



FRANKLIN TEMPLETON
INVESTMENTS

Global Economic Perspective

AUGUST 2010

Perspectives from the Franklin Templeton Fixed Income Group®



Christopher Molumphy

- THE DEFLATION DEBATE
- LOW GROWTH CAN PROVIDE OPPORTUNITIES
- HOPEFUL SIGNS AROUND THE WORLD
- EUROPEAN OUTLOOK



Michael Materasso

THE DEFLATION DEBATE

Worries about the pace of recovery worldwide have revived fears that parts of the western world could face a bout of Japan-style deflation. Some European countries (Ireland, for example) have already been grappling with the falling business and consumer spending, plus rising debt payment burdens, that typically characterize deflation. Many other countries currently hover on the edge as austerity drives trump stimulus programs. Fears have been heightened, we believe, by a paper from James Bullard, president of the Federal Reserve Bank of St. Louis, who suggested that the U.S. was “closer to a Japanese-style outcome today than at any time in recent history.” Bullard was referring to the prolonged stagnation of the Japanese economy since the early 1990s in spite of base interest rates that (like those currently in the U.S.) are close to zero.



Roger Bayston

How seriously are we to take the risks of deflation? In the U.S., sluggish consumer spending, high unemployment, the decline in some forward indicators, stagnant money supply and the progressive ending of stimulus spending are unsettling. In most developed countries, inflation lately has fallen below the 2% rate usually seen as an appropriate buffer against deflation.



Michael Hasenstab

In the U.S., the Consumer Price Index (CPI) and Producer Price Index (PPI) have declined for three consecutive months from April through June. Core CPI in June was just 0.9%, annualized. At the same time, data has suggested that the U.S. economic recovery has slowed. But there is a huge difference between disinflation and deflation. The U.S.’s second-quarter 2010 growth rate of 2.4% suggested to us that the country has not yet slipped into deflationary territory. Inflation has been low but still positive in the U.S. In Europe, Eurostat reported that the annual inflation rate in the eurozone actually increased in July (to 1.7%), and second-quarter gross domestic product (GDP)



John Beck

figures there are expected to be relatively buoyant, in large part due to Germany’s export performance. In the UK, inflation has remained above the Bank of England’s target rate.

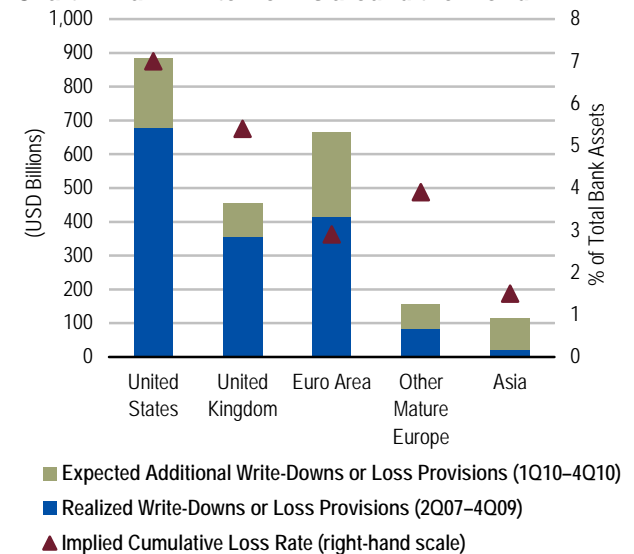
Chart 1: U.S. Leading Economic Indicators Index

February 2007 to June 2010



Source: Conference Board, July 22, 2010.

Chart 2: Bank Write-Downs around the World



There is no assurance that any projection, estimate or forecast will be realized. Source: International Monetary Fund, Global Financial Stability Report, April 2010. Other Mature Europe is Denmark, Iceland, Norway, Sweden and Switzerland. Asia is Australia, Hong Kong, Japan, New Zealand and Singapore.

Banks, corporations and households have been deleveraging in earnest for some time. We think monetary and fiscal policy have combined to lessen the impact of this necessary purging of balance sheets and to foster confidence in risk taking. Consequently, deflation fears did not materialize at the height of the financial crisis in 2008 because of decisive action by central banks and governments. More recently, European authorities and the International Monetary Fund (IMF) have stepped in, in an attempt to avoid a sovereign debt crisis in Greece, helping to improve market sentiment. Additionally, the Federal Reserve appears to stand ready to intervene again to support economic recovery, perhaps—as Bullard suggests—by reactivating its quantitative easing program to expand the money supply and stimulate lending.

Typically, inflation does not pick up for some time after a pickup in the economic cycle. But as long as western economies continue to recover—even at a modest rate—inflationary expectations could start to rise again, especially in view of the abundant liquidity already provided by public authorities.

LOW GROWTH CAN PROVIDE OPPORTUNITIES

Although we are skeptical about claims that the U.S. is currently facing deflation, deleveraging throughout the economy and a persistent output gap mean that inflation remains low for the moment. With recent economic data having generated somewhat mixed results, the Fed appears to have little incentive to tighten monetary policy anytime soon. For this reason, Treasuries across different maturities have continued to perform well and appear to be an investment haven of choice for some investors.

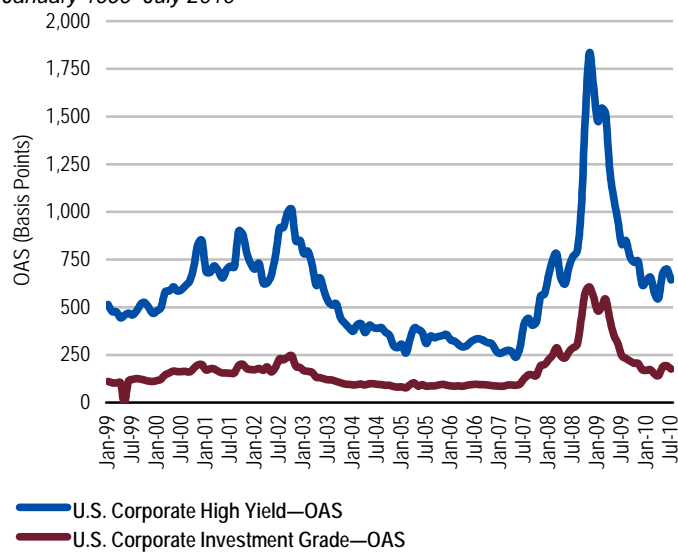
Consequently, prices (which move in the opposite direction of yields) for Treasuries are currently high relative to historical norms. U.S. 10-year Treasury yields were still below 3% in early August, while two-year paper was delivering a nominal yield of less than 0.60%. When annualized inflation is taken into account, two-year paper actually offered a negative return! In light of such figures, we believe that more opportunities can be had in certain mortgage-backed securities and in corporate credit.

Our view is that the American economy could continue to grow, although nominal growth figures may appear modest. For the moment, while consumer spending remains lackluster, the second-quarter GDP report showed that corporations were relatively confident, with nonresidential fixed investment up 17% on an annualized basis, according to the Bureau of Economic Analysis. Although earnings expectations may start to moderate, second-quarter results have also been mostly strong for American companies. Although low bond yields have helped the American government resist pressures for fiscal austerity, they have also allowed corporations to benefit from attractive rates for credit issuance.

Those corporate issuers that have strong fundamentals and are able to prosper in an environment of relatively low domestic growth present better potential than low-yielding Treasuries, in our view. With low bond yields reducing borrowing costs for companies, and with investors eager to find an alternative to low-yielding Treasuries, corporate bond issuance has recently picked up again, after having dipped somewhat toward the end of the second quarter of 2010. Heightened volatility in the equity markets has served only to increase investor interest in investment-grade corporate bonds (in part because debt holders rank higher than shareholders should a company collapse). As a result, yield spreads over Treasuries in recent weeks have been the lowest they have been in many years.

Chart 3: U.S. Corporate Bond Yield Spreads over Comparable Treasuries

January 1999–July 2010



OAS = Option Adjusted Spread.

Source: Barclays Capital, July 30, 2010.

The high-yield market has also been given a bump by reduced tensions in the sovereign debt market and the expectation that the Fed will keep interest rates close to zero for a while yet. Indeed, the combination of moderate U.S. growth and low interest rates is typically seen as the best-possible environment for high-yield credit. Higher interest rates hurt the prices of existing debt as yields rise, while a stronger growth environment tends to favor even riskier investments such as equities.

In truth, investors may eventually balk at the relatively low yields currently offered by corporate bonds. However, for the moment, those low yields (and low default rates) suggest the corporate bond market has been pricing in a modest recovery—but not a double-dip recession. On the contrary, low borrowing costs can be a boon for corporate profits, potentially benefiting the broader economy and hiring.

HOPEFUL SIGNS AROUND THE WORLD

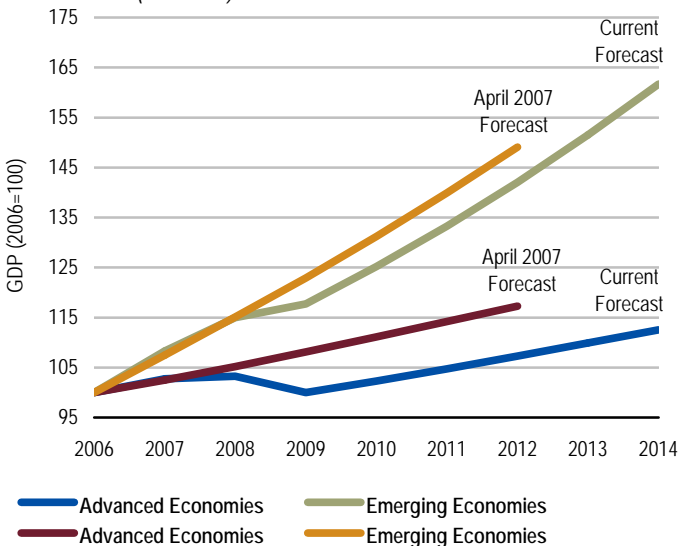
On a further note of optimism, the U.S. and Europe have continued to benefit from strong economic growth in Asia, as well as from a lowering of tensions in the sovereign debt market.

Growth has been remarkably strong in many Asian countries. Although down from 11.9% in the first quarter of 2010, China's annual growth rate of 10.3% in the second quarter was impressive. In India, the annualized GDP growth was close to 8% in the year to June 30; in South Korea, it was over 7% and in Indonesia it was 6.2%. Recent growth levels in China and other Asian countries may not be sustainable in the second half of this year in light of the mixed economic picture in Europe and the U.S. In addition, monetary authorities in China and in other countries in the Asia-Pacific region are closely attuned to the risks of overheating. In many instances, they seem to be ahead of the curve in terms of dealing with potential asset bubbles. Thus, thanks to what we view as eminently sensible measures to cool China's housing market and loan expansion, growth in China is expected by a number of analysts to slow down to a more sustainable 8–10% range in the third quarter.

Markets of late have been prone to overreaction, and there is a short-term risk that the market could extrapolate a measured slowdown to a more sustainable level of development as a hard landing. It is important for investors to understand why Asian growth may slow in the coming months and what the prospects are for 2011.

Chart 4: Growth Differences between Emerging and Advanced Economies

2006 to 2014 (Forecast)



Source: International Monetary Fund, World Economic Outlook, April 2010. There is no assurance that any projection, estimate or forecast will be realized.

We believe a normalization of growth numbers in Asia seems more likely in the wake of a v-shaped recovery, and—minus unforeseen shocks—we believe the region may achieve trend growth in 2011 and fairly elevated rates of growth for several years thereafter. Although more of this growth would probably come from domestic consumption and intraregional trade rather than exports to Europe and North America, the sluggishness of both these regions means that Asia should also continue to be a beneficiary of strong capital inflows, in our view. In these circumstances, we would take market talk of a “hard landing” in Asia as a potentially favorable opportunity to invest in a variety of assets in Asia, including currencies.

It is noteworthy that the markets' extreme pessimism over European sovereign credit has not yet been borne out by events. Greece's finances are still a cause for concern, but thanks to the European Central Bank's (ECB) intervention, Greece's funding requirements have been taken care of for the next two years, which should provide ample time for other southern European countries to get their houses in order. In other terms, there is a good possibility that Greece's problems can be circumscribed and that recent market fears of contagion will prove overdone. Spain has introduced some notable austerity measures and fiscal reforms. As a consequence, it was able to launch a highly successful 10-year bond offering in July, and yield spreads on Spanish bonds over Bunds have tightened.

Spain and the rest of Europe have also been helped by the recent European bank stress tests. Furthermore, while the European banking sector still has some huge structural problems, mechanisms have been put in place in an attempt to prevent a repeat of a Lehman Brothers scenario. The ECB appears to be clearly committed to providing liquidity in cases where the interbank market is not functioning fully. As a consequence, the TED spread (which measures the difference between the amount that banks and the German government pay to borrow for three months) has not approached the levels seen in the wake of the collapse of Lehman Brothers in late 2008. Clearly, while volatility did increase in recent months, this measure does not seem to indicate a funding crisis for European banks.

EUROPEAN OUTLOOK

In contrast to the doubts besetting the U.S., things would seem to be looking up for Europe—for the time being at least. The British economy expanded at its fastest rate in four years in 2010's second quarter, according to initial readings. The Federation of German Industry has forecasted that Germany's gross domestic product will grow a solid (by German standards) 2% in 2010, and unemployment there has been declining for several months. The economic sentiment index for the eurozone improved markedly in July. In recent weeks, manufacturers in the UK, Sweden and Germany have all reported solid growth in manufacturing output—thanks, notably, to export demand from emerging markets.

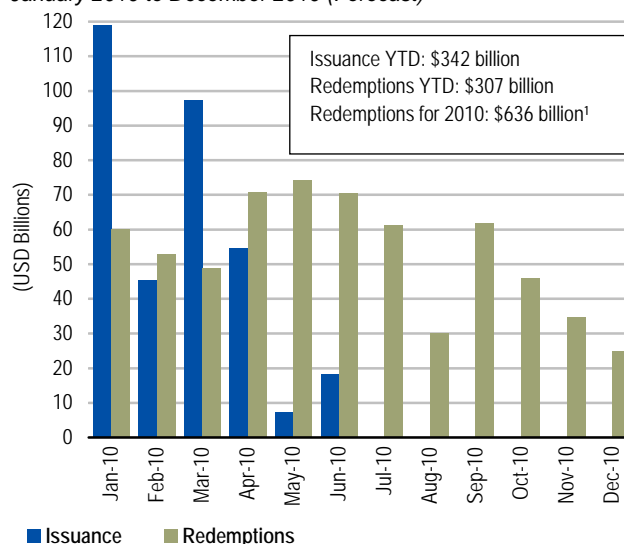
In addition to manufacturers, the European financial sector has also been making something of a comeback, with banks across the continent posting robust second-quarter results. Confidence in European banks was seen to be reinforced by the results of stress tests on 91 institutions in late July. Perhaps more reassuring than the stress tests themselves (which only seven banks failed) was the disclosure of European banks' sovereign exposure. As a consequence of the tests—plus the relaxation of proposed Basel III capital adequacy regulations—some bigger European banks have been finding it easier to finance themselves, with a clutch of bank bond issues launched across the continent in late July finding eager buyers.

Yet, the recovery in Europe remains uneven. Within the eurozone, large exporting nations have forged ahead, while the need to deleverage has held back economic activity in more fragile countries such as Spain, Portugal and Greece. Furthermore, the rebound in manufacturing has generally been erratic. A July survey of purchasing managers showed a slowdown in manufacturing in countries such as France. Even the stronger European economies eventually will likely have to deal with the effects of recently implemented fiscal austerity packages, the ending of various stimulus measures—car sales have already slumped in countries that have concluded “cash for clunkers” schemes—and the slowdown in growth in the U.S. and Asia.

Even for banks, it may be too early to sound an “all clear” message. Alongside successful bond issues from large commercial banks, there are a number of European banks (particularly in Greece, Portugal, Ireland and Spain) that are still unable to finance themselves on the open market and thus remain reliant on borrowing from the ECB and on state guarantees to roll over debts. According to research by the International Monetary Fund and Moody's rating agency, British and eurozone banks have €3.3 trillion of bonds to refinance by 2015.

While bank bond issues in July were broadly viewed as a success, the real test may come in September—after the summer lull—when banks will try again to raise capital on the markets. By the end of 2010, there will likely be many more offers and banks will have to compete against each other for investor interest, as well as against sovereign issuers. The investing climate has turned generally more benign in recent weeks, but that may have had more to do with the traditional lack of supply and increase in redemptions in the summer months. Pressure on Greek bond yields has lessened, but actual net buying of anything other than short-term Greek paper has been absent. In short, we may know whether investors have definitively changed their minds on peripheral eurozone countries and second-tier banks in autumn when issuance typically revs up again.

Chart 5: Funding Requirements of European Bank Debt
January 2010 to December 2010 (Forecast)



Note: Data includes issuance and redemptions for European bank debt; YTD redemptions and issuance are through June for European banks.
Source: Dealogic, J.P. Morgan, June 30, 2010.

1. Forecasts based on maturity dates of the debt issued. There is no guarantee that the forecasts will be met.

For all that, the market panic provoked by Greece's sovereign debt problems has receded for the moment. Although investors still seem to fear that Greece will eventually be forced into a debt restructuring, the country did manage to raise €1.6 billion in an auction of six-month treasury bills in mid-July. A European Union/International Monetary Fund rescue package worth €10 billion has provided reassurance that Greece can resist market pressure for now, allowing other Mediterranean countries time to reform their finances.

Thus, confidence has grown that Greece's problems can be circumscribed, as evident in the tightening of yield spreads over Bunds for Spanish and Portuguese government bonds. We think the brighter market tone, in turn, has helped move the ECB closer toward policy normalization. Significantly, since it intervened at the height of the Greek crisis in May to help stabilize public debt markets, the ECB has steadily reduced its purchases of government bonds.

IMPORTANT LEGAL INFORMATION

Because market and economic conditions are subject to rapid change, the analysis and opinions provided are valid only as of August 11, 2010. An assessment of a particular country, market, security, investment or strategy may change without notice and is not intended as an investment recommendation nor does it constitute investment advice.

EUROLAND MACROECONOMIC DATA

FINAL OUTPUT

	2Q09	3Q09	4Q09	1Q10
Gross Domestic Product (GDP) ¹				
GDP, Y/Y (%)	-4.9	-4.1	-2.1	0.6
Private Consumption, Y/Y (%)	-1.2	-1.3	-0.5	0.0
Gross Fixed Capital Formation, Y/Y (%)	-11.5	-11.4	-8.7	-4.8

ECONOMIC INPUTS¹

	MAR 10	APR 10	MAY 10	JUN 10
Retail Sales, Y/Y (%)	1.7	-0.7	0.6	0.4
Unemployment Rate (%)	10.0	10.0	10.0	10.0
Industrial Production, Y/Y (%)	7.8	9.6	9.6	-

INFLATION & WAGE PRESSURE

Inflation Indicators ¹	MAR 10	APR 10	MAY 10	JUN 10
Consumer Price Index (CPI), Y/Y (%)	1.4	1.5	1.6	1.4
Core CPI, Y/Y (%)	1.0	0.8	0.8	0.9

FINANCIAL MARKETS

	APR 10	MAY 10	JUN 10	JUL 10
Dow Jones EURO STOXX	13.52	12.50	11.30	12.06
50 Price Index EUR, Trailing P/E Ratio ²				
ECB Refinance Rate (%) ³	1.00	1.00	1.00	1.00
10-Year Yield—German Bunds (%) ²	3.02	2.66	2.58	2.67

BALANCE OF PAYMENTS¹

	FEB 10	MAR 10	APR 10	MAY 10
Trade Balance				
Billion Euro	1.87	3.83	0.27	-3.43
Current Account Balance	2Q09	3Q09	4Q09	1Q10
% GDP	-1.0	-0.2	0.3	-1.1

JAPAN MACROECONOMIC DATA

FINAL OUTPUT

	2Q09	3Q09	4Q09	1Q10
Gross Domestic Product (GDP) ⁴				
GDP, Q/Q ar (%)	6.9	0.4	4.6	5.0
Private Consumption, Q/Q ar (%)	-2.4	-1.0	1.8	2.7
Fixed Capital Formation, Q/Q ar (%)	-14.2	-8.1	4.7	2.6

ECONOMIC INPUTS

	MAR 10	APR 10	MAY 10	JUN 10
Unemployment Rate (%) ⁵	5.0	5.1	5.2	5.3
Industrial Production, Y/Y (%) ⁶	31.8	25.9	20.4	17.0
Tertiary Index, Y/Y (%) ⁵	5.0	4.0	3.4	-
Corporate Activities	3Q09	4Q09	1Q10	2Q10
Corporate Profit Growth (%) ⁷	-32.4	102.2	163.8	-
Tankan Quarterly Survey (index level) ⁸	-33	-24	-14	1

INFLATION

Inflation Indicators ⁵	MAR 10	APR 10	MAY 10	JUN 10
Consumer Price Index (CPI), Y/Y (%)	-1.1	-1.2	-0.9	-0.7
CPI ex-Fresh Food, Y/Y (%)	-1.2	-1.5	-1.2	-1.0

FINANCIAL MARKETS²

	APR 10	MAY 10	JUN 10	JUL 10
Nikkei 225, Trailing P/E Ratio	38.8	34.1	24.4	24.8
3-Month Yield—JGBs (%)	0.119	0.115	0.119	0.115
10-Year Yield—JGBs (%)	1.290	1.265	1.091	1.074

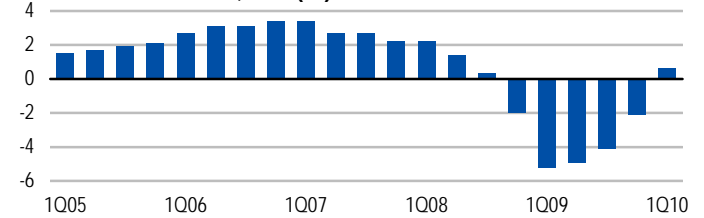
BALANCE OF PAYMENTS

	MAR 10	APR 10	MAY 10	JUN 10
Monthly Trade Balance ⁷				
Billion Yen	1,089	859	391	769
Current Account Balance ⁹	2Q09	3Q09	4Q09	1Q10
% GDP	2.4	2.4	2.8	3.3

Abbreviations: Q/Q ar: Quarter-over-quarter annualized rate. Y/Y: Year-on-year.

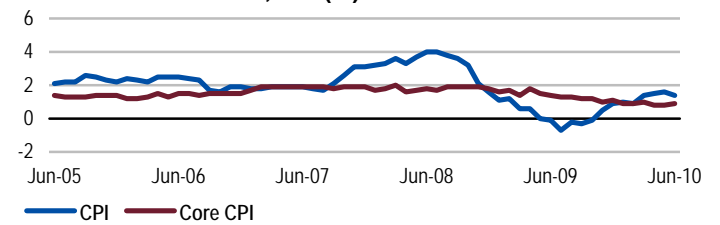
1. Source: © European Communities 2004–2008 Eurostat.
2. Source: Bloomberg. P/E ratios of Dow Jones EURO STOXX 50 Price Index and Nikkei-225 Stock Average as calculated by Bloomberg.
3. Source: European Central Bank.
4. Source: Economic and Social Research Institute, Cabinet Office, Government of Japan.
5. Source: Ministry of Internal Affairs & Communication, Japan.
6. Source: Ministry of Economy, Trade and Industry, Japan.
7. Source: Ministry of Finance, Japan.
8. Source: Bank of Japan.
9. Source: Bloomberg Indices.

Eurozone Real GDP, Y/Y (%)



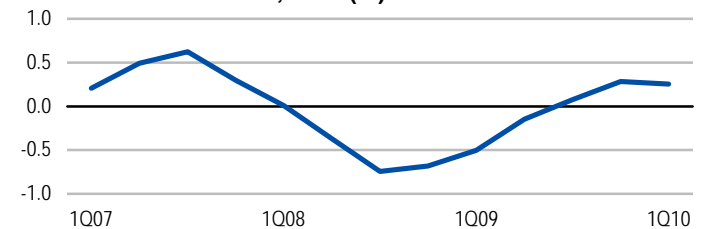
Source: © European Communities 2006–2010 Eurostat, as of March 2010.

Consumer Price Index, Y/Y (%)



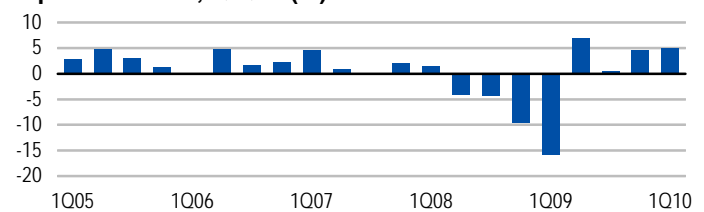
Source: © European Communities 2006–2010 Eurostat, as of June 2010.

External Trade Balance, GDP (%)



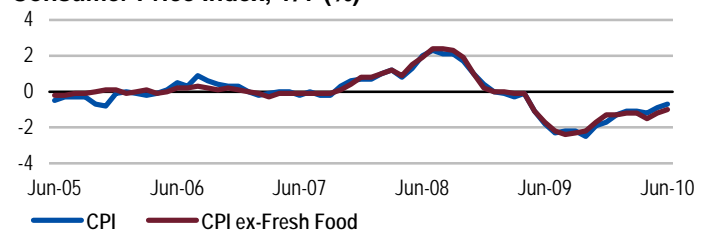
Source: © European Communities 2006–2010 Eurostat, as of March 2010.

Japan Real GDP, Q/Q ar (%)



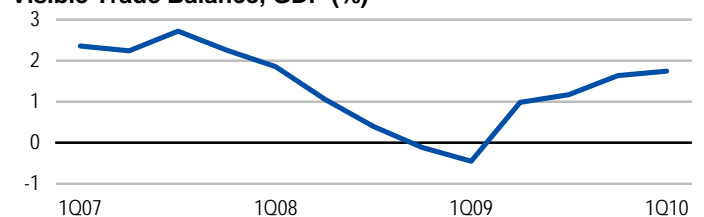
Source: ESRI, Cabinet Office, Govt. of Japan, March 2010.

Consumer Price Index, Y/Y (%)



Source: Ministry of Internal Affairs and Communications, June 2010.

Visible Trade Balance, GDP (%)



Source: Ministry of Finance, Japan and Economic and Social Research Institute, Cabinet Office, Government of Japan, as of March 31, 2010.

U.S. MACROECONOMIC DATA

FINAL OUTPUT

Gross Domestic Product (GDP) ¹	1Q10	2Q10	3Q10E ²	4Q10E ²
Q/Q ar (%)	3.7	2.4	2.7	2.8

ECONOMIC INPUTS

CONSUMPTION/FINAL DEMAND

Income/Savings ¹	MAR 10	APR 10	MAY 10	JUN 10
Consumer Spending, Y/Y (%)	4.0	3.8	3.7	3.1
Personal Income, Y/Y (%)	3.0	2.9	1.5	2.6
Savings Rate, (%)	5.4	6.0	6.3	6.4
Employment	APR 10	MAY 10	JUN 10	JUL 10
Unemployment Rate (%) ³	9.9	9.7	9.5	9.5
Participation Rate (%) ³	65.2	65.0	64.7	64.6
Nonfarm Payrolls (in thousands) ³	313	432	-221	-131
Jobless Claims, 4-wk average (in thousands) ⁴	459	461	467	459

Housing ⁵	MAR 10	APR 10	MAY 10	JUN 10
Existing Home Sales (in millions)	5.36	5.79	5.66	5.37
Y/Y Change (%)	16.3	23.2	19.2	9.8

INVESTMENT

Corporate Earnings ⁶	1Q10	2Q10	3Q10E	4Q10E
Earnings, Y/Y (%)	9.90	28.31	24.60	32.10
Production & Utilization ⁷	MAR 10	APR 10	MAY 10	JUN 10
Industrial Production, Y/Y (%)	4.4	5.5	7.9	8.2
Capacity Utilization (%)	72.8	73.1	74.1	74.1
Nonresidential Fixed Investment ¹	3Q09	4Q09	1Q10	2Q10
Y/Y (%)	-17.8	-12.7	-0.8	5.2

INFLATION & PRODUCTIVITY

Inflation Indicators	MAR 10	APR 10	MAY 10	JUN 10
Personal Consumption Expenditure (PCE), Y/Y (%) ¹	2.5	2.3	2.1	1.4
Core PCE, Y/Y (%) ¹	1.8	1.6	1.5	1.4
Consumer Price Index (CPI), Y/Y (%) ¹	2.3	2.2	2.0	1.1
Core CPI, Y/Y (%) ³	1.1	0.9	0.9	0.9
Producer Price Index (PPI), Y/Y (%) ³	6.0	5.5	5.3	2.8
Core Producer Prices, Y/Y (%) ³	0.9	1.0	1.3	1.1
Productivity ³	2Q09	3Q09	4Q09	1Q10
Productivity, Q/Q ar (%)	7.6	7.8	6.3	2.8
Unit Labor Costs, Q/Q ar (%)	0.1	-7.6	-7.8	-1.3

FINANCIAL MARKETS

Valuation	JUN 10	JUL 10	AUG 10E	SEP 10E
P/E S&P 500 ⁶	13.86	14.68	-	-
Fed Funds Rate ⁸	0-0.25	0-0.25	0.19	0.19

BALANCE OF PAYMENTS

U.S. Monthly Trade Deficit ^{1,9}	FEB 10	MAR 10	APR 10	MAY 10
Billion USD	-40.1	-40.0	-40.3	-42.3
U.S. Current Account Deficit	2Q09	3Q09	4Q09	1Q10
Quarterly (in USD billion) ¹	-84.5	-97.5	-100.9	-109.0
Annualized (% GDP) ¹⁰	-3.6	-3.0	-2.7	-2.7

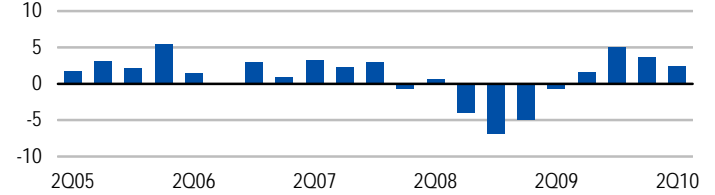
Abbreviations: Q/Q ar: Quarter-over-quarter annualized rate. Y/Y: Year-on-year.

1. Source: Bureau of Economic Analysis.
2. Source: Bloomberg Economic Forecasts.
3. Source: Bureau of Labor Statistics.
4. Source: Department of Labor.
5. Source: Copyright National Association of REALTORS®. Reprinted with permission.
6. Source: Bloomberg. Corporate Earnings and P/E S&P 500 represented by Bloomberg's calculation of the earnings of S&P 500 Index components as of 7/31/10. STANDARD & POOR'S®, S&P® and S&P 500® are registered trademarks of Standard & Poor's Financial Services LLC. Standard & Poor's does not sponsor, endorse, sell or promote any S&P index-based product.
7. Source: Federal Reserve. At the December 16, 2008 meeting, the Federal Reserve cut the main U.S. interest rate to "a target rate" between zero and 0.25.
8. Source: Chicago Board of Trade (30-Day Federal Funds Futures Rate for August and September 2010), as of 7/31/10.
9. Source: U.S. Census Bureau.
10. Source: Bloomberg Indices.



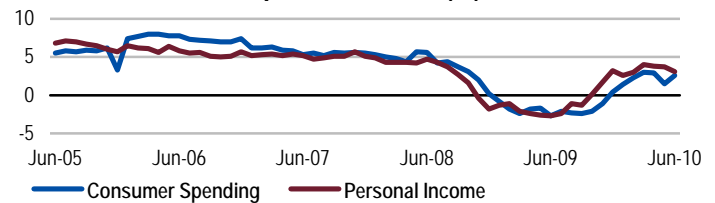
Franklin Templeton Distributors, Inc.
 One Franklin Parkway
 San Mateo, CA 94403-1906
 (800) 223-2141
 franklintempleton.com

Gross Domestic Product (GDP), Q/Q ar (%)



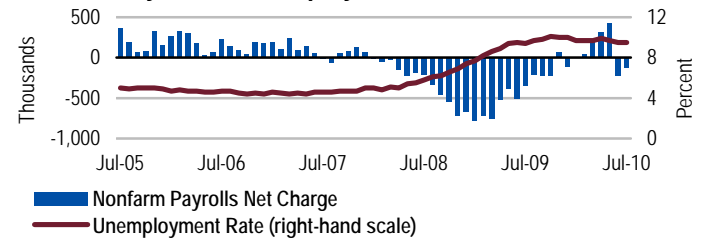
Source: Bureau of Economic Analysis, June 2010.

Personal Income & Expenditures, Y/Y (%)



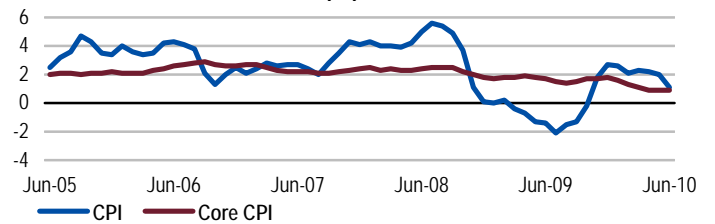
Source: Bureau of Economic Analysis, June 2010.

Nonfarm Payrolls & Unemployment Rate



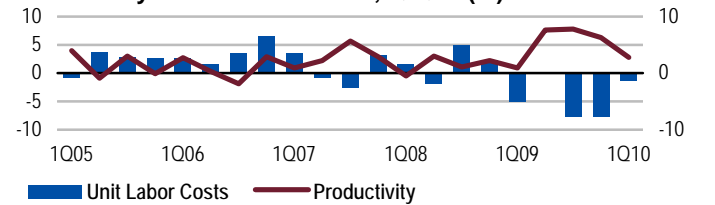
Source: Bureau of Labor Statistics, July 2010. All figures seasonally adjusted.

Consumer Price Index, Y/Y (%)



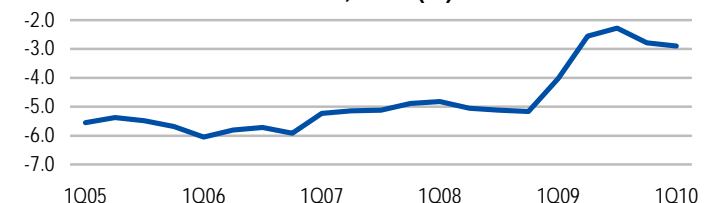
Source: Bureau of Labor Statistics, June 2010.

Productivity & Unit Labor Costs, Q/Q ar (%)



Source: Bureau of Labor Statistics, March 2010.

U.S. Annualized Trade Deficit, GDP (%)



Sources: U.S. Census Bureau and Bureau of Economic Analysis, March 2010.