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Several key economic indicators reported recently imply that the global economy may be beginning to emerge from one of the deepest and longest recessions since World War II. As a result of exceptional measures taken by governments and monetary authorities, financial conditions in many countries and industries have improved, and recent data suggest that economic activity is picking up by varying degrees. However, the massive monetary and fiscal stimulus introduced in many developed and emerging economies have raised the risks of inflation over the medium term. Investors are becoming increasingly concerned that when global economy recovery occurs, the liquidity injected into the financial system as well as the unprecedented expansion of fiscal deficits may eventually lead to difficult-to-control inflationary pressures, particularly if policymakers fail to unwind their very accommodative monetary policy in a timely fashion. Yet despite this possibility, the fragility of financial markets and global economy most likely may forestall most central banks from enacting any significant monetary tightening in the near term. We believe that the result of such possible actions (or inactions as the case may be) could lead to increased inflationary pressure over the medium term. Under such circumstances, we believe that the Global Bond strategy could potentially capitalise on rising inflation in one or more of the following ways, which could be implemented at our discretion based on market and economic conditions and subject to specific client investment guidelines:

- 1) **Duration exposure:** By typically avoiding holding any U.S. Treasuries, and possibly adding net negative duration exposure through swaps, options, or futures.
- 2) **Currency positioning:** By adding exposure to the currencies of commodity exporters and positioning the portfolio to potentially benefit from changing interest rate differentials and subsequent capital flows. Additionally, by gaining exposure to currencies that will likely be allowed to appreciate in order to counter inflationary pressure.
- 3) **Credit exposure:** By increasing sovereign credit exposure to countries whose terms of trade and fiscal revenues should benefit from higher commodity prices. Furthermore, where applicable, by increasing corporate credit exposure to firms with the ability to pass on higher prices.

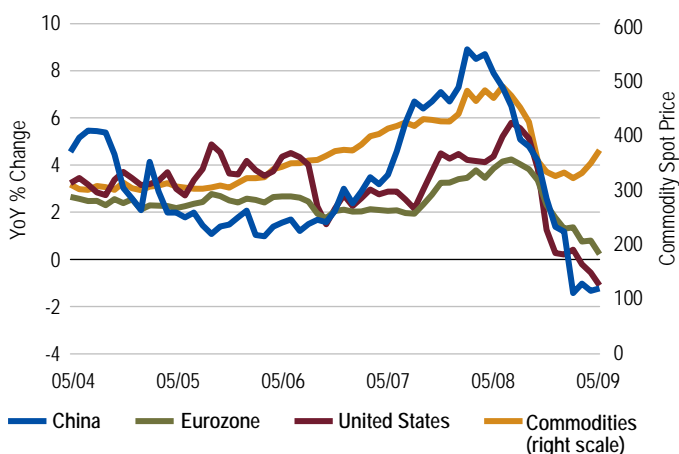
In this discussion paper, we examine inflation risk factors, policy responses and describe the extensive opportunity set for seeking to capitalise on inflationary pressure, which goes beyond traditional inflation-protected investments. The Franklin Templeton Global Bond team has the flexibility to employ various investment methodologies as it seeks to gain from a rising inflationary environment.

INFLATIONARY PRESSURE LIKELY TO REMAIN CONTAINED NEAR TERM

As a result of the financial crisis and decline in oil and commodity prices, inflation rates in many developed and emerging economies have declined markedly and have even dropped into negative territory since the global inflation peak in July 2008.

Chart 1: Consumer Price Indexes

Non-Seasonally Adjusted; Period ended May 2009



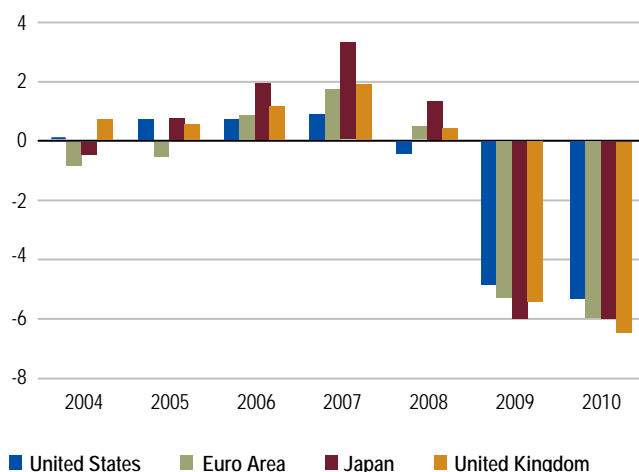
Source: EcoWin, Eurostat, FactSet.

Commodities represented by the Commodity Research Bureau/Reuters U.S. Spot All.

As evidenced by the data provided in Chart 1, inflation appears to be on a downward trend worldwide. Weakness in labour markets and a significant fall in asset prices (equity and housing prices) have produced a negative wealth effect, depressing demand. The collapse in global economic activity has significantly slowed the velocity of money. Additionally, the massive amounts of liquidity injected into the global financial system within the past year has so far been amassed by banks in an effort to repair their balance sheets and build reserves amid restrictive lending practices. Given these factors, the rapid and massive monetary and quantitative easing in major developed economies has not yet been inflationary. Moreover, we believe the presence of excess capacity, sluggish domestic demand and a high unemployment rate are likely to keep inflationary risks on hold in the near term. Major economies are experiencing negative output gaps (the difference between actual and potential long-term production i.e., the over- or underutilisation of a country's economy), which we expect should have a dampening effect on prices.

Chart 2: Output Gaps (%)

Deviations of Actual GDP from Potential GDP as a Percent of Potential GDP



Source: OECD Economic Outlook 85 database.

AMID INFLATIONARY PRESSURES, INVESTMENT OPPORTUNITIES EXIST VIA POLICY RESPONSES

If inflationary pressure builds, we believe investment opportunities can be created that take advantage of policy responses enacted by central banks and governments globally. Over the medium term, there is the potential risk that if the money supply grows disproportionately to the real economy and banks start to lend the large amounts of newly created money, this could result in higher inflation. To encourage price stability and counteract inflation, policymakers may implement different measures, which may create opportunities in interest rate, currency, and credit markets.

Interest rates: In an inflationary environment, the most common response for those central banks with the mandate to target inflation is to raise interest rates. In anticipation of this, the Global Bond strategy may reduce or eliminate duration exposure in countries where higher government bond yields are likely to materialise. We have already reduced several of our duration positions where interest rates have fallen to historical lows to reflect the very weak economy.

Additionally, through derivative instruments such as being a payer of an interest rate swap (a fixed-for-floating rate swap), we could add negative duration exposure and gain from rising interest rates. Similar positioning could also be achieved through the purchase of options or futures.

Currency positioning: Some currencies are likely to benefit from inflation even if rising commodity prices pose a global inflationary threat. Rising hard commodity and energy prices offer support to natural resource-rich economies through improved terms of trade, benefiting their currencies at the expense of the currencies of commodity importers. Therefore, when higher inflation is anticipated, exposure to currencies such as the Australian dollar, Brazilian real or Norwegian krone may be added.

Another potential investment opportunity for the Global Bond strategy is exposure to currencies that are used as a tool of monetary policy. Currency appreciation helps reduce the effect of imported inflation. At a time when global growth is slowing and prices are rising, a strengthening currency can help protect consumers by boosting their purchasing power. Further, government intervention to fight currency appreciation is often itself inflationary given that full sterilisation of inflows is difficult without fully developed capital markets. Less intervention can ease one of the causes of inflationary pressure, and often accompanies an appreciation of the currency. Also, currency appreciation is a way for countries to combat inflation without having to raise interest rates during a tentative economic recovery. Therefore, we believe adding exposure to currencies that are used as monetary tools may be of benefit in an inflationary environment.

Credit: We believe that sovereign credit exposure to commodity-producing countries such as Russia or Argentina have the potential to perform well in an inflationary environment, as rising commodity prices lead to better fiscal revenues and hard currency inflows. Furthermore, in commodity-rich countries, high commodity prices help to spur domestic investment and, consequently, economic growth. In addition to sovereign credit, we believe that select corporate credits are in a position to potentially benefit from higher inflation. Spread products generally provide some cushion from rising rates as spreads tend to compress with the initial rise in Treasuries. This is partly due to an improved growth outlook often leading to both high interest rates and lower spreads; however, even in a purely inflationary environment, we believe that corporate credit may potentially perform well. The upside of credit investment is the higher yield available and the potential for spread tightening as the financial market's view of credit quality improves. In an inflationary environment, credit qualities often improve and spreads tighten as companies increase their prices to restore their profits. The guidelines of our Franklin Templeton Global Multisector Plus strategy permits corporate credit investment; thus, by adding the corporate bonds we can offset some of the interest rate risk and generate extra income.

GOING BEYOND INFLATION-LINKED BONDS

While Treasury Inflation-Protected Securities (TIPS) are a popular way for bond holders to protect against inflation, the tradeoff is that TIPS still decrease in value, albeit to a lesser extent than other government issues of similar maturity, in a rising rates environment. TIPS are designed to provide a hedge against inflation risk, and provide a "real" rate of return over inflation. However, just as Treasuries lose value as nominal interest rates increase, the value of TIPS decreases if real rates increase. Further, TIPS generally have lower yields than comparable Treasuries since Treasury yields contain some premium to compensate investors for inflation risk over the life of the bond. Additionally, when inflation expectations are rising, demand for TIPS is generally high, pushing up the price of the bonds and reducing "real" yields. In other words, under these circumstances, the bonds would hardly be making any money for investors above the rate of inflation. For a conservative U.S. dollar-based investor seeking to preserve capital against inflation and have minimal credit risk, a TIPS portfolio may be the right approach; however, for an investor seeking higher returns through opportunistic global bond investing, a global bond strategy may be a more optimal choice.

SUMMARY

The threat of inflation could play an increasing role in currency and interest rate markets in the medium term. Currently, it is unclear whether central banks will be able to successfully fight inflation and withdraw excess liquidity from the financial system in a timely manner, without sacrificing the fragile recovery. Given this dilemma, the risk of increased inflationary pressure over the medium term is significant, and fixed income investors need to be flexible in order to avoid potential negative effects. We believe that the Global Bond strategy has the flexibility to react to the risk of increased inflationary pressures and thereby can provide the potential to not only efficiently weather but potentially benefit from rising inflation by capitalising on currency re-alignments, changing credit fundamentals, and interest rate differentials.

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