

A DISCUSSION PAPER FROM FRANKLIN TEMPLETON FIXED INCOME

Investment Grade Corporate Credit Markets: Where Do We Go From Here?

Yields on investment-grade corporate debt have widened to unprecedented levels. Is this an opportune time to invest in the sector? This paper takes a closer look at the fundamental and technical factors currently driving the investment-grade corporate market while analysing potential merit for investment.

INTRODUCTION

Financial markets around the world have experienced extreme and unprecedented volatility over the past year. The “credit crunch” that started in the summer of 2007, when subprime mortgage losses led to the collapse of a group of Bear Stearns hedge funds, morphed into a broader financial crisis which caused a significant downturn across a wide range of asset classes. In the autumn of 2008, we saw a number of takeovers, bailouts, bankruptcies and defaults of once considered highly rated banks, brokerage firms and finance companies. Around this time, money markets froze as banks hoarded capital and investors worried about counterparty risk. These and other well-publicised problems forced a massive coordinated government response, as countries around the globe sought to restore confidence in the banking system via debt guarantees, special liquidity facilities, and direct capital injections. In the interim is a weakening global economic picture, characterised by declining consumer confidence, increased unemployment, and a pullback in both consumer and corporate spending. Economic weakness has been exacerbated by the major decline in credit availability, as financial institutions struggle to rebuild their capital bases.

As of this writing, spreads on investment grade corporate debt moved to historically wide levels relative to government bonds. The new-issue market has been limited to mostly higher-quality borrowers over the past several months. Moreover, those companies that have successfully launched new issues have been obliged to sell bonds at substantial yield premiums. This has raised interest costs for companies that need to issue debt, and it has caused secondary market yield spreads to widen to new-issue levels.

Recent governmental actions to help stabilise the financial markets have begun to slowly thaw the credit markets. Yet investors remain wary as market liquidity is thin, volatility elevated and yield spreads high.



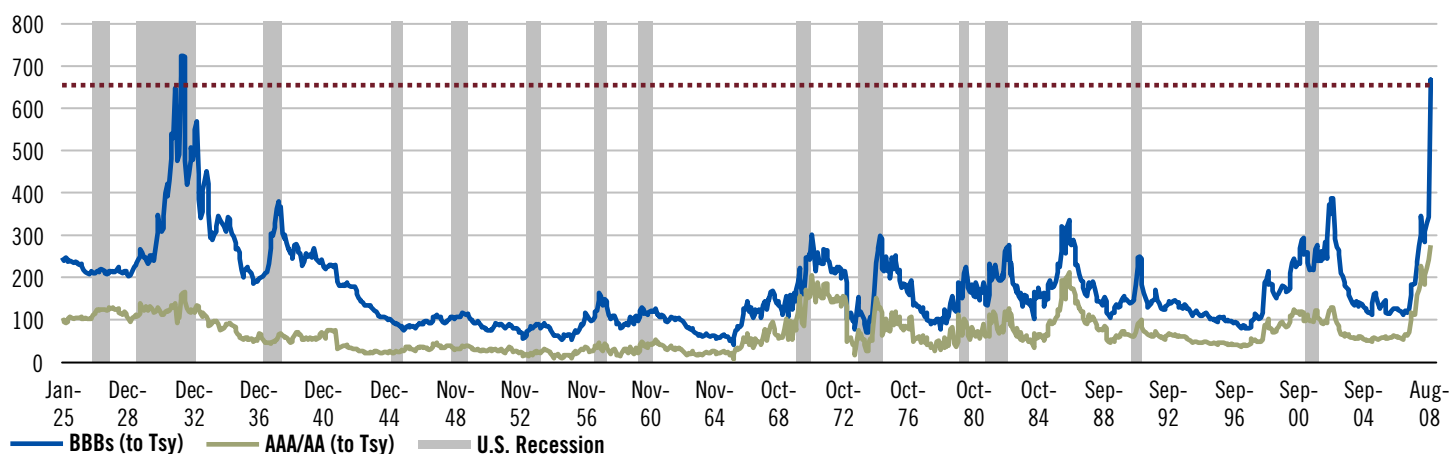
VALUATIONS—A HISTORICAL CONTEXT

Corporate bond yield spreads, the incremental yield on corporate bonds over “risk-free” government bonds, have widened to historically high levels. Spread levels normally change over time, depending on a number of factors, including the creditworthiness of debt issuers, investor risk appetite, and returns on competing investment alternatives. But data from Moody’s Investors Service compiled by Morgan Stanley shows that spreads of higher-quality “A”

and “AA” rated bonds have touched their highest level ever, while spreads of more risky BBB rated bonds reached levels not seen since the Great Depression.

Clearly, market structure has changed significantly since those early days of the corporate bond market, but the recent severity of the move in corporate spreads when compared to the levels reached in more recent recessions and financial market disturbances is jarring.

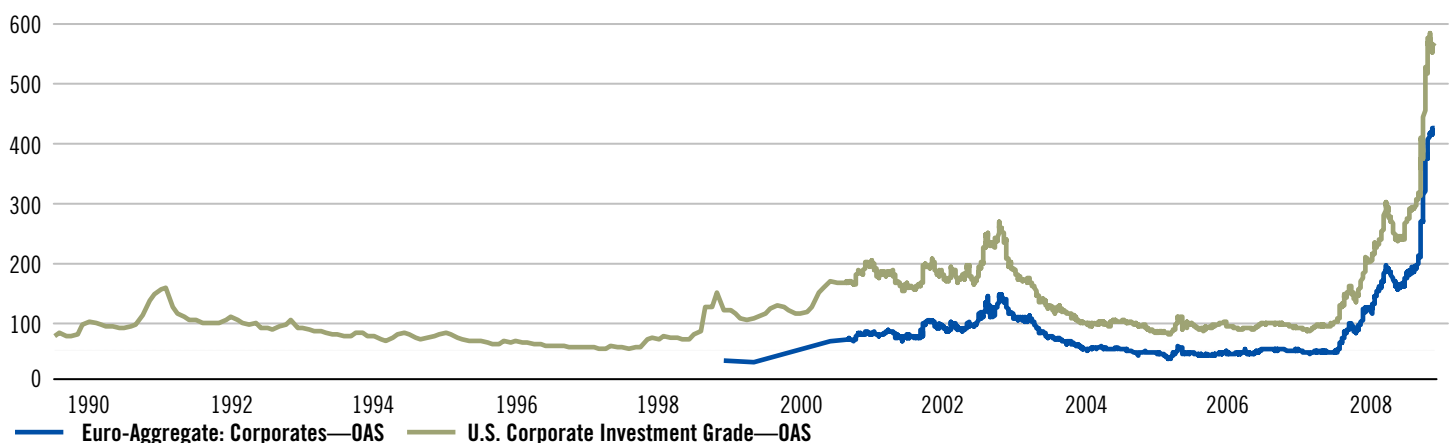
U.S. Corporate Yield Spread to Treasuries¹



As of this writing, spreads for the Lehman Corporate Index are approximately 560 basis points (5.6%) above government bond yields in the U.S. dollar market, compared to a longer-term average of 145 basis points. The euro corporate bond market has a shorter history, having been

formed only in the late 1990s but, as of 17 November 2008, spreads in that market rose to 419 basis points above governments versus a longer-term average of just 83 basis points.

U.S. and Euro Investment-Grade Corporate Bond Yield Spreads²



	Last	Minimum	Maximum	Mean	SD	SD Change		
Euro-Aggregate: Corporates—OAS	419.385	30.190	30/04/1999	419.613	14/11/2008	83.418	55.639	2.183
U.S. Corporate Investment Grade—OAS	561.952	51.138	31/07/1997	580.019	03/11/2008	145.229	76.749	3.297

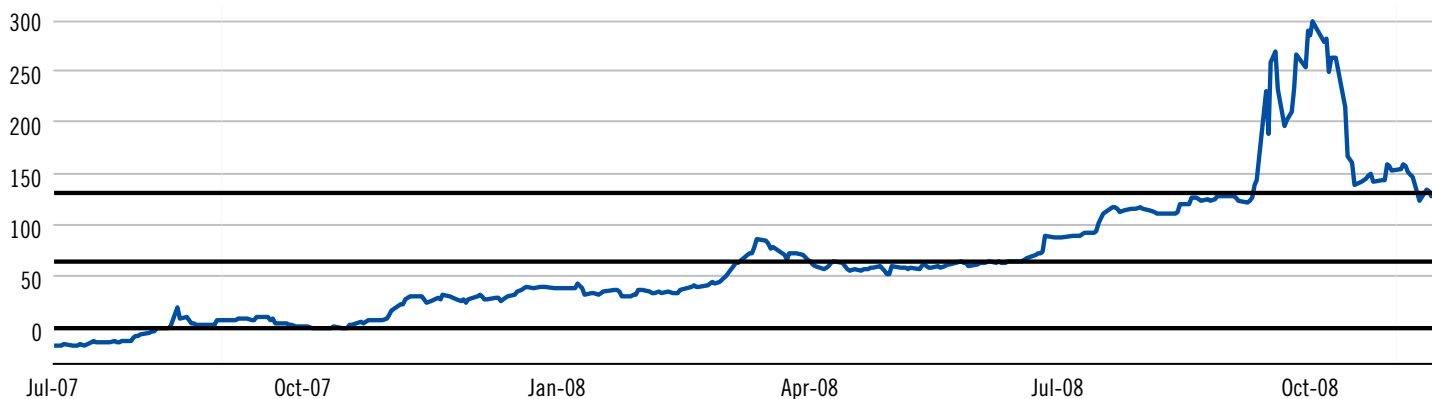
1. Source: Morgan Stanley. All data is historical for the time periods indicated and ended 17 November 2008. The “Last” is as of 17 November 2008.
 2. Source: Lehman Live®. All data is historical for the time periods indicated and ended 17 November 2008. The “Last” is as of 17 November 2008.

Spreads of financial issuers have led the move wider, as banks and brokerage firms were the front-line casualties of the U.S. subprime mortgage crisis. More recently, spreads of industrial companies and utilities have also widened substantially as fear of systemic risk has ebbed and been replaced by increased concerns about the global economy. Weaker economic conditions will likely lead to reduced

industrial profitability over the next several quarters, straining cash flows and other important credit metrics.

Given the combination of wide credit spreads and lower government bond yields, one potential upside is the overall yield available to investment-grade corporate bond investors.

Credit Spread Differential Between U.S. Financial and Industrial Bonds³



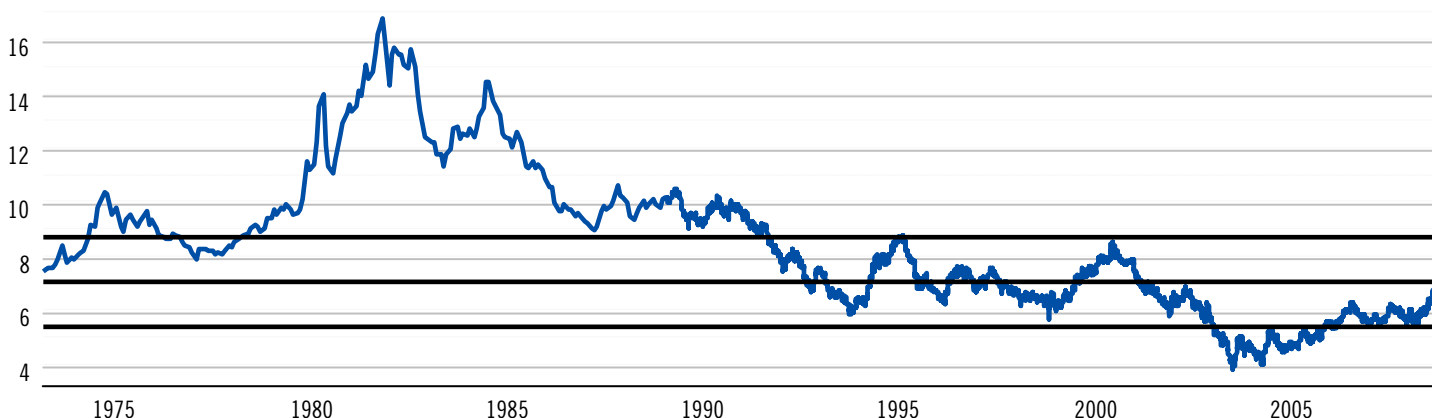
— U.S. Financials vs. U.S. Industrial

	Last	Minimum	Maximum	Mean	SD	SD Change		
U.S. Financials vs. U.S. Industrial	128.280	-17.682	13/07/2007	297.869	02/10/2008	65.080	65.575	9.306

As of this writing, yields on the Lehman U.S. Corporate Index were over 8.5%, the highest level since the early 1990s. The yields on individual bonds will depend on a number of factors, including sector, credit quality and maturity. However, while these higher yields provide more

attractive returns for patient investors, they could have a negative impact on corporate credit metrics, such as interest coverage ratios, and make future capital projects uneconomical to pursue.

Lehman U.S. Corporate Index Yield³



— U.S. Corporate Investment Grade—Yield to Worst

	Last	Minimum	Maximum	Mean	SD	SD Change		
U.S. Corporate Investment Grade—Yield to Worst	8.53	3.77	13/06/2003	16.79	30/09/1981	7.02	1.66	0.10

3. Source: Lehman Live®. All data is historical for the time periods indicated and ended 17 November 2008. The "Last" is as of 17 November 2008.

HOW ARE CORPORATE FUNDAMENTALS?

As we look ahead to 2009, we expect global economic weakness will increasingly pressure corporate earnings as consumers cut spending in the face of rising unemployment and weak housing markets. Consumers will also face more difficult credit conditions, as banks have pulled back on both secured and unsecured lending. In addition, substantial equity market declines have had a negative impact on confidence levels so even more affluent consumers are likely to be in a cautious mood through the 2008 holiday season and into 2009. One positive offset is the recent fall in energy prices, which has directly helped the consumer (although this has had a lesser impact in other parts of the world due to the strength of the U.S. dollar). In addition, recent rate cuts by a number of central banks could eventually provide some relief, as could economic stimulus plans once they are put in place.

Against this backdrop, fundamental changes in different corporate subsectors (financials, industrials, and utilities) will likely be quite different. Financials have already been through a cycle of asset write-downs and losses over the past year, and the most systemically important banks are now positioned to take advantage of government capital injections and are eligible to issue debt with a government guarantee. We believe this should help restore stability and hopefully restart lending. On the other hand, industrials and utilities initially came through the early stages of the credit crunch relatively unscathed. But conditions have clearly deteriorated since early September and these companies are now more directly impacted by a worsening economic situation.

Financials

A critical point in evaluating financial issuers over the next several quarters will be an understanding of where we are in the credit cycle and how economic conditions impact each institution. Banks have already taken tremendous write-downs on subprime debt and other securitised assets, but increased unemployment probably means that more prime consumer borrowers may begin to have trouble keeping up with payments. In addition, loans to business borrowers and commercial real estate developers are also likely to see further impairment. Diminished asset quality could have a significant impact on earnings and capital for banks around the globe. Over the near term, we expect the road ahead to remain bumpy, but take a considerable degree of comfort from the more active role governments have taken in supporting the largest, most systemically important financial institutions.

Changing Landscape for U.S. Institutions

Recent government intervention in the U.S. has radically changed the banking landscape in a manner few would have thought possible even a few months ago. Government action

has encouraged or forced banking consolidation, often using creative means to find willing acquirers. The injection of equity capital via the Troubled Assets Relief Program (TARP) into nine of the nation's largest banks and many smaller ones (and possibly other strategically important financial institutions) may provide additional flexibility in terms of asset disposals, since capital levels will be less of a concern. We believe the government's debt guaranty programme, in conjunction with several other measures designed to enhance access to funds, should make bank funding and liquidity less of a concern over the next several years.

We are closely watching additional regulations likely to be imposed in response to the current crisis. While these regulatory changes may help control risk, they could also result in lower profitability. Going forward, the overall bank earnings model is likely to change, as in recent years banks had increasingly originated assets with the intent to securitise them, rather than hold them on balance sheet. In the future, securitisation is likely to be a less attractive financing source, so banks will have more incentive to retain assets on balance sheet. This creates a different return profile and requires more capital, so finding cheap and stable sources of funding, particularly retail bank deposits, will be a key differentiator among institutions.

The desire to ease systemic risk resulted in the accelerated approval of applications from both Goldman Sachs and Morgan Stanley to become bank holding companies, essentially ending the independent broker-dealer business model. Moving to a bank structure and reducing leverage may hurt future shareholder returns for those companies, but the change should be a positive for bondholders. The extraordinary loans and preferred equity injection to keep American International Group out of bankruptcy and the decision to consider other insurance companies and finance companies for possible TARP funds also demonstrates the government's willingness to move beyond just banks, if necessary, to find ways to ease strains on the financial system.

Non-U.S. Institutions

Although perhaps initially slower to respond on the monetary and fiscal side, European policymakers have also taken steps to rescue troubled financial institutions. The UK government initially tried to sidestep the moral hazard issue by arranging private sector solutions for some smaller troubled banks but nationalisation has been resorted to twice, wiping out shareholders and negatively impacting subordinated bondholders. Subsequently, the UK government has announced a comprehensive financial stability package, aimed at recapitalising the system, encouraging interbank lending and restoring depositor confidence. Variations of this have been considered by other European governments.

Some European banks with operations in the U.S. have been affected by the subprime debacle. However, the vast majority have had indirect exposure via structured products like CDOs, as well as counterparty risk with U.S. banks and brokers. For example, many non-U.S. banks incurred losses due to the Lehman Brothers bankruptcy. Lastly, in some European countries, most notably the UK, Ireland and Spain, such problems have been compounded by falling domestic real estate markets.

Likewise, Asian and Australian banks have also been indirectly impacted by U.S. subprime loans and counterparty risk. Exposures have generally been deemed manageable, but have incrementally weakened profitability and capital levels at a time when slowing local economies are starting to inflict credit losses on more traditional loans. Another risk factor for some banking systems, such as Korea, is the large amount of borrowing the local banks have done in global capital markets, generally in other currencies. Governments in the region have followed the lead of their western peers and have taken measures to protect the competitiveness and the soundness of their banking systems.

Industrials and Utilities

Overall, we believe investment-grade industrial companies are entering the current downturn in a relatively strong financial position. Although many companies had increased their focus on shareholder returns over the past several years, often through share buybacks, the majority of companies financed these purchases with free cash flow, rather than through increased financial leverage. As a result, the most vital credit metrics are in relatively good shape to withstand some financial pressure over the upcoming quarters. Most vulnerable will be companies that have economically sensitive revenue streams, those who are already at or above their debt leverage targets, and of course those who have immediate substantial funding needs.

It's also important to note that for investment-grade companies the main risk from short-term financial pressures is typically not default (despite some recent examples in the bank and brokerage sectors). Rather, we believe the more likely outcomes are credit rating downgrades, possible debt covenant violations, or spread widening due to diminished credit standing. All of these can potentially be harmful to bondholders.

We believe that utilities may be the best positioned sector to withstand the weakening economy. Utility revenues are generally more stable, although they are not immune to the effects of an economic downturn since industrial customers often reduce energy usage and some residential customers are unable to pay their bills. Volatile fuel costs and regulatory changes could also each have impacts on profitability. However, many utilities have substantial financing needs as they attempt to upgrade or expand plants and equipment. Lastly, President-elect Obama's clean energy programme could also affect issuers.

TECHNICAL FACTORS

Separate from fundamentals, a number of technical factors are currently impacting valuations in the corporate bond market. These include deleveraging, investor liquidations, market liquidity, and the overhang of potential new issuance.

One of the reasons that corporate spreads tightened substantially in the mid-2000s and stayed tight for an extended period was a large increase in leverage throughout the financial system. Structured credit vehicles, such as CDOs, CBOs, and SIVs, created a huge demand for credit, as did the growth of hedge funds, securities lending programmes, and countless other types of specialised investments. Losses incurred in these issues over the past year, liquidation trigger events, increased spread volatility, and more conservative lending standards have forced many of these programmes to unwind positions or reduce risk. As a result, secondary market spreads have been impacted by the increasing supply of bonds returning to the market while demand has been reduced because there are fewer leveraged investors willing to buy.

Selling pressure from more traditional investors like mutual funds and pension plans also impacted the market. Fixed income mutual funds have experienced investor redemptions and have needed to sell securities to raise cash. In addition, given the larger drops in equity valuations some pension funds are rebalancing portfolios into equities from fixed income. On the positive side, traditional equity investors cannot ignore the higher yields available in the corporate market for quality issuers.

Since the onset of the credit crunch, market liquidity has significantly diminished for investment-grade corporate bonds. Spreads between the bid and ask prices for bonds have increased and it is often difficult to transact in all but the most liquid issues. There are a number of reasons for this change in liquidity, but it can partially be attributed to a decline in the outright number of broker-dealers and more constrained capital positions. As a result, brokers are less willing to take positions into inventory and, instead, try to act as intermediaries between potential buyers and sellers. Brokers willing to bid for bonds are also often bidding less aggressively, since heightened spread volatility increases the risk to these positions.

Lastly, the overhang of potential new issuance has kept spread levels wide. As previously mentioned, the new-issue market has seen only limited activity over the past several months due to volatile market conditions. When new issues have come to market, they have been priced with large concessions to secondary spreads, often more than 100 basis points. As a result, investors who want to add corporate bond exposure are being paid to wait for new issues, which can be bought cheaper (with higher yields) than existing bonds. The overhang of new issues creates a natural barrier to spread tightening since investors believe that any market

stability will cause an increase in issuance. The possibility of a significant supply of government-guaranteed bank debt also creates some additional uncertainty, since it remains unclear what type of yields these bonds will offer relative to straight bank debt, as well as government agency issues.

MARKET STRUCTURE

One development worth mentioning that has had a significant impact in recent years is the exponential growth of the credit default swap (CDS) market. Derivatives opened up a broader opportunity set in credit by allowing participants to implement a number of new strategies, including making negative bets on individual credits. Previously, most investors were limited to making positive credit bets by including cash bonds in their portfolios, while only being “short” credits they did not like to the extent they were underweighting those credits relative to their benchmark.

The growth of the CDS market certainly provides some benefits to investors, but there is a downside as well. Many of the most active traders in the market have been hedge funds attempting to earn short-term profits by betting on the rise and fall of individual credits or indices. This rapid-fire trading has increased overall volatility in the cash market, and often put pressure on companies who find themselves under attack in the CDS market. Negative news items or rumours can cause an immediate and substantial change in CDS levels. Cash bond spreads often widen in sympathy with CDS spreads, increasing funding costs or making market access more difficult. Equity investors closely watch the CDS market for hints of financial distress, and sometimes use CDS as an alternative to equity put options as a way to hedge equity portfolios.

The CDS market has recently come under a great deal of scrutiny in the media because of its perceived role in contributing to the current financial crisis. Increased regulatory oversight over the market is likely, as is the development of a clearing house mechanism that will reduce systemic counterparty risk. In addition, the closure of numerous hedge funds and more difficult financing requirements for the remaining funds will likely cause changes to the liquidity profile and volatility of the CDS market. Collectively, these developments will probably have important ramifications for the corporate credit market as a whole.

A COMPARISON WITH HIGH-YIELD BONDS AND LEVERAGED BANK LOANS

Suffering in the corporate market has not been limited to the investment-grade sector; high-yield bonds and bank loans are now trading at distressed levels. Unlike previous bear markets, investment-grade bonds led the move downward, as initial market concerns primarily surrounded higher-quality financial institutions involved in the subprime mortgage market. But worsening financial market

conditions and a bleaker economic picture caused prices on high-yield bonds and bank loans to fall in sympathy. High-yield companies tend to be at greater risk from economic weakness than investment-grade companies, since they are typically more highly levered and have lower cash flow coverage of their fixed financial obligations. As a result, they have less ability to withstand a drop in earnings or cash flow without getting close to the precipice of financial distress.

Problems among high-yield and bank loan issuers may take longer to lead to defaults in this cycle because of the more lenient covenant provisions contained in many transactions that came to market in 2006–2007. To date, actual default rates have remained relatively low and have been far below the levels that current market valuations would imply. Nevertheless, many analysts expect future defaults to rise.

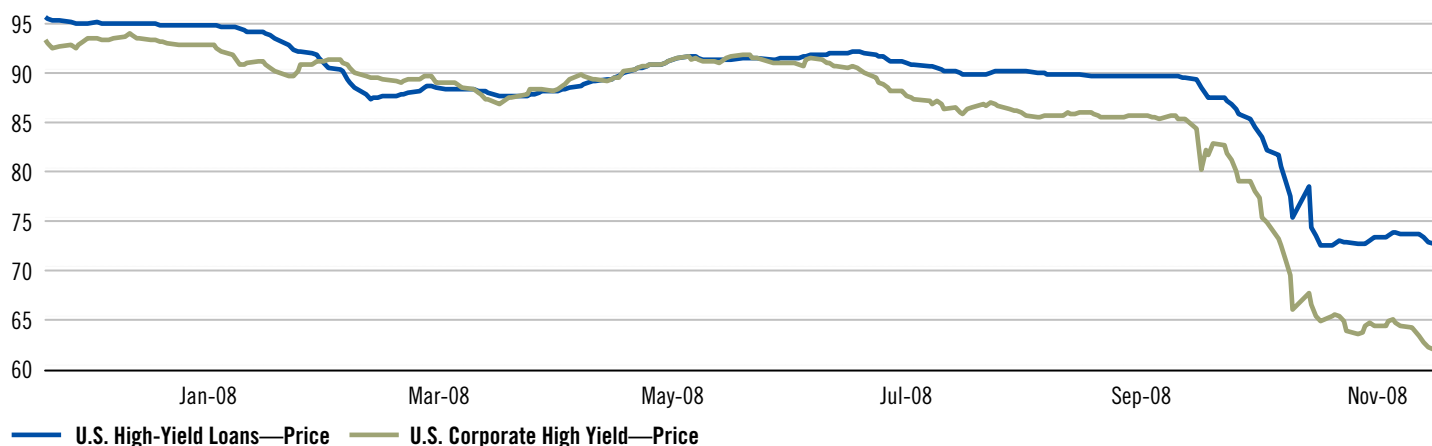
Prices in both the high-yield and bank loan markets have been impacted by some of the same types of technical pressures we discussed above. Significant outflows from bank loan mutual funds and the unwinding of derivatives tied to bank loans have caused loan prices to plummet. In addition, the absence of CLO buyers has also negatively impacted prices. Since bank loans are senior in the capital structure (to high-yield bonds), the price decline in bank loans has caused prices of high-yield bonds to fall, particularly in cases where issuers have both bank and bond debt outstanding.

ASSESSING THE OUTLOOK: HEALING TAKES TIME

We firmly believe that investment-grade corporate bonds offer the potential for exceptional long-term value at current spread levels. However, volatility is likely to remain high over the near term, as financial markets heal from the tremendous dislocations we have experienced over the past year. In addition, the length and severity of the current economic downturn will play a big part in determining how quickly more normalised conditions return to the corporate market. In the meantime, we are striving to ascertain which corporate sectors and individual companies are most likely to be impacted by current conditions and which individual bond issues offer the most significant investment potential. We end this paper with some signposts that will hopefully help investors navigate these choppy waters:

- Governments and central banks around the globe have taken unprecedented actions over recent months in an attempt to stabilise financial markets and provide additional liquidity. As of mid-November, money markets have finally begun to function more normally, as evidenced by the decline of LIBOR rates relative to short-term government securities as well as a greater ability of companies to issue commercial paper obligations. Continued functioning of the money markets and a willingness of financial institutions to lend to each other are both necessary preconditions for an improved tone in all financial markets, including corporate credit.

Lehman U.S. High-Yield Loan and Corporate Bond Indices—Price⁴



	Last	Minimum	Maximum	Mean	SD	SD Change		
U.S. High-Yield Loans—Price	72.278	72.171	17/10/2008	95.442	19/11/2007	88.503	5.838	0.446
U.S. Corporate High Yield—Price	61.326	61.326	17/11/2008	93.707	11/12/2007	85.866	8.215	0.539

- Problems in the U.S. housing and mortgage markets were the main contributors to the events that created the current market disturbance, given the large write-downs that financial institutions around the world had to take on mortgage-related securities. Any sign of stabilisation in those markets (either organically or because of the TARP programme or other housing-relief initiatives) would be a clear positive for the corporate bond market, since banks, brokers, and insurance companies would find themselves under less earnings and capital pressure.
- Although corporate bond investors and equity investors are both ultimately interested in ensuring that companies avoid financial distress, their shorter-term interests can sometimes diverge. Creditors want companies to maintain the largest margin of safety as possible, keeping financial leverage down and making sure that the continued flow of interest payments is not jeopardised by economic conditions. Equity investors, on the other hand, often will push to boost short-term returns by advocating share buybacks or increased dividends. Management teams currently seem to be more aware of the uncertain economic and financing environment and are conserving cash. A continuance of this trend should be a positive for corporate bonds.
- The decline in global equity prices has added to the pressure on corporate bonds. Lower equity valuations make it more difficult for companies to raise additional capital, and credit rating agencies are sometimes now even citing declines in equity prices as justification for credit rating downgrades. In addition, the day-to-day movements in equity prices and equity-implied volatility (such as the VIX index) generally set the short-term mood in the corporate bond market. Weak equity prices tend to lead to more risk aversion in the credit markets. Greater

stability in equity markets would help to underpin a longer-term recovery in corporate bond valuations.

- As noted above, corporate bond valuations have also been impacted by the rapid deleveraging of the financial system, which has reduced demand for corporate credit and increased overall supply into the secondary market as investors liquidate existing positions. We need to see a better demand/supply ratio in the corporate market, with more investors deciding that corporate valuations look attractive. The growing interest in corporate credit from equity investors is a positive sign. The potential supply of new issues and the pressure that new issue concessions has put on the secondary market also caused spreads to remain high. A broader opening of the new-issue market and contraction of new-issue concessions will be an important early indicator of a potential spread rally.
- Market liquidity will remain a key issue as investors will likely find it difficult to trade certain corporate bond positions and bid-ask spreads will probably remain wide. Although the recent loss of several major broker-dealers has hurt liquidity, we are hopeful that better financing terms for the remaining banks and brokers active in the market (who can take advantage of government-guaranteed financing) will enhance willingness to make active markets in corporate bonds. Better liquidity will help restore investor confidence and reduce the illiquidity premium that is contributing to wide spread levels.

CONCLUSION

Investment-grade corporate bonds, like most asset classes, have struggled over the course of the global financial turmoil, but current valuations are wider than we have seen in any recent recession or market disturbance. Economic headwinds remain a concern, as do structural changes to the

4. Source: Lehman Live®. All data is historical for the time periods indicated and ended 17 November 2008. The “Last” is as of 17 November 2008.

market that may result in lower liquidity and diminished demand. We continue to believe that valuations are already pricing in a lot of potential bad news for those investors who can accept short-term volatility.

Yield levels are high and even modest spread tightening from these elevated levels would further enhance returns for investors. In the U.S., for example, a 100 basis-point contraction in index spreads over a one-year horizon would result in more than a 10% excess return relative to treasury securities, while a 200 basis-point contraction would result in an excess return over 15%. We cannot forecast short-term market movements, but either of these spread moves would still leave us well above long-term averages. On the downside, U.S. corporate spreads could widen by over 100 basis points from current levels before investors would underperform treasuries.

It's difficult to predict what more "normalised" valuations should be once the markets begin to recover, but we are not likely to go back to the leverage-induced tight levels

achieved in 2005–2007 anytime soon. However, we do believe that spreads can move tighter once the economic picture becomes clearer and investors become more comfortable that recent defaults by investment-grade companies were more of an anomaly than a permanent change in the relative risk of highly-rated debt obligations. According to Moody's, default rates by investment-grade issuers have historically been very low, averaging just 0.145% of issuers per year from 1920–2007, with a peak of 1.56% of issuers back in 1938. As of the end of October 2008 the trailing 12-month default rate was 0.3%.

In these current market conditions, we are focusing new corporate bond investments in our client portfolios primarily on senior debt of the most important global financial institutions, as well as debt from less cyclical industrial and utility companies. Avoiding problem credits will be a major driver of portfolio performance over the coming months, as it has been for the past year. Careful security selection, backed by rigorous credit analysis, is crucial in these turbulent market conditions.

Examples of Performance after Recent U.S. Corporate Bond Spread Peaks⁵

	January 1991	October 2002
Lehman U.S. Corporate Index Spread Peak (bps)	+154	+266
1 year later	+102	+110
3 years later	+67	+89
Excess Returns vs. U.S.T		
1 year from peak	3.0%	9.3%
3 years from peak	4.8%	11.3%

This paper was developed by the Franklin Templeton Fixed Income Group, in conjunction with Franklin Templeton Fixed Income Investment Product Management.

5. Data Source: Lehman Live®. Excess returns shown are cumulative, not annualised. All data is historical for the time periods indicated.

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