tied to the US election cycle also contributed to uncertainty. Events such as these, while analyzable at some level, are very difficult to predict. However, bouts of volatility often create opportunities for longer-term investors with a staunch fundamental focus to take advantage of dislocations in equity markets.

Through it all, fundamental analysis and bottom-up stockpicking have remained the primary focus for many of our investment teams, while sector-specific insights from our seasoned team of analysts across the globe sharpen our views on the year ahead. Despite the uncertainty surrounding the pace of global economic growth and the duration of the current economic expansion, we regard numerous factors as supportive of equities across geographies and sectors, offering investors the potential for multiple opportunities in the year ahead.

Figure 2. Seeking income in a low yield environment: breadth of yield oppuertunities across sectors



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Emerging-Market Equity Outlook

EMs started 2016 on a weak note as equities were buffeted by concerns surrounding China's economy and falling oil prices. However, as the year progressed, positive factors took hold of investor sentiment, leading to EM strength and building, we believe, a robust foundation for EM equities as we look toward 2017.

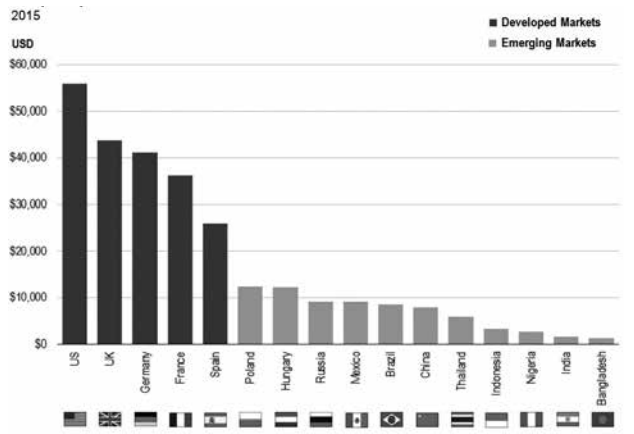
Solid Growth, with Momentum and Valuation Support

Following recent improvements, we expect macroeconomic advances to continue in 2017. This could bode well for top-line growth opportunities and the earnings outlook for EM equities.

We believe that, while GDP growth in a number of EM countries has been gaining ground, it is likely that over the next few years we could see further relative advances in sizable economies like Russia and Brazil. The economies of these two countries are still contracting, but they are on an improving trajectory and could significantly influence the growth rate of the whole group if they continue to progress. Meanwhile, China's growth, which has been a key concern for many observers, has shown signs of stability and remains at a strong level compared to most other large economies. In the third quarter of 2016, the country's year-on-year growth in GDP came in at a rate of 6.7%, which was in line with the pace reported in the previous two quarters.

Overall, we expect to see GDP growth for EMs in 2017 at a solid and accelerating level, markedly above the rate expected from DMs. EM countries are still far behind their DM counterparts when it comes to overall GDP-per-capita, and so we continue to expect strong growth prospects over the long term.

Figure 3. GDP per capita: EMs vs. DMs



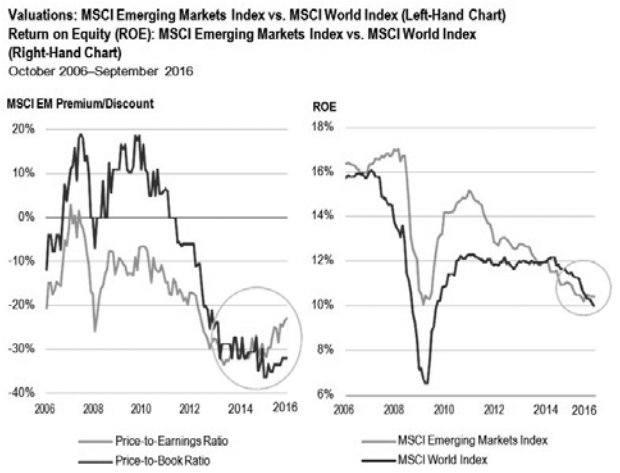
Source: Bloomberg, the World Bank. Data as at 41/10/16.

Additional economic factors are, we believe, important to our expectations for likely further strength in EMs. First, as a group, manufacturing economies are generally back into a position of current account surplus, while there has also been headway in bringing down the deficits of commodity-exporting countries. Second, the debt-to-GDP ratios of EM countries are generally below those of DMs, providing a more stable and, we believe, sustainable economic foundation. Finally, interest-rate differentials between the two groups are wide, giving EM central banks greater flexibility to maneuver, if required, in the future.

The "hunt for yield" has been a frequently used term in recent years, yet the issue still remains front and center for many market participants. With low and negative yields on many government bonds globally, we continue to expect investors to look toward EM equities, given the income prospects available. For example, the dividend yield was an eye-catching 2.5% as at 31 October 2016 for the MSCI Emerging Markets Index. Year-to-date flows toward EMs have been positive, partly due to the attractive income expected. However, this follows three years of outflows, and so further moves into EMs could be another of 2017's trends to look out for.

In terms of valuations, the MSCI Emerging Markets Index has traded at a significant discount to the MSCI World Index, for example, on a price-to- earnings-multiple basis. Earnings growth trends have improved markedly during 2016, and we expect this turnaround to continue, with economies and corporate fundamentals across the asset class stabilizing.

Figure 3. EM valuations: is the turnaround just the begining?



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Sectoral Opportunities and Challenges

We believe that companies in the consumer-related and information technology (IT) sectors are particularly attractive in the current environment. Select stocks in the consumer sectors can provide an effective means to gain exposure to EM economic expansion and, in particular, access to growth in spending as rising regional wealth fuels a burgeoning consumer class. IT in particular is becoming increasingly integral and competitive in EMs, and, although we are cautious of the recent rapid share-price advances in many of the China-based Internet stocks, we see value in the sector across EMs as a whole. Elsewhere, select commodity shares remain attractively valued, in our view, even though oil prices, for example, are currently significantly above their 2016 lows.

We remain cautious of China's banks as non-performing loan recognition dampens our outlook for the country's financial firms. Like banks, China's real estate sector has staged a striking turnaround from a lengthy downturn, but we have remained on the sidelines, in part due to risks of overleverage and regulation.

A Small but Attractive Prospect

We continue to like Asian small-capitalization stocks as they are particularly exposed to the solid growth potential we expect from this region over the long term. This is helped by small-cap companies' generally greater domestic focus than their larger peers, binding them less to challenging macroeconomic factors at a global level. Their valuations typically reflect the stronger growth expected from the smaller equities, but, given there are thousands of small-cap stocks in Asia, the opportunities to discover mispriced securities are often plentiful. These valuation anomalies usually occur due to market inefficiencies as research coverage for many of these companies can be thin on the ground.

Fed Policy: A Key Impediment to EMs?

Fed monetary policy is still a source of apprehension for many participants in EMs. We expect the trajectory of any rate increases to be gradual, although larger- or faster-than-expected US interest-rate moves could dampen sentiment and lead to volatility.

Other meaningful tests for the global economy may include geopolitical troubles, currency fluctuations, the UK's progress toward leaving the EU and commodity-price moves. Meanwhile, recent political events in the United States may also test markets; the US presidential election victory for Donald Trump is likely to have many implications for markets around the world, including EMs, and may well add to volatility in equities. It is something we will continue to monitor closely. However, we believe it will be important for investors to take a long view and not be swayed by short- term gyrations that we could continue to see in financial markets.

Active Management; Prepared for Change

On balance, although we are mindful of the potential for volatility and watchful for the risks, we believe sentiment toward EMs could continue to become more positive. In our opinion, the search for higher yields and improving risk perception toward EMs, helped by robust economic tailwinds, could provide a basis for further strength in EM equities.

But markets are fast-moving and dynamic. So, whatever the environment in 2017, we believe active equity management, driven by our experienced team located across the globe, will allow us to move deftly as we look to uncover the best investment opportunities as they arise. **FS**