



2013 Market Review and 2014 Investment Perspective



2013 MARKET REVIEW

In 2013, the global economy grew at its fastest pace in nearly three years, signaling steady if unspectacular expansion of roughly 3% annualized, according to estimates by the International Monetary Fund (IMF).¹ Aided by global manufacturing activity, global growth accelerated markedly in the latter half of the year after nearly stalling in early 2013. Services sector growth also picked up alongside an upturn in global trade flows, with global export business quickening to its strongest pace since early 2011.

Across Major Regions, Global Expansion Appears to Broaden as Year Progresses

One of the most prominent influences on global economic and market activity during the year was the United States, which was on the mend economically. The country's economy, which expanded at an annualized rate of 4.1% in the third quarter, was supported by a strengthening housing recovery and rising consumer and business spending that helped offset the drag resulting from a wave of new government spending cuts. In the second half of 2013, US corporate profits collectively reached all-time

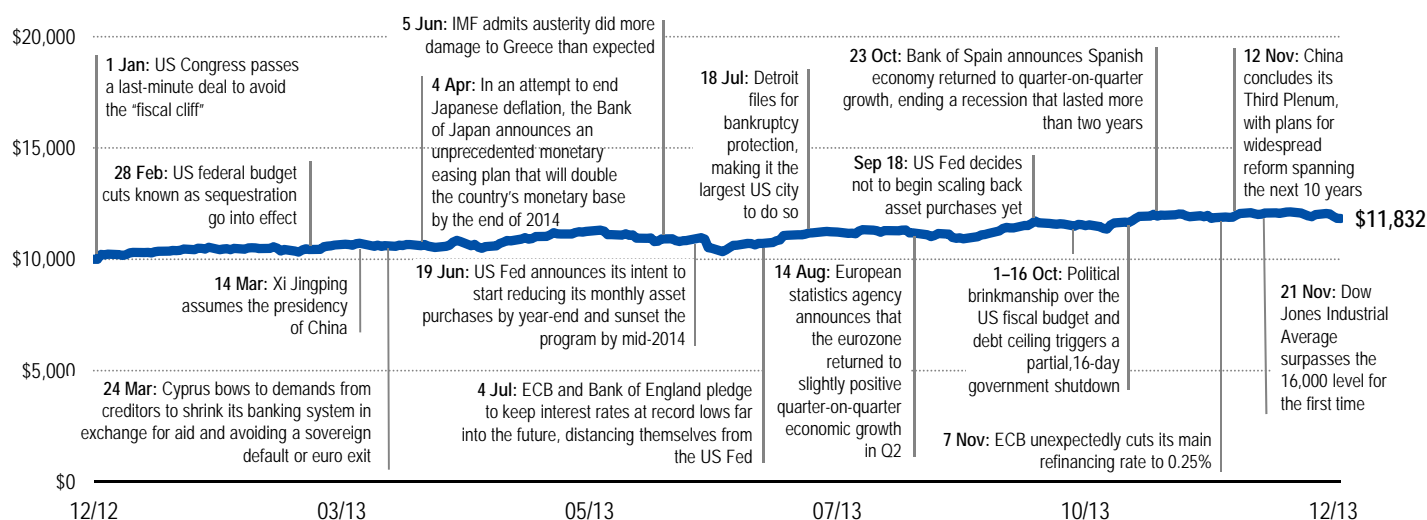
highs, buoying financial markets across the world. The profit success of many US corporations stemmed in part from layoffs and other deep cost-cutting measures undertaken in the 2008–2009 recession, and relatively incremental domestic hiring since. US companies have also generally reaped the benefits of the US Federal Reserve's (Fed's) low interest rates by refinancing debt. Fed policy developments and related speculation, however, were highly influential in 2013's market environment, as investors sought to determine if the central bank would continue its efforts to support the US economy through its latest asset purchase program, which has been providing liquidity to the global financial system since September 2012. Additionally, a brief partial shutdown of the federal government in October took a toll on sentiment, presaging possible difficulties for US equities when another debt ceiling deadline occurs in early 2014.

Importantly for the global economy, the 17-nation eurozone economy expanded slightly in the second and third quarters, ending the longest recession since the single-currency union started 14 years ago, and eurozone manufacturing reignited after having fallen for two years.

Global Equities and Major Events of 2013

Growth of a US\$10,000 Investment in the MSCI All Country World Index

31 December 2012–13 December 2013



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However, unemployment continued to be a key challenge, and third-quarter economic indicators showed the region's recovery came close to a standstill. The eurozone also weathered several serious setbacks that included a messy and largely inconclusive Italian general election, a bailout of Cyprus and a political crisis in Portugal.

In Japan, "Abenomics," or the massive fiscal stimulus and monetary easing campaign introduced by Prime Minister Shinzo Abe, spent much of 2013 steadily trickling through to the Japanese corporate sector. Japanese corporate earnings and share prices generally benefited from the aggressive monetary and fiscal policies and the downward pressure they placed on the yen. However, observers still waited for wide-ranging structural reform—the so-called "third arrow" of Abenomics—to arrive in full. The first signs of it came as the government announced a rise in the sales tax starting in 2014 (the first increase in 17 years) to fund cuts in the corporate tax burden. Reforms of the Japanese labor market and other aspects of the country's economy were pending at year-end.

Among emerging economies, commodity-exporting countries were initially hit by falling raw materials prices and softness in the Chinese economy, which is highly dependent upon commodity inputs to its industrial complex. China's economy decelerated from rates achieved in recent years in response to policies implemented in 2010 and 2011, along with an ongoing transition from export- and infrastructure-led growth to more internally led, consumer-oriented growth. Nonetheless, China saw its gross domestic product (GDP) growth accelerate to 7.8% on a year-ago basis in the third quarter (and 7.7% year-over-year in the first nine months of 2013), and seemed to be on track to surpass the country's full-year 2013 growth target of 7.5%. Additionally, emerging-market factory and services activity hit a combined seven-month peak in 2013's fourth quarter, according to key purchasing manager indexes and gauges of services sector activity. These factors helped equities in some emerging markets get back on track after poor results in the first half of 2013, which were largely due to fears of liquidity diminishing should the Fed taper its stimulus program.

Investors Decide Whether or Not to "Fight the Fed"—or Any Other Central Bank

The Fed and other central banks had a highly active year in terms of policy-setting and communication. Though evidence of fundamental improvement grew more abundant in key global economic engines such as the United States and Europe, the 2013 rally for most global equity markets was largely a liquidity-driven phenomenon given the stimulus of ultra-loose monetary policy by key developed-market central banks. Investors reacted to the

potential loss of part of this support with a measure of panic on occasion, which at times ignited broad-based selloffs, particularly in emerging markets.

Global financial markets had believed the Fed would begin to trim its bond-buying program, known as quantitative easing, after its September meeting. Instead, Fed policymakers waited until December to announce a January 2014 onset of modest reductions in purchases of Treasuries and mortgage-backed securities. The Fed indicated it will also maintain its near-zero interest-rate policy past the point at which unemployment falls to 6.5%. A chief complaint among market observers earlier in the year was that the Fed did not skillfully communicate its processes and plans, leaving investors scrambling for clarity during periods of confusion over Fed maneuvers. Elsewhere, the European Central Bank (ECB) near year-end communicated that it was not on the same path as the Fed, cutting its main policy rate, yet was also not pushing its stimulus agenda as aggressively as Japan. And in the United Kingdom, record-low interest rates and quantitative easing by the Bank of England spurred advances in housing and construction, helping to offset the impact of budget cutting.

At the same time, central bankers in many developed markets also faced an inflationary environment seen by many as too low and possibly harmful, particularly in the eurozone. Inflation in the developed world has been low and stable for well over a decade, and at year-end, the average inflation rate in the developed world was generally below central banks' official targets as global commodity prices for most energy and food-related inputs fell during the year, with globalization exerting downward pressure on prices. Meanwhile, Japan appeared to have finally escaped 15 consecutive years of falling prices, with its monthly inflation rate hitting a five-year high late in 2013.

Global Equities: Overall Developed Markets Move Higher through Turbulence, Emerging Markets Lag

Monetary easing throughout the developed world was generally supportive of "risk" assets globally, and consequently, global equities generally had a strong year despite modest global growth, lackluster employment gains and high unemployment in several key areas, with many investors appearing to view such an environment as the "new normal." Overall, soft global growth and a strong US dollar favored US stocks over developed international and emerging-market stocks in the first half of 2013, but this scenario unraveled somewhat in the year's latter half as the dollar weakened and signs of growth outside the US solidified. Whereas the first half of 2013 indicated a distinct bifurcation in equity performance between developed and emerging markets, sharp rallies in the second half of the

year broadened in scope. For a three-month period in the fall, equities in many emerging markets outperformed those of developed markets. Global equity market strength continued into the year's final months as wariness ahead of a partial shutdown of the US government dissipated and the actual closure had little apparent effect.

The MSCI World Index of developed-market equity performance closed the year ended 31 December 2013 with a total return of 27.37%, while the broader MSCI All Country (AC) World Index, which includes emerging markets, lagged with a 23.44% result for the period, as did the narrower MSCI EAFE (Europe, Australasia, Far East) Index, which returned 23.29%.^{2,3} In terms of company size, the small-, mid- and large-cap groups within the MSCI AC World Index indicated the stocks of small, fast-growing businesses were particular market favorites as "risk-on" trades gained momentum while the year wore on, with the average small-capitalization stock advancing 29.18% in 2013.^{2,3} Mid-capitalization stocks, by comparison, returned 24.89% on average, while large-cap equities trailed with an average gain of 23.15%.^{2,3}

Among regions, European equities followed a weak first half with a rebound in the year's latter half as news flow and economic data showed fundamental improvement. Overall, the region's equities, as measured by the MSCI Europe Index, rose 25.96%.^{2,3} Europe's equity market was supported by gains in Finland (+47.99%), Ireland (+41.71%), Germany (+32.40%) and Spain (+32.30%), as measured by MSCI country-specific indexes.^{2,3} The US equity market outperformed many of its European peers by a wide margin and had a 32.61% gain for the year, as measured by the MSCI USA Index.^{2,3} A prominent factor in the United States was businesses increasingly returning strong cash flow to shareholders—in addition to a boom in stock buybacks, US stock dividends generally enjoyed a steady increase. Asian equities lagged those of Europe and North America with a 13.66% return, as measured by the MSCI AC Asia Index, with gains largely attributable to the region's developed markets.^{2,3}

Overall, emerging markets had a tough road in 2013, with most suffering more frequent and extreme waves of selling than developed markets. Emerging-market equities, as measured by the MSCI Emerging Markets (EM) Index, returned -2.27% in 2013.^{2,3} Leaders among this group, according to MSCI country-specific indexes, were Greece (+52.65%) trailed by Taiwan (+9.77%), and Egypt (+8.18%), while Peru (-29.84%) and Turkey (-26.52%)

underperformed their developing peers.^{2,3} Emerging Asian powerhouses China and India had a difficult year as both countries worked through economic reforms and structural policy issues as a means to revive flagging economic growth momentum. China's stock market rose 3.96%, while India's declined 3.83%, as reflected in MSCI country-specific indexes.^{2,3} Latin American countries were more deeply out of favor and detached from outside influences, with local constraints playing into the MSCI EM Latin America Index's decline of 13.15% for the year.^{2,3} Elsewhere, frontier markets garnered much more positive overall attention from investors in 2013 than they did in 2012 and registered only two extended downturns, in June and again in late summer. For the year, the MSCI Frontier Markets Index had a 26.32% return.^{2,3}

Global Fixed Income: Fed Expectations Drive Sentiment

Changes in expectations for the Fed's asset-purchase program broadly drove global bond market sentiment in 2013, increasing volatility and triggering knee-jerk reactions by investors to shift out of emerging markets and other assets that historically have tended to exhibit higher volatility. Continuing signs that the global economy was recovering, including reduced worries about the eurozone's debt crisis compared to 2012, also curbed investors' interest in fixed income. Meanwhile, China's moderate growth has continued to support economies in the Asia-Pacific region and more broadly across emerging markets. Overall emerging-market economic growth has decelerated from the rates seen in the recovery phase that directly followed the global financial crisis, but it remained relatively robust.

Growing expectations for a near-term start to the Fed's tapering of its quantitative easing program pushed up intermediate- and longer-term US Treasury rates significantly, with the 10-year yield rising rapidly in the second quarter of 2013. They also had a sharply negative impact on emerging-market debt as investors feared a loss of liquidity. Nonetheless, other central banks, including the ECB and the Bank of Japan (BOJ), pledged to continue monetary policies to boost global liquidity. Those policies, and signs that global growth appeared likely to continue, limited declines in select fixed income markets in 2013.

Developed-government fixed income securities, as measured by the JP Morgan (JPM) Global Government Bond Index, returned -4.50% for the 12-month period ended 31 December 2013.^{2,4} The Barclays U.S. Treasury

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Index returned -2.75% for the year, and already rising interest rates in the United States encouraged yield-hunting among corporate bonds.^{2,5}

US dollar-denominated emerging-market debt, as measured by the JPM Emerging Markets Bond Index Global Diversified, returned -5.25% amid uncertainty about the Fed's program and global liquidity.^{2,4} Local-currency sovereign emerging-market debt fell 7.26%, as measured by the JPM Government Bond Index–Emerging Markets Broad Diversified.^{2,4}

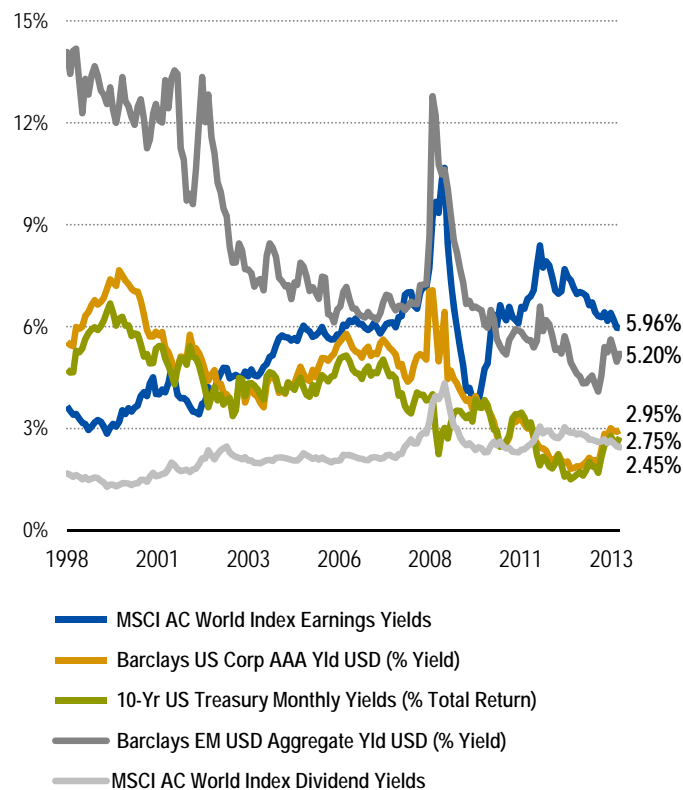
Corporate debt securities as a whole, including the investment-grade, high-yield and leveraged bank loan sectors, ended the year with slight increases amid generally solid corporate credit fundamentals. The Barclays Global Aggregate Corporate Index closed the year with a positive return of 0.35%.^{2,5}

One major sector posting gains for the year was US high-yield corporate bonds as firming corporate credit fundamentals appealed to investors trying to escape from rising yields on US government bonds or volatility in international bond markets. The Barclays U.S. Corporate High-Yield Index returned 7.44%, while investment-grade debt, as measured by the Barclays U.S. Corporate Index, returned -1.53%.^{2,5}

Overall, US municipal bonds also declined for the year, hurt by financial concerns in specific locations such as Detroit, which declared bankruptcy in July, and Puerto Rico, as its bonds plunged in August. For the year, the Barclays Municipal Bond Index returned -2.55%.^{2,5}

Yields Over Time

MSCI AC World Index Earnings Yields and Dividend Yields, 10-Year US Treasury Yields, Barclays EM Yield USD Index and U.S. Corp. AAA Yield USD Index
15-Year Period Ended 30 November 2013



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OUTLOOK 2014: SELECT FRANKLIN TEMPLETON INVESTMENT MANAGEMENT TEAMS

FRANKLIN EQUITY GROUP®

Edward B. Jamieson, President, Chief Investment Officer and Portfolio Manager

Broad US equity-market gauges ended 2013 at record levels powered by record-high corporate profits, increased dividend payouts, continued share repurchases and improved investor confidence. The Fed's decision to begin tapering its stimulus efforts also appeared to be positive for investor sentiment and could signal a favorable environment for earnings growth potential, in our view. After the market rise in 2013, valuations at year-end were generally closer to fair value, in our opinion. We would expect to see market performance driven less by multiple expansion and more by earnings growth in 2014.

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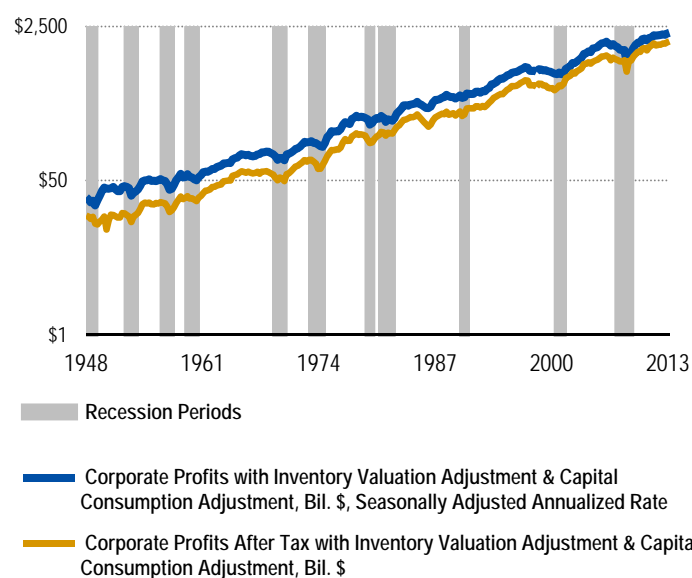
5. Barclays Global Family of Indices. © 2014 Barclays Capital Inc. Used with permission.

There are a number of specific trends that led to particularly strong earnings growth for some companies in 2013 that we think could continue into 2014. For example, in the United States, consumer spending growth has boosted sales and profits for auto and auto parts manufacturers. Manufacturers that have developed advanced fuel-efficiency technologies have benefited from this trend, as well as the trend for more fuel-efficient cars. Fuel efficiency also has been a growth driver in aerospace, benefiting companies that have developed new high-strength, lightweight carbon fiber materials used in modern aircraft. This composite material is stronger than aluminum while being significantly lighter, and it is more reliable than other traditional metallic materials, all of which can lead to lower aircraft maintenance and fuel costs. Longer term, additional applications of these materials may include cars and other industrial products for which innovations that can reduce weight are highly valued.

Among other industrial companies, new technologies and methods for the production of oil and gas in the United States have driven profit growth for the developers of those technologies, as well as oil producers, and they have moved the country further down the road to energy independence. Our positive outlook for these firms is underpinned by the fact that combined oil and natural gas shale resources in the United States have put it on pace to potentially top Russia as the world's largest producer of both fuels, with the possibility of also surpassing Saudi Arabia as the world's largest oil producer by 2020, a somewhat startling shift that has been reshaping global energy markets.

US Corporate Profits (Logarithmic Scale)

Q4 1948–Q3 2013



Source: FactSet.* Shaded areas represent approximate recessionary periods as determined by the National Bureau of Economic Research.

Elsewhere, new developments in electronic technology have enabled brand-new content and Internet-focused industries to spring up, generating extraordinary revenue growth. Just one such strategic shift involves treating software as a service: Companies that provide as-needed delivery of software through cloud computing can give corporate purchasers access to state-of-the-art programs whose affordability might otherwise be out of their reach.

Additionally, we have significant optimism about what we view as a new renaissance period for drug research, development and production. In 2013 alone, new developments in genetic mapping and analysis led to spectacular breakthroughs in the treatment of cancer, cystic fibrosis, multiple sclerosis and hepatitis C, creating billions of dollars of new market value for the discoverers of these treatments. Overall, we believe the biotech industry has reached a tipping point in terms of targeted therapies often termed “personalized medicine” because they target a specific molecule, which can both improve effectiveness and reduce the instance of off-target side effects.

These are just some of the examples of how the dynamic private economy in the United States and rapid technology changes for many industries have met our society's needs and driven the US stock market higher in recent years. Looking forward, we believe this dynamism will continue to raise living standards and could potentially deliver profit growth for many companies.

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Edward D. Perks, CFA, Director of Portfolio Management

US stock markets enjoyed a strong year in 2013, buoyed by continued extraordinary monetary support from the Fed, as well as gains in revenues and earnings for many US corporations. Overall, gains were relatively broad-based across the market, with both growth and value stocks experiencing strong performance, as well as across market-capitalization sizes, with gains from large- and small-capitalization companies alike. Companies from a broad range of sectors participated in the equity rally, led in part by those perceived by investors to be most geared to improving economic conditions, including financials, consumer discretionary and industrials. The health care sector—and major pharmaceutical and biotechnology companies in particular—also delivered attractive gains despite uncertainty surrounding the implementation of the Affordable Care Act and an overall environment that proved less beneficial toward defensive stocks.

Despite challenges at the beginning of the year, including fiscal drag effects in the United States, the eurozone's difficulties emerging from recession and slower growth in important emerging economies such as China, Russia and Brazil, stock markets in the United States benefited from an improvement in the labor market outlook, along with improved consumer confidence and business conditions. Continued high profit margins and strong balance sheets among many US businesses, aided by the record-low level of interest rates over the past several years and record corporate bond issuance, helped enable an expansion of valuation multiples for many companies' shares. Greater focus on shareholders continued to develop as a broader theme for many US stocks as evidenced by the general increase in dividend payments and stock buyback activity. During the year, we continued to see more companies both paying dividends and increasing dividends from the prior year's level, trends we expect could potentially continue into 2014.

After roughly three decades of mostly falling US interest rates, the long-term path of interest rates recently hit a turning point according to many economists and investors. A broad bond market selloff during 2013 sent benchmark 10-year Treasury note yields surging, driven in part by investor fears around the Fed beginning to taper its monthly asset purchases. As 2014 gets underway, we believe continued improvement in US and global economic growth and an inevitable normalization of monetary policy may lead to a lengthy period of comparatively low but rising long-term interest rates. While investor concern over many fixed income investments appears elevated in reaction to the recent path of long-term interest rates, inflation expectations remain anemic and may ultimately reduce the likelihood of further significant rate hikes in the short term. Within this challenging macroeconomic environment, we remain focused on opportunities created by heightened interest-rate volatility. In the current environment, our hybrid strategy generally emphasizes short- and intermediate-term maturities, particularly among high-yield corporate bonds as credit fundamentals remain constructive, according to our analysis. We believe higher interest rates may further impact prices of longer-duration fixed income assets, creating potential investment opportunities for investors looking for incrementally higher yields and the potential that comes with purchasing bonds at discounts to their face value.

Consistent with our approach to look across a wide range of equity and fixed income asset classes, we have continued to see a variety of potential opportunities for our hybrid strategies. While the asset mix of our hybrid strategy remained broadly tilted toward equity versus fixed income at year-end, the recent rise in long-term interest rates has

broadened our fixed income opportunity set, enabling select investments in longer-duration assets that have been negatively impacted by the recent increase in interest rates. In terms of equity market opportunities, we continue to be focused on bottom-up, research-driven ideas across a range of sectors, including energy, utilities, materials, industrials, technology and financials. While the overall attractiveness of dividend yield remains important to our core equity strategy, the potential for greater shareholder focus by companies through both dividend growth and share buybacks will also remain important considerations for our investments.

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Frederick G. Fromm, CFA, Portfolio Manager
and Senior Security Analyst

Stephen M. Land, CFA, Portfolio Manager
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Matthew J. Adams, CFA, Portfolio Manager
and Research Analyst

In our view, 2013 was a year of transition for the natural resources sector as commodity-related markets sought balance in an environment of slower global economic growth and growing supply for several key raw materials. In response, many companies aggressively cut costs and deferred or cancelled projects to stem cash outflows and repair balance sheets. Although this was not a surprise for some industries such as gold mining that had experienced rising costs and a significant decline in the price of gold, the trend of greater capital discipline was also evident among companies still enjoying relatively stable conditions. Such a shift typically occurs during more difficult times and could have important investment implications longer term. In some cases, shareholder activism played a role as various companies responded to a rising drumbeat of shareholder demands for stronger returns and return of capital through higher dividends and share repurchases.

Although our outlook for natural resources sectors is varied across related industries, we believe the trend of cost reduction and capital discipline should ultimately be positive as most companies would be in stronger financial positions to weather prevailing market conditions while spending reductions could be sowing the seeds of tighter supply-and-demand balances in the future. Ultimately, we believe improved cost positions combined with the potential for slower supply growth, resilient demand and rising commodity prices could lead to the potential for rising equity values. In addition, we are encouraged by investors' renewed interest in companies with stronger long-term growth opportunities as opposed to their focus on income and near-term cash flow that was prevalent over the past couple of years.

Looking to 2014, we have been tracking several trends we believe could translate into the potential for attractive equity performance for investors in the natural resources sector. We think an improving global economic outlook has set the stage for potentially stronger commodity demand, particularly from the United States and Europe, which have had little, and in some cases a negative, influence on commodity markets in the recent past. Although supplies have been expanding for some commodities, production disruptions and curtailments may help limit the impact on commodity prices, while what we think could be stronger-than-expected demand could absorb some additional capacity, as was the case for some commodities in 2013.

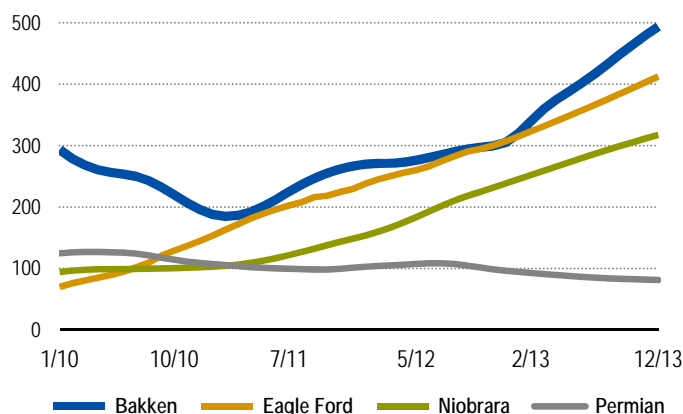
However, our strategy does not primarily rely on general trends in commodity prices and instead seeks to generate performance by identifying companies we believe possess the ability to grow earnings and cash flow in a normalized commodity price environment, or one in which prices trade near the marginal cost of production.

In energy markets, we expect healthy demand growth from developing markets while developed countries may show greater demand stability. Surprisingly, even US petroleum-product demand has been showing signs of life after a couple of years of stagnation or outright declines, and although we do not expect demand from the United States or Europe to grow significantly, we expect them to be less of a drag on global consumption growth than in recent years.

Importantly, the US economy has been undergoing a dramatic shift toward energy self-sufficiency through rapid crude oil and natural gas production growth driven by the application of new drilling technologies and methods to extract previously uneconomic resources. This “energy renaissance” is likely to have broad implications for the US economy and global politics, in our view.

US Exploration and Production Rig Productivity per Basin (Barrels of Oil per Rig per Day)

January 2010–December 2013



Source: U.S. Energy Information Administration, Monthly Drilling Productivity Report, 9 December 2013.

At the company level, many US energy exploration and production companies have been moving from the assessment stage to the production of unconventional resources, which includes shale development. We believe this move has the potential to translate production growth into cash flow and improved equity valuations as producers could benefit from development-related efficiency gains. Oilfield equipment and services providers are a key component of this trend, in our view, as they strive to leverage increasingly efficient development and extraction techniques. Notably, unconventional resource development has begun in many other countries, potentially creating new markets for US companies.

FRANKLIN TEMPLETON SOLUTIONS

Thomas A. Nelson, CFA, Managing Director of Strategic Allocation Research

Samer Hahl, Managing Director of Tactical Allocation

Looking back on 2013, it was generally a strong year for “risk assets,” particularly developed-market equities. As major central banks and policymakers across the globe continued to implement expansionary policies, growth expectations increased and consequently so did price-to-earnings multiples. Leading economic indicators rose for most of the year, and their breadth improved as well. Many businesses became healthier and more efficient, in our view, reporting higher cash balances and profit levels. An absence of prolonged periods of volatility also created a generally supportive market environment. Major central banks were successful in easing investor concerns about tail risk—meaning the risk of unusual or extreme events happening more frequently than expected—that had plagued the global economy in previous years, and Europe was a case in point. Since the ECB’s 2012 pledge to take all necessary means to support the euro and the currency union, the eurozone economy stabilized with no significant crisis events, and Germany’s federal elections in the fall of 2013 concluded without controversy. Moreover, it is important to note that inflation generally remained at or below policy targets, and we believe it is likely to stay at low levels. When quantitative easing was first introduced, worries about inflation were high, but the ample liquidity so far has not translated into broader money and credit growth.

As we enter 2014, we believe the continuation of the Fed policy to keep short-term interest rates at ultralow levels should provide more underpinnings to equity growth potential. Meanwhile, rising rates at the medium to long end of the yield curve will likely represent a significant drag on bond market performance potential, in our view. In this environment, we generally continue to favor global equities over fixed income heading into 2014. We also generally prefer exposure to developed markets over emerging

markets because Fed tapering could spark another round of deleveraging, removing some of the support that benefited emerging markets during part of 2013's second half. Within credit, we think there has been value potential despite yield spreads that were approaching their 10-year lows at year-end. However, we generally continue to prefer short-duration positioning in light of our expectation for rising interest rates. Finally, within currencies, we see the potential for an additional round of quantitative easing in Japan, which factors into our negative view of the Japanese yen versus the US dollar.

FRANKLIN TEMPLETON REAL ASSET ADVISORS®

Jack Foster, Head of Real Assets

Wilson Magee, Director of Global Real Estate and Infrastructure Securities and Portfolio Manager

As a result of generally recovering underlying property market trends, listed property companies around the world overall have continued to deliver growth in both revenues and per-share profits. We expect many global property markets and property sectors to potentially continue these fundamental growth trends in 2014 as recovering economies and limited construction deliveries of commercial properties are likely to support further rental growth, in our view. Despite concerns regarding increases in interest rates, many listed companies are likely to lower financing costs on existing debt in 2014 as lower-cost debt replaces maturing debt. Based on our fundamental analysis, we believe investors in property stocks could potentially continue to see dividend growth over the next few years because of profit growth potential and historically low payout ratios. Many factors affecting profit growth and share price performance vary by market, however.

Trends in underlying property markets have remained positive for most US real estate investment trusts (REITs), primarily because of muted levels of commercial property construction, coupled with positive leasing demand for most property sectors. Improvements in leasing markets have pushed up occupancy rates, and in many markets lower vacancies and limited new supply should lead to rising rental rates for landlords, in our view. These improving underlying property market trends have led to earnings and dividend growth for many US REITs. US REITs also have been taking advantage of their access to capital markets, both debt and equity, in competing for acquisitions of assets and new development projects. We think these incremental investments can offer additional potential for value creation as well as for earnings and dividend growth.

Asian property markets have experienced significant rental growth trends in 2013, particularly among office rents in Japan and Singapore. However, these positive signs are offset somewhat by macroeconomic concerns such as decelerating Chinese growth and multiple government policy measures, especially in Hong Kong and Singapore, which have the potential to negatively affect sales trends. As a result, investors seem worried that residential prices may fall further.

Signs of improving economies within continental Europe have been encouraging for property stocks there but may filter slowly into rental markets. Retail landlords have been posting modest results in terms of tenant sales, but rental revenues generally have been rising. Within the United Kingdom, a growing list of positive economic results has continued to support real estate fundamentals in the greater London area. Consistent with other improving economic data, retail sales have been growing, as have retail rents, particularly in London's prime shopping districts.

The myriad industries and fundamentals in global listed infrastructure make broad generalizations for the asset class difficult. Highlights for 2013 include continued strong growth from North American energy infrastructure companies as well as from a variety of sectors in Asia and Latin America. Significant oil and natural gas discoveries in North America have been supporting significant investments in new pipeline infrastructure, as well as in gathering, processing and fractionation facilities. Utilities in developed western economies, however, produced the weakest fundamental revenue and earnings growth, with European utilities generally posting declining profits. We expect lower earnings for many companies and are wary that additional dividend reductions may occur. We are much more positive in our expectations for European water and waste companies as industrial demand has been leading modest economic recoveries. Fundamentals are also positive for water and waste companies with Asian operations, in our view, particularly in China. Results for transportation companies were mixed, with potentially positive signals for 2014. Airports were in various stages of recovery amid growth in markets around the world, with Latin American and European airports leading in growth rates. We expect this growth could continue in 2014, with volume growth supplemented by revenue-enhancing capital-investment projects. Marine port operators in Asia produced uneven results, with Hong Kong disappointing while many of China's ports continued to show strong throughput growth, and ports in Europe were signaling early-stage recoveries.

K2 ADVISORS^{®6}

William A. Douglass, Founding Managing Director

David C. Saunders, Founding Managing Director

Global equity and credit markets generally experienced a strong rally in 2013, driven by highly accommodative central bank policies. For 2014, we believe there should be an improving economic environment across much of the developed world, led by the United States. Against this backdrop, we believe investors should remain vigilant regarding a further potential rise in market-driven interest rates and how any rate increases may impact specific companies or sectors to varying degrees. Thus, we anticipate that security selection and sector tilting will affect performance to a greater degree over the next year.

Our outlook for equity long/short strategies remains positive. We expect global equities could hold potential in 2014 as investors are likely to focus on earnings and revenue growth versus multiple expansion, which was a strong driver of 2013 market performance. In what we expect to be a low earnings-growth environment, fundamental long and short stockpicking could continue to add value potential as investors increasingly differentiate between companies' growth prospects, thereby potentially creating a dispersion in results. In addition, we believe there are improving opportunities outside of the United States, especially in Europe, which had once been regarded as a key risk to the global economy and to global corporate earnings, but now is widely viewed as a source of growth.

Our outlook for credit and event-driven strategies also remains positive. We expect the benign economic environment, generally low default rates and high levels of new issuance to persist in 2014, which may continue to provide support for corporate credit and possibly present attractive relative value and trading opportunities. With significant cash on balance sheets and more readily available access to financing, many companies in need of additional growth have continued to rely on transformative corporate events. The pace of mergers, spinoffs, recapitalizations and restructurings, if continued, should lead to strong levels of corporate activity and a resulting robust opportunity set for event-driven strategies, in our view.

We remain positive on our outlook for global macro strategies. Both developed- and emerging-market countries continue to implement measures to manage growth and inflation. While the Fed will be tapering its quantitative easing program, other central banks such as the BOJ are just getting started with their pro-growth reflationary policies. This dispersion in policies among global economies potentially offers attractive relative value opportunities. Also, market expectations of the impact of

such measures tend to have a far-reaching effect spanning across various asset classes, which we believe bodes well for these strategies given their typical dynamic global trading approach.

Commodities faced many macroeconomic-related market headwinds in 2013. Going forward, we expect fundamental price drivers to take a prominent role and could potentially lead to lower correlations with other asset classes and across the commodity sector. We believe the challenging "risk-on/risk-off" trading environment could abate. We think the environment will tend to favor active strategies focused on relative value and shorter-term directional trading. All three core commodity sectors—energy, metals and agriculture—provide for interesting trading opportunities, in our view. Several commodities have relatively tight supply-and-demand balances, which we regard as a prerequisite for wider price dispersion potential.

LOCAL ASSET MANAGEMENT

Stephen H. Dover, CFA, Managing Director, International Chief Investment Officer

For both global equity and fixed income markets, 2013 was an eventful year as the global economy continued to recover from the financial crisis. Policymakers around the world tried to find the right balance between promoting growth and improving long-term fiscal stability. We believe global economic conditions have been improving and global economic growth should stabilize. Imbalances in the global economy also have been progressively unwinding, but the process is unlikely to be linear, and we think some market volatility is to be expected.

Global equity markets have experienced a bifurcation over the past year, with developed markets generally benefiting from many investors' increased rotation toward equities. Select emerging markets also benefited from this development, particularly during the latter part of the year. Going into 2014, the momentum seems to remain with developed markets for a variety of reasons, including perceived improvement in their growth prospects, as well as uncertainty over the impact of the Fed's pullback from quantitative easing measures. However, while many investors historically have considered emerging markets as a separate and homogeneous investment category, this can no longer be the case, in our view. We think now, more than ever, there is a need to evaluate individual markets and the companies within these markets—with in-depth analysis of the fundamentals driving each specific market and company—as drivers of growth differ across markets. In fact, we believe being even more selective than in the past may be warranted, given the variation in growth dynamics and drivers from one country to the next: Some countries undoubtedly have serious macroeconomic

6. Franklin Templeton Investments acquired a majority stake in K2 Advisors in 2012.

problems and are very dependent on external financing and export activity, while others have reduced dependency on foreign capital, have stronger domestic growth and have policy flexibility to deal with short-term challenges. While some developed markets have been reverting to their mean, longer-term growth rates, many emerging markets currently reflect different growth drivers and growth rates. Select markets in both the developed and emerging world appear poised to benefit from the next phase of growth as investors search for performance potential in a less correlated market. For these reasons, we favor an approach that considers the whole global equity market for investment opportunities, rather than looking at emerging markets as a separate investment category.

In the United States, macroeconomic and corporate earnings data have been improving, which, along with a renewed commitment to easy monetary policy from the Fed, has created a benign scenario for equity markets, in our view. US equities could continue to benefit from this backdrop as long as the Fed can successfully navigate the path to a more sustainable long-term monetary policy and growth rate. European equities overall had a strong run-up during 2013 on the back of a turnaround in the region's economic growth and higher conviction among investors that austerity measures have succeeded in avoiding a systemic shock. This favorable sentiment appeared to be less about the region exiting recession, and more about stabilization in terms of longer-term economic growth. In Japan, the introduction of "Abenomics" and the BOJ's loose monetary policy have signaled that the government and the central bank are both committed to doing whatever it takes to stimulate growth. In Asia, a number of commodity-producing and export-oriented countries have started to benefit from the turnaround in the Chinese economy, as well as from continued global recovery. The slowdown in several Asian economies seen in 2013 was, in our opinion, largely cyclical in nature, and market pessimism may have been overdone. We believe current initiatives in countries such as China and India could help pave the way for further sustainable economic growth.

Coordinated action by the developed world's central bankers has driven currency markets as of late, and we think global liquidity and capital flows are likely to continue doing so in 2014. Much attention has been paid to the currencies of those emerging-market countries that are likely to be impacted by reduced global liquidity due to their dependence on foreign capital. Countries that successfully use the current period of increased liquidity and foreign funding to improve and stabilize their economies could provide us with interesting investment opportunities when financial conditions eventually tighten.

As global economic conditions improved during 2013, investor sentiment appeared to generally begin shifting from a fear of "risk assets" to a fear of missing out on growth opportunities by staying on the sidelines. We believe the decrease in correlations and greater dispersion between equity markets over the past year are likely to continue, increasing the importance of differentiation between countries and sectors, and individual security selection should be increasingly important going forward. The unprecedented easy money policies of developed-world central banks must inevitably come to an end at some point, but should economic growth continue to improve and fundamentals remain strong, any resulting market correction could provide favorable buying opportunities for us, and we remain optimistic about the potential for global equity markets in the new year.

MUTUAL SERIES®

Peter A. Langerman, Chairman, President and Chief Executive Officer

Global financial and economic conditions generally improved during the course of 2013, and we anticipate the trend to likely remain intact during 2014. We recognize the path of improvement is likely to include stretches of volatility, but the fact that periods of uncertainty during 2013 did not prompt any spikes in equity-market correlations reminiscent of post-crisis years is encouraging to us. We would expect generally muted market reactions in 2014 barring a significant and unanticipated financial or political event.

In our view, potential speed bumps appear to be skewed toward the early stages of 2014 when the Fed will initiate its tapering of monthly asset purchases and politicians in Washington, DC, look set to continue their battle over fiscal matters. In addition, we view recently proposed structural reforms by China's government as a long-term positive for the country's economy and capital markets, but we also realize that such measures may initially exert a drag on economic growth. In a positive turn of events, we are fairly hopeful about the prospects for Europe, as economic data appeared to show a general bottoming out of the economy in 2013, with the potential for improvement in the coming year.

We have continued to find companies trading at what we deem to be attractive valuations, although equity markets in general no longer appear particularly cheap to us. We believe our process of bottom-up stockpicking, driven by rigorous fundamental analysis, is well positioned to search for the best potential opportunities in 2014. The general erosion in correlations across and within equity markets over the last year would appear to validate our viewpoint, as fundamentals are more likely to drive the performance of individual stocks, in our view.

Elsewhere in financial markets, we continued to observe rather limited opportunities within distressed debt investing. The prolonged period of low interest rates has allowed highly levered institutions to borrow or refinance debt at fairly inexpensive levels, thereby holding down the rate of corporate bankruptcies that one might expect to see in a challenging economic environment. We believe an uptick in opportunities may occur if interest rates begin to rise in reaction to Fed tapering, but the timing and degree of any such increase in distressed debt opportunities remain uncertain.

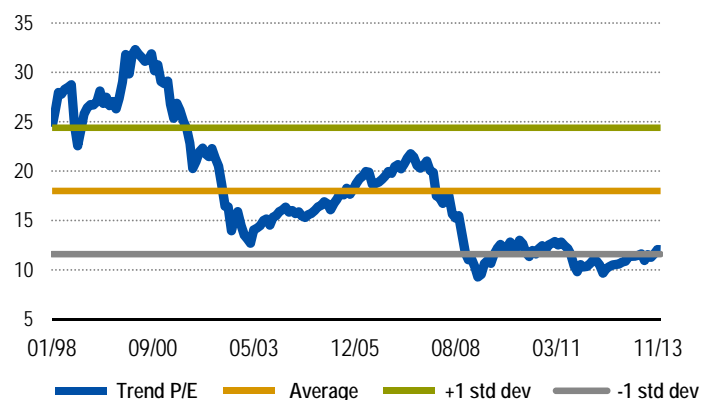
Within the merger arbitrage space, we have seen some major deals, but the overall level of activity has remained subdued. We continue to believe a gradually improving economic and financial outlook bodes well for a greater willingness among companies to consider deals. For now, however, many companies continue to choose share buybacks or dividend increases as the preferred means to deploy the cash on their balance sheet.

TEMPLETON GLOBAL EQUITY GROUP

Norman J. Boersma, CFA, Chief Investment Officer

In our view, the investment outlook for 2014 is clouded by uncertainty. By year-end 2013, global stocks had generally rebounded strongly off crisis-era lows, and many indexes were near record highs. Corporate profit margins in the United States, the world's largest economy, were near peak levels, and US equity valuations appeared to us to be pricing in optimism at a time when politics are highly fractious and monetary stimulus will soon be tapered. Europe has continued to flirt with deflation, while China and Japan embark on very different, but equally

European Equity Valuations:
Price/Earnings Ratio below Long-Term Average
30 January 1988–30 November 2013



Sources: FactSet.* Data as of 30 November 2013. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI. Indexes are unmanaged, and one cannot invest directly in an index. Past performance does not guarantee future results and results may differ over future time periods.

experimental, reform paths with unknowable consequences. While investor sentiment has admittedly improved and equity inflows have been slowly picking up, this continued backdrop of macroeconomic and political uncertainty has kept enthusiasm in check. Consequently, investor skepticism has continued to create what we believe are selective opportunities at the bottom-up level, particularly in Europe, where we believe valuations and the corporate profit cycle remain clearly depressed.

Overall, we think equities remain cheap relative to other asset classes as of December 2013 and an attractive source of yield potential in a low interest-rate environment. We believe net global policy conditions remain supportive, with excess liquidity still rising and Fed tapering easily offset by the BOJ's promise to double the size of its balance sheet. While we claim no ability to forecast the market and are aware that equities have enjoyed a prolonged rally without a significant correction, conditions do not evoke the euphoria normally associated with bull-market endings, in our view. Historically, sustained recoveries have tended to follow extreme contractions, making the current environment not as unusual as it may now seem to many observers.

At the sector level, we remain positive on financials, particularly those in Europe. Political and economic concerns in the region have allowed us to own what we believe are fundamentally improving franchises with strong competitive positions at sensible valuations. In addition to deeper-value banks in lagging eurozone economies, a diverse array of banks in northern Europe are among those we remain constructive on because we believe they have the potential to benefit from healthier domestic fundamentals and exposure to attractive markets abroad. Overall, we continue to favor European banks as a more robust regulatory framework and significant restructuring initiatives could help these franchises stabilize against a backdrop of gradual economic recovery. We also continue to find value potential in the energy sector. Like financials, energy represents a formerly high-flying cyclical sector that has lagged since the global financial crisis, creating what we believe to be value opportunities for disciplined investors. In particular, we have found increasingly compelling value potential in oil services, particularly those companies exposed to the shale revolution in North America.

As ever, we believe investors should remain cautious and skeptical, with a focus on identifying where macroeconomic pressures are unjustly punishing businesses with improving fundamentals and favorable long-term earnings, cash flow and asset-growth prospects. We continue to look for such opportunities in markets and sectors around the world, and we remain positive about the long-term potential of our portfolios regardless of the market's near-term trajectory.

TEMPLETON EMERGING MARKETS GROUP

Mark Mobius, Ph.D., Executive Chairman

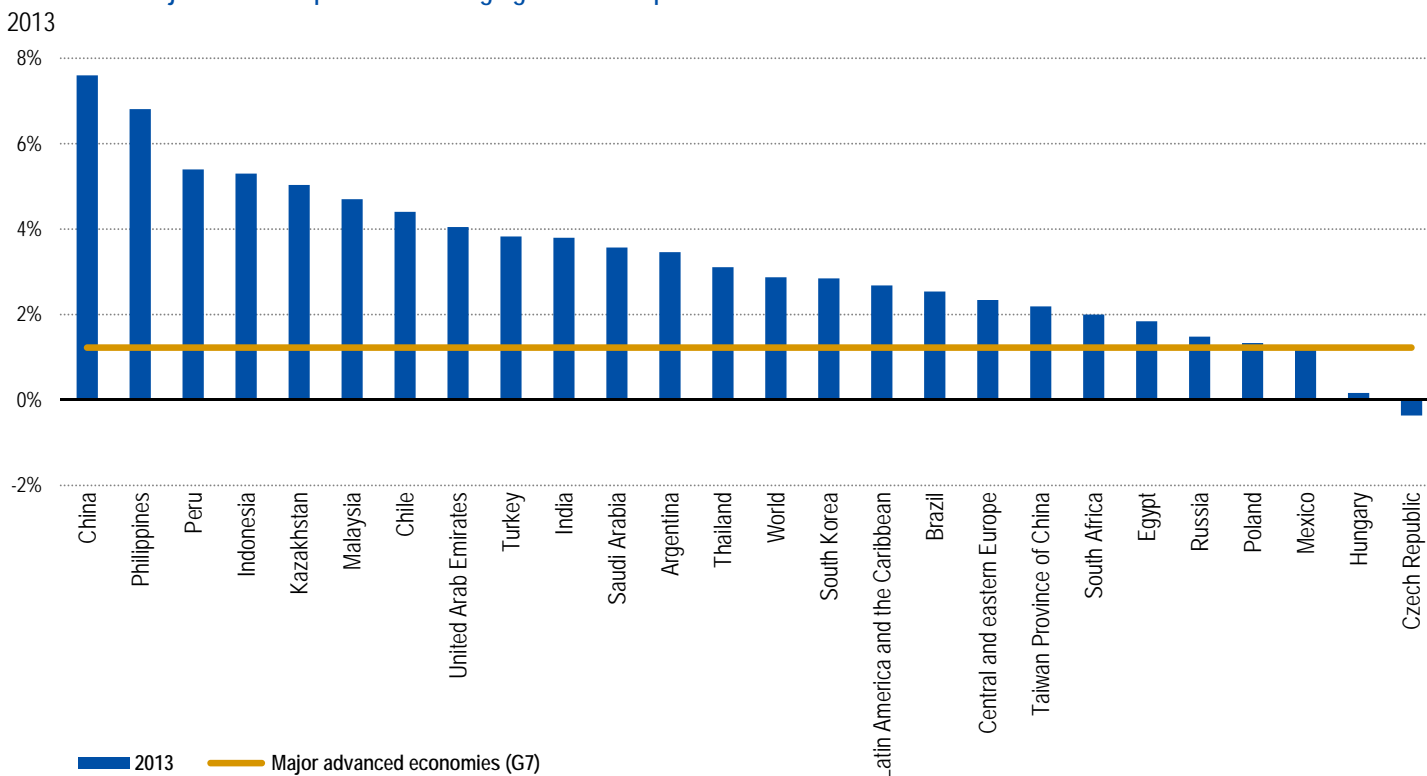
We believe 2014 could be an important year for many emerging markets, establishing trends that could play out through much of the remainder of the decade. In particular, Chinese government initiatives announced in late 2013 could have far-reaching significance. Some 60 proposals across a gamut of issues could have dramatic consequences in areas including health care and social security, justice and the rule of law, intellectual and physical property rights, banking and monetary policy, and environmental protection. The proposed changes, intended to facilitate sustainable economic growth in China, could also create substantial opportunities for investors. Reforms to state-owned enterprises aimed at improving their professionalism and efficiency in resource usage could benefit their listed subsidiaries. Measures aimed at encouraging enterprise and innovation, as well as blocking unfair competition, could speed up the process of rebalancing the economy away from investment-led growth and toward a more entrepreneurial, consumer-focused and service-oriented model. The project has a decade-long timescale, but we nevertheless expect to see some progress in 2014, perhaps through initiatives in free trade zones such as the one announced for Shanghai in late 2013 and others hinted at in the proposals. Of course, there are likely to be casualties as a result of these reforms.

Companies facing intense competition and now deprived of the level of government support obtained in the past could be negatively impacted. We therefore need to keep our eyes open to avoid such situations.

A number of major emerging markets will see key elections in 2014—Indonesia, South Africa, Thailand and India in the first six months of the year, and Turkey, Brazil and Nigeria later on. As the electoral cycle peaks, we believe administrations may feel more able to address barriers to long-term growth and retreat from populist measures. In these circumstances, ongoing strengths, in terms of solid economic growth potential, strong public and consumer finances, rich natural resources, and favorable demographic trends that have helped emerging markets over the past several years, could gain new traction.

We believe many emerging markets, in addition to China, possess considerable economic growth potential. For example, Southeast Asia has been seeing a notable extension of growth and wealth away from traditional economic hubs, with previously underdeveloped regions starting to see significant catch-up growth. Thailand is most notable in this regard as the reforms instituted by former Prime Minister Thaksin Shinawatra have resulted in more money going to the countryside and areas outside Bangkok. Russia has continued to see gradual reform as authorities seek foreign investment. Nevertheless, investors have been wary, and

IMF Growth Projections: Comparison of Emerging and Developed Markets



Source: *World Economic Outlook*, October 2013. © By International Monetary Fund. All Rights Reserved. The G7 comprises seven countries: Canada, France, Germany, Italy, Japan, the UK and the US. There is no assurance that any projections will be realized.

thus Russian equity valuations at year-end were exceptionally low, in our view. Some South African consumer companies have been starting to enjoy solid growth, both domestically and in ventures elsewhere on the continent. Among frontier markets, Kenya is home to a groundbreaking mobile money transfer system that is spreading to other countries and likely will have implications for emerging markets globally. Microfinance initiatives in Bangladesh are justly famous, in our view, and are being duplicated in other parts of the emerging-markets world. In Egypt, we have continued to find companies thriving. We thus have continued interest there even though the news headlines may sometimes be alarming. Central and South America also continue to provide appealing long-term investment opportunities across a range of sectors. We believe that smaller companies in many markets could represent a particularly rich source of investment prospects. As is often the case, adverse short-term news flow in emerging markets typically creates attractive investment opportunities, in our opinion.

As long-term fundamental investors, we do not make short-term predictions for share prices, but we believe longer-term developments that look likely to gain traction in 2014 could drive solid growth potential in emerging economies for years into the future.

FRANKLIN TEMPLETON FIXED INCOME GROUP®

Christopher J. Molumphy, CFA, Chief Investment Officer

As we look ahead into 2014, we are optimistic that we could finally see better economic growth in the United States. Since 2009, when America emerged from the Great Recession, we have seen a fairly consistent pattern of subpar growth up to and including 2013. During 2013, however, the US economy faced significant headwinds from a variety of sources, such as higher taxes and diminished government spending levels. In evaluating the prospects for the US economy in 2014, we think that the diminished impact from fiscal drag leads us to a modestly more constructive outlook than last year.

Internationally, we think prospects for developed markets relative to their emerging-market counterparts are looking better for the first time in a long while. In particular, we think several countries in the core eurozone have the potential for modestly improved growth. In addition, we are reasonably constructive on the Japanese economy based on the supportive aggregate impact of the country's monetary and fiscal policy regimes.

In contrast, while we believe there are still a number of emerging economies with decent opportunities, we think it will be critical to discriminate from country to country. While certain nations such as South Korea, Poland and Malaysia have maintained fiscal discipline, face positive growth

prospects and appear poised to potentially do well in 2014, in our view, others are facing weaker growth amid limited policy options.

In this environment, we think a number of fixed income sectors hold appeal. For example, the corporate credit sector may continue to benefit from solid underlying fundamentals such as healthy balance sheets, ample liquidity and reasonable earnings prospects. Consequently, we are constructive on market sectors such as investment-grade securities, high-yield bonds and floating-rate bank loans.

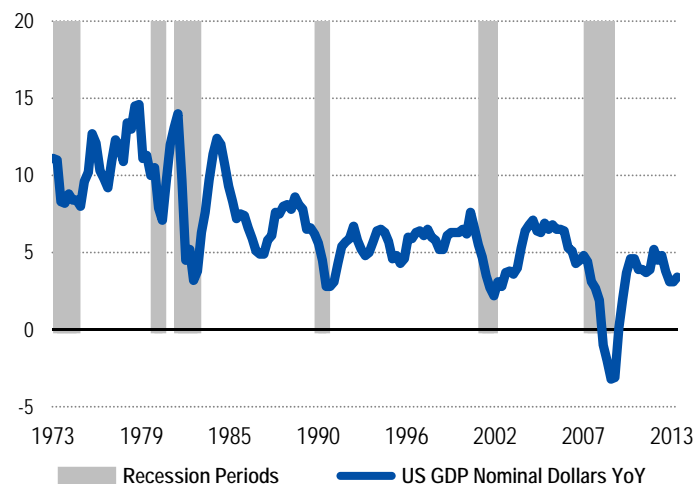
In our view, the global fixed income market also holds opportunities for investors, although we do not think it will be as easy as investing in the broad emerging-market category. However, we think it could prove beneficial to have selective exposure to countries where, despite better fundamental fiscal conditions and growth prospects, yields are higher than in the United States. As a result of the supportive fiscal situations in those countries, investors may also be exposed to the potential for currency appreciation.

Overall, we think the US municipal bond sector has sold off indiscriminately in recent months, driven by a few high-profile situations, notably those in Puerto Rico and Detroit. In contrast, we believe that many state and local governments have made solid progress in achieving fiscal sustainability and that the situation overall has continued to improve. As a result, we believe there are attractive opportunities in that sector.

Fundamentally, we are constructive on the broad fixed income asset class. Given year-end market valuations following some of the negative media coverage and the subsequent indiscriminate selloffs in the asset class, we think the fixed income sector may represent some value potential in 2014.

US Nominal GDP Growth (Year-Over-Year % Change)

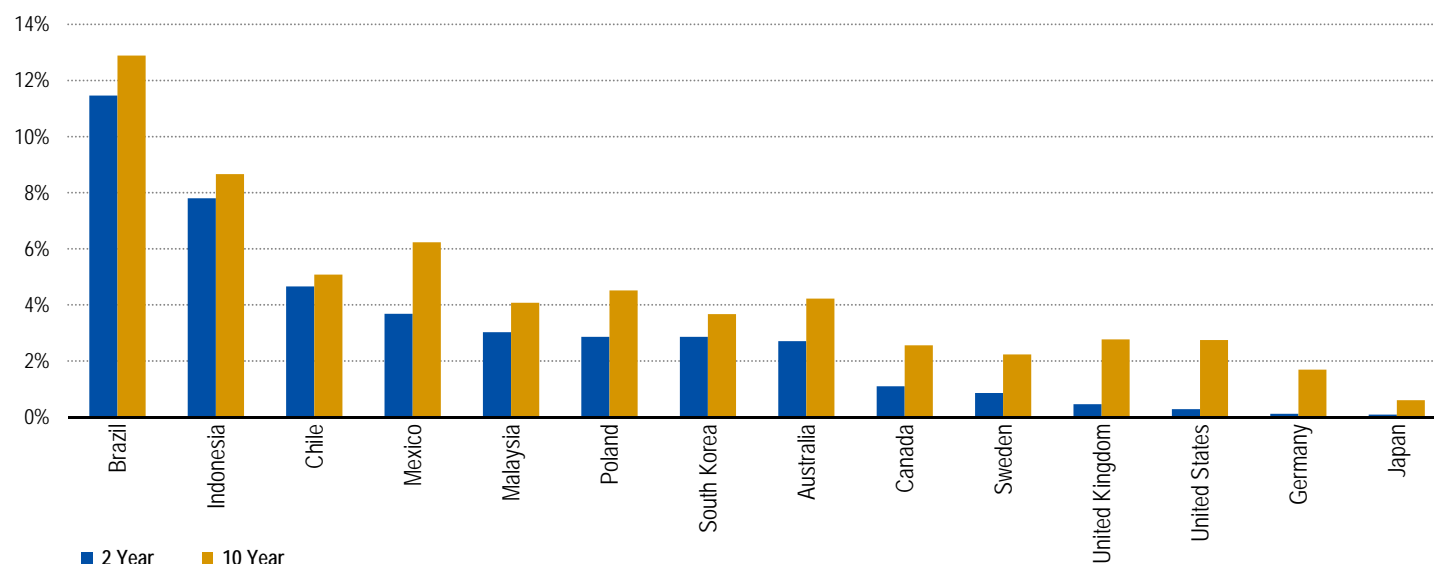
30 September 1973–30 September 2013



Source: Bloomberg LP, Bureau of Economic Analysis. Data as of 20 December 2013. Shaded areas represent approximate recessionary periods as determined by the National Bureau of Economic Research.

Relatively High Yields Available Internationally: 2-Year and 10-Year Government Bond Yields

As of 30 November 2013



Source: Bloomberg L.P. Brazil data source: FactSet.* Data as of 30 November 2013. Past performance does not guarantee future results.

FRANKLIN TEMPLETON FIXED INCOME GROUP

Michael Hasenstab, Ph.D., Chief Investment Officer,
Global Bonds

Global liquidity should continue to increase, in our view, as a number of central banks in developed markets have maintained very loose monetary policies. The BOJ appears likely to accelerate the pace of monetary easing with further measures to amplify accommodative monetary policy in the coming months. The ECB recently cut rates a further 25 basis points to 0.25% as the eurozone slowly deleverages and several countries within the eurozone face ongoing disinflationary pressures. The ECB has indicated it could take further measures.

In the United States, the decision by the Fed to begin reducing its bond-purchasing program in January 2014 was inevitable, in our view, as it is not a realistic expectation for the Fed to print money indefinitely. We believe that the longer the program continues, the longer distortions in the market could last. Furthermore, we believe it is important to remember that the end of printing new money does not mean the end of loose monetary policy in the United States. While the Fed will eventually discontinue new purchases, and eventually even gradually raise interest rates, we believe that would still equate to fairly loose monetary policy at the global level, given the size of the Fed's outstanding balance sheet, as well as the actions of the BOJ and the ECB. The total pool of global liquidity remains abundant and is likely to continue to expand, in our view.

We believe the fear of liquidity being pulled out of emerging markets due to the Fed eventually ending its bond-purchasing program is overstated, as we do not believe there would be a massive contraction of liquidity out of emerging markets. Instead, we think the situation will likely result in less new money pouring into these markets. Many emerging markets have a surplus of savings and low indebtedness. Furthermore, many of these emerging-market countries no longer rely on foreign capital inflows as they did in previous decades due to improved fiscal accounts and a large amount of foreign reserves, which can provide a cushion against capital outflows. When the Fed does end its bond purchases, we believe the interest-rate differential will likely be in favor of emerging markets with high growth and inflation dynamics that should dictate higher interest rates than those in the United States. We believe the relative value potential of these countries' assets is still intact as they have not been printing money; therefore the pace of Fed tapering is unlikely to have a fundamental impact on countries that continue to exhibit strong fundamentals.

The current low levels of interest rates and the likelihood of facing a rising-rate environment are central to our near-term outlook. We expect many emerging markets should benefit from solid fundamentals as well as ongoing capital inflows from worldwide quantitative easing. We remain encouraged about the growth prospects and low indebtedness of many emerging markets. Asia ex-Japan looks reasonably strong to us, as do select economies in Latin America and Europe. We believe credit conditions have remained favorable in these regions given their low levels of debt and relatively stronger growth rates.

FRANKLIN TEMPLETON FIXED INCOME GROUP
Sheila Amoroso and Rafael Costas, Co-Directors of the
Municipal Bond Department

The 2013 municipal bond market could be referred to as “Dr. Jekyll and Mr. Hyde.” The year opened with the market’s broadly positive momentum from 2012’s price appreciation and strong positive flows into municipal bond mutual funds. However, once the Fed began to openly discuss the possibility of tapering its bond-buying program, fixed income markets—and the retail-driven municipal market in particular—entered a period of uneven performance that lasted for the remainder of 2013. The negative tenor of the municipal bond market was exacerbated by the City of Detroit’s bankruptcy filing in July and by significant price erosion in Puerto Rico bonds resulting from negative press and media coverage about the island commonwealth’s fiscal and economic situation. Consequently, municipal bond funds had strong net outflows during 2013.

While issuers like Detroit and Puerto Rico dominated the headlines with their troubles, state and local tax increases, along with US economic growth, have generally helped state and local revenues. While there are cost pressures building up over time, such as pension obligations and other retirement benefits, states and localities have generally seen their fiscal positions improve. Independent credit-rating agency Standard & Poor’s reported that municipal bond upgrades led downgrades through the third quarter of 2013 by a wide margin. Although we are encouraged by this news, we still caution that such progress is likely to be slow and the ability of states and municipalities to meet their challenges may be uneven across the nation, with some bond issuers being more proactive than others in addressing expenditures.

As we cautioned in last year’s commentary, the municipal bond market started 2013 with yields generally at or near 50-year lows, and we felt the potential for continued price appreciation was very minimal. We suggested that investors focus instead on what we believe is the primary purpose of investing in municipal bonds: the potential for tax-free income.⁷ While market corrections and periods of weak performance are painful from a price perspective, we believe funds able to begin investing money at higher interest rates may be able to improve the income potential of their investments, which could lead to increased dividends.

Lower supply and improving credit fundamentals were generally supportive of municipal bond values in 2013. However, levels of demand were volatile over the period, and we believe this volatility is likely to continue through 2014. While municipal bond funds have continued to experience negative flows, the magnitude of these flows has decreased markedly since late summer 2013. In our view, the generally higher yields available on municipal bonds at year-end may entice more investors who have been sitting on the sidelines waiting for higher yield potential. Additionally, more and more baby boomers are retiring and seeking income for their retirement years, and higher federal taxes (and in some cases, state taxes) can make the tax exemption of municipal bonds more appealing. Conversely, negative news of any credit event might dampen demand (as Detroit and Puerto Rico did), and a continued rally in the equity markets may siphon funds away from fixed income. It is impossible to tell what forces will prevail, but we believe that the municipal bond market can provide tax-free income potential for those who seek it.

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7. For municipal bond fund investors subject to the alternative minimum tax, dividends may be taxable. Distributions of capital gains are generally taxable.

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