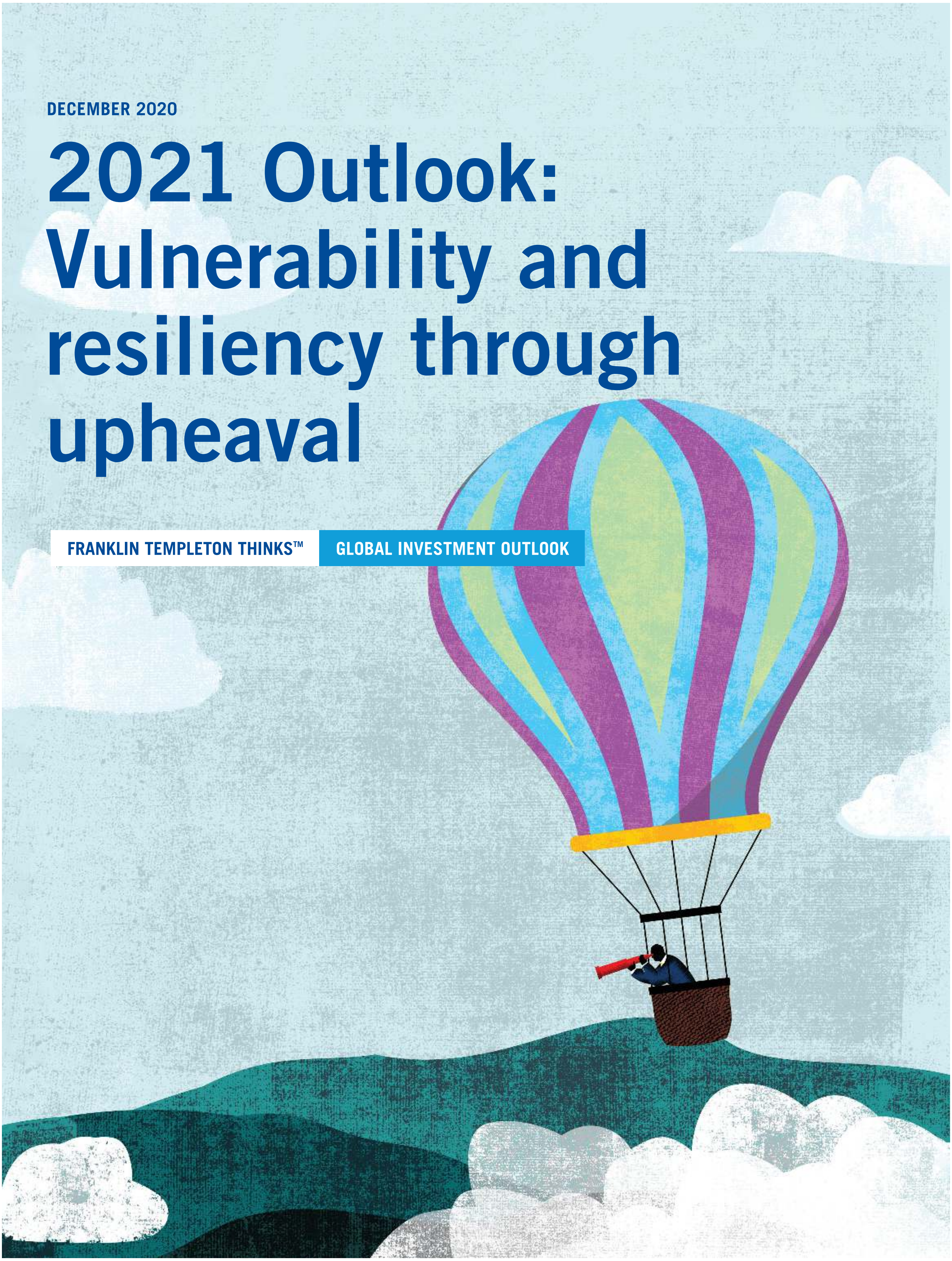
DECEMBER 2020

2021 Outlook: Vulnerability and resiliency through upheaval

FRANKLIN TEMPLETON THINKS™ GLOBAL INVESTMENT OUTLOOK



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Introduction

The COVID-19 pandemic instigated extraordinary challenges, uncertainties and upheavals in 2020. Businesses and individuals learned how to cope, while financial markets generally remained resilient.

Looking ahead to 2021, our investment professionals remain cautious in the near term, but find reasons to be optimistic. They anticipate the COVID-19 global economic recovery will accelerate as a vaccine becomes available and central bank support continues, and that new investment opportunities will result.

You will notice that our family expanded this year to include contributions from Brandywine Global, Clarion Partners, ClearBridge Investments, Martin Currie, Royce Investment Partners, and Western Asset.

In the following pages, we're pleased to share this expanded range of investment experts across multi-asset investing, equities, fixed income, emerging markets and real estate.

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Preparing the post-pandemic playbook

Ed Perks, CFA
Chief Investment Officer, Franklin Templeton Investment Solutions

Governments and central banks remain in unprecedented territory as part of the effort to control COVID-19, while ongoing political uncertainty in the United States offers up opportunities and challenges for investors. Risks to recovery are still tilted to the downside, but we look toward 2021 with cautious optimism, following an extraordinary period for global financial markets.

Volatility is likely and inflation is possible

We expect both monetary and fiscal stimulus measures to continue deep into 2021, but we do not have much clarity about the pace of the global economic recovery. The speed at which governments can overcome the COVID-19 pandemic, alongside the efficacy of vaccines, will dictate how stimulus is implemented and when the pivot away from current levels of support will come.

Commitment from central banks and governments is still unquestioned at this point, but the outlook is not as transparent as we would like it to be. The concept of "lower for longer" interest rates is well-established and should remain in place throughout 2021, although the approach major central banks will take toward broader quantitative easing is more difficult to predict. For example, there is an argument to suggest that the unprecedented support for "fallen angels" (i.e., companies previously rated as investment grade that have been downgraded to high yield) will cease as the recovery gathers pace. This was a powerful and unusual measure taken to prevent the dislocation of the global economy and cannot be guaranteed to remain in place. Insufficient stimulus could potentially increase volatility within markets as corporate defaults multiply and asset prices begin to lose value on falling demand and deteriorating market sentiment.

Despite the best efforts of policymakers, we believe inflation expectations will remain subdued across developed markets throughout 2021 and are unlikely to increase much until 2022 at the earliest, as economic weakness and high unemployment continue to balance the effect of stimulus. There is, however, a scenario in which central banks and governments remain cautious in the face of a surprisingly sharp economic recovery, maintaining stimulus beyond the point that economic indicators would deem necessary, scarred by the damage incurred in 2020.

These circumstances, taken together with rising consumer demand, may mean inflation begins to increase sooner than forecast, particularly in the United States. This would have a profound impact on fixed income markets, as yields on long-term US Treasury bonds are currently very low, and the robust performance of long-duration assets was a feature of the early part of 2020 due to a flattening yield curve. This is unlikely to unwind completely in 2021, but the US Treasury yield curve has already begun to steepen. Essentially, excessive stimulus, combined with the release of pent-up demand in a post-pandemic environment, has the potential to raise inflation and would prove a challenge for investors with a longer-term perspective predicated on a steady recovery.

The good news amid this uncertainty is that our ability to invest across multiple asset classes can provide an effective counter to the challenges described above. Our multi-asset portfolios are positioned for a steady but uneven recovery, although prudent diversification allows us to prepare for all scenarios. Real assets such as commodities, alongside Treasury Inflation-Protected Securities (TIPS), are favorable correlation diversifiers, in our assessment, and can help us to counteract the effects of any unexpected increase in inflation. Lower-volatility investments such as developed market government bonds, gold or high-quality stocks also form part of our portfolios should volatility increase.

The myth of TINA—look for opportunities outside the obvious

The stratospheric rise of growth equities during 2020 has convinced many investors that a small number of large-capitalization technology stocks are the only way to grow investment portfolios as we move into 2021. We think this phenomenon, known as "There Is No Alternative" (TINA), is misguided despite the bifurcation and divergence seen between different sectors within the equity asset class.

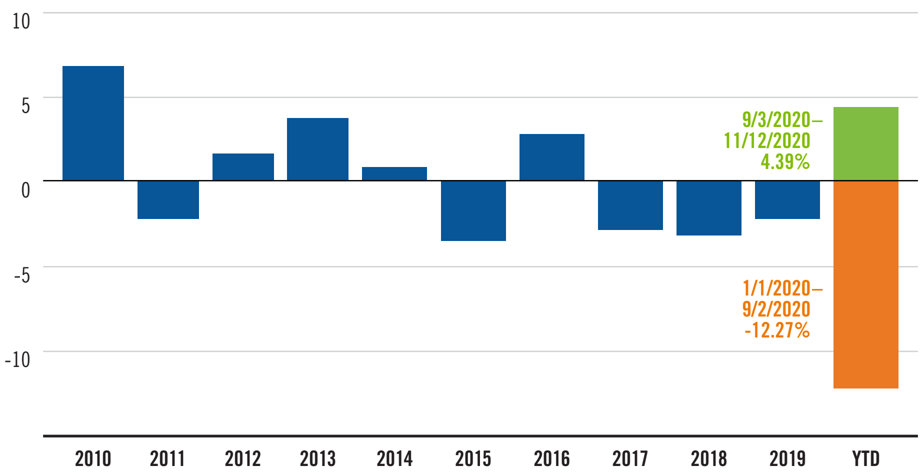
We are optimistic about the long-term return potential of equities and expect to see opportunities arise for investment in undervalued stocks during 2021, depending on how quickly and effectively global governments can deal with the ongoing COVID-19 pandemic. The so-called FAANG stocks (Facebook, Apple, Amazon, Netflix and Alphabet) saw robust performance throughout last summer, contributing to a situation in which the 10 largest companies listed on the S&P 500 Index made up more than 25% of its market capitalization.[1] Gains have begun to slow, as demonstrated by the S&P 500 Equal Weight Index, which outperformed the broad S&P 500 Index (based on free-float market capitalization) during October and November. This suggests a price correction, if not a full-scale rotation. (Past performance is not an indicator or a guarantee of future performance.)

It is difficult for any group of stocks to maintain earnings growth and expanding multiples at the level experienced by this cadre of technology companies. Therefore, outperformance relative to other equities is less likely in 2021, in our view. We expect to see opportunities in sectors that will benefit from a return to relative normality, particularly those where the expected decline in dividends did not materialize.

Utilities is an example of a sector that we believe has reasonable absolute valuations but quite attractive relative valuations compared to other equities and fixed income. Utility companies typically offer consistent returns, not dissimilar to bonds, and should benefit from any fiscal stimulus implemented in 2021 due to their key role in addressing climate change. The financials sector is another area in which we see value, as stocks appear to be ready to re-rate following investor caution related to issues such as regulatory oversight. Financial companies are generally in a much better place than in 2008, following the global financial crisis, and should be part of the recovery solution this time around, rather than the problem.

THE FAANG EFFECT: LARGE-CAP TECH STOCKS OUTPERFORMED THE BROADER US MARKET DURING THE SUMMER, ALTHOUGH THAT TREND BEGAN TO CHANGE LATER IN THE YEAR

Performance of S&P 500 Index: Equal weight versus market cap-weighted
2010–November 12, 2020



Sources: Franklin Templeton, SPDJI, Macrobond. Indexes are unmanaged and one cannot invest in an index. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future performance.** Important data provider notices and terms available at www.franklintempletondatasources.com.

We are also positioning our portfolios for opportunities in other assets that can benefit from economic recovery, including convertible securities (bonds or preferred stocks that can be converted into common equities) and short-duration investment-grade credit. These assets can provide yield, while also offering opportunities for capital growth, particularly in undervalued sectors.

Policy missteps could dampen the recovery

The election of Joe Biden as US president seems to have calmed financial markets, as investors enjoy some much-needed clarity. The outlook for fiscal stimulus is still unclear though, and any near-term support agreed by the US Congress is likely to be smaller in scope than desired by the Democrats.

Aside from the delivery of emergency economic support, the incoming US administration also has a mandate to change the current approach in many policy areas, including international relations, infrastructure, taxation and climate change, although a potential lack of control over the US Senate makes it harder to implement the full wish list.

Failing to extend existing measures designed to support the economy risks killing a nascent recovery and would, in our view, be a policy misstep. Implementation of new policies should wait until the economy is demonstrably post-pandemic.

ESG will define the post-COVID era

Michael Hasenstab, Ph.D.
Chief Investment Officer, Templeton Global Macro

At first glance, nothing ahead in 2021 could be as bad as 2020. We have been enduring the worst economic crisis in 80 years and the worst global health crisis in 100 years—events that have profoundly damaged lives and livelihoods around the world. The International Monetary Fund (IMF) projects that when we finally close the books on 2020, the world economy will have contracted 4.4%.[2] Fortunately, as we flip the calendar to 2021, we are getting closer to a point at which the economic shocks of the past year become prologue for the economic stories ahead. Global growth is projected by the IMF to expand 5.2% in 2021, as economies improve from the lows of the prior year.[3] Promising vaccine trials have presented scenarios for mass distribution by the spring of 2021, with the potential to drive the COVID-19 pandemic into remission by the second half of the year. Optimism for a return to better days abounds as 2020 draws to a close.

Yet the current state of the pandemic paints a starkly harsher reality. Second waves of COVID-19 infections have surged exponentially in areas of Europe and the US in the waning months of 2020, compelling several regions to reinstate restrictions and lockdowns. Some of the roughest conditions of the entire pandemic are likely to be faced in the final months of 2020 and the first quarter of 2021. In the absence of a widespread remedy, economic hardship will continue to deepen with each month of restricted mobility and stifled economic activity. Time is the key factor for many people and businesses teetering on the brink of insolvency—each day of income destruction threatens lasting damage. Unfortunately, near-term conditions are likely to worsen before they ultimately improve.

Investment opportunities are emerging

From an investment standpoint, optimism for the second half of 2021 should be counterbalanced with caution over acute near-term risks, in our view. The pandemic continues to destroy areas of economic activity, resulting in substantial risks for a number of financial assets. Broad disinflationary effects are likely to persist until economies return to full mobility. We have been maintaining a cautious approach on risk assets in anticipation of second waves of COVID-19 in the fall and winter months.

However, several longer-term investment opportunities are beginning to emerge. We expect staggered timelines for when certain investments may become suitable given the wide variance in macro fundamentals and the divergent levels of control over the spread of the virus in specific countries. COVID-19 cases appear likely to reach a zenith during the winter months before vaccine treatments may cause the pandemic to ebb in the late spring and summer of 2021. The timing and effectiveness of vaccine treatments will be the key determinant for economic activity and financial asset valuations in the upcoming year.

Fiscal deficits and high levels of debt present longer-term risks

It is also crucial to map economic trajectories beyond the impulses of 2021. The rate of growth during the rebound is unlikely to sustain its magnitude in 2022 and the years that follow. World gross domestic product (GDP) growth will moderate to around 3.8% in the 2022–2025 period, according to IMF projections, with advanced economies averaging 2.2% and emerging/developing economies averaging 4.9%.[4] Stimulus programs will eventually wane as governments that were already burdened with high debt levels before the pandemic are forced to contend with limited fiscal space and deepening fiscal deficits. Debt-to-GDP ratios have risen significantly in just about every country. Unorthodox policies such as modern monetary theory and debt monetization are likely to see greater political interest in upcoming years, increasing the risks for structural damage by imprudent governments. The upcoming decade will be increasingly defined by quality of governance factors, in our view, both at the domestic level as well as geopolitically.

In the US, debt levels are projected to exceed 100% of GDP over the next decade with a fiscal deficit heading toward more than 5% of GDP by 2030.[5] Monetary policy is projected to remain loose for the foreseeable future, with the US Federal Reserve (Fed) anticipating near-zero-percent rates through 2023, while it continues to provide unlimited balance sheet support to financial markets. The Fed has also indicated a willingness to let the economy run hot in upcoming years to make up for several quarters of below-target inflation. Short-term US Treasury yields are likely to remain anchored by monetary accommodation in the near term, but surging fiscal deficits, massive debt levels and rising reflation expectations should eventually drive term premiums higher.

Geopolitical risks remain elevated

Adding to the complexity of the current crisis is the precarious state of the world that existed before the pandemic. Heightened geopolitical tensions, rising nationalism and political polarizations have made it difficult for countries to find the collective goodwill needed to design collaborative solutions for shared problems, both domestically and internationally. COVID-19 has also enabled a number of governments to enact over-reaching policies that would otherwise be objectionable. Some regimes have drifted further toward authoritarian rule, using the pandemic for political cover.

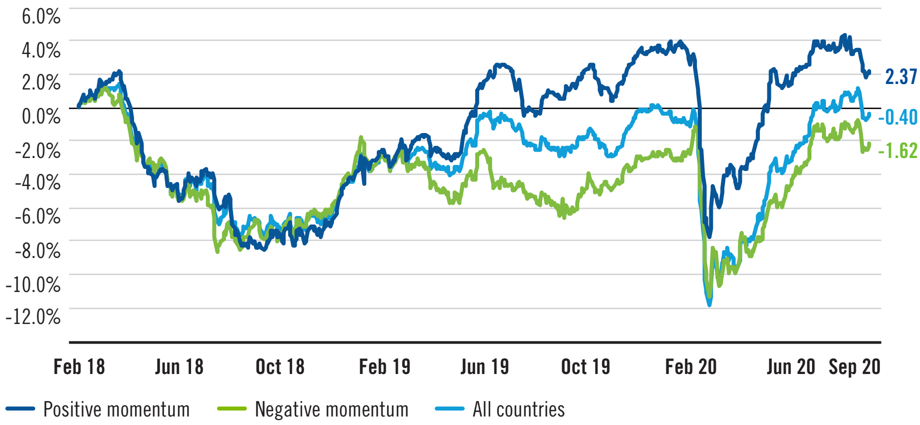
Additionally, the deglobalization trends that existed before the pandemic have accelerated, as countries have increasingly turned inward to prioritize domestic concerns. Trade relations have been decaying among major economies in recent years. Structural shifts toward domestic production and regional supply chains would have substantial implications for the global economy and financial markets in the years ahead.

ESG factors will shape the post-COVID world

Environmental, social and governance (ESG) factors will play a major role in rebuilding the post-COVID world. Social cohesion and good governance have the power to accelerate a country's post-crisis recovery, or the lack thereof can stymie it. Tragically we have seen the consequences of weak ESG factors in specific emerging markets during the pandemic. Countries that were less prepared for a health crisis due to weaker health care systems and less developed infrastructure, and/or less prepared for an economic crisis due to

CUMULATIVE TOTAL RETURNS FOR COUNTRIES WITH POSITIVE ESG MOMENTUM VS. NEGATIVE ESG MOMENTUM

February 2018–September 2020



Source: Templeton Global Macro. To quantify the investment outcomes of our ESG research, we modelled our research results in a rules-based index of government bonds that aimed to isolate the ESG inputs from other macro, valuation and risk factors. The construction of this index follows similar methods to those used in the construction of major fixed income indexes. First, the entire fixed income universe is filtered for local currency government bonds, then several exclusion rules are deployed to aggregate certain types of bonds and duration ranges that are consistent across different issuers. By combining the resulting sets of bonds with our TGM-ESGI scores, we construct a portfolio of equal-weighted countries with an improving TGM-ESGI, which can be viewed as an unbiased implementation of our ESG research outcomes in portfolio form. This chart shows the return of the "positive momentum" countries as compared to the "negative momentum" countries and the entire set of countries. **Past performance is not an indicator or a guarantee of future performance.**

fiscal imbalances, high levels of debt and external dependencies, have suffered greater damage. By contrast, countries that were in stronger fundamental shape before the crisis, with stronger institutions, lower levels of debt and more diversified economies, have generally fared better.

Widening income inequality in many countries also remains a critical issue that threatens to undermine economic stability and intensify social discord. Damaged economies and elevated unemployment from the pandemic have only worsened several pre-existing structural problems. Countries that effectively address these challenges in the years ahead can strengthen the underpinnings of their economies, while those that neglect these factors risk further instability. We expect ESG to be a defining attribute for global fixed income markets in years ahead. Countries that are projected to improve on ESG factors often present the strongest investment opportunities.

Tactically opportunistic for the year ahead

Overall, we anticipate being constructive in a number of regions as the world transitions toward a post-COVID era. However, near-term risks remain substantial. Regional lockdowns and restrictions will likely continue to be needed in upcoming months to counter exponential spread of the disease. Mobility restrictions will continue to be the most effective tool of virus suppression until a vaccine becomes broadly available. Until that point, lost incomes and damaged aggregate demand will continue to have a detrimental impact on macroeconomic conditions. We expect perceived safe-haven assets to remain relevant during the extant months of a worsening pandemic, but to eventually diminish in importance as medical advances incrementally beat back the disease. Looking ahead, we remain tactically opportunistic in specific local-currency markets while continuing to manage near-term risks. We remain optimistic for the new year, and the potential eradication of COVID-19.

From crisis to recovery—the road ahead

Sonal Desai, Ph.D.
Chief Investment Officer, Franklin Templeton Fixed Income

A strong rebound, but the challenge is far from over

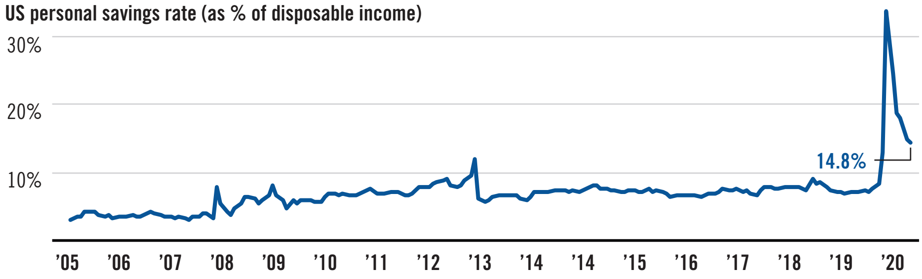
I feel cautiously optimistic as I look to 2021—and "cautiously" is the operative word.

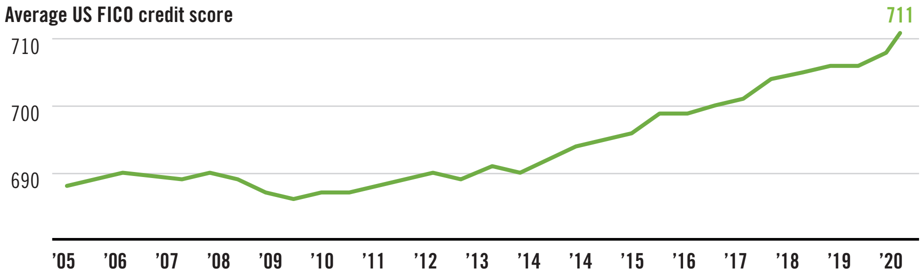
The US economy has demonstrated a remarkable resilience, showing it still has the stamina to bounce back from the COVID-19-induced recession. As states eased lockdown restrictions earlier this year, consumer spending rebounded, driving a V-shaped recovery in gross domestic product (GDP) and employment. Fiscal and monetary support has proved crucial, and the benefits will continue to accrue: the personal savings rate remains high, at close to 15%, and households have improved their credit standing with average credit scores at their highest levels since records began in 2005—building firepower for future spending.[6]

This recovery in spending and jobs growth has already withstood two adverse shocks: the second wave of COVID-19 contagion during the summer, and the expiration of the first extraordinary fiscal support package in July. This provides some optimism for how economic activity will respond to a potential winter seasonal surge in new infections. There has also been a positive trend of the contagion becoming relatively more benign, with hospitalizations and deaths rising less than new cases. This is partly because more new cases involve younger and less vulnerable age brackets, and also thanks to improved knowledge on effective therapeutics.

CONSUMERS BUILDING FIREPOWER FOR FUTURE SPENDING

US personal savings rate and average FICO score
October 2005–September 2020





Sources: Franklin Templeton Fixed Income Research, U.S. Bureau of Economic Analysis, Fair Isaac Corp. As of September 2020 and July 2020 (FICO). Important data provider notices and terms available at www.franklintempletondatasources.com.

Navigating the path to recovery

Our Franklin Templeton–Gallup Economics of Recovery Study has confirmed that Americans' willingness to engage in a range of economic activities—from traveling, to visiting restaurants and shops, to working outside the home—has similarly proved resilient to the second and third waves of COVID-19 contagion; but it also revealed that the launch of an effective vaccine could prove essential for a majority of people to feel comfortable enough to go back to fully normal patterns of behavior.

And the latest news on the vaccine front has been encouraging: shortly after the US presidential election, pharmaceutical companies Pfizer and Moderna separately announced that their vaccines have shown around 95% effectiveness in clinical trials. There now seems to be a good chance that we could have a highly effective vaccine on the market by the spring.

The November US elections are now behind us. While not all official results have been determined at the time of this writing, it seems extremely likely that Joe Biden will be the next president. At the same time, however, the Democratic Party has seen its majority in the House of Representatives diminished, and Republicans may well maintain their majority in the Senate, as long as they win at least one of the two runoffs scheduled for January in Georgia.

A divided government might bring some benefits for the economic outlook, by reducing the probability of major changes in policies and regulations that might otherwise risk having an adverse impact on the overall economy or on specific sectors.

I expect additional sizable fiscal support measures to be passed between the end of this year and the first quarter of 2021. If the Republicans keep a majority in the Senate, the fiscal package might be somewhat smaller than was expected in a "blue sweep" scenario—where Democrats controlled the House and Senate along with the presidency—but it would still be very significant.

A vaccine would also brighten the economic outlook in the rest of the world, notably in Europe where a resurgence of COVID-19 cases is currently pushing several governments to reimpose serious restrictions on social and economic activity.

Cautiously optimistic

I said the operative word was "cautiously." If the vaccines see their effectiveness and safety confirmed, they will then have to be produced and distributed at massive scale, which is no small challenge. Moreover, our joint study with Gallup has shown that only between one-third and one-half of Americans would be ready to take a vaccine. Unless a large enough majority of the population is willing to be vaccinated, even a highly effective vaccine will not be able to rapidly reduce contagion and allow economic activity to return to normal.

Meanwhile, even the very resilient US economy has suffered some significant damage, some of which might prove long-lasting. Permanent job losses are up by 2.4 million since February and account for nearly half of the increase in unemployment since then, even though job openings have already risen above pre-COVID-19 levels.[7] This might signal an emerging structural mismatch of skills, possibly tied to the fact that the COVID-19 recession has hit some sectors a lot harder than others. Prolonged school closures might also have significant adverse long-term effects. Remote learning has proved a very inferior substitute for in-person education, especially for younger students and particularly for those from lower-income backgrounds; the long-term damage in terms of lower skills, reduced earning potential for the students and lower productivity for the economy might prove heavier than we currently realize.

These adverse consequences would be magnified if the country were to head into a new phase of widespread lockdowns, which could also potentially result in a double-dip recession.

How policymakers manage the next several months therefore matters a lot, not just for the immediate recovery and the 2021 outlook, but also—and perhaps even more so—for the longer term. We are thus still heading into 2021 with a lot of uncertainty, some massive economic imbalances and policy measures of unprecedented magnitude on both the monetary and fiscal sides. It's not surprising that stock prices and bond yields have already shown massive swings in response to headlines on the political or health care fronts.

The market may also be underestimating the potential inflationary effect of the unprecedented fiscal and monetary stimulus and rescue packages, in addition to the likelihood of increased in-sourcing and shifts in supply chains that may result from the current crisis and ongoing tensions with trading partners. (I believe tensions between the United States and China are here to stay even with a change in US administration.) With the economy already demonstrating a healthy capacity to rebound, and given the amount of fiscal and monetary stimulus already delivered and under consideration, an earlier-than-expected rebound in growth and price dynamics cannot be ruled out.

I am not predicting a major rise in inflation, but even a moderate acceleration in price dynamics would be enough to exceed the sanguine expectations of most market participants and cause further yield curve steepening in US Treasuries over the course of 2021.

Finally, the combination of large potential macroeconomic swings with some long-term structural shifts triggered or accelerated by the pandemic strengthens my view that active asset selection based on high-quality fundamental analysis will be crucial to any successful investment strategy. Fixed income allocations will continue to play an important role in many investor portfolios as a diversifier, as well as a historically lower-volatility asset compared to equities. But from the perspective of credit, bottom-up selection has never been more important, in my view.

Valuations are a concern in many sectors, as the market is not properly priced for the level of uncertainty. We see no obvious areas of undervaluation remaining; to the contrary, some sectors like commercial real estate remain vulnerable. As a number of states will likely need to increase taxes to get their finances on a more sustainable footing, the tax-free municipal bonds sector will likely become an even more valuable source of investment opportunities. Non-US fixed income assets also present selected opportunities. The massive stimulus program in Europe, combined with the European Central Bank's accommodative monetary policy, offers support for European government bonds.

2021 will be challenging, but it could be equally rewarding.

A year of lingering uncertainty, but ample global opportunities

Stephen Dover, CFA
Head of Equities

The economic response to COVID-19 will continue to be the biggest uncertainty stalking global equity markets in 2021. It is likely to continue weighing on global economic activity and to keep pressure on policymakers to produce programs that support economic activity until an effective vaccine is widely available. And while we have received positive news regarding effective vaccines, widespread inoculation, especially in emerging markets, remains some months off. The positive news on vaccines gives us comfort that COVID-19 will be contained, but the timeline remains uncertain.

For global equity investors, however, we see promise, not only in the sectors benefiting from the profound digital transformation the global pandemic has only pushed into overdrive, but also in several specific regional markets, like Japan and China, that may be beneficiaries of distinctive trends worth watching in the coming year.

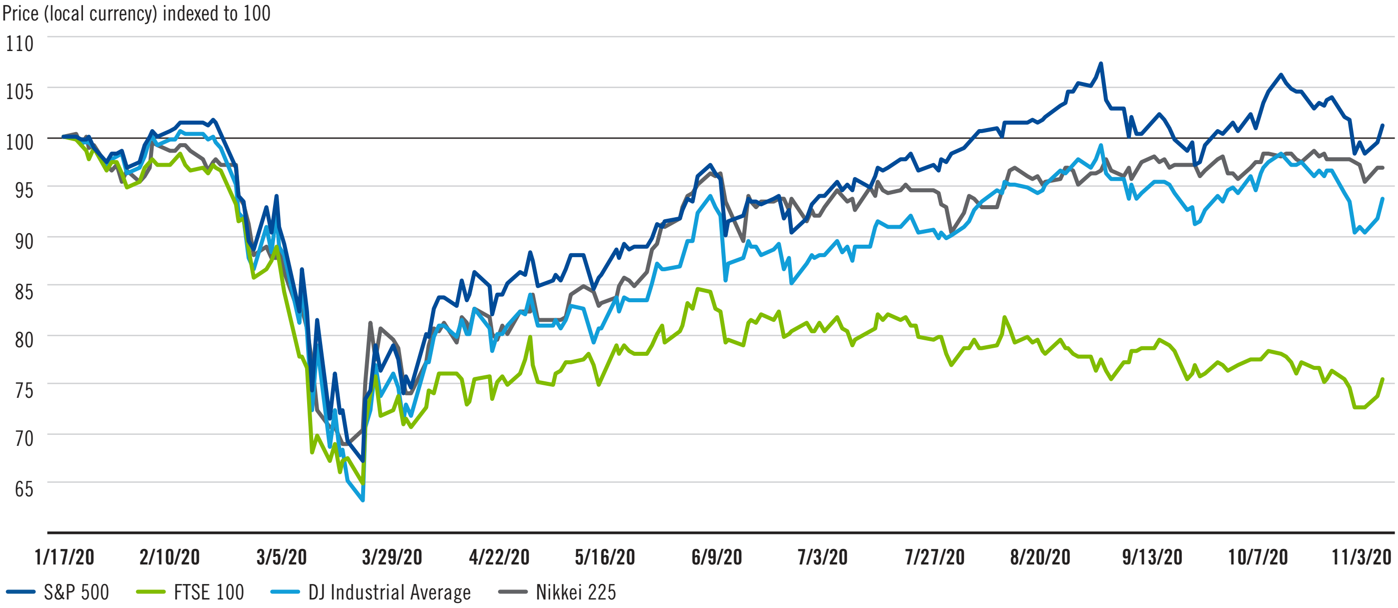
COVID-19 will be the main 2021 story

Now that the US election is largely over, we believe the focus for global equity investors heading into 2021 will be primarily on the economic effects of the global pandemic's progression. Outbreaks continue to flare up in parts of Europe, the United States and Latin America, while large parts of Asia look to us to be in much better control of the coronavirus.

Until the spread of COVID-19 is reduced—probably once one or more vaccines become widely available later in 2021—the outlook for the world economy is likely to remain volatile. Certainly, we have been encouraged by the snapback in economic activity from the disruption the lockdowns caused in the spring of 2020, but the recovery may be stalling, and global gross domestic product remains well below where it was before the pandemic started. Many equity investors are trying to look past the current economic and earnings disruptions toward longer-term earnings growth.

THE IMPACT OF COVID-19 ON STOCK MARKETS SINCE THE START OF THE OUTBREAK

COVID-19 impact on stock markets
January 17, 2020–November 3, 2020



Sources: FactSet, S&P and Dow Jones Indices, FTSE Russell, Dow Jones, Nikkei. Indexes are unmanaged and one cannot invest in an index. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future performance.** Important data provider notices and terms available at www.franklintempletondatasources.com.

> Although COVID-19 will continue to be a major uncertainty in 2021, we believe individual equity sectors and markets hold promise."

The International Monetary Fund (IMF) expects the global economy to contract 4.4% in 2020, which is an improvement from its June forecasts following a strong rebound in activity in the United States and Europe in the third quarter.[8] Next year, the IMF forecasts the global economy will grow 5.2%, with the uncertainty about COVID-19 outbreaks and the potential for renewed restrictions creating more risks to the forecasts, in our view.[9] That puts greater pressure on policy-makers in the United States and elsewhere to continue supporting their economies through fiscal stimulus.

Encouragingly, we believe the victory of US President-elect Joe Biden could pave the way for some form of stimulus deal to support short-term economic activity. A potentially split Congress, meanwhile, may create a positive back-drop for US markets more broadly over the coming year, as a likely divided Congress reduces the risk of major changes to the US tax code or to health care.

Focusing on long-term themes

In a low growth, low interest-rate world, we believe investors will continue to look to global equity markets for attractive investment opportunities relative to other asset classes. And the trends that have driven equity markets higher since the start of the pandemic, such as digital transformation and innovation in the technology, health care and consumer sectors, are set to continue, in our view.

Technology stocks should remain a key beneficiary. The pandemic has only accelerated several long-term secular trends in how people work, shop and interact with others. We believe remote work and e-commerce will only become more entrenched over the coming decade, as technology companies continue to innovate and offer new tools to help manage this ongoing digital transformation. We would also expect any potential infrastructure bill from a new Congress and presidential administration to include some funds for areas of technology such as 5G and greater broadband access that could further underpin this digitization story.

For those investors a bit squeamish about the high valuations found in many large technology stocks that have driven the US equity market higher over the past few years, we believe there are plenty of opportunities in overlooked companies all over the world that are benefiting from these same trends but trading at more attractive valuations.

Other sectors such as health care and consumer discretionary are also seeing some promising long-term secular growth drivers. Within health care, we expect an aging global population and growing middle class to support demand for a range of medical services and treatments over the longer term.

Consumer spending also may not completely return to its old patterns after the pandemic ends, with e-commerce, for instance, becoming more entrenched. Travel and leisure, meanwhile, is one area that is still under pressure during the pandemic, but we believe it could rebound strongly once travel is safe again.

Finding opportunities in Asia

Regionally, we continue to see opportunities in China and other emerging markets, mostly in Asia. We expect they should rebound much more strongly from the economic weakness of 2020 than some of their developed market counterparts. Asian economies in general have been well prepared for both the pandemic and the accelerated shift toward a more digital economy, in our view.

The IMF forecasts that emerging and developing economies overall are likely to grow at 6.0% in 2021 after a 3.3% contraction in 2020.[10] Emerging Asia is likely to pace the advance, according to the IMF, with the region growing 8.0% in 2021 and China posting an even faster 8.2% growth rate next year.[11]

Already, we have seen manufacturing and services in China return to near pre-COVID-19 levels as the government has largely controlled the spread of the coronavirus. We are aware of the host of political risks associated with investing in China but believe there are plenty of interesting Chinese companies in the technology and old economy sectors that are worthy of investment consideration. China's latest five-year plan also puts an emphasis on self-sufficiency that may help boost domestic industries over time.

Japan too may hold some promise, in our opinion. The September 2020 election of a new prime minister, Yoshihide Suga, could bring structural reforms to the country in the areas of regional bank consolidation and digital transformation. Moreover, we believe Japanese corporations have done a better job of improving their balance sheets than investors have given them credit for, which should create opportunities for fundamentally focused investors.

Within Europe, we are seeing a leadership change out of the United Kingdom, given the market's large exposure to the financial and energy sectors, and toward Switzerland, with the latter market's emphasis on the health care and pharmaceutical companies that are in greater demand during the global pandemic. According to MSCI data as of September 30, 2020, financial and energy companies made up about a quarter of the UK index, while health care was 40% of the Swiss market.[12] A combination of low interest rates and weak oil prices has turned investors away from industries like banks and oil firms and toward those more defensive growth areas such as pharmaceuticals, in our view. We believe this is a trend that is likely to persist in 2021.

Regardless of how the coronavirus progresses and what the broader economic environment over the coming year looks like, we think global investors should keenly focus on individual company fundamentals when making long-term investment decisions.

Emerging markets: A strong year, a stronger outlook

Manraj Sekhon, CFA
Chief Investment Officer, Franklin Templeton Emerging Markets Equity

2020 has been a testing year—literally and figuratively—with terms such as "safe haven" acquiring new salience. Across countries, sectors and companies there have been clear winners and losers from COVID-19, which in some instances have confounded expectations. It is clear that key emerging markets, particularly in East Asia, have substantially outperformed other countries in terms of health outcomes, economic impact and equity markets.

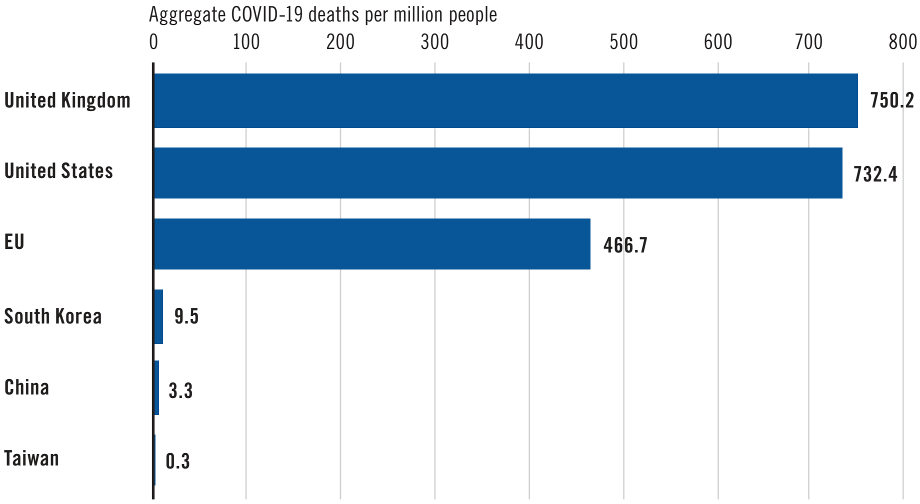
Economies and markets globally have thus far primarily been affected by the first-order impact of COVID-19, including lockdowns and movement restrictions, as well as near-term supply chain and consumption disruptions—resulting in significant gross domestic product (GDP) declines.

Over 2021, we expect the second-order effects of COVID-19 to become more evident. These would include fiscal and monetary macroeconomic risks resulting from the unprecedented stimulus policies pursued globally to mitigate the effects of the pandemic. In addition, inequality has been exacerbated globally both within and between countries, increasing the risks of political instability. Less susceptible to these risks will be those countries that were better able to minimize disruption during 2020, notably East Asian emerging markets.

We expect COVID-19 to remain prevalent in 2021—while the outlook for a vaccine is improving, production

EAST-WEST DIVIDE

Total COVID-19 deaths per million people for select countries
As of November 13, 2020



Source: Our World in Data, European CDC—Situation Update Worldwide. Important data provider notices and terms available at www.franklintempletondatasources.com.

and distribution in sufficient scale are challenges equal to its development. As such, we expect countries to continue to experience sporadic COVID outbreaks, which will add volatility to the underlying trend of economic and market recovery.

Gravitating toward strength

As recovery becomes more widespread across emerging markets, led by East Asia, this improves earnings visibility, enabling a broadening of market performance. Many companies have successfully executed during the pandemic and should emerge out of the crisis in a stronger competitive position—and not only the commonly recognized COVID-19 winners. We continue to closely monitor the pace of recovery in what we consider good quality companies that have corrected significantly beyond the limited near-term impact to their intrinsic value.

East Asia remains well placed to lead global markets. China is expected to be alone in seeing GDP growth in 2020, underpinned by a diversified domestic economy driven by innovation and digitalization. We continue to see the emergence of high-quality companies that are well-placed to benefit from ongoing market consolidation and booming domestic consumption. Taiwan and South Korea are beneficiaries of the structural growth in information technology (IT) hardware, as well as the diversification of global technology supply chains.

Geopolitical tension between China and the United States remains a key headwind likely to persist irrespective of the US president. Although this is resulting in decoupling between the two countries in the technology sector, we have seen continued liberalization in China's financial markets, driving increased foreign ownership. Investor interest in China's domestic A-share markets is rising alongside increased bond market flows as China is added to international indexes.

> "The challenges of 2020 have highlighted structural advantages and other beneficial secular trends in emerging markets that bode well for 2021. For so many different markets across this landscape to concurrently offer compelling investment potential, individually and in aggregate, presents an exceptional investment window, in our assessment."

It is likely that with a new US administration we'll see a shift to a more constructive tone, although longer-term strategic tension will remain. Regardless of this, the economic imperative for US companies to grow, develop and sell into—as well as source from—China will ultimately drive US policy.

Next wave of recovery

The Association of Southeast Asian Nations (ASEAN) region and India have lagged in terms of COVID-19 normalization but are gradually re-opening, with macroeconomic recovery supported by the favorable demographics of younger, less susceptible, populations. The case for foreign direct investment is being improved by regulatory change and global supply chain diversification, while the significant scope for consumption growth from a low base also bodes well over the longer term.

India has seen surging COVID infections, but with mortality having been contained, economic reopening has continued. Although the disruption of traditional business models has weighed on some companies, we expect to see a positive impact on Indian technology service providers. Largely ignored over the last few years due to slowing growth and margin pressures, the IT services sector has been supported by both higher client traction as well as structural cost saving initiatives. The resurgence of manufacturing activity, as India embarks upon indigenization and import substitution, as well as global efforts to diversify supply chains could drive demand across a range of product categories, including electronics, defense, automobile parts and pharmaceuticals. Normalization of credit stress on the back of falling interest rates and improving liquidity should have a positive impact on banks, an area where we maintain a positive outlook. Meanwhile, negative real rates in India will provide very significant support for the economy and markets going forward.

In Latin America, COVID-19 has accelerated a trend of low interest rates and digitalization. Simultaneously, a strong global rebound in the manufacturing supply chain has boosted metal prices, supporting the region's mining industry after a long cycle of underinvestment and weak currencies.

Brazil, despite the political noise, has continued to focus on important economic reforms that are leading to a structural downward shift in its historically high real interest rate. The central bank has also cut its policy interest rate to a record low, which reduces the cost of renegotiating or restructuring loans, and could be a catalyst for longer-term credit growth. Credit penetration in Brazil is far below many other markets, signaling room to head higher in the coming years, supporting the prospects for the financials sector. More broadly, negative real rates will provide structural support to Brazil's growth outlook. We are also witnessing a long-term trend of "equitization" of investments that benefits participants in the financial services industry.

Challenges remain in Brazil, however, including rising debt levels as a result of stimulus measures, paired with uncertainty surrounding continued economic reforms amid a politically fragmented environment. This may in turn place upward pressure on longer-term interest rates. The planned end of emergency aid in place to support those impacted by lockdown measures could also impact economic recovery.

Even in South Africa, an emerging market that has stagnated in recent years, there is cause for optimism. The outlook is improving under President Cyril Ramaphosa, with announcements of a host of reform measures and redirection of public spending, including infrastructure projects, initiatives to support re-industrialization, spending cuts (centered on a civil servant wage freeze) and efforts to address corruption. There have, however, been false dawns before in the Rainbow Nation.

A better future

The challenges of 2020 have highlighted structural advantages and other beneficial secular trends in emerging markets that bode well for 2021. The resilience of key markets in East Asia during the crisis, paired with their ability to capitalize on secular shifts to the new economy, should drive continued strength next year. Laggards, including India and Brazil, will likely benefit from a uniquely accommodative environment of negative real rates (and an undervalued currency in Brazil), paired with ongoing reform efforts and excess capacity in the economy, boosting growth.

This broadening of economic recovery should continue to drive improved earnings visibility into 2021 and amounts to a compelling opportunity across emerging markets as a whole—both from a near-term tactical perspective as well as structurally. For so many different markets across this landscape to concurrently offer compelling investment potential, individually and in aggregate, presents an exceptional investment window, in our assessment.

Endnotes

1. Sources: SPGlobal.com, CompaniesMarketCap.com. Data as of 10/31/20.
2. Source: International Monetary Fund, World Economic Outlook, October 2020.There is no assurance that any forecast, estimate or projection will be realized.
3. Ibid.
4. Ibid.
5. Source: Congressional Budget Office, An Update to the Budget Outlook: 2020 to 2030, September 2, 2020.
6. Sources: Franklin Templeton Fixed Income Research, US Bureau of Economic Analysis, Fair Isaac Corp. As of September 2020 and July 2020 (FICO).
7. Sources: Franklin Templeton Fixed Income Research, US Bureau of Labor Statistics. As of October 2020.
8. Source: International Monetary Fund, World Economic Outlook, October 2020.There is no assurance that any forecast, estimate or projection will be realized.
9. Ibid.
10. Ibid.
11. Ibid.
12. Sources: FactSet, MSCI. Indexes are unmanaged and one cannot invest in an index. They do not include fees, expenses or sales charges. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI. Important data kprovider notices and terms available at www.franklintempletondatasources.com.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds adjust to a rise in interest rates, the share price may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging market countries involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Such investments could experience significant price volatility in any given year. High yields reflect the higher credit risk associated with these lower-rated securities and, in some cases, the lower market prices for these instruments. Interest rate movements may affect the share price and yield. Treasuries, if held to maturity, offer a fixed rate of return and fixed principal value; their interest payments and principal are guaranteed. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Diversification does not guarantee profits or protect against risk of loss.

Companies and/or case studies shown herein are used solely for illustrative purposes; any investment may or may not be currently held by any portfolio advised by Franklin Templeton.

The year of less uncertainty, more certainty

Francis A. Scotland
Director of Global Macro Research

Jack P. McIntyre, CFA
Portfolio Manager

Macroeconomic outlook: Post-pandemic boom?

A bevy of traditional macro-indicators point to better global economic growth for 2021. Some of these indicators include the lagged influence of falling bond yields, the cumulative effect of past policy stimulus measures, the low level of energy prices, and high household savings rates in China, the US, and Europe, which indicate pent-up purchasing power. Recoveries already have been stronger than expected, but economic policymakers in the developed world want to cushion any economic slippage caused by new social isolation measures and remain laser-focused on supporting a full recovery in employment.

The pandemic has triggered a major regime shift, which also plays to a stronger outlook, at least for the near term. For 40 years, the macro policy regime of the US was to guard against the return of inflation, work toward fiscal balance, and keep monetary and fiscal policy separate. That regime is over for the time being. Paul Volcker put his stake in the ground nearly 40 years ago with his announcement that the Federal Reserve (Fed) would use the monetary aggregates to crush inflation. Fed Chair Jay Powell has put his own stake in the ground with the commitment to keep rates at zero until inflation rises above 2% and his encouragement to Congress that the risks of too little fiscal stimulus are much greater than too much. The vehicle for achieving the Fed's goal of higher inflation will be coordinated fiscal spending. This new regime is a politician's dream come true.

The only known-unknown standing in the way of this upbeat outlook is the COVID-19 virus and how governments and people react. However, promising vaccine developments significantly strengthen the case for a stronger-than-expected recovery for the year. China has already demonstrated this result. There, the authorities have effectively gained control of the epidemic through rigid compliance on social isolation measures and extensive testing. Within the Chinese economy, many sectors have rebounded back to normal while others are regaining momentum. So advanced is the progress that China's monetary authorities already are throttling back stimulus. If the vaccines prove to be effective, the world recovery by the end of next year could be very surprising.

Uncertainty subsides for global bonds

In determining where bond markets may head in 2021, there are three major developments to consider. First and right out of the gate is the remaining influence of COVID-19 on the global economy. The pandemic will impact economic activity through the first half of the year with a significant shift in the second half. However, this impact will not be linear across all economies. It also will be a case of "it's darkest before the dawn," as infection and mortality rates will remain elevated until the vaccine implementation program becomes more widespread. However, we need to consider what scenario is already being reflected in bond market sentiment. The Treasury market appears to be looking into 2021 when the vaccine will be readily available. The prior two times when hospitalization rates were in the vicinity of 60,000 people there was a flight to safety bid in Treasuries. Not this time, despite the hospitalization rate being at 100,000 and likely to rise. This change signals the Treasury market is more forward looking and starting to discount 2021's normalization, aided by the widespread distribution of the vaccines.

The second key factor to figuring out the glide path for global bond markets involves expanding the uncertainty analysis to also include "political and economic" uncertainty. This factor is more concentrated on the US but has a global reach. In early January, we will learn the outcome of the run-off Senate election in the state of Georgia, which is critical to the US political and economic agendas. When push comes

US COVID-19 HOSPITALIZATIONS VS.10-YEAR US TREASURY YIELD

As of December 03, 2020

Sources: Brandywine Global, Macrobond, The COVID Tracking Project, SPDJI, ICE, Macrobond.

to shove, we will see an orderly transition of power at the White House in mid-January. Unlike President Trump, President-elect Biden is not known to "weaponize" uncertainty, so we expect to see overall political volatility diminish in 2021 and beyond. If the Senate remains under Republican control as expected, there will be less "economic" uncertainty. Gridlock will reallocate power to the "problem solver" caucus, which is a group of centrist politicians.

The third factor involves the global monetary policy front, where we also expect to see less uncertainty due to two key influences. First, and more important, is that inflation should not be a significant issue in 2021, which will keep global monetary policy biased toward more accommodative polices. This expectation is drastically different from the post-Global Financial Crisis (GFC) experience when there was a collective rush to remove policy stimulus. The use of "unorthodox" policies back then ignited a fear of monetary induced inflation. However, it never happened. Central bankers have since changed their tune on inflation coming into 2021 with a more welcoming attitude toward higher prices. Unlike in the past, they won't fight it. If market rates were to spike higher, we would expect an increase in rhetoric on the potential use of yield curve manipulation, but we are not there yet.

What are the market implications of this "step function" lower in medical, political, economic, and monetary policy uncertainty? It means that bond market volatility will remain low, which will support the collective search for yield in 2021. Marry this development with a shortage of yield. There is now in excess of $17 trillion equivalent of negative-yielding nominal sovereign bonds. The bottom line is fixed income securities that offer a risk- adjusted yield relative to this giant pool of negative-yielding bonds will capture outsized capital flows. Yes, spreads have already narrowed across most non-sovereign credit, but there will be more room to go. However, we expect the primary beneficiary of these capital flows to be emerging market local currency bonds. On a real-yield basis, they continue to look attractive outright and relative to developed market bonds.

Income with growth In 2021: Got real estate?

Tim Wang, Ph.D.
Head of Investment Research

Despite the recent second wave of COVID-19 cases globally, there are reasons to be optimistic about growth prospects in 2021. Several vaccines and treatments, including from Moderna and Pfizer/BioNTech, have shown highly effective trial results and are expected to be in mass production and distribution over the next few months. With these stunning medical breakthroughs, the end of the pandemic may be in sight. In addition, a closely contested US election is over. A Biden White House and GOP Senate is arguably a more desirable outcome for the financial markets. A divided government may suggest relatively predictable policies going forward. Furthermore, another sizable fiscal stimulus package (CARES 2.0) in the range of $1 to $1.5 trillion will likely gain bipartisan support and receive approval by early 2021.

Interest rates are near historic lows, but for how long?

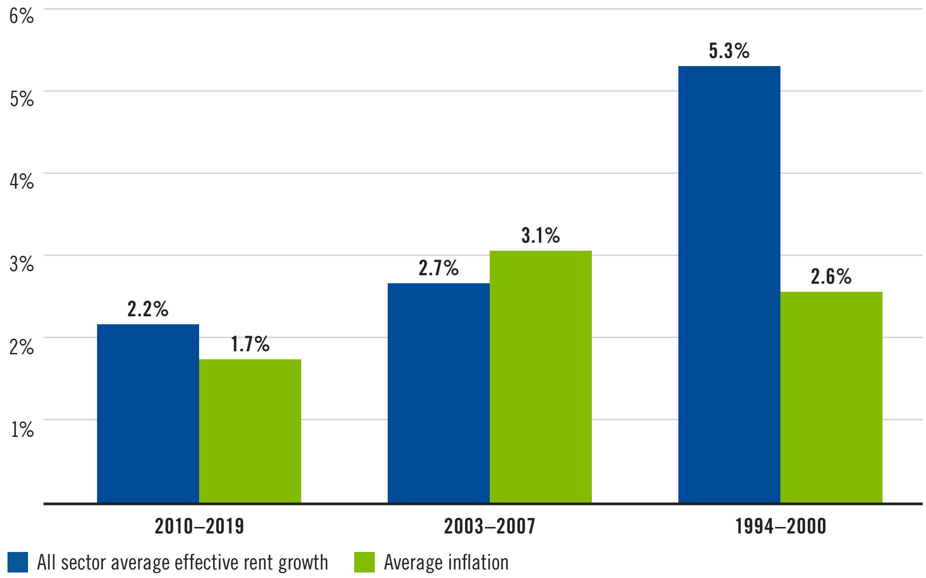
According to Moody's Analytics, US real GDP is forecast to grow by 4.0% in 2021 and 4.5% in 2022, driven by continued accommodative monetary and fiscal policies, pent-up consumer demand, and rising corporate investment. However, this strong projected growth over the next two years is clearly at odds with today's low interest rates and low inflation—the 10-year Treasury yield remains under 1% and annual inflation is under 1.2% (as of October 2020). Indeed, major central banks have pumped approximately $8 trillion of liquidity into the global economic system since the beginning of the COVID-19 pandemic, raising concerns of potential future inflationary pressure. According to Bloomberg, 5-year inflation expectations have increased steadily from 0.9% in early April 2020 to near 1.9% in late November 2020. The key question to investors is: if the accommodative monetary policies successfully support a fast economic recovery, what adjustments should investors make to their portfolios amidst such economic growth?

The current investment environment is particularly challenging. Aging populations and savings gluts globally have resulted in increasing desire for steady and high current income. Major stock market indexes have rallied significantly over the past several months to or near record highs, while, largely driven by central banks' quantitative easing (QE) and interest rate reductions, global bond yields are at ultra-lows, with more than $17 trillion in negative yields. In addition, a large amount of cash is still on the sidelines ($4.5 trillion in the US money markets alone), collecting almost 0% interest and waiting for potential investment opportunities.

Real estate: The best of both worlds

Many institutional investors have steadily increased their real estate target allocation over the past three decades to over 10% on average.

AVERAGE EFFECTIVE RENT GROWTH VS. AVERAGE INFLATION DURING THE PAST THREE ECONOMIC EXPANSION PERIODS



Sources: CBRE-EA, Bureau of Labor Statistics, Clarion Partners Investment Research, Q3 2020.

Note: Average effective rent growth is calculated using simple average of the four main property sectors (apartment, industrial, office, and retail). Data are available going back to 1994. Effective rents are rents after any concessions.
Past performance is not indicative of future results.

Real estate is often viewed as a hybrid investment asset class between stocks and bonds. On one hand, it has similarities to bonds because landlords collect contractual rents as current income. On the other hand, it has similarities to stocks because landlords can increase rents under better economic conditions. In turn, real estate investments can be less volatile than stocks during recessions because of continued rent payments; conversely, it can outperform bonds under improving economic conditions because the ability to raise rents may serve as a hedge, at least partially, against rising inflation or interest rates.

Income with growth is a key characteristic of real estate. Historically, average rent growth has equaled or exceeded inflation during the three most recent periods of economic expansion (1994–2000, 2003–2007, and 2010–2019), as illustrated in the chart on the previous page. The correlations between rent growth and inflation were over 96% in all three expansion periods. This makes intuitive sense: apartment operators can adjust annual rents at each renewal, while for longer-term leases for office, industrial, or retail properties there are typically built-in periodical rent bumps that are either linked to an inflation index or at a fixed annual rate, typically of 2–3%.

A versatile investment vehicle for your investment objectives

2020 may be remembered as a volatile but resilient year. While hotels and malls have been hit hard by the pandemic, other real estate sectors such as industrial/warehouse, life sciences, and rental housing have benefited or been minimally impacted. 2021 will likely mark the beginning of the next new real estate market cycle. Demand is expected to continue to recover across most markets and property sectors, as rising occupancy and higher effective rents should drive higher net operating income, supporting higher dividend and property appreciation. Thus, adding core real estate to a mixed-asset portfolio can be potentially beneficial because of relatively high current income, lower historic volatility, and portfolio diversification benefits (from low/negative correlations with stocks and bonds).

While a dramatic rise in inflation is not a likely scenario, the risk of moderate inflation over the medium term has increased. As such, "income with growth" should be an important part of a portfolio allocation strategy given accelerating economic growth and a potential reflation environment. Real estate can be an effective vehicle to help achieve this investment objective.

Conditions supportive of more balanced equity performance

ClearBridge Investments

Scott Glasser
Co-Chief Investment Officer

The recent backdrop for equities is instructive in forming our views for the year ahead. 2020 has been a year of extremes, with the global COVID-19 pandemic leading to one of the sharpest but shortest bear markets on record that was immediately followed by the best-ever 50-day rally for the S&P 500 Index. Equities ended the year on an upswing as two major uncertainties—the outcome of US elections and the timeline for a COVID-19 vaccine—were largely resolved.

Liquidity is another significant determinant in framing our outlook. Whether judged by money supply, interest rates or credit spreads, liquidity is ample in the current environment and likely to remain supportive of equities in the medium term as the Federal Reserve stays accommodative in its policy approach. Increased liquidity is especially beneficial for small cap companies in accessing the capital markets for financing as well for the continuation of a robust IPO market. The beneficial effects of a higher liquidity environment tend to wane after 12 to 18 months.

Given these factors, we have a moderately positive view for equities in 2021. Volatility has come down since the election to a level where we do not expect to see significant spikes in the VIX like markets experienced early in the pandemic or significant declines. Investor sentiment and earnings forecasts for the first half of 2021 have become a bit exuberant, which will likely lead to consolidation and perhaps a slight correction early in the new year. Longer term, we believe markets should head higher as the economy normalizes with the distribution of a vaccine and adjustment to a new presidential administration. Based on a green expansionary signal for the ClearBridge Recovery Dashboard, we also believe that a durable economic bottom has formed, providing further support for equities, which tend to perform strongly coming out of recessions.

The election outcome was very good for equities, which surprisingly tend to do best with a Democratic president and split Congress. This assumes at least one of the runoffs in Georgia will be won by the Republicans, allowing them to hold the Senate. The results take big tax increases off the table, but also lower the likelihood of a fiscal stimulus package in the $2 trillion range that Democrats have been pushing. We see the failure to pass some form of stimulus before the new Congress is sat in January as the biggest short-term risk to markets and the economy as many consumer assistance programs have already expired or will soon.

The approval and distribution of a COVID vaccine is critical for the market and economy to get back on track. Positive vaccine results from three separate drug candidates in November immediately boosted the outlook for cyclical stocks, a broadening of market leadership that should continue into 2021. Vaccine distribution is a complicated task, however, and one we will be monitoring closely. Our base case is that high-risk groups and a good portion of lower-risk portions of the population will be getting the vaccine by the end of June.

FOLLOWING RECESSIONS, EQUITIES TYPICALLY DO WELL

S&P 500 returns during economic expansions

Trough month	S&P 500 level	Peak month	S&P 500 level	Duration (months)	Change	Secular trend
November 30, 1970	87.2	November 30, 1973	95.9	36	10.0%	Secular Bear
March 31, 1975	83.4	January 31, 1980	115.1	58	38.1%	Secular Bear
July 31, 1980	121.7	July 31, 1981	130.9	12	7.6%	Secular Bull
November 30, 1982	138.5	July 31, 1990	356.2	92	157.1%	Secular Bull
March 28, 1991	375.2	March 30, 2001	1160.3	120	209.2%	Secular Bull
November 30, 2001	1139.5	December 31, 2007	1468.4	73	28.9%	Secular Bear
June 30, 2009	919.3	February 28, 2020	2954.2	128	221.3%	Secular Bull
Average				**74**	**96.0%**	
Secular Bull Average				**88**	**148.8%**	
Secular Bear Average				**56**	**25.7%**	

Sources: FactSet, NBER. **Past performance is not a guarantee of future results.** Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Given these tailwinds, we believe the cyclical and value-oriented sectors most severely impacted by the pandemic shutdowns look the most attractive. We expect the greatest increases in earnings growth will occur in these areas, as they will benefit from easier year-over-year comparisons and improving sentiment. The market has already responded to this anticipation for improvement and should continue to do so.

Dividend paying stocks are a good example of a beaten up segment poised for recovery. Dividend payers did not display their usual defensive characteristics during the height of the pandemic, but instead suffered their worst performance in the last 20 years. Dividend stock multiples are at about 60% of the overall market, the lowest they've been in a long time, and should do well as the broadening of leadership continues. In an environment where we expect interest rates to remain close to zero, dividend stocks offer more attractive yields relative to fixed income and the potential for growing payouts.

Simply looking at valuations would suggest technology stocks are overbought and most at risk of disappointing investors in 2021. Yet much of market forecasting is based on past analogs and we would argue that given the unique nature of the COVID-19 pandemic, which caused voluntary shutdowns of broad swaths of the economy, such analogs are not as applicable today. At current interest rates, technology valuations are well supported. Technology companies, which also include names in the communication services and consumer discretionary sectors, were direct beneficiaries of the shift to work from home and e-commerce. While valuations have expanded, growth has expanded as well and the major trends reliant on technology software and services remain in place. The pandemic accelerated those trends, making the digital parts of the economy larger, and we expect technology stocks will continue to grow faster than the overall market.

In addition to taking on a more cyclical bias in 2021, we believe it's important to continue maintaining exposure to these technology disruptors that are transforming the economy. A more balanced market should lessen the index concentration of mega-cap growth stocks and we expect the equally weighted S&P 500 Index will outperform its market cap weighted counterpart in the year ahead. Smaller companies should also benefit from abundant liquidity, greater savings and the gradual normalization of the economy as vaccines become available.

2021 and beyond: Technology remains a key geopoliticial battleground

MARTIN CURRIE

Kim Catechis
Head of Investment Strategy

The next decade will likely see increasing efforts to disassociate the two largest economies in the world. Technology is central to this struggle. China's response will be to accelerate its efforts to cut its dependence on Western technology, while the US is unlikely to drop its currently aggressive stance. Heading into 2021, below are some of the areas where we believe technology will be key to the global power struggle.

Semiconductors—the underrated key

The electronics industry worldwide was worth US$5.2 trillion[1] in 2018, led by China, the US and Japan. The industry is crucial for virtually every sector of the economy and is therefore strategic in its importance. Inconveniently, it totally depends on semiconductors, an underrated but key component, the global market for which was worth US$412 billion[2] in 2019. One of the reasons why the semiconductor supply chain has worked so well over the past 20 years is that after many iterations it has separated itself into well-defined divisions of labour, with companies becoming specialists. The benefits of lower costs and faster development have been shared across the whole chain, across many countries and time zones, resulting in high-quality, competitively priced products for consumers.

One of the key prerequisites of such a supply chain is, of course, the combination of free trade and freedom of association—meaning the freedom to sign contracts with any corporate anywhere in the world. That has come to an end, as geopolitical objectives are increasingly becoming a source of interference and obstruction.

As a result of this specialisation, there are stages in the supply chain where a single company has a disproportionately dominant position. This creates bottlenecks which are now well understood by governments around the world and we have seen moves by both the US and Japan to block access to certain component parts of the supply chain for geopolitical rationales.

The biggest players in the semiconductor supply chain are based in the United States, South Korea, Japan, Taiwan, the European Union and more recently, China. Given the US moves to block Chinese companies from accessing US intellectual property, the industry structure is being dismantled. Shareholder value is prejudiced and both management teams and investors must think laterally to identify alternative routes around these actions.

Robotics

The global robotics market turnover hit US$50 billion[3] in 2019, including robot systems, software and peripherals, according to the International Federation of Robotics (IRF). The operational stock of 2.7 million industrial robots are dispersed globally with 62% in Asia, 21% in Europe and 17% in the Americas, as of 2019.

Given the extent of the economic decoupling between China and the US that will be continuing into 2021, there will have to be significant investment made in restructuring supply chains as manufacturing relocates from China to other Asian countries, or even back to the US. As that process plays out, there will inevitably have to be a radical adoption of automation technology in all industries, leading to a major disruption of labour markets as the cost and efficiency benefits unfold in many industries. Over the next decade, countries with ageing populations (Japan, China, Germany, Italy, Poland and Czech) have a chance of accelerating the process, as their working populations shrink. Those with 'middle aged' populations (UK, US, Australia, Canada) will have to carefully balance the rate of adoption with retraining and social welfare programmes, to minimise social unrest. The worst affected are the countries with young, less-educated populations and weak government capacity. Bangladesh, Pakistan and India look the most exposed, but Indonesia, Brazil and Mexico also seem ill-equipped for the challenge. The International Labour Organisation (ILO) estimates[4] that 56% of jobs in the five ASEAN countries of Cambodia, Indonesia, Philippines, Thailand and Vietnam are at high risk from automation.

Medtech

The telemedicine market worldwide is estimated at US$45.5 billion in 2019, according to Statista[5], who project it to nearly quadruple to US$175 billion in 2026. The line between medicine and technology has blurred. In the context of the current geopolitical struggle, health and medical technology is right in the middle of the battlefield. COVID-19 has only served to intensify the focus, as the first country to develop a safe and effective vaccine will clearly strengthen its diplomatic hand and be in a position to influence third parties' ability to deal with the pandemic. Hence the apparent attempts at hacking scientific research institutes and high-profile companies.

The technology to enable communications is already there—but it remains broadly underutilised, other than for basic consultations, presumably because of inertia and perceived data-collection limitations. But data collection is not a problem. Many routinely used bracelets measure blood pressure and heartbeat rates to look for arrhythmia; some measure haemoglobin levels to detect anemia. More importantly, patients have proved acutely sensitive to the potential for their medical records to be compromised. Whether it concerns a medical condition or a medical procedure, most prefer to keep these private. So that means cybersecurity is likely to becomes extremely important in 2021 and beyond as a tool for building confidence in the telemedicine domain.

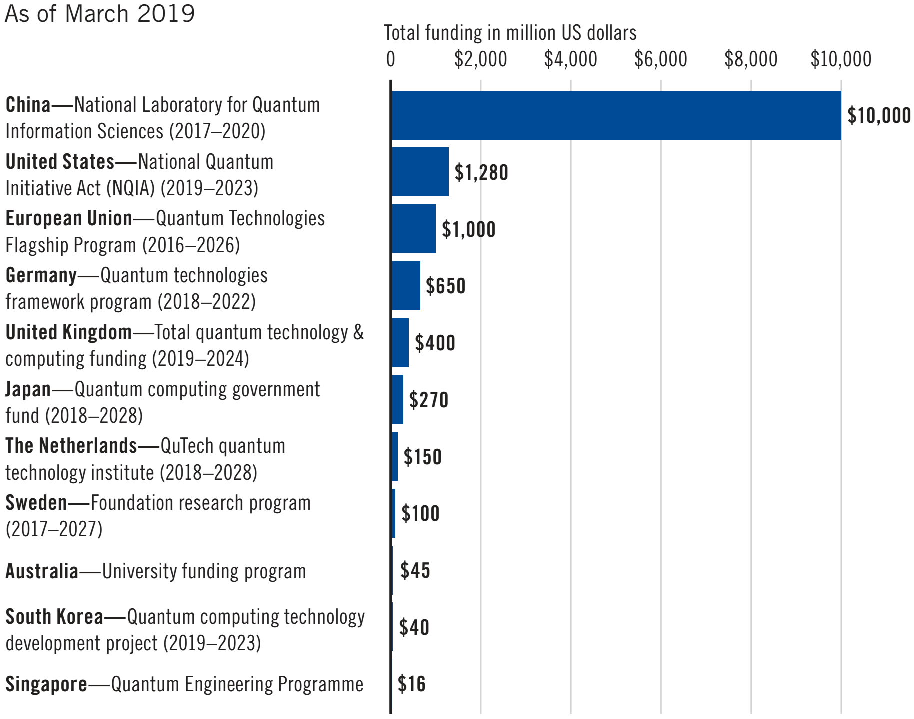
Quantum computing (QC)

The size of the enterprise quantum computing by industry is still very small, but the breadth of its use is impressive—life sciences, automotive, manufacturing, civil engineering and oil & gas are the biggest users to date.[6] Consensus in the sector is that adoption is accelerating in areas such as material science, chemistry, pharma and drugs—where it will be implemented in drug delivery first, rather than drug discovery. One of the key drivers is optimisation; the other is for natural language processing. As of March 2019, China had outstripped everyone else in terms of government funding for research into quantum computing.[7]

Western intelligence agencies are very concerned with China's explicit commitment to attain a leading position in this field. The view is Beijing is pursuing a civil-military partnership in innovation, research and development—China's armed forces believes that the next war will be won by the use of technological advances, even in "experimental" fields. If attained, quantum technology leadership will give China an advantage in offensive intelligence operations and encryption. The resultant advanced weapons systems will increase China's geopolitical and combat options, threatening the West. This fear guarantees a heightened focus from governments going forward and a space to watch in 2021.

WORLDWIDE GOVERNMENT FUNDING—INVESTMENT INTO QC TECHNOLOGY

As of March 2019



Source: Statista.

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6. Source: Statista, Tractica 'Size of the enterprise quantum computing market by industry from 2017 to 2030' https://www.statista.com/statistics/962882/global-enterprise-quantum-computing-market-by-industry/
7. Source: Statista—Quantum Computing DossierPlus—October 2019 page 26 https://www.statista.com/study/61640/quantum-computing/

Factors favoring small-cap stocks in 2021

In looking toward 2021, we think one of the most significant factors, which has been affecting equity valuations over the last several years, is the precipitous decline in interest rates. In fact, recent years have seen lower rates than most financial professionals have seen over their entire careers. However, many equity investors have still not adapted their valuation tools to account for this. As experienced small-cap specialists, we think this omission has fostered misleading conclusions.

We take the classic "Finance 101" view that a company is worth its future free cash flows discounted at some rate back to the present. As we are now experiencing some of the lowest rates on record, it would support among the highest valuations well. To evaluate current small cap valuations by taking ultra-low interest rates into account, we use the equity risk premium, subtracting the free cash flow yield (free cash flow divided by enterprise value) from the US 10-year Treasury yield. A higher number is preferable because it indicates the potential extra return "risk premium" that the market is offering for small caps compared with Treasuries. The small-cap equity risk premium at the end of September was greater than 1%. That number may sound small, but the historic returns from periods when the equity risk premium was 1% or more have been anything but. When the equity risk premium was 1% or greater over the past 20 years, the subsequent average one-year return was 25.5%.

Do past patterns of market cycles, recent subpar small-cap returns, and higher-than-average equity risk premiums assure us that better days are ahead? Not necessarily, of course, as past performance cannot guarantee future results. What we can offer as experienced small-cap investors is the close examination of past patterns to identify when we think the probabilities are indicating it's a good time to invest in small caps. We think now is one of those times.

Have the US elections impacted our viewpoints on the above?

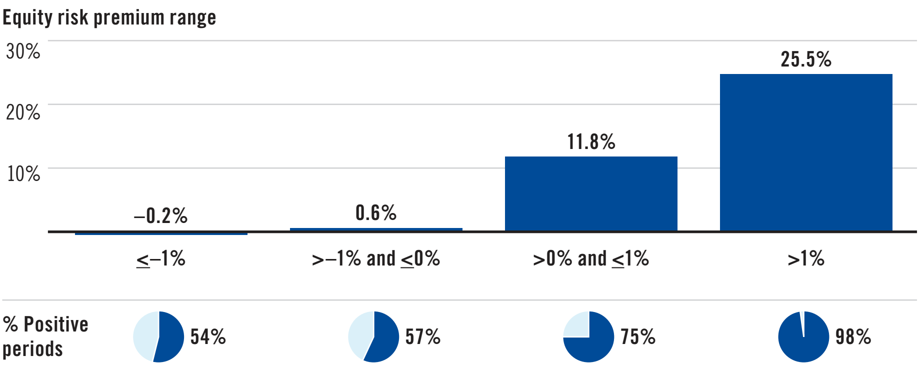
Small caps have done well (and poorly) regardless of which party was occupying the White House. As a result, we think investors tend to overweight the impact of government actions on stocks. In our experience, industry supply and demand dynamics play a much bigger role than regulatory changes or tax policies. In today's highly partisan environment, the likelihood for consequential investment legislation is low unless one party has majorities in both houses of Congress in addition to the White House—and even in that case, the long-term effects are likely to be less meaningful compared to where we are in the economic cycle. If Republicans retain control of the Senate, the recovery is likely to proceed at a moderate pace. If the Democrats win a majority, we may get a more significant fiscal response, probably driven by spending increases and higher taxes. In any event, a significant increase in fiscal stimulus would likely improve what we think is already a favorable climate for small-cap stocks.

What challenges or headwinds do we expect could affect small cap performance?

In our view, the timing, efficacy, and adoption of vaccines remains the wild card, as it were. Progress has been highly encouraging, yet the longer the world waits, the longer it will likely take

HISTORICALLY HIGH EQUITY RISK PREMIUM HAS LED TO HIGH RETURNS

Average subsequent Russell 2000 1-year performance in equity risk premium Ranges from 9/30/00 to 9/30/20



Equity risk premium = Latest twelve months free cash flow divided by enterprise value minus 10-year Treasury yield. Source: FactSet. **Past performance is no guarantee of future results.**

for a robust economic rebound to get fully underway. If incremental news about a vaccine roll-out turns negative, either for logistical or public adoption reasons, that will likely cause a downgrade in the cyclical outlook, which would be negative for small caps.

While a fiscal package would likely accelerate the current risk-on factor rotation into cyclical names, a more modest stimulus (or none at all) may not prove sufficient to counteract the near-term negative effects of increasing cases and resulting restrictions on activity and therefore could also create challenges for small caps.

What are the investment opportunities Royce sees across its small-cap strategies?

As a general observation, we see the pandemic's effects on various industries not as a change in course but as an acceleration of existing trends. The first opportunity we see surrounds the accelerated adoption of digitalization and related technologies that enhance productivity and efficiency, especially inside the factory walls of many industrial companies. Ongoing reshoring would amplify this already vibrant trend.

The second theme is related. We like the prospects for companies that allow other businesses to innovate or improve efficiency. For example, we own a firm that provides robust apps for local community banks, allowing them to better compete with bigger industry players. Another example would be companies that are helping to enable e-commerce from both digital natives, such as Amazon and Wayfair, as well as branded apparel companies like Levi Strauss and Ralph Lauren. Other small-cap opportunities we have identified include companies providing supply chain management software, transport, and logistics. Finally, there are recreational areas that are benefiting from changes in consumer leisure time behavior in which demand is exceeding capacity—most notably in RVs and boating—and we mostly own businesses that provide parts and services, which are less dramatically cyclical.

Based on what we see in small cap's fundamentals, current valuations, and market behavior, we're optimistic for attractive returns over at least the next several years. We're in accord with the consensus that expects the economic recovery to continue broadening and deepening, which should be highly supportive for small-cap stocks, as it has been historically, especially the economically sensitive cyclical sectors that many of our portfolios are emphasizing now.

The gamechanger has arrived

Ken Leech
Chief Investment Officer

> **"Everything has to come to an end, sometime."**
> L. Frank Baum
> *The Marvelous Land of Oz*

The recent Pfizer vaccine announcement (followed swiftly by Moderna's) was the gamechanger. With claims of a 95% efficacy rate, it heralded the definitive beginning of the end of COVID-19. If a year ago no one could imagine a world engulfed in a pandemic, now it is hard to envisage a world without COVID. And this spectacular breakthrough could not come at a more propitious time. COVID cases are spiraling all over the world. Europe has had renewed broad-based lockdowns. The US is considering regional lockdowns. Fortunately, the death rate continues to recede. But the sheer magnitude of case increases is leading the death toll to mount. As investors, our particular challenge is how to weigh the benefits of a COVID-less future with the still profound difficulty in getting there.

Our inclination is that markets are very forward looking. Risk markets have been rallying since the depth of the crisis in March, as sentiment and expectations that the war against COVID and the enormity of the policy response to maintain economic momentum would carry the day. Even as COVID resurgence brings more cautious economic behavior, and slack in the global economy remains dangerously high, markets are trying to calibrate to a future that should look meaningfully different from the present.

What has changed is the timeline. Our Coronavirus Task Force still believes the difficulties in getting vaccine production, acceptance, distribution and widespread global vaccination will take the better part of a year. But as the medical focus on front-line workers, those with pre-existing conditions and the elderly begins to broaden, the economic anxiety of society and the need for recurrent lockdowns may vanish.

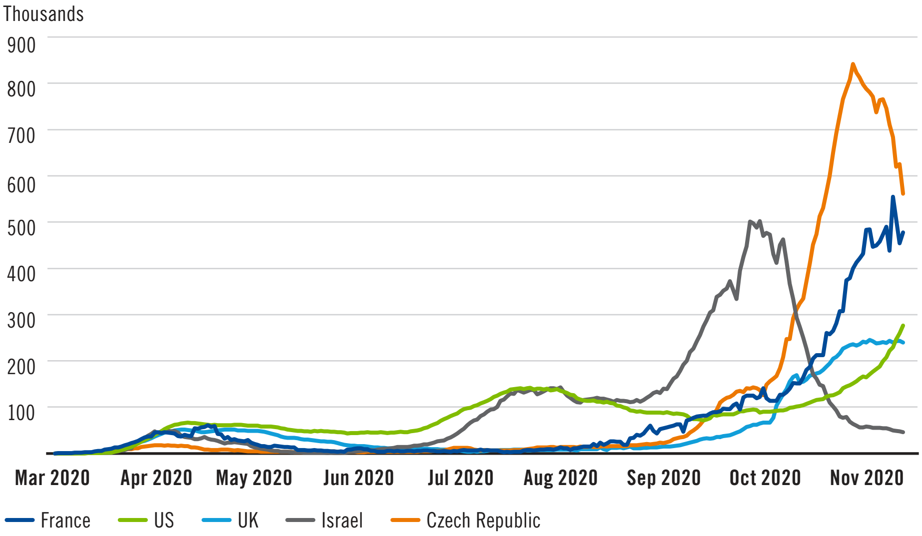
We thought all the major risk sectors of fixed-income were badly oversold in the fear that followed the global pandemic. Our belief has been that policy support coupled with a meaningful recovery from a very depressed condition would eventually benefit all these sectors. Going forward, we feel markets will extend their optimism more broadly in these areas. The other area where we are optimistic is emerging market (EM) debt, which we believe is a highly undervalued space. Despite the enormous medical and fiscal challenges EM countries face, the steadily increasing probability of a global economic recovery will entice investors into EM debt.

In the immediate future, the COVID crisis is increasing. In the intermediate future, as the COVID vaccination process extends, the willingness to provide ongoing massive fiscal support should wane. In the longer term, the need for fiscal retrenchment—think higher taxes—will likely emerge.

What will remain constant? The historically unprecedented asymmetric nature of monetary policy, particularly in the US, will keep interest rates ultra-low for years. Central bankers from developed countries around the world have been extremely explicit in

COVID-19 VIRAL TRENDS—US VS. EUROPE

7-day active cases per 100,000
As of November 11, 2020



Sources: Bloomberg, Western Asset.

guiding markets for a "lower-for-longer" rate environment. Concerns over higher, more permanent levels of unemployment are first and foremost. "Scarring"— the inability to easily regain employment or career traction—will persist. The monumental workforce change of utilizing technology will also slow labor force reabsorption.

Nowhere is this commitment to accommodative monetary policy more evident than in the US. The Federal Reserve (Fed) came into the year already poised to ease 10 years into an expansion due to the chronic undershoot of inflation. The Fed then massively expanded its balance sheet, easing more in three months than during the entire aftermath of the global financial crisis. The Fed's battle cry was "we will do whatever it takes." Then the Fed used its long-term policy review to change its reaction function in an even more structurally dovish direction. On inflation, the Fed is committed to seeing actual realized inflation of at least 2% before hiking—but it must also be judged to be able to continue this above-target level for a sustained period of time. (Is this one year? Two years?) In combination with that higher bar of inflation, the Fed also upped the ante on unemployment. Now full employment must be achieved for every segment of the population, most particularly for the lower-income and disadvantaged groups. Fed Chair Jerome Powell specifically noted last week that this took six to seven years in the last economic expansion. Clearly, if there are bumps in the road, the Fed will do more. If the recovery proceeds apace, the Fed will be extremely careful before "even thinking about raising rates."

The combination of truly extraordinary news on the vaccine front, reasonable current economic momentum and probable further fiscal help should support fixed-income spread products. The Fed's determination to prevail against strong disinflationary forces is encouraging, even if the task will prove difficult. The enormity of the Fed's commitment to its asymmetric approach also supports the likelihood of the sustainability of the recovery even given the immediate growth challenges from the COVID crisis. This "very low, for very long" commitment also enhances the prospects that Treasury duration can be a useful complementary portfolio asset.

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