

## FINANCIAL MARKETS - REVIEW & OUTLOOK

After starting the year on an optimistic note with expectations of higher growth in the developed markets, global financial markets were impacted by a series of events, both natural and man-made. Despite the various challenges, the global economy managed to post positive growth, albeit lower than the expectations at the start of the year. The increased risk aversion impacted asset classes such as equity and commodities, while treasury yields declined (also helped by increased liquidity).

While the Arab Spring and natural calamities (Japan and Thailand) were unforeseen, policymakers' response to fiscal issues in developed markets clearly disconcerted investors. In second half of the year, monetary policy across the globe shifted towards easing and central banks in Developed Markets put in place additional dollar liquidity measures to ease funding pressures and boost credit growth.

Region/Country	2012 economic growth forecasts	Representative Index	1 year returns
World	4.0% (↓ 0.5%)	MSCI AC World	-9.41%
Advanced Economies	1.9% (↓ 0.6%)	MSCI G7	-5.98%
US	1.8% (↓ 0.9%)	S&P 500	0.00%
Europe	1.1% (↓ 0.6%)	FTSE Eurotop 100	-9.58%
Japan	2.3% (↓ 0.5%)	Nikkei	-17.34%
Emerging Economies	6.1% (↓ 0.4%)	MSCI Emerging Markets	-20.41%
Developing Asia	8.0% (↓ 0.4%)	MSCI Asia ex-Japan	-19.16%
China	9.0% (↓ 0.5%)	SSE Composite	-21.68%
India	7.5% (↓ 0.5%)	BSE Sensex	-24.64%
Brazil	3.6% (↓ 0.5%)	Bovespa	-18.11%

Symbol and numbers in brackets indicate the direction and extent of revision in growth projections from those released in January 2011.

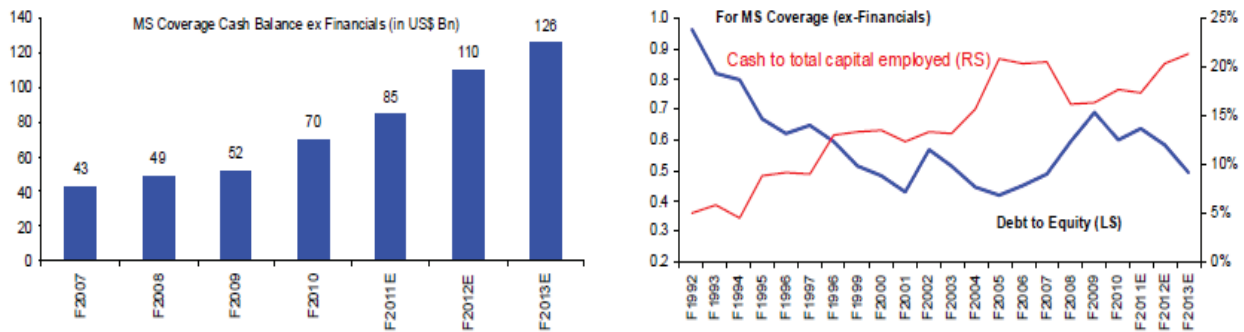
10-year bond yields (%)	US	UK	Germany	Japan
30-Dec-2011	1.88	1.97	1.84	1.10
31-Dec-2010	3.29	3.40	2.96	1.28

Source: IMF WEO September 2011, MSCI, Bloomberg, BSE, Financial Times

Despite a slowdown in growth momentum across the globe, commodity prices did not fall sharply due to continued investor interest and geopolitical tensions in the Middle East. Emerging Markets maintained the growth lead over developed counterparts and while the growth rate has moderated, it remains robust on a relative basis. The region's relatively strong position however did not help equity market performance – capital outflows and concerns about knock-on effects from the European debt crisis weighed on investor confidence.

## INDIA

India's economic growth moderated in 2011 on the back of cyclical headwinds (direct result of monetary tightening) and loss of confidence in policy making weighed on business & investor activity. RBI maintained its anti-inflationary stance for most of the year and increased interest rates consistently (by 225 bps in 2011). Economic growth came in slightly below the 7%-mark in the September quarter and inflation remained at higher levels. Despite the sharp hike in rates, private consumption held steady. This was reflected in the continued strength in topline growth for corporates, while profitability was impacted by the higher input costs and rise in borrowing costs. Corporate balance sheets remain in good shape helped by low leverage and free cash flow generation.

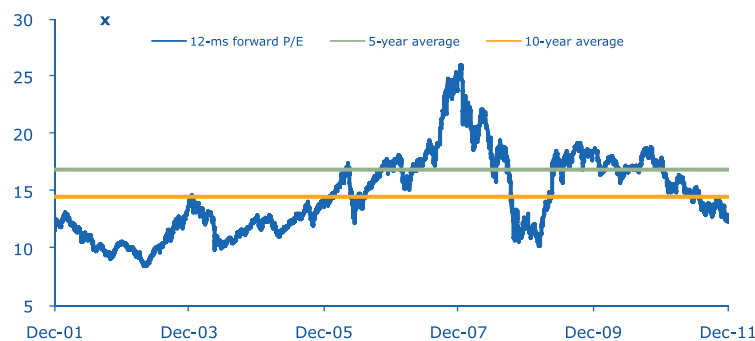


Source: Capitaline, MSCI, FactSet, Company Data, Morgan Stanley Research, Morgan Stanley Estimate

**Equity Markets:** Domestic macro-economic headwinds along with weak global sentiment weighed on Indian equity markets and leading indices underperformed their developed counterparts. Mid and small cap stocks witnessed a steeper selloff compared to large caps. The sell-off was fairly broad-based with all sectoral indices, except FMCG, closing in the negative territory. Real estate, metals and capital goods indices were the top losers amidst concerns of slowdown in investment activity. FIIs pulled out close to \$500 mn from Indian equities.

The recent correction in Indian equity markets has resulted in attractive valuations – markets are currently trading at a discount to 10 year average. The valuation premium enjoyed by Indian markets over peers is also lower than long-term averages. Earnings estimates were cut sharply and currently seem to be aligned to reality better compared to the start of the year.

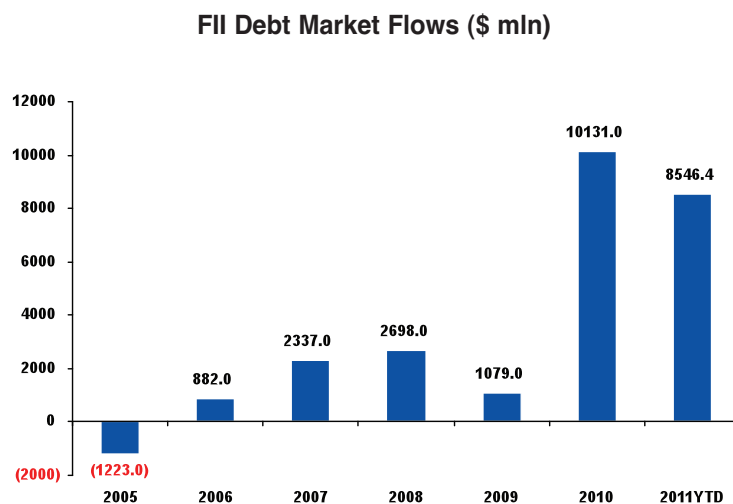
### Absolute valuations - BSE Sensex



Source: CLSA Asia-Pacific Markets

**Fixed Income Markets:** The steep rise in interest rates, inflation levels and concerns about fiscal slippages resulted in a sharp increase in Indian bond yields in 2011. The central bank continued to pursue monetary tightening in the wake of sustained high inflation rates and lack of complementary fiscal policy measures. In terms of the regulatory mechanism, the RBI introduced couple of key changes – a) moved to a single policy rate, and b) de-regulated the savings deposit rate.

In an environment of low bond yields across developed markets, FII interest in Indian bond markets remained high – FII flows aggregated \$8.5 bn. The government also raised the debt ceiling on government and corporate bonds by \$5 bn each to \$15 bn and \$20 bn respectively.



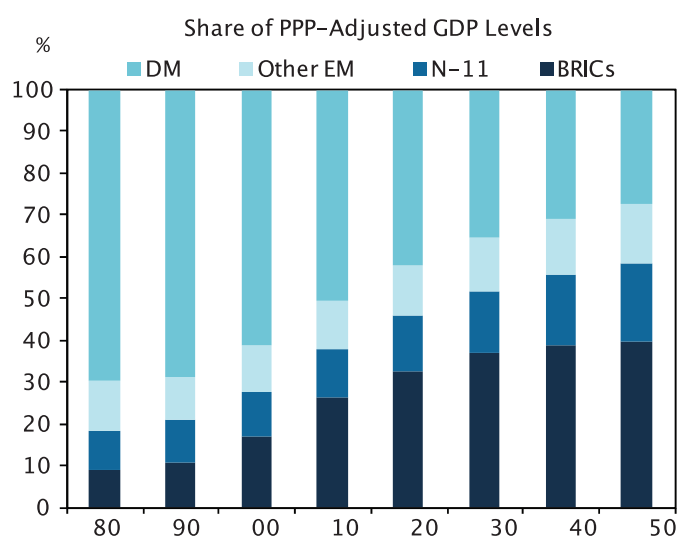
Source: SEBI, Cline, Morgan Stanley

Concerns about the twin deficits and capital outflows led the rupee to touch multi-year lows against the dollar. The decline prompted RBI and the government to announce measures to boost capital flows and prevent speculative activity in forex markets. Systemic liquidity was tight for most part of the year and in recent months RBI has conducted OMO auctions to alleviate systemic stress caused by slowing capital flows alongside a current account deficit. Towards the end of the year, RBI signaled a pause in its monetary tightening and held out the possibility of rate cuts if growth trends deteriorate sharply.

## OUTLOOK

On the global front, we expect the key concerns of 2011 to play out during the first half of the year and financial markets could continue to be volatile. Developed economies will continue to unwind the excesses of the past and the situation in the Eurozone will be a key driver of investor sentiment. Overall, the global economy is expected to witness varying degrees of recovery in the coming years. Emerging economies will tread on their relatively fast growth path while the developed economies will grow at a slower pace as they continue to absorb the costs of the recent excesses in the financial sector combined with declines in productivity. Central banks could continue to pursue quantitative easing as a tool to boost liquidity and support growth.

## Share of BRICs and Frontier Markets in World GDP to remain on the rise



Source: IMF, GS Global ECS Research

We believe that 2011 has underlined the need to focus on quality companies and corporate governance and expect stock picking to deliver better results than momentum based top down trading that has been the norm over the last few years. We could see further earnings downgrades for companies with unsustainable business models. While India is well placed in terms of its low export dependence and lack of leverage in the financial system – weakening business confidence could have an impact on investments as well as loans. A growth rate of 7% would be more sustainable given the infrastructural bottlenecks. There is a clear need for policy reforms to ensure that India realizes its long term growth potential and should also help in addressing supply-side issues that have been pushing up inflation.

Apart from the cyclical headwinds we had witnessed during 2011, other factors to watch out are the possibility of increased NPAs and losses in the state electricity boards. The underlying strong economic fundamentals remain intact – demographic dividend, rising income levels and expected increase in infrastructure spending. Investors are looking for clear signs of policy resolve to address the critical issues facing the economy and any progress on this front will be a positive. Over the medium to long term, as the growth rate resumes upward trajectory, well-managed companies will be able to take advantage of the higher demand.

We will continue to focus on companies with strong positions (superior products/services, healthy balance sheets, strong and reliable cash flows) and better corporate governance standards. Given the overall macro economic situation, we will remain focused on the short end of the curve, especially on corporate debt. On the long end of the curve, we remain cautious and will try to take advantage of emerging trading opportunities.

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