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Macro Perspectives

A changing inflation and growth climate

Introduction

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In the first half of 2023, investors faced aggressive US Federal Reserve (Fed) monetary policy tightening, consecutive quarters of falling corporate profits, two of the largest bank failures in US history, a near-default by the US federal government, and universal predictions of US and global recessions.

With these issues in mind, I moderated a panel of our leading economists including John Bellows, Portfolio Manager, Western Asset; Sonal Desai, Chief Investment Officer, Franklin Templeton Fixed Income; Michael Hasenstab, Chief Investment Officer, Templeton Global Macro; and Francis Scotland, Director of Global Macro Research, Brandywine Global. The key question I wanted to address: What's in store for investors in the second half of 2023?

Below are my key takeaways from the discussion.

- **Inflation will continue to be an issue for the next 6–12 months.** There are some indicators that point to slowing inflation and the global economy entering a period of disinflation, where the rate of inflation is falling and prices are not increasing as rapidly. Failure of inflation to retreat is a risk, and core price inflation has been sticky, but the lagged effects from tighter monetary policy have yet to be fully felt. There is less risk of deflation, where prices actually fall.

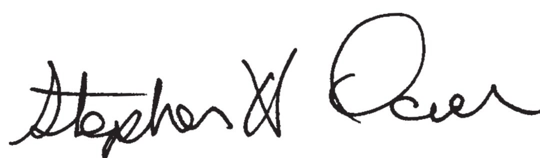
- **While inflation is coming down in many countries, the global economic recovery is uneven.**
  - **China is struggling to find sources of economic growth.** An expected surge in growth did not materialize following post-COVID reopening. The Chinese government is likely to step in with more macroeconomic stimulus.
  - **Supply-chain rebuilding and friend-shoring should contribute to growth opportunities in some countries.** Supply chain rebuilding is leading to increased investment within Asia, particularly in countries like India and Indonesia. Other countries that should benefit include Mexico and Canada.
  - **Japan benefited from recent increases in inflation after struggling with low economic growth for decades.** The current inflation and growth levels created opportunities to deploy corporate cash balances. Japan also benefited from higher female participation in the labor force that prevented a labor shortage, which in turn supported growth.

- **The upcoming economic data will likely provide further evidence of slowing growth and ongoing disinflation in the US.** However, while markets have been anticipating a recession for some time, the strength of the US consumer will likely prevent a massive recession.

- **Where will interest rates settle?** There appears to be a disconnect with how fast rates will drop in the future. The financial market is pricing rate cuts with an expectation that inflation returns to pre-pandemic levels. However, we think the 10 years following the 2008 global financial crisis (GFC) were an aberration, and inflation is likely to revert to pre-GFC levels as the long-term norm (core inflation in the US averaged approximately 4% between 1958 and 2008, and just under 2% from 2009 through 2019.)[1]
- **Real interest rates are expected to continue increasing.** The Fed just approved another interest rate hike and is expected to hold interest rates above 5% for several more quarters. While inflation is expected to slow or decline over this period, the result is real interest rates (nominal rates minus inflation) rising even if nominal rates do not. This creates a more positive return for investors.
- **Where are the opportunities?**
  - **Fixed income investments are resuming status as good portfolio diversifiers.** Unlike 2022, where both fixed income and equities had negative returns together, there is now a low correlation between fixed income investments, equities and other risk assets.
  - **Selectively increasing duration offers an attractive total return.** We see neutral to shorter duration providing better risk/return profiles for the rest of 2023. The current yield levels and the expected peak in interest rates combine for a positive expected total return.

- **High-yield debt is priced attractively as investors remain cautious about the economy.** Current yields are providing active investors with high returns. However, investors need to be selective as some lower-quality corporate credit is susceptible to default risk and we have concerns about credit spreads widening.
- **Emerging markets can provide diversification.** Many emerging markets have demonstrated strength, partially by controlling debt issuance to a greater extent than their developed market counterparts. They also reacted quickly to bring inflation under control, raising rates ahead of the European Central Bank (ECB) and the Fed. With many emerging market bonds enjoying attractive yields, this asset class provides another source of return that is not necessarily synchronized with the rest of the world.

While the investor experience for the last six months was extreme volatility in terms of interest rates and changing opportunities, we believe the Fed will continue to bring inflation more fully under control and might hold rates higher for longer than some expect. Growth opportunities vary around the world, and across sectors and maturities. Fixed income once again has a low correlation with other risk assets, providing potential diversification and increased portfolio protection.



Wild cards: Worries and optimism
Here are some key themes our economists are watching closely.

Monetary policy
The global rate-hike cycle may not yet be over, but if the Fed doesn't engage in rate cuts next year as markets are anticipating, risk assets could be vulnerable. Most of the effects of prior policy tightening have yet to work through the economy.

Inflation
Post-pandemic inflation has been a challenge to the global economy, but it has been on the decline. The question is whether this disinflation will continue—and whether it will even turn to deflation. We think inflation is likely to return to the pre-GFC period.

US dollar and political volatility
The US dollar's long-running bull market looks to be over, which will play into investment opportunities globally going forward.

Slowing economic growth
China is struggling to find sources of growth. If the inverted US Treasury yield curve is right about a possible recession, the United States could be in a similar position going forward.

Expanded viewpoints from the roundtable

Inflation starts to ease

Francis, you've said inflation is your top concern. Given recent data showing a decline in inflation, what do the next six to 12 months look like?

Francis: Inflation has been *numero uno* on the agenda for some time, and I think that will continue for a while. However, I think the economy is heading for a big period of disinflation, and we may even end up with a whiff of deflation at some point next year. To clarify, *disinflation* just means the rate of inflation is falling, or that price levels keep rising but at an ever-slower rate. Disinflation has been the trend for over a year now in the United States—but so far not *deflation*, which is an outright decline in price levels.

It's clear in the recent data that the pandemic-related inflation surge is reversing. The question is just how far is it going to go? This is not just a US issue—it's a global phenomenon. For example, China's Producer Price Index (PPI) was –5.4% year-over-year in June (deflation). The latest (May) PPI reading for the eurozone was negative as well at –1.5% (deflation). Even in places like Brazil, inflation has fallen from a very high level already (disinflation).

I think the next six to 12 months are going to be very important. Our thesis has always been for an economic soft landing, contingent on inflation falling far enough, fast enough, for the Fed to pull back (on its rate-hike cycle) before it overshoots. We are in that window right now.

Historically, US Treasury yield curve inversions have preceded recessions by roughly 12 to 15 months, on average. The current inversion of the two-year and 10-year US Treasury notes is about one year in. Risk assets have rallied mainly because of the downtrend in inflation and the optimism that it will continue and that the Fed will be able to ease. However, I don't think the Fed is on the same wavelength as the market, based on what we've heard from various Fed policy-makers recently. What this implies is that there is a good case for some deflation next year, because monetary policy has a long and variable lag. Inflation has been retreating for a year, yet the Fed didn't change monetary policy in a meaningful way until a year ago as well. In other words, I would argue that most of the recent decline in inflation is tied to the supply side—improving supply chains, reduced oil prices, etc. Most of the effects of Fed tightening have yet to come through the pipeline, which means even lower inflation and that's why I stress how crucial the next six to 12 months are going to be in terms of how this story plays out.

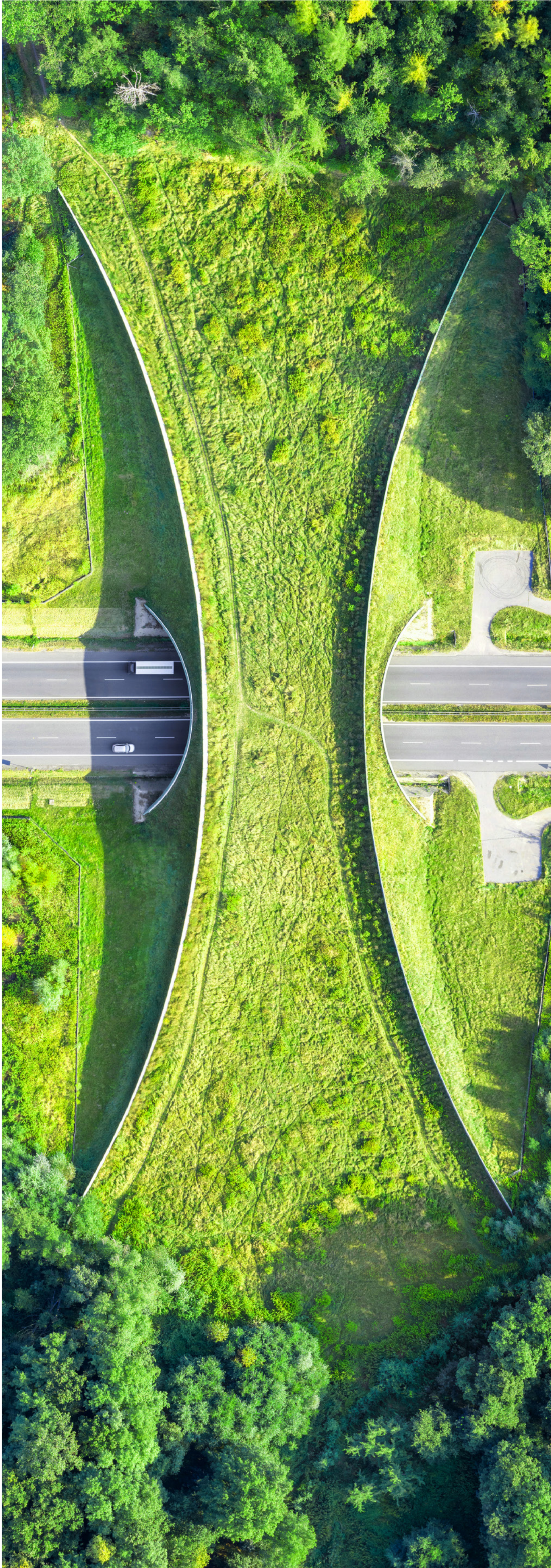
> **"As far as deflation, to me it's a bit of a stretch. The United States didn't get deflation after the GFC, and really the only place globally we've seen sustained deflation is Japan—for a host of reasons."**
>
> Sonal Desai

Let's turn to you, Sonal. What are your views on this disconnect between the Fed and the markets?

Sonal: June US inflation readings were unambiguously good. But I would note a few factors. First, the Atlanta Fed's Wage Growth Tracker shows wages growing at around 6%. Second, we've seen a notable rally in equity markets recently—financial conditions are back to where they were around 400 basis points[2] of Fed rate hikes ago. Financial conditions are looking pretty good. Third, fiscal policy is still pretty easy, and I actually tend to disagree with Francis about the inflationary impulse being all about supply bottle-necks and so on, which of course are working their way out the system.

I do think we are going to see the supply-chain bottlenecks get better; but on the demand side, I think there are still some issues to play out. Inflation is coming down, but I would note it's mainly the headline readings down, which largely reflect base effects. The June core US Consumer Price Index (excluding food and energy) ran at 4.9% seasonally adjusted, which is a good number but still more than double what the Fed would like to see.

As far as deflation, to me it's a bit of a stretch. The United States didn't get deflation after the GFC, and really the only place globally we've seen sustained deflation is Japan—



for a host of reasons. We could see a negative inflation reading for a month or so, but if we are talking about deflation—that is, a sustained decline in prices—to me that's a stretch.

In terms of where I see the 10-year US Treasury yield, I still think it can get to 4.00%–4.25%. But the market is getting ahead of itself right now. Having said that, I think the long end of the yield curve probably has some ways to sell off. Not massive, but the upside in terms of yields is definitely less than it was a few months ago.

Sonal, one of the things you've been writing about recently is the idea that interest rates will go back to pre-GFC levels, versus pre-pandemic levels. Can you talk about that?

Sonal: That's the next big divide I see, because the Fed's medium-term forecasts have the federal funds target rate at 2.5%. The Fed sees this as the new neutral rate, where monetary policy is neither expansionary nor contractionary. However, once annual inflation is back at the 2% target, a 2.5% nominal federal funds target rate implies a real interest rate of only 0.5%—since the real rate equals the nominal interest rate minus inflation. A real rate of 0.5% is extremely low, and it was the norm only in the post-GFC period of quantitative easing and extremely loose monetary policy. The long-term average of the real interest rate, from the 1950s to the GFC, was 2.0% to 2.5%; I believe this long-term average represents a more realistic normal level for the real rate looking forward. We are much more likely to revert to this long-term average than to the levels of the post-GFC period, which was dominated by an exceptionally loose monetary policy. And a real rate of 2.0%–2.5%, with inflation at 2%, would imply a neutral federal funds target rate of 4.0%–4.5%. I think we will see the medium-term forecast for the federal funds target rate start to go up, and ultimately that's what I think pushes 10-year US Treasury yields up a bit more as well.

John, last year the correlation between equity and fixed income was strong—and everything fell. What are your observations on where things stand today?

John: Ten-year US Treasury yields reached as low as 3.25% in March and April, but then bounced around above 4%. I think the thing to emphasize is that this year the US Treasury market is behaving as we would expect in terms of its relationship with risk assets. When US Treasury yields were low, risk-asset prices were low. This reflected investor

concerns about a potential financial crisis. US Treasury yields declined as they usually do when there are worries about growth and risk. On the flip side, US Treasury yields have been high when there is optimism about growth and earnings. That's kind of where things are now, and this is a really important point to emphasize because it's very different from what we saw last year.

Financial assets were positively correlated last year. So, to move from an environment like that to the one we're in now—where correlations are behaving more as traditionally expected, with inverse correlations—means investors are getting some diversification benefits. It's an important change in 2023.

In terms of the prior comments on falling inflation, I think we are basically in agreement with the idea that the most acute phase of inflation is well behind us. Extremely high inflation was such a challenge last year—now lower inflation is a tailwind. Lower inflation improves real earnings, and it bolsters consumer sentiment. It provides the Fed an opportunity to pause its hiking cycle, and I think that's probably good for risk assets.

I would also point out that the bond market is pricing in a scenario that's quite different from the last 10 years. Over the last decade, real bond yields were close to zero. Recently bond yields have risen, however, and now real yields on longer bonds are between 1.5% and 1.75%. The rise in real yields is a significant part of how nominal yields have risen to their current levels, with yields on 10- and 30-year bonds both close to 4%. So, the current level of yields already reflects significantly higher neutral rates than what we had prior to 2020. On the other hand, if we were to return to what we saw prior to 2020, then there's a lot of adjustment that would be needed, and bond yields could move lower.

Michael, can you talk more about inflation outside of the United States? Is inflation being tamed in Asia, Latin America and Europe?

Michael: Even as inflation became a global problem post-pandemic, different regions led and lagged. Europe has been a little problematic in terms of more entrenched inflation. Latin America was the first region to really see inflation surge, but that cycle is now past its peak. As Francis alluded to, annual inflation readings in Brazil were hitting double-digits but have moved back below 4% recently. Different countries have different dynamics, but in general we have seen inflation come down in other regions, too.

"I would highlight one country where a surge in inflation has been a good thing—Japan. For a couple of decades, Japan was stuck in a deflationary spiral and struggled to produce inflation."

Michael Hasenstab

Economic growth in Asia was slower to accelerate than elsewhere because of the region's slower post-COVID reopenings. Consequently, inflation lagged there, but has now reached what appears to be peak rates in many places. A number of Asian central banks—including those of South Korea and India—have put their rate-hiking cycles on pause. Australia's central bank implemented a surprise rate hike in June, so pauses are not necessarily certain, but in general there has been a stabilization in terms of monetary policy response.

I would highlight one country where a surge in inflation has been a good thing—Japan. For a couple of decades, Japan was stuck in a deflationary spiral and struggled to produce inflation. More recently, annual inflation indicators have ranged from around 3% to over 4%, levels that have been unprecedented for years now. There are a couple of important factors leading to that surge. One is a labor shortage. Japan did an excellent job over the last decade in improving female participation in the labor force, which helped prevent a demographic cliff. However, that driver is running out of steam and Japan is now facing some labor shortages. As a result, wage growth has accelerated in the country.

In terms of economic growth, Japan saw a 2.7% annualized growth rate in the first quarter of 2023, and much of that was tied to domestic investment. So, if a country has had no inflation and companies have huge amounts of cash on their balance sheets doing nothing, and inflation suddenly surfaces, there is going to be shareholder pressure for some of that capital to be deployed into domestic investment. To the Templeton Global Macro team, it looks like conditions in Japan, in general, are developing in a positive way. The country is benefiting from a healthy inflation surge. While things can change, on both the economic growth side and the inflation side, the situation is notably different there than what we have seen for a couple of decades.

The most-predicted recession ever: Still in the cards?

We've heard US recession predictions for a long, long time. It hasn't arrived. If anything, there are now some predictions it will not arrive at all. Francis, I think you've talked a bit about a rolling recession. Explain what that is, along with your outlook on economic growth.

Francis: For the last two years, we've been looking at the economic cycle through the lens of normalization instead of typical business cycle analysis. The economic profile to us can be better described as if it were hit by a natural disaster that came in the form of a huge bust caused by the COVID-19 lockdowns and was then followed by some major policy flip-flops over the course of the last two years. Through all of that, the economy has been trying to find its footing and get back to some semblance of whatever the new equilibrium is going to look like. So, in that environment, our idea has been that it would make sense that some sectors of the economy would be expanding while other sectors would be contracting. Looking at it through the lens of normal business cycle analysis could be misleading. When you look at something as simple as the growth rate in personal consumption and the growth rate in personal income, these data series capture what we've been going through—cycling back and forth and in sync for decades and then suddenly going off the rails in different directions for three years—and now realigning.

Our outlook over the past year or so has been for a soft landing, which I would define as below-trend growth or maybe a shallow recession. That outlook was based on the expectation that part of the normalization would include the return of inflation to target and the Fed basically saying, "The job is done, we can now relax, and we can go back to something that's more normal, even if we really don't know what that is."

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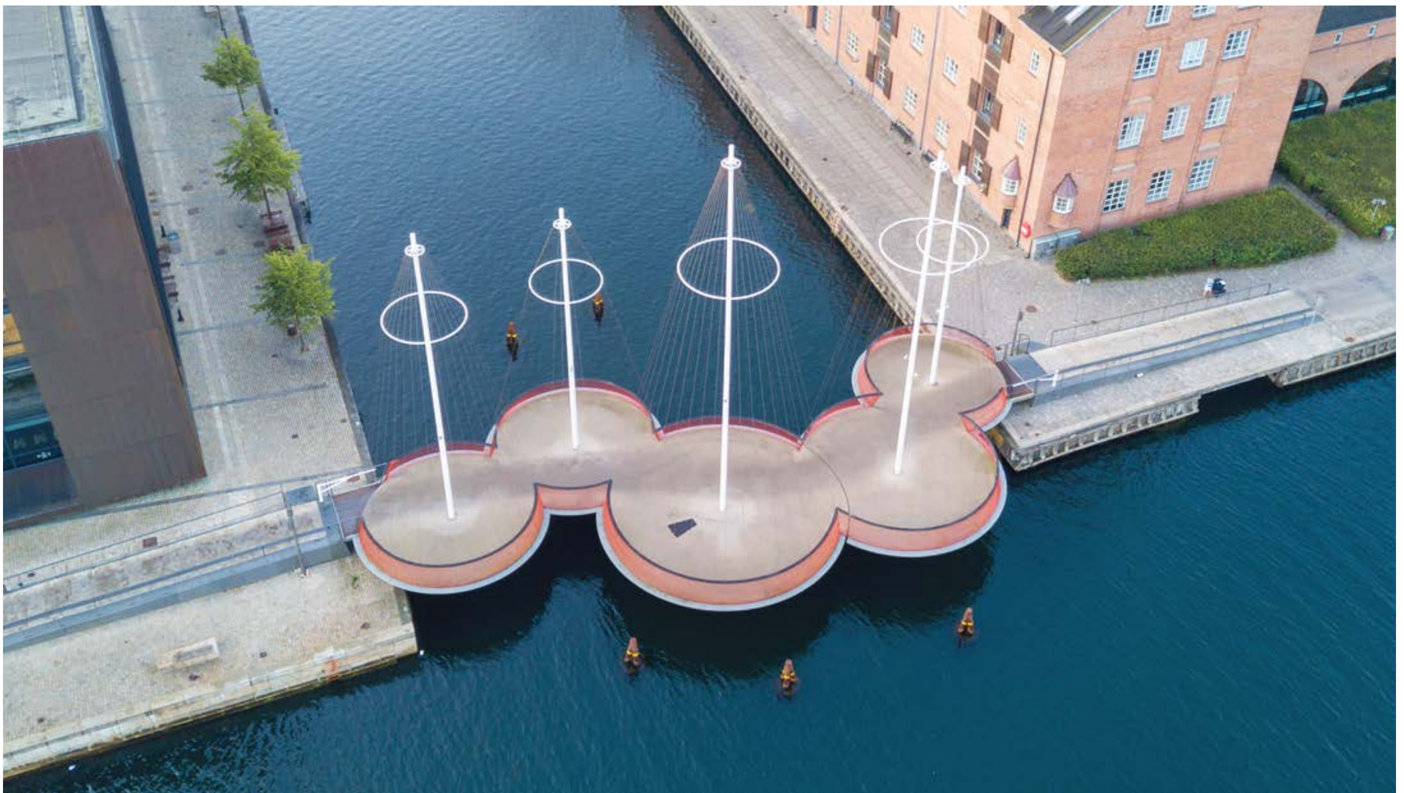
>
> Francis Scotland

Some of the indicators out there imply the Fed is on the tight side of what's "normal." I think the market has generally accepted that the equilibrium real interest rate coming out of this pandemic period is higher than where we started and for the average of the post-GFC period. But a lot of that equilibrium rate is priced in the market. I focus on the yield curve because it's very anomalous. It is the second-most inverted curve in US history. And so, what goes through my head is what must happen for the curve to normalize. The long end of the curve could sell off, 10-year US Treasury note yields could go above 5%, or we have a meaningful decline in yields at the front end. It seems likely that the longer the yield curve is inverted, the more likely there will be a negative consequence. That's why I stress the next six to 12 months are crucial because of this normal lag time between when the curve inverts and when there is some economic fallout.

There are some signs of weakening in the system, but I don't think there's anything that points to a recession with absolute certainty. We've seen a couple of stress events—the UK pension fund industry last year and some US regional bank failures this year. It seems logical to expect the front end of the curve to rally if inflation continues to fall materially and the US economy avoids a recession. This implies significant rate cuts forthcoming from the Fed. So, the rhetorical question is: "How low does inflation have to fall for the Fed to say, 'Game over, we've accomplished our objective and now we can start to retreat'?" There is a lot of monetary and credit data signaling policy is tight; the monetary profile is not at equilibrium and it has to be relaxed at some point in the future. So, what's going to be the catalyst to get the Fed to move?

Sonal, while many pundits have been predicting a recession for quite some time, you have had a different view—that the United States was not likely to see a recession, but if it did fall into one, it would be quite light.

Sonal: Yes, absolutely. Within Franklin Templeton Fixed Income, I think for the better part of two years now we have been saying that a big recession in the United States is not going to happen. I would add one statistic to Francis's numbers in terms of the inversion discussion, and that's the US unemployment rate, which is close to a 50-year low currently. When the Fed is looking at the different statistics, I'd say that the unemployment rate is an important one



for growth. With the Fed owning more than 35% of the market in terms of outstanding US Treasuries, the yield curve shape tells us very little except the market expectations of the Fed's next move. So, I'm not completely convinced that the inverted yield curve in and of itself indicates a recession. And indeed, the yield curve is a part of the reason the market has been screaming for a recession for the last year, but it hasn't arrived. I'm not expecting a US recession, although I have been expecting an economic slowdown for quite a while. Even the slowdown seems to be coming slowly.

I don't think the real economy is going to break. I do think that if the short end of the yield curve needs to come to equilibrium at close to around 4%, then the long end needs to recalibrate a bit.

As investors, we tend to approach some of the riskier fixed income sectors with a bit more caution right now. We do think investment grade credit, for example, is very attractive. We continue to like municipal bonds quite a bit. We also see opportunities selectively in emerging markets because they did not go on a fiscal binge, which developed markets did.

Francis: I think that the only logical basis for expecting a soft landing and no recession is that inflation falls enough to give the Fed an opportunity for reprieve. I think the United States is surrounded by a sea of weak external growth and a disinflationary global environment. It's in that context that I wonder how much longer the Fed continues to sustain interest rates where they are. We know a big chunk of the labor force retired during the pandemic. So, the natural unemployment rate is probably lower than what it was prior to COVID. It could be the equilibrium situation in the United States would be 2% annual inflation, with a 4% unemployment rate.

John: Let me make a quick comment on economic growth and what we've seen year-to-date. Global markets had a solid start to the year. I think that tells us two things. The first is that people were pessimistic—and there were reasons for that. The second thing is that the growth outlook has generally been wrong. Economic growth has held up, and investors have been buying risk assets to reflect that kind of divergence from what had been expected. Where do we go from here? I think there's a good chance the US economy continues to find a way to keep expanding.

Sonal points out the labor markets are still strong. People continue to find employment and get wage increases to some extent. That's going to support economic growth. I think it's probably right to be constructive on the growth outlook going forward, but there are also risks tilted toward slower growth from here.

So, what do you do in a portfolio? People are turning back toward owning some risk assets. In our case, that's been corporate credit, and a little bit in emerging markets as well. I think having that type of diversification is reasonable today.

Coming back to the conversation about real rates and long-term neutrality, I think bond yields are quite high—a 4% yield on 10-year or 30-year US Treasuries is high. So, there's an opportunity to add some diversification to your portfolio to have something that could perform should economic growth weaken from here and, at the same time, offer a pretty attractive yield at least relative to the last 15–20 years.

China's economic growth struggle: Will it spread?

Let's talk more about the global environment. One could argue China is experiencing an economic growth struggle right now. Does that lead to secular stagnation—little to no economic growth despite low unemployment rates and low inflation—more broadly there or anywhere else?

John: There's been some disappointment in China because of high debt loads—and perhaps its growth model is broken. China is headed toward a pretty soggy economic growth, low-inflation backdrop. There's a potential that the United States and even the rest of the developed world could find itself in a similar situation a few years from now.

The COVID-19 shocks are behind us in the United States, and the real policy boost we saw in 2020 and 2021 is also now in the rearview. In China, however, we're seeing high debt loads and challenged demographics, so we are looking for additional sources of growth. I think what we see in China right now corresponds with low growth, low inflation and low bond yields. That's not where the United States is right now, because its economy is still in a robust growth environment. But if we were to look forward, I think it's entirely possible that the United States could be in a similar situation, looking for sources of growth. And if that's true, it probably would be associated with lower bond yields than we have today.

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>
> John Bellows

Secular stagnation means a lot of things to a lot of people. I think about it as a world that's looking for economic growth, and a world where inflation tends to be a little bit lower. Real interest rates and bond yields both tend to be a little bit lower. I think that's playing out in China right now, and it could be a possibility set for the United States a few years from now.

Michael, let's turn to you. What are your thoughts on China's economic growth, and also on opportunities you see given recent trends?

Michael: The economic growth surge that people were anticipating in China didn't materialize to the level of expectations. I think expectations in the market had started to get unrealistic, but also the domestic recovery was probably a little bit lower than one might have anticipated. There have still been some positives with the post-COVID reopening as Chinese tourists have started to travel abroad, and that has beneficial effects on other parts of the region. In my view, there is not a pending collapse of China's economy. Clearly, there is a question about China's growth model—in the long term, will this highly authoritarian and government-led growth model work or not? That's a very open question. But that's different than an immediate collapse, as now the government is able to pull levers such as those that can stabilize the property market and make sure things don't go too far off track. The story is not just about China—it's also about the rest of the region, which I think is functioning on all cylinders.

One thing we are looking at is "friend-shoring"—this includes the reshoring adjustment of supply chains out of places like China toward more strategic allies. I think at the margin this is going to be a longer-term positive for a number of countries from Japan to India, to Indonesia, to Mexico, to Canada and even the United States. The change in supply chains is a long-term adjustment; we are probably not going to see it in the immediate data, but we are starting to see anecdotal announcements of new capital and new investments going to countries like India, Indonesia and Japan that

have attractive foreign direct investment opportunities. These countries could be big beneficiaries of the reshoring trend over the medium term.

We've talked about changing dynamics in Japan, which has been largely off the radar of many investors. There has been a lot of disappointment there, but if we think about changing investment and consumption behaviors because of inflation, I think Japan could look very different. There is a lot of potential there. It's within the US security umbrella, and many perceive it as a safe place to put investment when there's uncertainty around Taiwan and China. There is also significant technical ingenuity in terms of robotics. So, I do think Japan is worth looking at.

But generally, emerging markets really showed their resolve and their strength during the COVID-19 pandemic. There wasn't a debt binge, and policies were generally quite responsible in terms of tightening when necessary to bring inflation under control. Many emerging markets are getting some basic things right that some developed countries are not. Emerging markets, having proved their resolve, now will likely benefit from not having a debt overhang. By contrast, the US debt-to-gross domestic product ratio has surged. It was high before COVID-19 and then went even higher. I think we must be careful though, looking country by country within emerging markets. Certainly, there is political volatility in emerging markets and, consequently, there are higher yields that we think, in many cases, compensate for the potential risks. But I think relative economic growth rates and the evidence of good policy in the face of a once-in-a-100-year shock should give us some encouragement. Asia has a lot of these opportunities. Latin America has some as well. They're quite different and, again, each country requires careful scrutiny. But in general, emerging markets can offer diversification.

The International Monetary Fund has forecast emerging Asian growth at 5.3% for 2023, with world growth at 3.0%.[3] So we expect that relative growth differential to start being attractive. That's not to say there aren't still great opportunities in the United States, but I think they will be a little bit more constrained. I think the rest of the world, particularly in Asia and parts of Latin America, could be a big beneficiary of investment flows going forward, because a lot of US capital just stayed within the United States and it may start flowing out for better returns elsewhere.

US dollar: Is the bull run over?

Michael, that leads to another big question I've been getting. What is your view of the US dollar and where it's going?

Michael: Our view is that the US dollar probably has peaked against other currencies. We think structural and cyclical factors will not generally be supportive of the same magnitude of dollar strength that we've seen over the last decade. Cyclically, amid the slowdown in inflation and the slowdown in economic growth, we are getting close to the terminal rate in the federal funds target rate. Whether the Fed may still implement another hike from here is not that material—we know that the cycle is near the end. While you can't draw too much from one day, the release of the June Consumer Price Index report on July 12 was a great example—bond yields retreated, and the US dollar fell sharply. I think that's a type of behavior that could be repeated.

Structurally, the problems of massive US debt levels and large current account imbalances are well-known, and those are likely to come home to roost in terms of lower economic growth. And when you look at relative growth and debt levels, Asia just looks much more attractive compared to the United States or Europe. While there is no certainty in anything and currencies tend to be volatile, we currently see the US dollar likely to continue to decline against other currencies, and as investors, we are positioning for a weaker dollar.

That supports our thesis of being quite positive on fixed income—but also equity—outside of the United States. So, do you think the US dollar is at risk of losing its reserve currency status?

Michael: No, not in the short term. At the margin other currencies try to compete, but the US dollar is still the largest reserve currency. However, the US dollar can both maintain its reserve status and fluctuate in valuation. Arguably, the US dollar's role as a reserve currency back in the early 2000s was possibly stronger than it is today, and yet the dollar depreciated. So, I think it's important to separate reserve status from valuation adjustments—it can still be a reserve currency with valuation adjustments if the flow of funds begins to shift.

Sonal: I would reiterate what Michael said—reserve currency doesn't mean a fixed exchange rate. There will be extended periods of strength and weakness, and the US dollar is probably heading toward a period of weakness. To get to reserve currency status, it's not enough to just look at the balance of trade in the goods and services account. You have to look at the capital account. Whenever you think about any country that is trying to launch a reserve currency, there are two things to consider: a) it's not up to the country, it's up to the rest of the world; and b) everyone needs to be able to invest that currency somewhere. I think this is the big flaw in the argument that China is going to be the next holder of the world's reserve currency. Eventually, I think it will, but it needs to open up its capital markets because one can't do anything with the Chinese renminbi except trade with other people who use Chinese renminbi.

Endnotes

1. Source: US Bureau of Labor Statistics (BLS), analysis by Franklin Templeton Institute.
2. A basis point is one one-hundredth of one percentage point (1/100% or 0.01%).
3. Source: International Monetary Fund, as of July 2023. There is no assurance any estimate, forecast or projection will be realized.

About Macro Perspectives

Macro Perspectives allows the Franklin Templeton Institute to feature economists from across the firm dissecting key macroeconomic themes driving markets. The mission of the Institute is to deliver research-driven insights, expert views and industry-leading events for clients and investors globally through the diverse expertise of our autonomous investment groups, select academic partners and our unique global footprint.

Two related Institute publications of note are Allocation Views, produced by Franklin Templeton Investment Solutions, which offers our best thinking on multi-asset portfolio construction, and Global Investment Outlook, from our Institute's strategists, which highlights managers' views on markets across the firm.

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Templeton Global Macro

WHAT ARE THE RISKS?
All investments involve risks, including possible loss of principal.

Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls.

Equity securities are subject to price fluctuation and possible loss of principal.

Special risks are associated with investing in **foreign securities**, including risks associated with political and economic developments, trading practices, availability of information, limited markets and currency exchange rate fluctuations and policies; investments in emerging markets involve heightened risks related to the same factors. Sovereign debt securities are subject to various risks in addition to those relating to debt securities and foreign securities generally, including, but not limited to, the risk that a governmental entity may be unwilling or unable to pay interest and repay principal on its sovereign debt. To the extent a strategy focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a strategy that invests in a wider variety of countries, regions, industries, sectors or investments. **China** may be subject to considerable degrees of economic, political and social instability. Investments in securities of Chinese issuers involve risks that are specific to China, including certain legal, regulatory, political and economic risks.

Active management does not ensure gains or protect against market declines.

Notes

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