

## Is rate tightening on the horizon?

**By Dr. Michael Hasenstab, Co-Director of Global Fixed Income, Franklin Templeton Fixed Income Group.**

The global economy is recovering but at different paces – emerging economies, especially those in Asia, are experiencing stronger growth, while developed economies continue to face difficulties. Meanwhile, the outlook for global interest rates has taken a back seat in recent weeks, overshadowed by sovereign debt crises in Europe.

Dr Michael Hasenstab, senior vice-president and portfolio manager of the FTIF Templeton Global Bond Fund at Franklin Templeton Investments believes that global financial markets in 2010 will be marked by economic delineation between over-leveraged developed economies versus emerging markets, particularly in Asia, that have stronger underlying fundamentals. The successful monetary and fiscal policy stimulus to stave off a global recession has created future risks of excess liquidity, inflation, higher taxes and other negative consequences which added to the timing of reversing stimulus will present a challenge for policymakers worldwide.

However, Dr. Hasenstab notes that emerging markets are currently in a favorable position within a business cycle that is largely facilitated by higher productivity, increased investment and stronger capital inflows. He answers readers questions on interest rates, inflation and growth opportunities in bond markets, below.

### **What would be the likely impact of successful monetary and fiscal policies in emerging economies on investment strategies by investment funds in 2010?**

The structural improvement evident in many emerging markets has caused many investors to reconsider their traditional assumptions. For example, while many developed economies have been running high fiscal deficits and seen the debt burdens of their public and private sectors rise, most emerging markets are in much better positions with lower debt levels and sustainable fiscal balances.

Further, many of these emerging economies continue to run current account surpluses and are likely to have much stronger growth going forward. This economic outperformance should favor the assets of these emerging markets going forward.

It seems reasonable to see some economies (such as the UK, US, the peripheral eurozone countries and so on) as having more public and private debt that they could ever hope to service at 'normal' rates of interest. Would it not therefore be better to 'reboot' the machine by allowing interest rates in each economy to find their own level, writing off the uncollectable debt, and allowing asset prices to readjust? Would that at least remind everybody that risk-free returns only exist if everybody behaves prudently? Is prudent behaviour a practical impossibility when policymakers promise and encourage too much stability and 'predictability'?

We believe that a sovereign default in the US, UK or core eurozone is extremely unlikely. There has been a deterioration in the balance sheets of these governments, which is likely to have an adverse impact going forward as higher taxes and lower expenditure become necessary.

However, these governments still have a lot of room before a credit event is likely. The needed fiscal consolidation will be a challenge, especially in economies that do not recover quickly, but ultimately a much less negative outcome is likely.

### **Are US TIPS<sup>1</sup> still a buy? Is the European sovereign debt crisis more like Asia in 97/98 or 2008? Do you still think we are headed for much higher treasury yields longer- term and that the US will end up monetising the debt?**

We are pursuing ways to not just be cushioned from but actually capitalise on rising US yields, and we currently hold no Treasuries in our portfolio. There is a strong correlation between US Treasury yields and the Japanese yen. The narrowing of the interest rate differential has supported the yen against the dollar recently, but if US yields rise, reversing the interest rate convergence, the yen may weaken. Thus, our negative exposure to the yen serves as a hedge against the potential rise in US yields.

I would say that the Greek debt crisis is less like Asia in either period than Argentina in 2000: Greece needs to fully implement the tough fiscal adjustment planned in the IMF program to put its public finances back on a sustainable footing, and at the same time

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<sup>1</sup> Treasury Inflation-Protected Securities

faces the problem of a significant loss of competitiveness. Other peripheral Eurozone countries however are in stronger positions, although some of them also need additional fiscal adjustment, and we therefore believe that a systemic crisis can and will be averted.

**Which fixed income investment strategies should be considered by investors worried that increases in interest rates, withdrawal of stimulus measures and high levels of corporate debt maturing in 2012-14 will compound to reduce the value of current debt investments?**

Rising interest rates around the world are likely to pose a challenge and an opportunity to fixed income investors. The different speeds at which economies around the world recover will be central to capitalising on this environment. For example, we have already seen countries like Australia, Norway, and more recently Brazil raise interest rates as their economic recoveries have accelerated.

Not surprisingly, their currencies have performed well in comparison to the currencies of economies where growth remains weak and tighter policy is unlikely over the short term. This dynamic should continue going forward favoring the currencies of rapidly growing economies, such as emerging Asia, against those of slower growing regions, such as the Eurozone and Japan.

Beyond currency exposure, it is important for investors to be careful of duration exposure, particularly in economies where government debt burdens are likely to rise. We currently hold no US treasuries, gilts, or Japanese government bonds as we believe yields are likely to rise over the medium term. Further, investors can actually position to make money on rising rates.

One important conclusion of where we currently see opportunities is that it is very important for investors to utilise a flexible investment approach. Benchmark exposure results in the largest duration exposures in the developed countries with the highest debt burdens. In order to capitalise on rising rates, flexibility and a focus on fundamentals are essential.

**I have a major position in your FTIF Templeton Global Bond Fund\* and note that you have been carrying a significant short position on the Euro. Do you have a target EUR/USD rate or various policy actions in mind that would motivate you to remove your short position?**

We do not have fixed targets for our investment positions and rather are continually re-evaluating our exposures as the underlying fundamentals evolve. In the case of the euro, while its valuation relative to the dollar has moved closer to a level we think the fundamentals would support, we still believe the dollar will strengthen against it going forward as the recovery in the US strengthens ahead of that in Europe.

**What impact is China tightening likely to have on the exit strategies of its trading partners? Can China slow its economy without the whole world feeling the effects?**

We have been encouraged by the prudent policy response so far in China. It is clear that the economy has recovered quickly, and we believe that if the significant stimulus authorities implemented last year was not withdrawn, there would have been a significant danger of the economy overheating.

Fortunately, local policy makers have recognised this threat and are taking incremental steps to slow the economy and asset prices. However, we do not believe these tightening measures are likely to derail the economic recovery. The tightening has been fairly conservative so far, and authorities are very focused on achieving a sustainable, high level of growth.

**The European debt crisis has been described as “Europe’s Lehman Brothers”. Do you think it has the capacity to become the systemic failure that could eventually bring down the euro?**

Our view is that the euro will remain a viable currency. Fiscal reforms are definitely needed as well as some sort of broader political structure to co-ordinate fiscal policy. But Europe probably has five or 10 years to do that, so it’s not something that has to happen right away.

We see it as very unlikely that any country leaves or is forced out of the euro. That is a very remote possibility at this time, but the challenges are likely to further stress an already slow growth environment. These challenges further support our bearish position on the euro.

**Do you think all these fears about a eurozone sovereign debt crisis are casting a shadow over other bond markets — for corporate debt as well as government debt — if the situation does not become clearer, how can we be sure that contagion hasn’t started? What indicators do you look for to identify when it will, if it does?**

We have seen some contagion already as the prices of many fundamentally unrelated assets have seen increased volatility of late. As always, we maintain our focus on medium term fundamentals and are using this period of volatility to add to positions with strong

fundamentals at more attractive levels. Such periods of volatility can take time to pass, but we are confident that by only maintaining exposures that we believe are attractive relative to their fundamentals, we will be well positioned to benefit when the market normalises.

**Will the Fed still be holding rates at historically low levels “for an extended period” this time next year? I’m wondering whether recent equity market falls, and fears over debt will persuade it to hold fire. Will inflationary pressures be as bad with China trying to cool its economic growth?**

While we do not anticipate interest rate hikes over the short term in the US, we do expect some degree of monetary tightening over the medium term as the recovery strengthens and the extraordinary support of the Federal Reserve is no longer needed. Monetary policy makers have many tools at their disposal to gradually normalise policy in a way that doesn't disrupt the recovery. In fact, a smooth tightening of fiscal policy will likely prove to be the bigger challenge.

**What is your view on events in Greece and Southern Europe? Do you hold any Greek, Spanish or Italian sovereign bonds?**

Right now we are negative on the euro and have no exposure to Greek bonds or government bonds of other over leveraged eurozone members. Greece's debt dynamics are currently unsustainable and require unprecedented and painful adjustments. Compounding the problem is the difficult political environment in which such spending cuts and tax hikes must be made as well as the lack of credibility of the Greek government following years of misreported statistics.

This is likely to present a challenge to the euro area, however, we do not expect any country to ultimately exit the eurozone. Given the challenges facing these economies, it is important to differentiate between credits. For example, countries such as Hungary and Lithuania have already recognised the changes that need to be undertaken and have made significant progress towards correcting the imbalances that plagued the region during the boom years.

While Greece's problems may lead to contagion driven sell offs in the region, we would look at such an event as a buying opportunity since we believe a systemic crisis in the eurozone will be averted, and considerably stronger fundamentals of countries in central and eastern Europe should prove resilient to the stress on Greece and other countries in the eurozone's periphery.

**Given the recent market response to the Greek bailout (i.e., not good) and increasing concerns about sovereign debt representing the next serious systemic risk, how are you positioning yourselves to protect against such risk? I note also you're bullish on emerging markets, what are your thoughts on de-coupling as protection against sovereign risk in the developed countries...it didn't seem to help much during the 2008/09 melt-down.**

We believe the contrast between emerging and developed markets will lead to an important theme in financial markets in 2010, economic delineation. Decoupling was a popular thesis heading into the global financial crisis, which was debunked by the violent recoupling of all risky assets during late 2008 and early 2009.

During the initial stages of the recovery, the high correlation between risk exposures persisted. Moving forward, however, it will be increasingly important to differentiate between economies with strong underlying fundamentals and those that are still vulnerable to their difficult economic positions. Overleveraged credits such as Dubai World and Greece are early stage examples of this trend.

In contrast, better balanced economic conditions have allowed developed markets such as Australia, Norway and Israel to already begin to tighten monetary conditions while emerging markets such as China have exhibited double-digit growth in the fourth quarter of 2009. Assessing individual countries' fundamental growth and inflation outlooks will therefore provide important guidance toward our positioning in global interest rates and currencies. In particular, we would expect Asian currencies to be supported over the medium term against the G3 (the US, eurozone and Japan), in light of the Asian region's far stronger economic recovery.

**The situation in Greece has caused contagion selling in sovereign debt worldwide, regardless the relative strength of other nations' fiscal balance sheets. You recently predicted that the Greek crisis will re-emerge in 2011, 2012 and 2013. Do you believe that otherwise healthy EM sovereign debt (for example, that of Korea and Brazil) will face headwinds throughout the same multi-year period and, if so, how will the FTIF Templeton Global Bond Fund\* be positioned to protect principal in such a negative environment?**

In such a differentiated recovery, a flexible investment approach is essential. While we do not expect to see the indiscriminate risk rally of last year duplicated, the differentiated global recovery will present many opportunities. There may well be periods of elevated volatility as a result of negative headlines coming from over-leveraged credits, but we would look at episodes of contagion as an opportunity to add to positions with strong fundamentals at more attractive levels. Given our flexible approach, focus on fundamentals, and broad expertise and participation in varied economies around the world, we are confident of being able to continue to provide strong returns going forward.

**\*A sub-fund of the Luxembourg registered SICAV Franklin Templeton Investment Funds**

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