



Perhaps too soon to exit risk assets just yet

- POTENTIAL IN EQUITIES
- EQUITIES VERSUS FIXED INCOME
- REAL ESTATE, COMMODITIES
- ALLOCATION DECISIONS



BRENT SMITH, CFA
Senior Vice President,
Portfolio Manager and CIO,
Franklin Templeton Managed
Investment Solutions



PAUL VAILLANCOURT, CFA
Senior Vice President,
Portfolio Manager and
Director of Portfolio Strategy,
Franklin Templeton Managed
Investment Solutions

STILL POTENTIAL IN EQUITIES

The world economy continues to heal, with an impressive upturn in developed markets. Indexes of manufacturing and services activity suggest that the developed world may be emerging from recession. World trade, while not back to pre-crisis levels, has been improving steadily. While we do not anticipate a double-dip recession in the west, we believe that a 'v'-shaped economic recovery is also unlikely.

A wide variety of risk assets have rebounded since lows reached in the first quarter of this year. However, we believe that we may have seen the easy part of this market recovery and that the uptrend in prices will moderate in the months ahead. The market revival is due to an apparent disappearance of the deflation risk premium and tentative signs of global recovery. But the revival is also in part due to technical support and a huge increase in liquidity from loose fiscal and monetary policies. The likely removal of various kinds of support for markets in the months ahead urges us toward caution.

But it may be too soon to exit risk assets just yet. Thanks to stimulus packages, liquidity remains high, and much of it is being poured into risk assets. With the markets' focus shifting to company earnings, equities, for example, may still offer further potential in the coming months. The inevitable rise in price/earnings ratios does not necessarily indicate that stocks are close to being overvalued, although they may be overbought. The upward spike in price/earnings ratios can be easily rectified in the coming quarters with decent

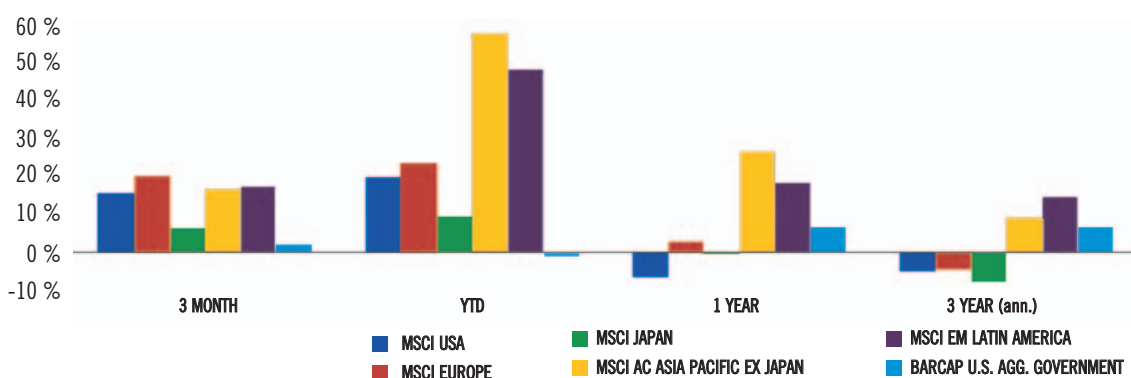
corporate earnings. But before we can genuinely declare a 'bull market,' we will need to see evidence of sustainable earnings growth from companies even as developed nations try to regain control of their finances by reining in fiscal and monetary stimulus.

At the same time, asset prices in emerging markets are being underpinned by (re-) accelerating growth. Stimulus efforts—most significantly in China—have been financed by domestic savings, not by borrowings from abroad. While retail sales and consumer confidence indexes have been rising again in many leading economies, retail sales never actually dipped significantly in China.

With U.S. consumers busy rebuilding balance sheets, we believe a recovery is more likely to be led by domestic demand in countries such as China, Brazil and India than by consumers in the U.S. Growth in emerging countries is not just due to trade, but also due to big rises in fixed capital and household consumption. In China, for example, fixed capital formation and household consumption represent three-quarters of GDP. With recovery in the U.S. likely to be sluggish and the U.S. dollar in the doldrums, fast-growing domestic demand is likely to play an increasing role in China's economic development.

The rising clout of developing countries is plain to see. In 1999, China accounted for 3.7% of world GDP. Ten years later, it accounts for 7.6%, according to figures compiled by FactSet. India and Brazil's share of the world economy, while still modest, has also been growing. In addition,

Chart 1: Index Returns to September 30, 2009 (in U.S. dollars)



Source: Franklin Templeton Investments, October 2009

we believe that a number of long-term factors such as economic and market reform, globalization and urbanization continue to favor emerging markets. Thus, with western countries facing difficult choices between higher taxes, inflation and/or currency depreciation as ways to bring down their much-expanded debt burdens, we could see a substantial bifurcation in growth between developed and emerging markets.

EQUITIES VERSUS FIXED INCOME

For all our caution, we are still of the view that stocks may continue to outperform bonds—at least until policymakers start to remove stimulus measures. Early cyclicals, particularly financials, have performed well with the rebound in equity prices since March. The MSCI All Country World Index rebounded by 53% (in U.S. dollar terms) between its low point in early March and the end of September. But financials gained 103% over the same period. However, as economic recovery gains hold, such a trend could change. Forward estimates of earnings per share growth in information technology, materials and Asian consumer discretionary stocks all suggest that it may be time to shift increasing attention to more 'mid-cyclical' sectors.

In credit markets, we have seen a sharp decline in high-yield spreads over government bonds. Yields demanded of high-yield and investment-grade corporate bonds have fallen since early 2009, while yields on government bonds throughout the developed world have risen gently at most. In the long term, it is conceivable that the glut of new government bond issuance would lead investors to seek higher risk-adjusted premiums for holding government paper. But for the moment, we believe that government bond yields will likely remain range bound and highly correlated—at least until we see signs of inflation seeping into economies.

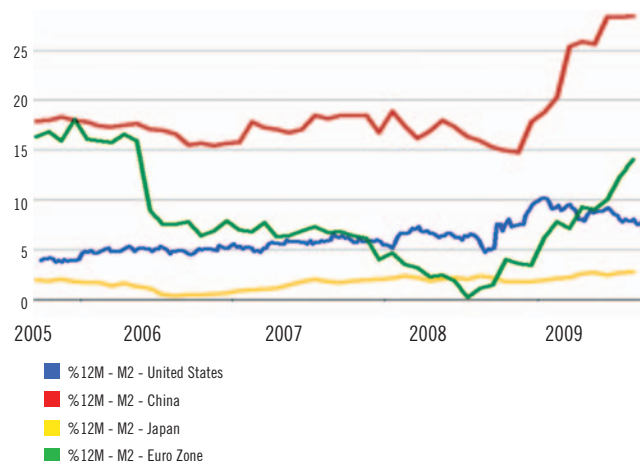
We think that deflation remains the bigger threat in the developed world. It is true that some countries, most notably Australia, have started to raise rates again, but the American and European economies still have to contend with massive excess capacity, a negative output gap, household and corporate deleveraging, falling house prices and rising unemployment. By contrast, inflation could again become an issue in some fast-developing countries where food and fuel constitute a larger percentage of total spending.

REAL ESTATE, COMMODITIES

There are some signs that a bottom has been formed in the U.S. housing market. According to the S&P/Case Shiller Index, there have been several consecutive months of home price rises. Construction of single-family homes has also been rising. But a number of headwinds remain in place. With mortgage defaults running at 5-6 million homes, there is a risk that foreclosures will continue to rise. The overhang of existing homes for sale is still exceptionally high—equivalent to over nine months of housing supply. Exposure to the fragile commercial real estate sector could also hurt a number of second-tier banks.

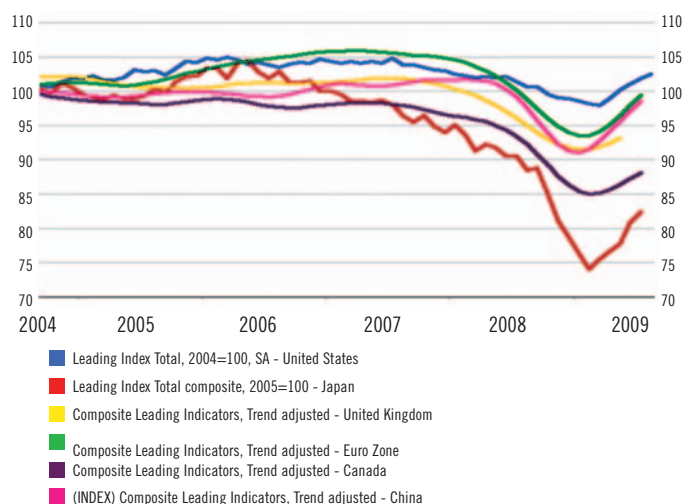
We remain generally positive on commodities and the currencies of commodity-producing countries. Continuing signs of economic

Chart 2: 12-month changes in money supply



Source: FactSet, data to end September 2009

Chart 3: Leading economic indicators



Source: FactSet, data to end September 2009

Chart 3: The rise of emerging markets

Country	Market Value (Billions USD)	% of Total GDP 2009	% of Total GDP 1999
United States	10,929.1	28.7%	30.3%
Japan	4,433.6	11.7%	14.0%
China	2,904.7	7.6%	3.7%
Germany	2,414.6	6.3%	7.5%
France	1,764.4	4.6%	5.1%
United Kingdom	1,746.4	4.6%	4.9%
Italy	1,289.4	3.4%	3.7%
Brazil	1,148.6	3.0%	2.8%
Canada	865.7	2.3%	2.3%
India	814.3	2.1%	1.4%
Spain	812.2	2.1%	2.1%
South Korea	786.6	2.1%	1.7%
Russia	742.8	2.0%	1.3%
OTHER	7,404.0	19.5%	19.2%
TOTAL	38,056.4	100.0%	100.0%

Source: FactSet, data to end September 2009

stabilization, demand from China and the speculation associated with abundant liquidity are all lifting commodity prices. While valuations have been moving higher, we think the correlation of commodities with economic recovery should matter just as much for investors.

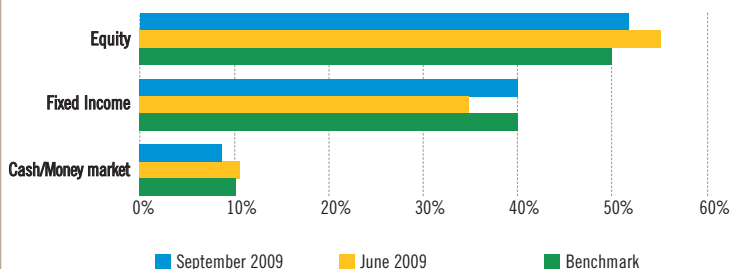
ALLOCATION DECISIONS

The FTMIS portfolios have done well based on our decision to remain invested in risk assets over the seven-month market rebound. Based on our ongoing tactical assessment, the portion of FTMIS assets invested in equity products rose somewhat over the third quarter, although we have decided to book profits from some equity investments in recent weeks. We are overweighted in Canada, Latin America and Asia outside Japan, but underweighted in the U.S., Europe, the UK and Japan. We believe the big boom seen in financial stocks in recent months will be tough to maintain and have instead begun to focus on 'mid-cyclical' sectors such as materials, IT, and emerging market consumer discretionary, which seem likely to perform well before recovery reaches a peak. For the moment, we believe any occasional dips in price offer good tactical opportunities to increase equity exposure.

Meanwhile, the fixed income portion of the portfolio is positioned quite aggressively. While we are underweighted in U.S. Treasuries, a large portion of portfolio assets are invested in non-government bonds outside North America and in spread sectors, including high-yield bonds. At the same time, while high-yield has provided some of the best returns of any asset class this year, we are conscious that this relative outperformance is destined to fade eventually.

Although we believe economic and monetary dynamics are such that the U.S. dollar may stabilize against the euro and the Japanese yen in the months ahead, we believe that currencies of fast-growing developing and resource-producing countries should continue to strengthen against the U.S. dollar.

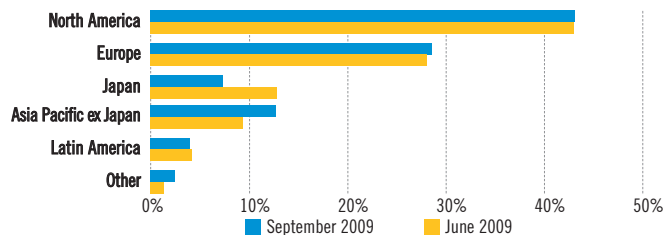
Chart 5: FTSAF Franklin Templeton Strategic Balanced Fund (USD), asset mix



- Reduced equity exposure in early September, still overweight
- More neutral stance in bonds during September
- But prefer corporate and high yield bonds over government bonds

Source: Franklin Templeton Investments. Data as of September 30, 2009.

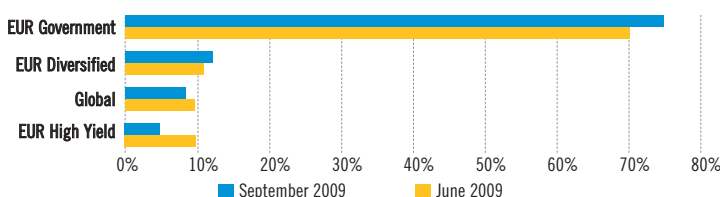
Chart 6: Regional allocations for equity part of FTSAF Franklin Templeton Strategic Balanced Bond (Euro)



- Expanded Asia/Pacific ex Japan further during the quarter
- No changes in North America and Europe

Source: Morningstar, Franklin Templeton Investments. Data as of September 30, 2009

Chart 7: Asset allocations for fixed-income part of FTSAF Franklin Templeton Strategic Balanced Fund (Euro)



- Still underweight in EUR government bonds – despite increased position in September
- Added new quant. managed EUR government bond fund at expense of more passive mandate
- Took profits in EUR High Yield

Source: Morningstar, Franklin Templeton Investments. Data as of September 30, 2009.

FTMIS portfolio strategy in light of macro factors

Asset Mix:

- 37% fixed income and 63% equities (vs. 40% fixed income / 60% equity benchmark)

Equities:

- Overweight Canada, Latin America and Emerging Asia
- Underweight U.S., Europe, the UK and Japan

Fixed Income:

- Bias towards the spread sectors:
 - Overweight corporate
 - Overweight high yield
 - Underweight government

Sectors:

- A transition to mid cyclical such as materials, technology and consumer discretionary from early cyclical

Currencies:

- Generally positive on natural resource and emerging market currencies both in the short term and the long term
- The US dollar will likely stabilize versus the yen and the euro

Real Assets:

- Commodities – Overweight precious and base metals as well as energy, neutral agriculture
- Real Estate – Underweight commercial real estate

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