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# Long-Term Opportunities Amidst Short-Term Volatility Perspective from Dr. Michael Hasenstab

Dr. Michael Hasenstab, SVP and Co-Director, International Bond Dept, Franklin Templeton Fixed Income Group® shares his thoughts on how recent short-term volatility belies long-term opportunity

**Elsa Goldberg:** Welcome to the Global Investment Perspectives from Franklin Templeton. I'm Elsa Goldberg and joining me today is Michael Hasenstab, Co-Director for Franklin Templeton International Bond Department. Michael, thank you for joining us.

**Michael Hasenstab:** My pleasure Elsa.

**Elsa Goldberg:** Michael, we have a couple of questions that would like to address. The first one is what are the main drivers of the strategies recent short-term underperformance? Have you changed your portfolio positioning and macro outlook?

**Michael Hasenstab:** There have been a couple of factors that have driven the short-term underperformance. Obviously the global markets have been experiencing an incredibly high level of volatility, in particular there has been a lot of speculative pressure on many of the Asian currencies and Scandinavian currencies which we continue to believe have long-term value. In fact, I think the strong fundamentals of many of those regions are illustrated by the fact that a country like Indonesia went through the global financial crisis without ever going into a recession. And since the global financial crisis, many of these countries have further strengthened their government as well as corporate balance sheets, they have decreased some of the leverage that we saw in places like Korea, countries like China have grown reserves massively, so the fundamentals, if anything, are actually more robust in many of these countries yet the market has traded these currencies back to the levels we saw or at least close to those levels in the 2008-2009 period. So to us, this represents a tremendous potential and given our good liquidity and cash positions, we've actually been better buyers and taking advantage of this weakness and taking the other side of the more speculative and leveraged sellers. Additionally, our underweight position in duration has led to some underperformance, but given the low yields globally, the fiscal concerns in many countries, the rise of inflation globally as well as recently some rising labor price pressures out of China, we don't believe that the incredibly low yield that you see today represent value. And so we have positioned the strategy to be underweight duration. Now the recent rally in interest rates particularly in the U.S. has hurt a relative performance but on a long-term basis yields that are below levels that they were during the financial crisis to us do not represent value. So, it's particularly been a selloff in some Asian currencies and our underweight position in duration, but on a long-term basis we think those make sense and are using this opportunity to add to positions that we like.

**Elsa Goldberg:** Thanks Michael. But are you taking measures to mitigate the recent market volatility in bonds and currencies with respect to the strategies you manage?

**Michael Hasenstab:** We are constantly evaluating the fundamentals and most of our research effort is focused on looking at fundamental conditions in particular the outlook for the global economy and we are also looking at ways to potentially hedge downside risk through some of our currency strategies, so that is certainly an ongoing process that ourselves and our risk team continue to work on. But at this point the main



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drivers are the weakness of Asian currencies and those levels just don't seem consistent with long-term fundamentals.

**Elsa Goldberg:** And Michael, the Fed recently announced its intent to extend the average maturity of its U.S. Treasury holdings, do you expect the Fed's "Operation Twist" to have a strong impact on economic activity and reduce the risk of a U.S. recession?

**Michael Hasenstab:** The recent announcement by the U.S. probably will have a fairly limited effect on economic activity in the U.S. Interest rates are already incredibly low, monetary policy is already incredibly loose. The one thing that both the Fed and ECB have been very consistent about that I think will prevent a systemic global banking sector crisis is their great willingness to provide almost infinite liquidity to the financial sector in particularly the banking sector. And this liquidity prevents a repeat of the end of 2008 or early 2009 period where there weren't those facilities in place to replace the private sector if it was no longer willing to lend. Now if the private sector doesn't lend in the interbank market, the public sector takes over and the balance sheet of the ECB and of the Fed are incredibly large and can provide that liquidity. But I think what is more important is thinking about what are the economic prospects for the U.S. and globally and are we at the end of the cycle or are we just in a significant soft patch and our assessment is this is a significant but a soft patch as opposed to the end of the cycle. And in particular in the U.S., if we think about the conditions that are necessary for a major contraction of economic activity as opposed to just a stagnant or slow level of growth, the conditions that are required for that major contraction are large excesses whether that be in the goods markets such as companies over investing or companies over hiring or whether that be in the asset markets such as equities or real estate and if we look at all of those most of those excesses have been cleaned out. Think about the unemployment rate, incredibly high, companies are running very lean, now it's true that is unlikely to come down in the near term but that is a very different prospect than saying companies are about to fire a large amounts of people which is equally unlikely.

Additionally, if we look at levels of investment, if anything most U.S. companies have underinvested in the last couple of years and that can be seen by the tremendous amount of cash that they have on the balance sheets that they have not put to work, so there's not a need for cleansing in both investment or in the labor markets and of course the real estate markets have already had a huge correction. But this is a recovery from a post financial market excess, there is a lot of deleveraging that is going on and so typically in those type of recoveries, they are characterized by weaker than normal growth and also prolonged periods of higher unemployment. So, the conditions we are seeing today are not atypical, but it also doesn't signal that we're about to go into a major contraction.

And lastly, I think it's important to expand that globally, I just spent the last couple of weeks in Latin America and it's clear that most other parts of the world are experiencing very different fundamentals, growth is quite strong and if anything there are risks that economies are reaching their full capacity, so the growth conditions in the rest of the world remain quite robust and the tremendous amount of liquidity that the U.S., Japan, and Europe are providing to the global economy leaves those markets and goes globally and boost investment further. So even though growth in the U.S., Europe, and Japan is likely to be weak and they will have lower demand for emerging market exports; on the flipside, they are pumping a tremendous amount of money through low interest rates and quantitative easing into those economies and helping boost growth. So globally, our outlook remains reasonably positive although we recognize the economic growth rates in the U.S., Japan, and Europe are likely to remain fairly anemic for at least the short term.



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**Elsa Goldberg:** And Michael, what would be the contagion effect of a Greek default on European Banks and the rest of Europe? Do you think a default by Greece or another European country could cause a systemic risk in Europe?

**Michael Hasenstab:** Well, it's been our view for a while that Greek's debt situations and finances are insolvent and we do need to probably anticipate a world where there is a default or a major restructuring of Greek debt, but then the question is as you asked, will that event trigger a systemic crisis across Europe and I think there's a couple of important issues to look into. One, is Italy the same as Greece and if it is, then I think we have a serious problem but it isn't. Through the last couple of decades, Italy has actually undertaken pretty significant fiscal reform efforts to stabilize its debt-to-GDP unlike Greece which was on an explosive and expanding path. It's true the level of debt is high in Italy but it is also stable and it is true that growth rates are fairly low, but they have also been fairly responsible in running good fiscal balances. So the debt conditions in Italy are nowhere near as problematic as that they are in Greece. But then, we have to think a little bit further what if the markets were to pressure a major borrower like Italy from a good equilibrium into a point of questionable solvency and then I think the most important agent becomes both the Italian policymakers, which in the past have proved effective at imposing fiscal constraint when necessary, and also the ECB. The European Central Bank has shown a willingness despite it's not first choice to do so, but a willingness when necessary to intervene in the government bond markets to prevent contagion effects from hurting countries that are not insolvent but the market is trying to make them insolvent. The ECB also most importantly is providing a tremendous amount of liquidity to the banking system. It is true that European Banks are a bit more credit constrained than those in the U.S. because they haven't made a lot of the write downs, but they also have a tremendous access to liquidity and the capitalization of the major European Banks is certainly adequate. So, provided the ECB continues to ring-fence, situations in Greece it's unlikely to be systemic. It is going to be volatile, there's no question it's a complicated political process there and there certainly are tail risk events that we are monitoring very closely, but at this point we don't think the conditions are set for, if there is a Greek restructuring, for it to be globally systemic. Additionally I think it actually could be a positive event for Europe to move beyond this. The market is already pricing in a significant restructuring and so it wouldn't necessarily be a surprise and as long as the ECB is there at that time to provide the backstop and prevent contagion, we think it is manageable. Again, it will be a messy process but we think it isn't necessary and there aren't the prerequisites for a Lehman style global collapse of the banking system.

**Elsa Goldberg:** Great insights Michael. Thank you for talking with me today and thank you for listening to Franklin Templeton's Global Investment Perspective.

**Michael Hasenstab:** Great, thank you for having me.

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