

From G8 to G20: Global Opportunities in an Uneven Recovery

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Overview

1. Risk—What is it and how did we get here?

2. Economics—The Problems/The Opportunities

3. Conclusions—Thoughts for relative positioning

The Normal Distribution ...

... the Most Dangerous Concept in Finance?



- Two thirds of data points **should** lie between the standard deviation of the norm

But How do we Know? “It is Far Better to be Roughly Right than Precisely Wrong.”

“With a free hand to choose coefficients and time lags, one can, with enough industry, always cook a formula to fit moderately well a limited range of past facts. But what does this prove?”

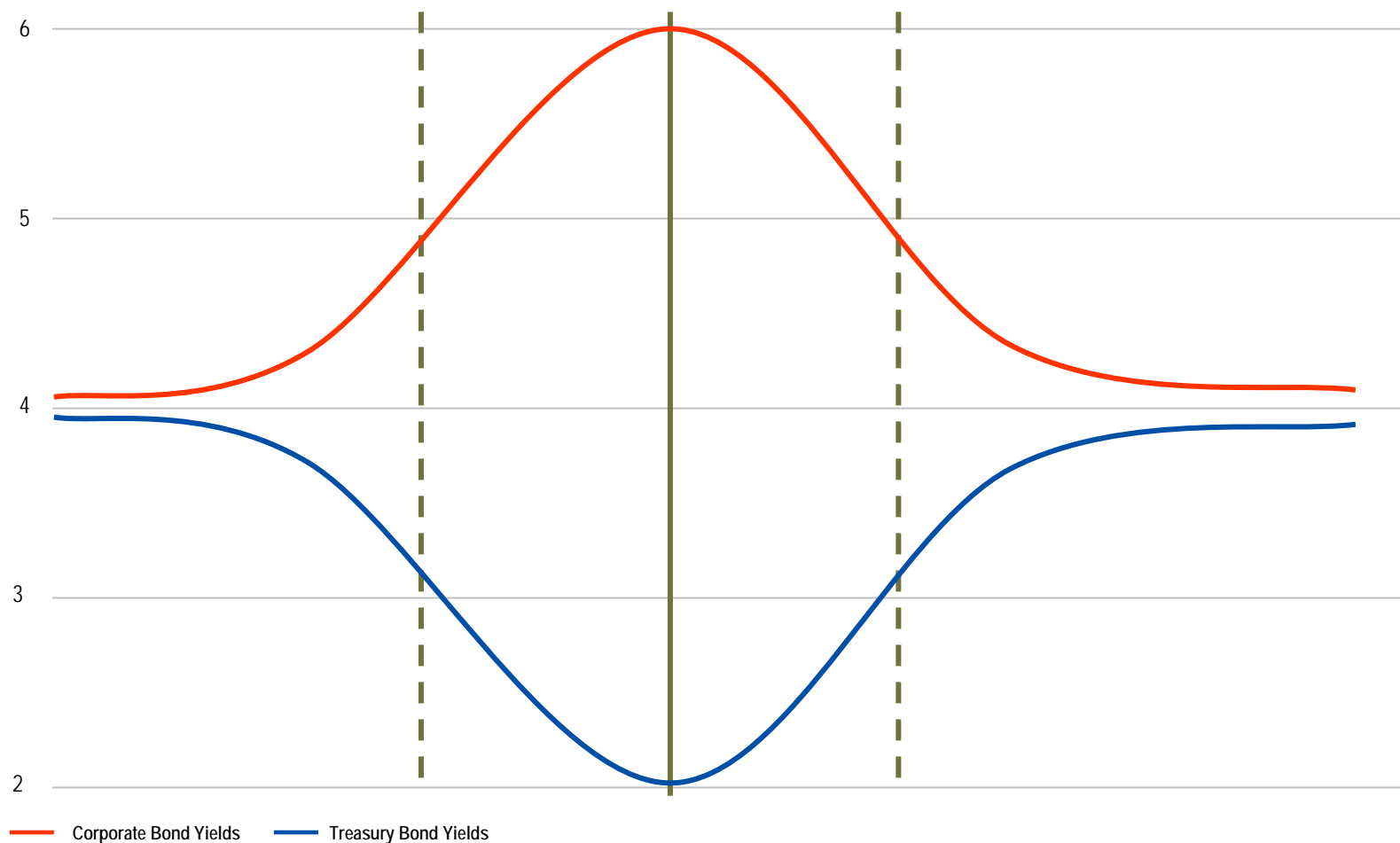
J. M. Keynes 1921

... alternatively in the words of a much derided politician:

“There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we now know we don’t know. But there are also unknown unknowns. These are things we do not know we don’t know.”

Donald Rumsfeld 2002

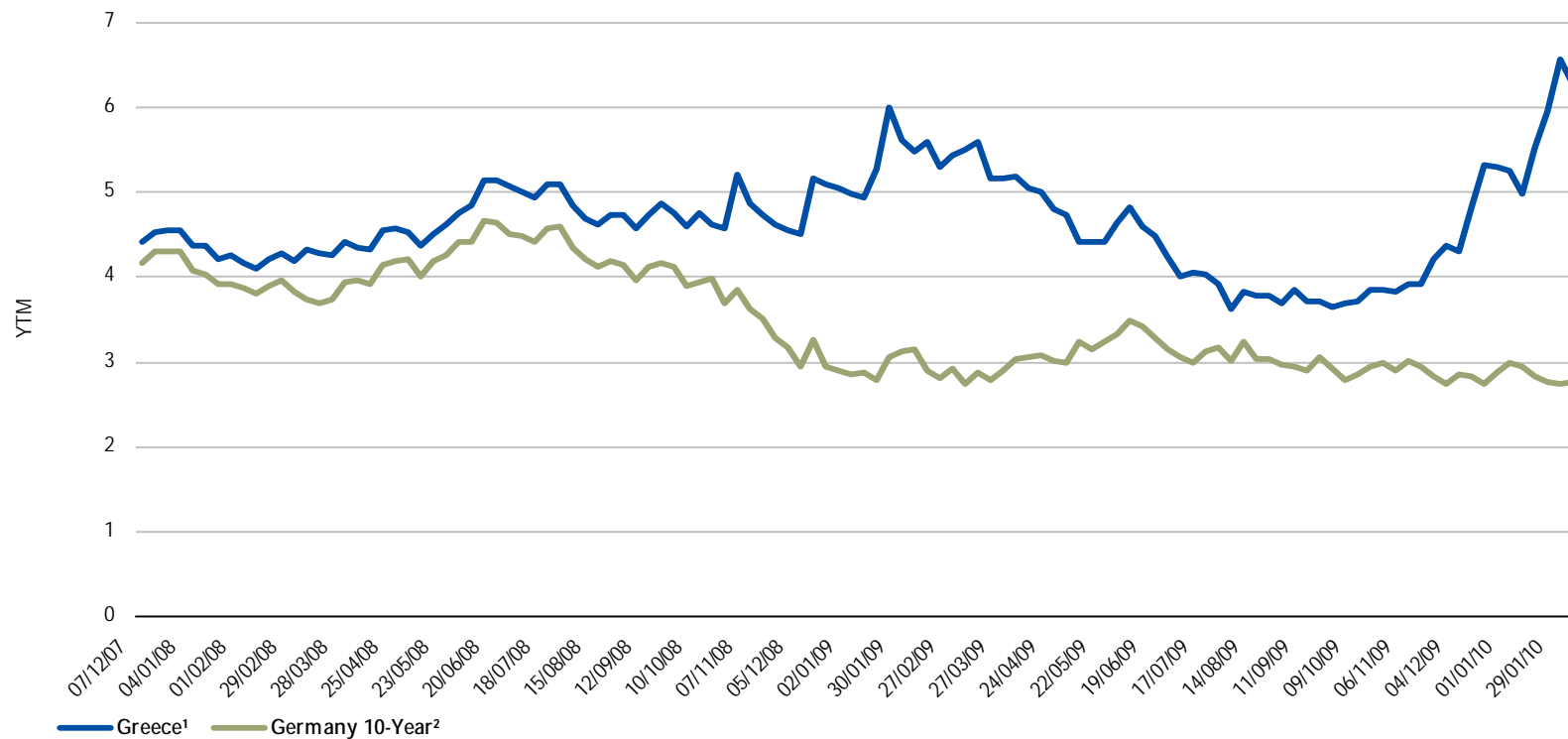
Hard Wired to Risk? Stylistic View of Government Versus Corporate Bond Yields



- During 2008 the Treasury Bond yields “collapsed” from 4.00% to 2.00% in yield. Simultaneously Corporate Bond yields “soared” from 4.00% to 6.00%. Which is riskier?
- We are hard wired to conclude Government Bonds carry low (or no) risk.

What is Risk?

Greece



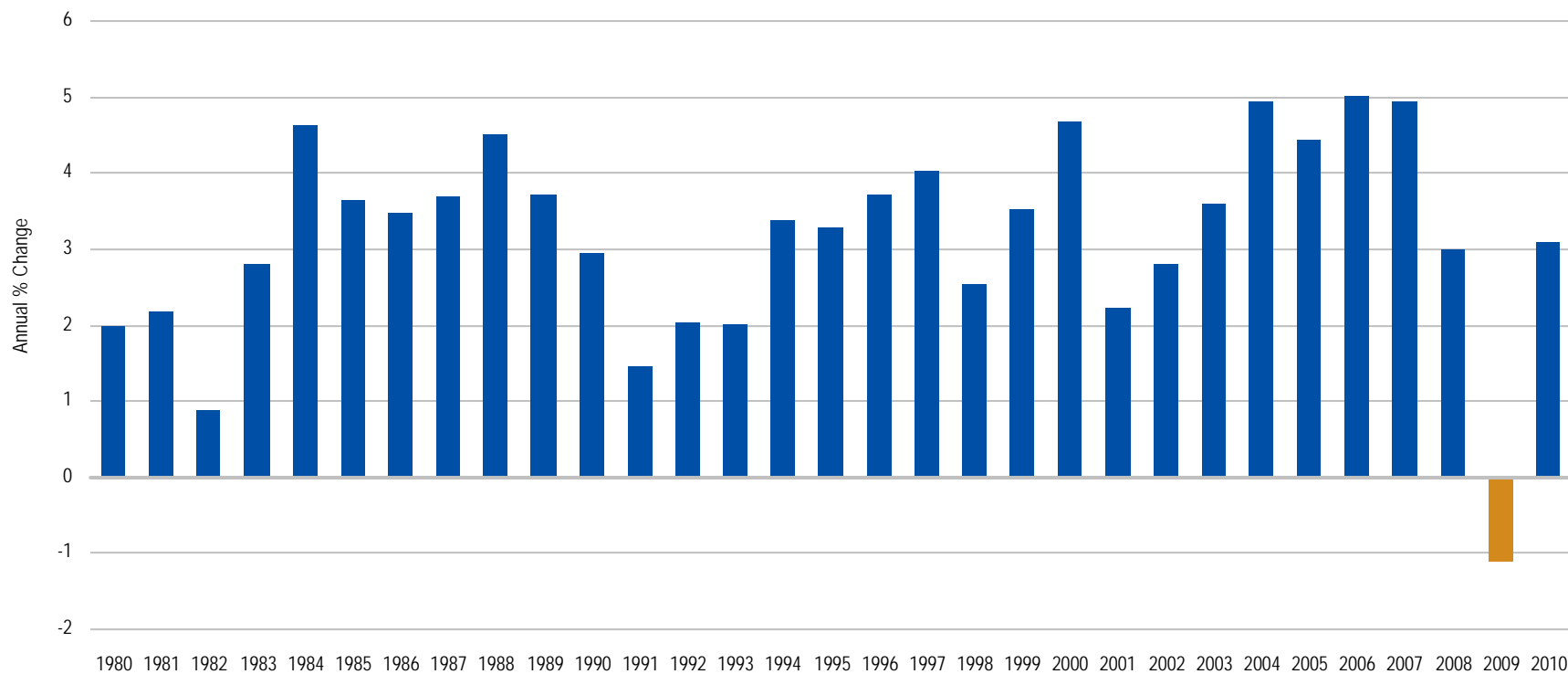
1. Greece ISIN: GR0124028623. Hellenic Republic 10yr 3.60% 07/20/2016 A-.

2. Germany ISIN: DE0001135317. 10 yr Bund 3.75% 01/04/2017 AAA.

Global Growth

IMF World GDP

As of October 2009



The International Monetary Fund (IMF) forecasts global growth falling by 0.8% in 2009 from 3.0% in 2008, but rising by 3.9% in 2010. However, three downward revisions were made in 2008-2009, and two upward revisions made from October 2009–January 2010.

“It is far better to be roughly right than precisely wrong”

Global Growth

Year-on-Year % Change

	2008	2009	Projections		Difference from October 2009 WEO projections	
			2010	2011	2010	2011
US	0.4	-2.5	2.7	2.4	1.2	-0.4
Eurozone	0.7	-3.9	1.0	1.6	0.7	0.3
UK	0.7	-4.8	1.3	2.7	0.4	0.2
Russia	5.6	-9.0	3.6	3.4	2.1	0.4
China	9.0	8.7	10.0	9.7	1.0	0.0
India	7.3	5.6	7.7	7.8	1.3	0.5
Middle East	5.4	2.2	4.5	4.8	0.3	0.2
Brazil	5.1	-0.4	4.7	3.7	1.	0.2
World trade volume ¹	3.0	3.0	5.8	6.3	0.3	1.1
Advanced economies	0.6	0.6	2.1	2.4	0.8	-0.1
Emerging and dev. economies ²	6.0	6.0	6.5	7.7	0.9	0.2
US dollar Libor	3.0	3.0	0.7	1.8	0.0	0.0

If anything, our suspicion would be after three downward shifts in growth forecasts from October 2008–January 2009, the IMF is at risk of repeating the error, but in an opposite direction between October 2009 and January 2010. Two upward revisions down, and one to go!

Source: IMF.

1. Goods and services.

2. Consumer prices.

**Questioning the Strength of the Euro and Yen
Against the U.S. Dollar. Comparison of U.S.,
Japanese and European Conditions**

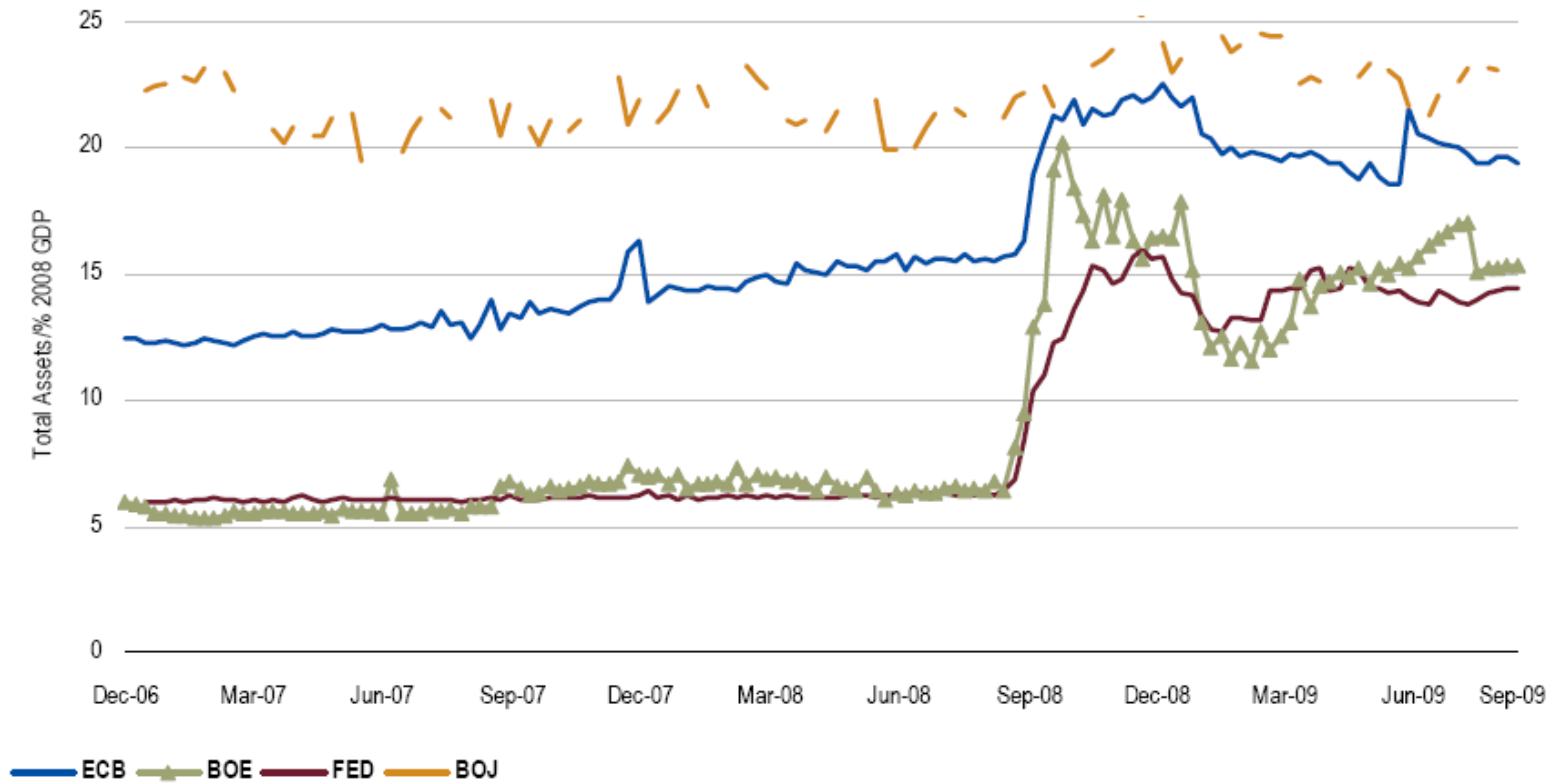
Federal Reserve's Balance Sheet



In response to the financial crisis, the Federal Reserve has expanded its balance sheet in an unprecedented manner in order to unfreeze credit markets and lower interest rates. This policy is starting to have the desired impact on credit; however, we believe the dollar is likely to suffer with this expansion of the monetary base. A larger monetary base coupled with an easing of lending conditions may eventually create excessive liquidity in the economy unless the Fed takes pre-emptive action.

Extraordinary Monetary Policy

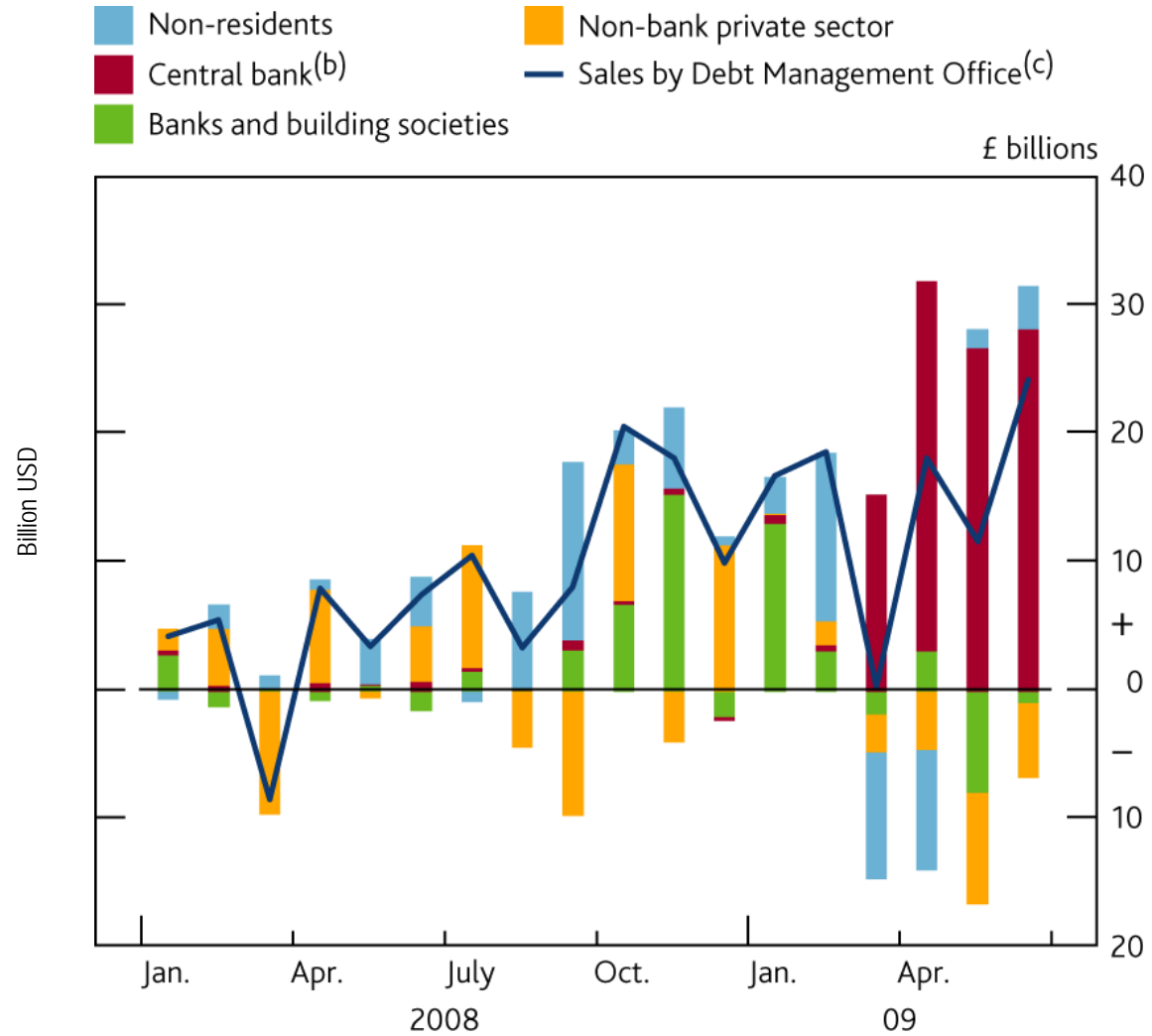
Central Banks Balance Sheets as of 30/09/09



To help mitigate the damage to the economy from the withdrawal of credit, Central Banks injected huge amounts of liquidity into the system through a variety of programs. While these efforts succeeded in their primary goal of unfreezing credit markets, there will likely be long-term costs.

Bank of England Balance Sheet

As of April 2009

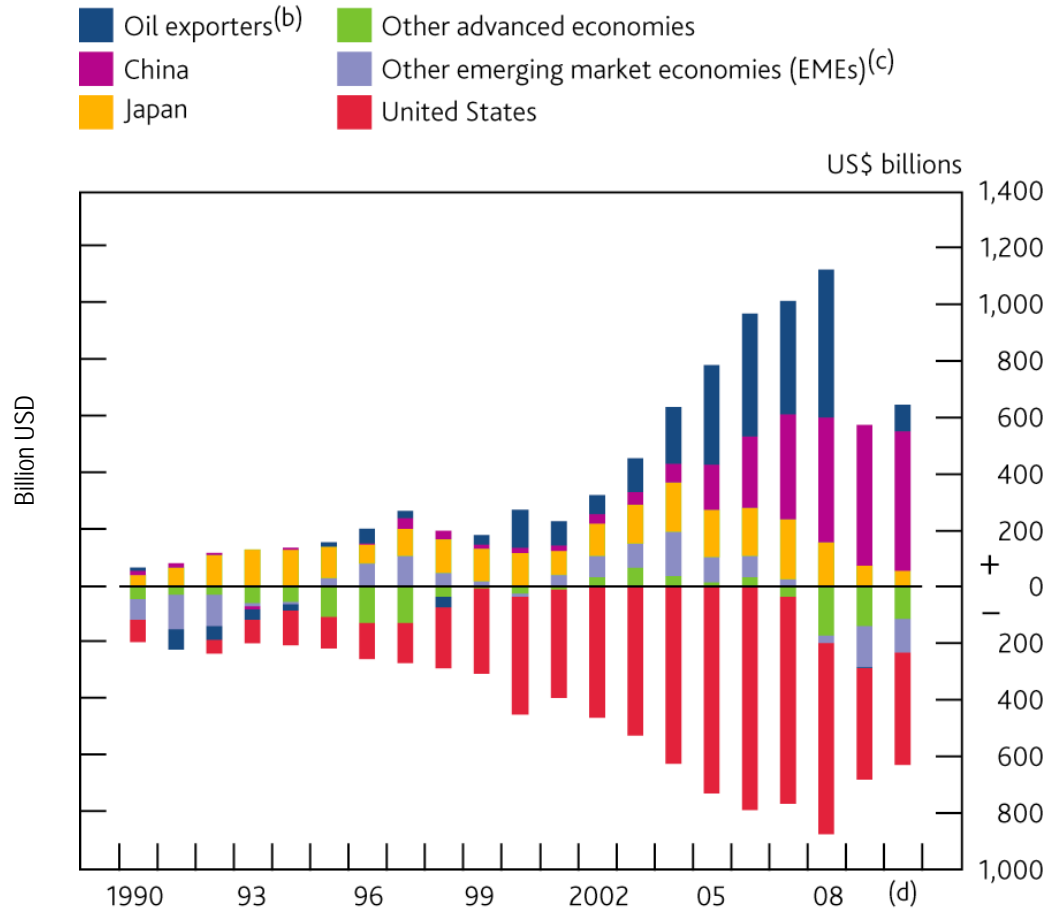


Source: IMF World Economic Outlook (April 2009) and Bank calculations.

Savings and Consumption Imbalances

“The Americans get the toys, the Chinese get the Treasuries, and we get screwed”

As of April 2009



Sources: IMF World Economic Outlook (April 2009) and Bank calculations.

Notes:

A. Global current account balances do not sum to zero due to errors and omissions.

B. The sum of the ten largest oil exporters in 2004: Algeria, Iran, Kuwait, Mexico, Nigeria, Norway, Russia, Saudi Arabia, United Arab Emirates and Venezuela.

C. Other EMEs includes the newly industrialised Asian economies.

D. IMF World Economic Outlook (April 2009) forecast for 2009 and 2010.

We Have Observed 4 Archetypes of the Deleveraging Process

Archetype	Number of Episodes After a Crisis (total ¹)	Description	Examples	Years
1. “Belt-tightening” <i>Most common developing path.</i>	16 (23)	<ul style="list-style-type: none"> Episodes where the rate of debt growth is slower than nominal GDP growth, or the nominal stock of debt declines 	<ul style="list-style-type: none"> Finland Malaysia U.S. S. Korea 	91-98 98-08 33-37 98-00
2. “High Inflation” <i>Absence of strong central banks, often in emerging markets.</i>	8 (12)	<ul style="list-style-type: none"> Periods of high inflation mechanically increase nominal GDP growth, thus reducing debt/GDP ratios 	<ul style="list-style-type: none"> Spain Italy Chile 	76-80 75-87 84-91
3. “Massive default” <i>Often after a currency crisis.</i>	7 (7)	<ul style="list-style-type: none"> Stock of debt decreases due to massive private and public sector defaults 	<ul style="list-style-type: none"> U.S. Argentina Mexico 	29-33 02-08 82-92
4. “Growing out of debt” <i>Often after and oil or war boom.</i>	1 (3)	<ul style="list-style-type: none"> Economies experience rapid (and off-trend) real GDP growth and debt/GDP decreases 	<ul style="list-style-type: none"> U.S. Nigeria Egypt 	38-43 01-05 75-79

Source: McKinsey Global Institute.

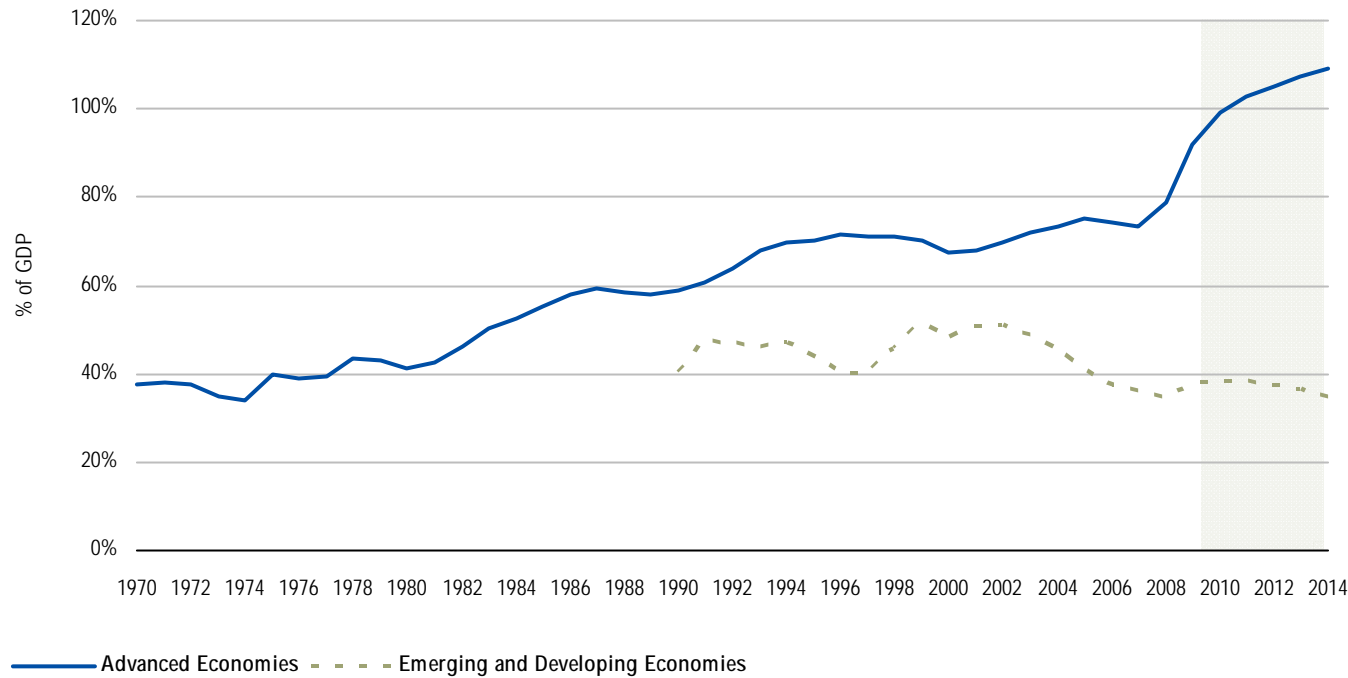
Notes:

1. Includes 13 deleveraging episodes that were not preceded by a financial crisis.

Better Debt Ratios and Lower Supply Risks

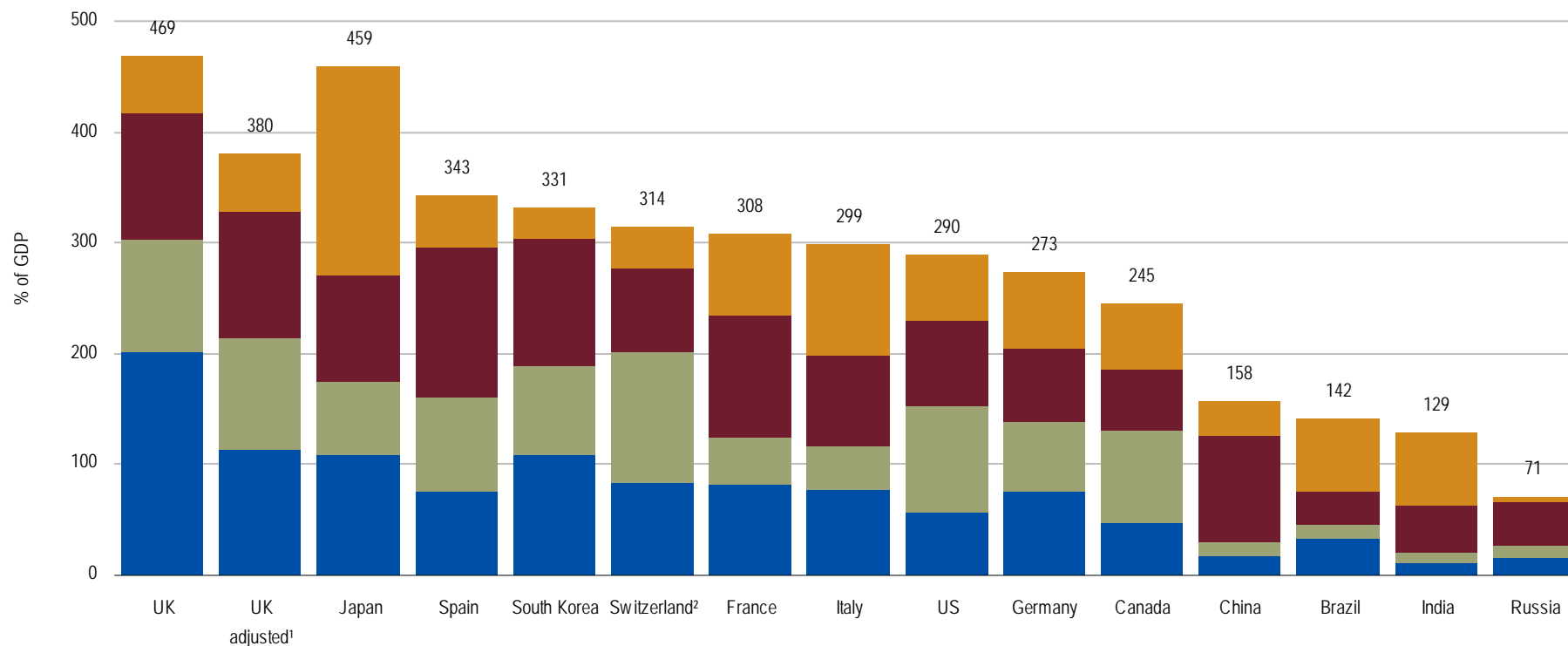
The lower debt levels of emerging market governments will become even more pronounced as policy responses in developed countries cause debt levels to rise quickly.

Government Debt to GDP



The Sectoral Composition of Debt Differs Across Economies

Debt by Country—2008 (% of GDP)



Compound annual growth rate of debt in local currency (%):

2000-08	10.2	0.3	14.5	10.8	4.5	7.7	6.3	8.1	2.5	6.1	15.1	15.1	16.5	31.6
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■ Financial Institutions ■ Households ■ Non-Financial Business ■ Government

Source: Haver Analytics; McKinsey Global Institute.

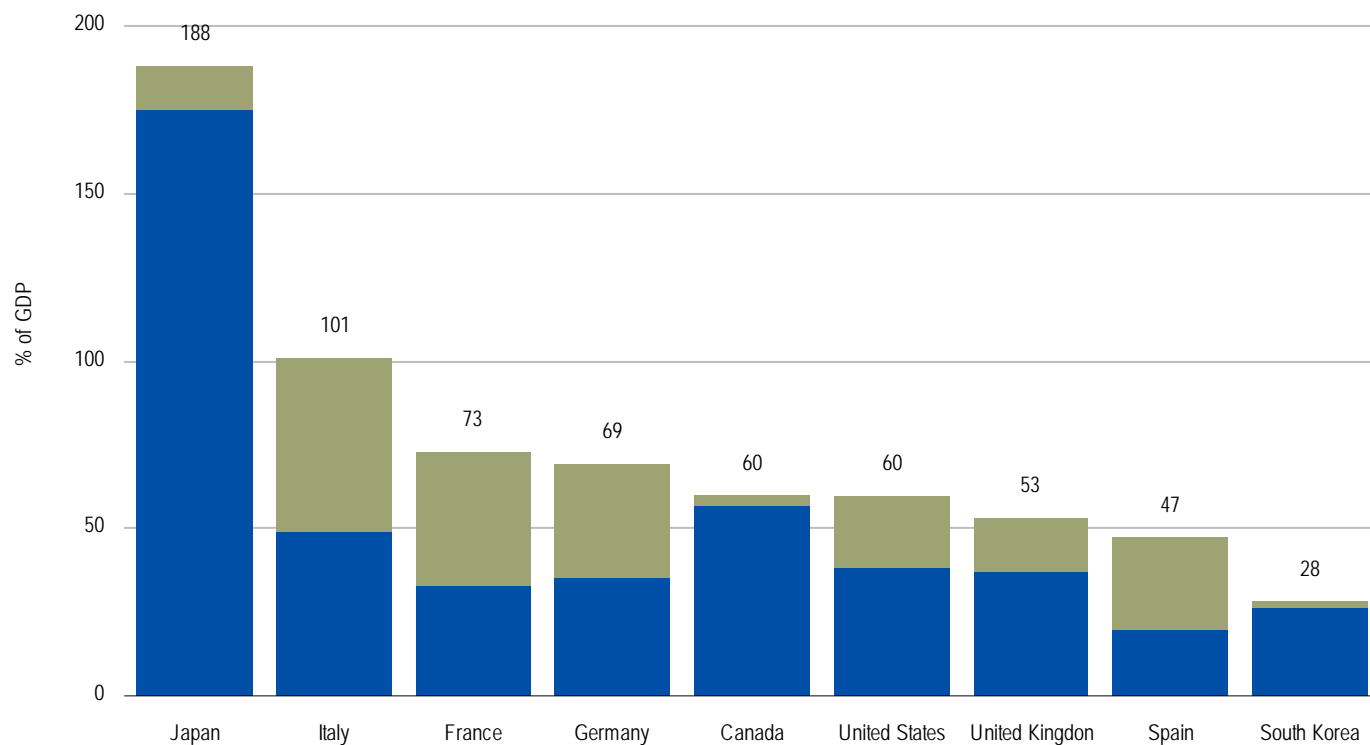
Notes:

1. The UK financial sector was adjusted to reflect its position as a financial hub.

2. Data for Switzerland represent year-end 2007.

Japan's Government Debt is Mostly Owned by Domestic Investors

Composition of Government Debt Ownership by Nationality—2008 (% of GDP)



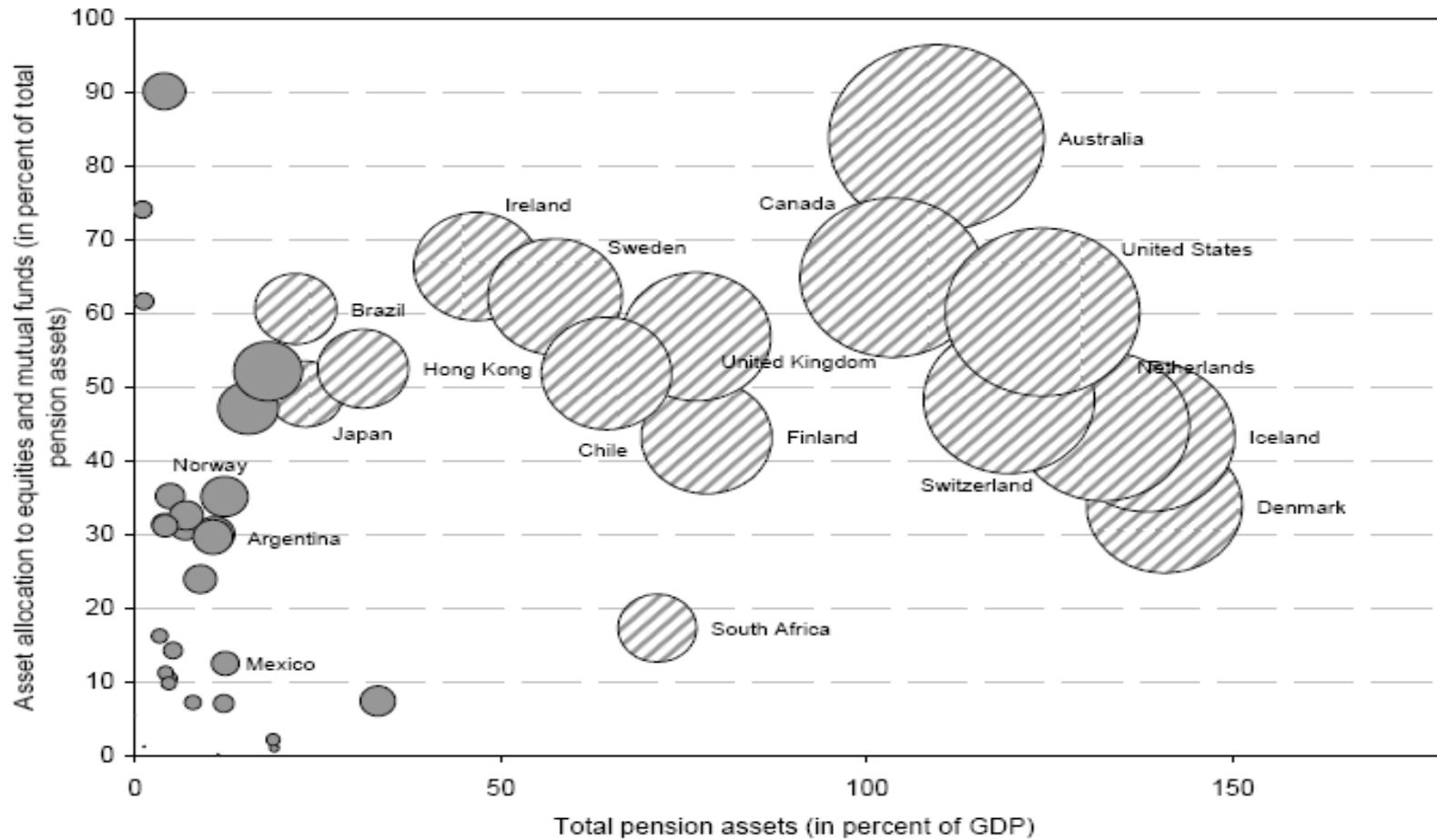
Average Maturity:

Years	6	7	7	6	7	4	14	7	5
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■ Domestically Owned Share ■ Foreign-Owned Share

Aging Populations, Generous Benefits, Wrong Asset Mix ?

Pension Plan Assets by Country, End-2007



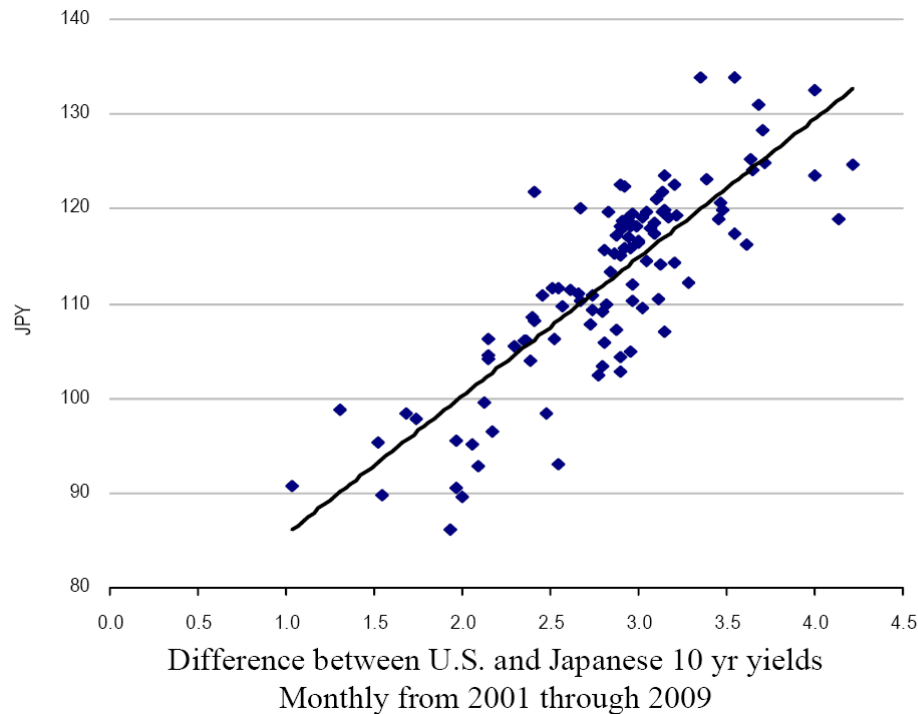
Source: OECD Global Pension Database; and IMF staff estimates.

Note: Size of circles represents pension funds' equity and mutual fund assets as a percent of GDP. Circles with stripes denote countries where this value exceeds 10 percent of GDP. Data do not include reserve funds of social security systems or funds whose assets may be used for purposes other than financing the social security system, such as in Norway.

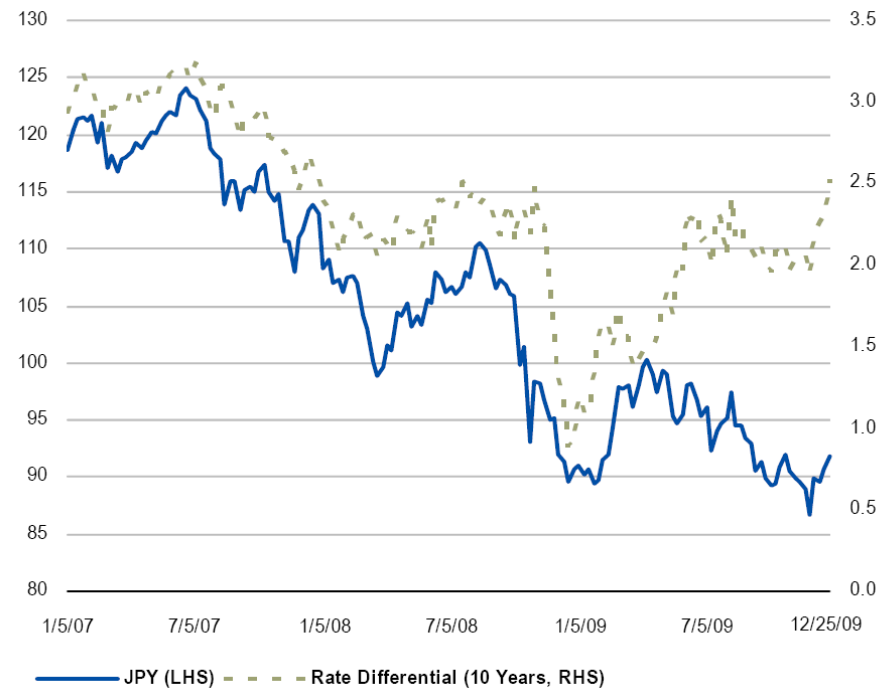
Japanese Yen Likely to Weaken if U.S. Yields Rise

Historically, there has been a strong correlation between the relative strength of the yen against the U.S. dollar and the difference between their interest rates. In part due to the large international portfolio flows of Japanese investors, a relative rise in U.S. yields has historically led the dollar to appreciate against the yen. The current interest rate differential as of December 2009 would argue for a weaker yen, and we expect that differential to grow as the large negative output gap in Japan is likely to persist for several years.

Interest rate differential and exchange rate, U.S. and Japan



Interest rate differential and exchange rate, U.S. and Japan



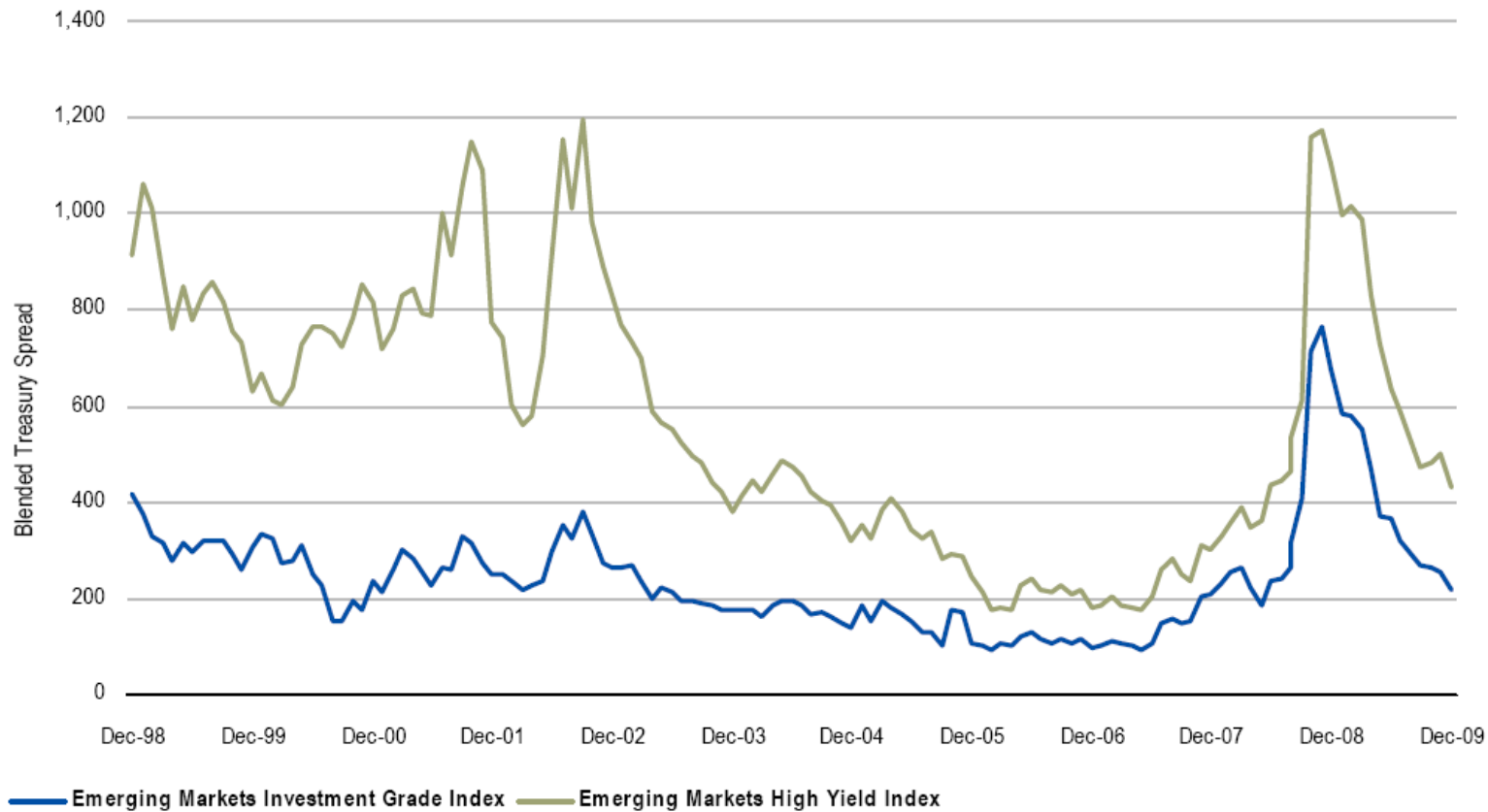
Credit Opportunities

- Forced selling has created attractive opportunities where markets are pricing in too high a probability of default.

Attractive Sovereign Valuations

- While spreads have broadly compressed from the distressed levels seen at the height of the crisis, we believe that select opportunities persist.

Emerging Market USD Government Bonds as of 31/12/09

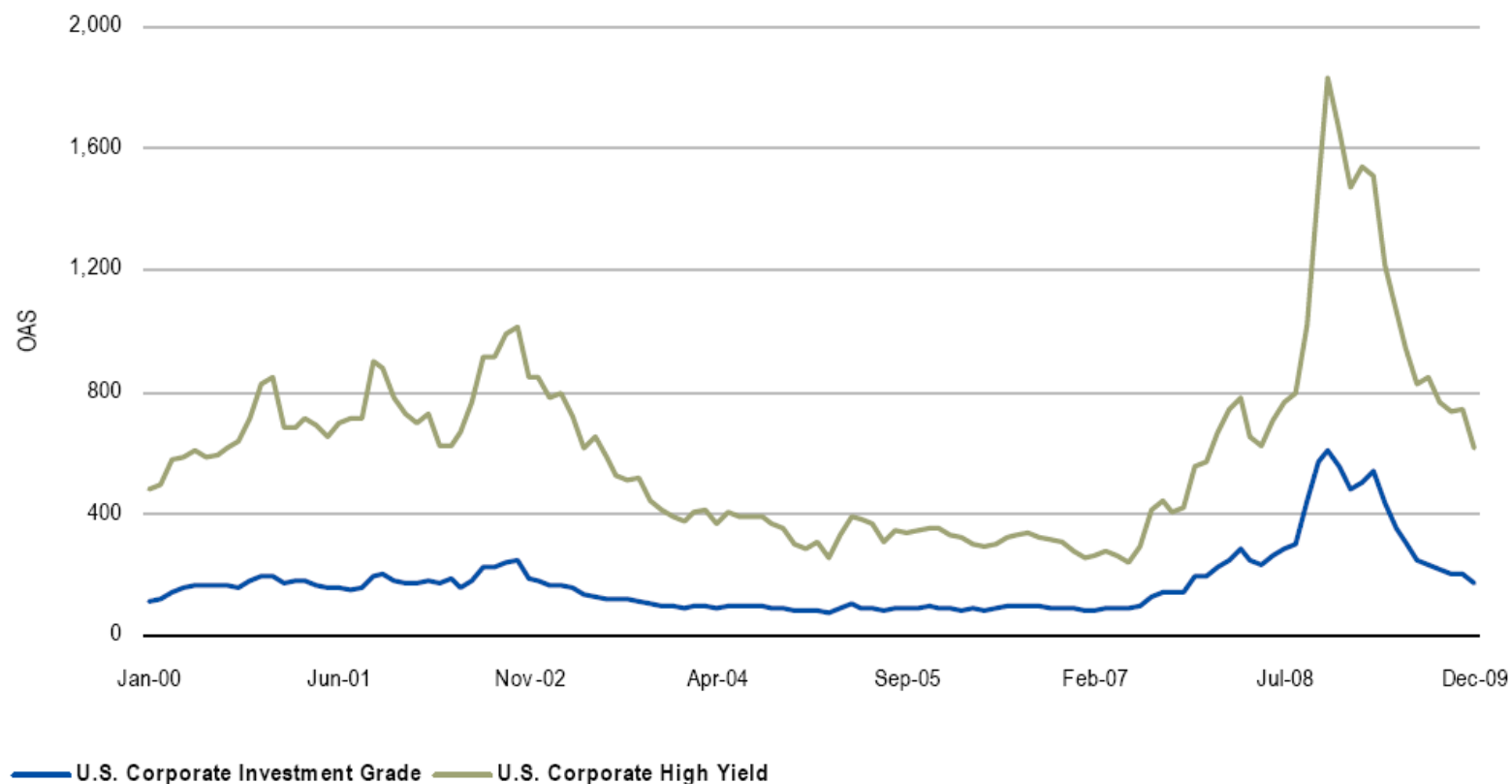


Source: Barclays Capital, as of 31 December 2009. Sovereign valuations are represented by blended treasury spread.

Evolving Corporate Opportunities

- While spreads have generally compressed since November 28, 2008, we are still seeing what we consider long-term opportunities.

U.S. Corporate Bonds as of 31/12/09



Conclusions

1. Underweight all major currencies but against what?
2. In order of weakest.
 - The Yen is least well placed
 - The Euro will no longer be a strong currency—buy SEK, PLN, even GBP
 - The Dollar—First into the crisis is first out
3. G20 ex G8 outperforms. Asia in particular.
4. Credit less “risky” than Governments.
5. Emerging Sovereigns outperform near term. Medium term credit risks return.
6. Tariffs/Smoot–Hawley?

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