Risk Considerations
● The Fund may invest in emerging market securities which are exposed to higher risk of economic, political and regulatory changes that may pose additional risk to the Fund.
● The Fund may invest up to 100% of their total net assets in structured products, mortgage- and asset-backed securities and derivatives (such as credit default swaps, forwards and options), and is subject to significant liquidity and counterparty default risks.
● The Fund may invest in defaulted debt securities on which the issuers are not currently making interest payment, and as a result may be subject to liquidity and counterparty default risks.
● The Fund may invest in non-investment grade debt securities, and as a result may be subject to liquidity and counterparty default risks.
● The Fund's value may be affected by exchange control regulations and changes in exchange rates.
● The Fund may invest extensively in financial derivative instruments for hedging purposes as well as investment purposes which may expose the Fund to the potential for significant losses and as a result may be subject to counterparty and volatility risk.
● The Fund may at its discretion pay dividend out of the capital of the Fund.
● Payment of dividends out of capital amounts to a return or withdrawal of part of an investor’s original investment or from any capital gains attributable to that original investment.
● Any distributions involving payment of dividends out of the Fund’s capital or payment of dividends effectively out of the Fund’s capital (as the case may be) may result in an immediate reduction of the net asset value per share.
● This investment involves risks which may result in loss of part or entire amount of your investment.
● Before you decide to invest, you should make sure the intermediary has explained to you that the fund is suitable to you.
● Investors should not only base on this marketing material alone to make investment decisions.

Michael Hasenstab, Ph.D.
Executive Vice President,
Portfolio Manager,
Chief Investment Officer
Templeton Global Macro
**Q:** 2015 has been quite the tumultuous year. It’s been characterized by turbulence across global financial markets. What are the reasons for the volatility and how have your strategies been affected?

**Michael:** “Market activity in 2015 can be divided into two distinct parts: 1) what occurred in the first part of the year up through the end of June, and 2) what we have seen since the end of June up through today. In that first part of the year, market activity was very much aligned with what we have been positioned for—our Templeton Global Bond Fund and Templeton Global Total Return Fund were short the euro and yen, both of which continued to weaken, and they were short US Treasuries, which underperformed during that period. Those events were good for the funds and provided opportunities to hold and accumulate positions in select emerging markets (EMs) that had experienced currency depreciations of anywhere from 10%–15%.

Markets then entered a period of panic and massive risk aversion at the end of June, triggered by economic concerns in China. Many EM currencies depreciated another 10%–15%, while the yen and the euro remained largely flat, acting as perceived safe havens. Concurrently, US Treasuries appreciated. The combination of these events was a perfect storm against the funds as our short US Treasury duration and long EM currency exposures detracted from performance. But what encourages us is that many EM currencies are now in many cases 15% to 30% undervalued, in our assessment, and we were able to use this period of volatility to continue to buy these really distressed assets. We saw specific valuations reach levels that are not only a once-in-a-decade opportunity, but what we believe to be rare multi-decade opportunities to capture extraordinary longer-term investment potential.

In our view, the parts of the funds that performed poorly this year, particularly in the recent period, have really good gearage to upside potential, and we’re quite excited about the performance prospects there. And then, in terms of some of those other macro-hedges, our short Treasuries we think ultimately will help performance when the US Federal Reserve (Fed) does start to hike interest rates. Fed policymakers have been slow and are potentially getting behind the curve, but eventually they will be forced to hike interest rates. That part of our funds has not been performing, but we think it will reaccelerate. Similarly, the yen and euro have been essentially flat over the last couple of months, but we believe they are poised for further depreciation when the Fed begins to tighten monetary policy while the European Central Bank and Bank of Japan move toward additional monetary easing. Thus, we believe that the three major themes that went against the funds in the last few months (short US Treasuries, short euro and short yen, and select EM exposures) have strong potential to reverse in the periods ahead.”

For distributors/dealers use only. The content of the document should not be reproduced/distributed to the public without the prior approval of Franklin Templeton Investments.
Q: Conventional portfolio theory would suggest that investors should hold some allocation to fixed income in their portfolios to help diversify from equity allocations. However, we’ve seen a slight increase in your funds’ correlations to equity market performance over the last couple of years. Why should an investor consider an unconstrained fixed income allocation if it might not provide that negative correlation to equities that fixed income traditionally provides?

Michael: “First, in terms of why an investor should go unconstrained, we think it’s clear that you don’t want duration risk given that we are at a 30-year low in interest rates. That’s why we’ve moved the funds to have negative US Treasury duration. Our strategies have portfolio duration close to zero because we don’t want that interest rate sensitivity. Now that didn’t work in the last month or so, but we’re looking at a multi-year period ahead, and we think that should work very well.

Moving to the equity correlation aspect of our funds, the question really depends on what market conditions would trigger an equity market selloff. If it’s because higher interest rates trigger an equity market selloff, then we think we have established a very good negative correlation to both traditional fixed income and equities in that scenario, through our short duration positioning. However, if instead the equity markets sell off because of risk aversion due to concerns about some global catastrophe, such as China collapsing, then we are going to have more of a positive correlation to equities.

So we have to make an assessment as to which is the more likely scenario. In our view, we do not see the global economy collapsing. Yes, there are some growth pressures, but if you add up the US growing between 2%–3%, Europe growing above 1%, Japan at about 1%, and China between 6%–7%, that macro backdrop is certainly not a global collapse. It’s not deflation, and it’s not a global financial crisis.

Given this, we don’t think that this recent period of complete panic is likely to continue. We think the greater risk is the sensitivity of financial markets to a rise in interest rates. Thus we want to be positioned for interest rates to go higher (specifically US Treasuries) and have a negative correlation to the bond market as well as other risk assets that could be affected by higher interest rates.

We think the big tragedy in a lot of portfolios will be the belief that the correlations of the last 30 years will hold (namely inverse correlations of equities and bonds), but when they don’t—when we potentially get a falling bond market and a falling equity market—people’s portfolios may not be well positioned. We haven’t seen that for the last 30 years, but that doesn’t mean it can’t happen. We are now in extraordinary times; we’ve never had monetary policy distort Treasury markets to the current extent, so we have to think a little bit differently. What worked for the last 30 years might not work for the next five years. Therefore, we have to be pro-active and create portfolios that have these different characteristics and that have the potential to be uncorrelated to rising interest rates.”
Q: Can you provide three areas of investment opportunity that you see in the period ahead?

Michael: “We are currently focused on three main areas of investment potential: 1) the profound value in specific EMs, 2) short US Treasuries in a rising-rate environment, and 3) the flexibility of management within the currency markets to be long and short. These three broad sources of investment return really excite us about the opportunity set for the next couple of years.

First, right now we are buying select EMs at multi-decade and/or all-time low valuations. We can buy the Mexican peso at the weakest level it’s been in the history of Mexico. Similarly, the Malaysian ringgit and the Indonesian rupiah are at levels we have not seen since the Asian financial crisis in 1998. On a valuation basis, these are not just once in a decade, but multi-decade opportunities to buy what we believe to be very cheap assets. Certainly, not all EMs have good value. We are not buying everything. We’re not investing in countries such as Turkey or South Africa. But there are a handful of countries that are being caught up in the current market turmoil that we think are the diamonds in the rough; multi-decade opportunities, or for some of these countries, once-in-their-history opportunities.

Second, we are positioning our funds to aim at a negative correlation to US Treasuries. We view one of the biggest risks over the next five years to be rising US interest rates. In our assessment, the strength of the US economy justifies higher rates, and we think inflation is underpriced in the Treasury yield curve. For the last 30 years, most investors made money from declining rates; we think over the next five years you want to make money from rising rates. Thus, our strategy is positioned to be short US Treasury duration.

Third, we believe it’s important to have a highly flexible strategy that can directionally position across the currency markets. One of the most attractive aspects of the currency markets is there is generally always something undervalued; things are usually never in perfect alignment. Thus, an investor can allocate in opposing directions—going long the US dollar or short the US dollar. Currently, we have the flexibility to be long the US dollar against short positioning of the yen, the euro and the Australian dollar. At the same time, we can also short the US dollar against long positions in currencies that we view as undervalued, such as the Mexican peso. Those positions could completely flip around in a couple of years if we see valuations adjust, so the flexibility to move to where value resides in the currency markets is an opportunity set that we believe never runs out. By contrast, other security markets often depend on where they are in an investment cycle. Taken together, we see vast opportunity sets for the upcoming years.

So in conclusion, we would say currently there are attractive value opportunities in many emerging markets—once-in-a-decade opportunities or once-in-their-history opportunities for some of these countries. Second, being short US Treasuries in a rising-rate environment. And, third, the flexibility within currency markets to be long/short. ‘We’d say those are the three areas that really excite us about the opportunity set over the next couple of years.’

Copyright © 2015. Franklin Templeton Investments. All rights reserved.