NOVEMBER 2019

No need to panic—keep calm and carry on

FRANKLIN TEMPLETON THINKS™ | FIXED INCOME VIEWS

FRANKLIN TEMPLETON

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In this issue

Our expectation continues to be that the global economic outlook will prove more resilient than widely predicted by many market participants. While the trade and political environment is significantly more volatile than during past periods, the US economy continues to hold up relatively well and should partly compensate for a mixed outlook in the rest of the global economy.

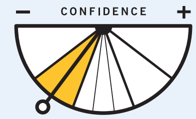
The period following the Federal Open Market Committee's (FOMC's) decision to cut rates in July—its first policy rate cut in a decade—can be described as nothing short of what US Federal Reserve (Fed) Chair Jerome Powell called "eventful." We've seen global manufacturing data contract, intensification of protests in Hong Kong, a drone attack on Saudi Arabian oil fields, the initiation of an impeachment probe in the United States, and a Turkish military offensive in Syria, as well as a further ratcheting up of the US-China trade dispute (although a recent agreement to suspend another round of tariffs in exchange for Beijing's commitment to buy more American farm products has alleviated some pressures). Volatility has risen, putting markets on edge.

Abundant liquidity in the market fueled by unconventional monetary policy continues to be a source of financial market distortions, particularly for risk asset valuations, and keeps pushing investors toward riskier, less liquid assets. At current levels, we remain cautious overall in many regions and sectors. From a fixed income perspective, we currently recommend keeping assets at the ready in highly liquid portions of the market to take advantage of periods of volatility to invest in fundamentally sound sectors at more attractive valuations.

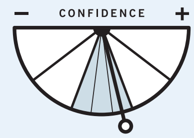
Sector settings

US Treasuries

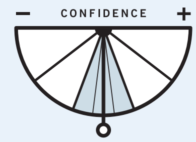
US High-Yield Corporates



Eurozone Government Bonds

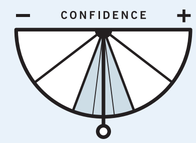


Euro High-Yield Corporates

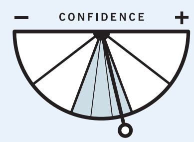


Japanese Government Bonds

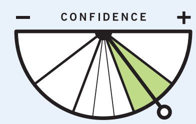
Floating Rate Loans



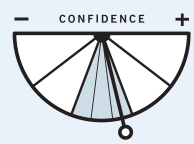
Mortgage-Backed Securities



Municipal Bonds



Asset-Backed Securities

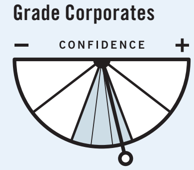


Emerging Market Debt

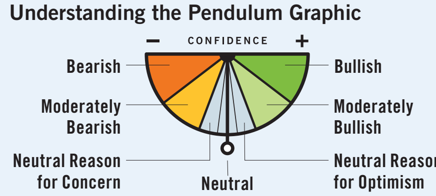
US Investment-Grade Corporates

Emerging Markets Corporates

European Investment-Grade Corporates



Understanding the Pendulum Graphic



Franklin Templeton Fixed Income macroeconomic views

Yield curve inversions: much ado about nothing?

The recent inversion of the US Treasury yield curve has had the financial press in a bit of a frenzy. With global growth weakening, geopolitical tensions on the rise, continued uncertainty around trade and inversions of the US yield curve, many are asking: Is a US recession imminent?

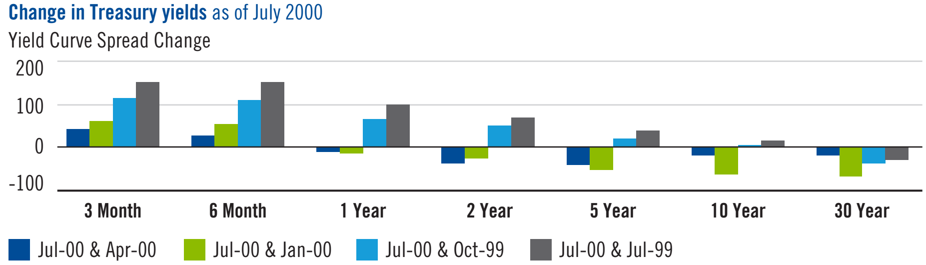
We see a glaring contradiction in the fact that so many market participants and commentators emphasize the heightened level of economic uncertainty, and at the same time seem to consider flat or inverted yield curves as foolproof predictors of a recession. We believe this is completely misguided—the yield curve today is telling us very little about what lies ahead for the real economy. Market fears of an imminent recession are overblown, in our opinion, and investors need to look closer at the nature of the yield curve inversion.

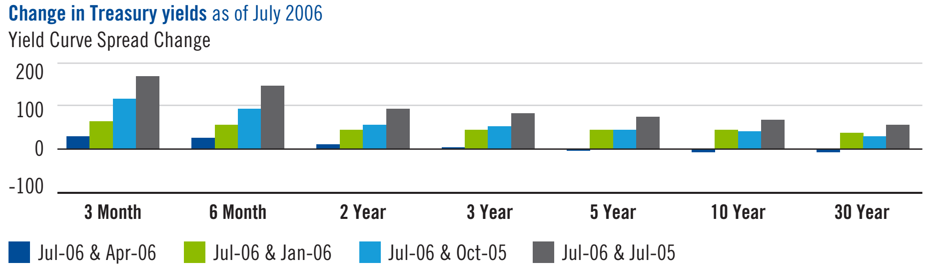
Inversions are seen by many as a harbinger of an economic recession because the yield curve spread has flattened and then inverted preceding the past seven recessions. A closer look, however, suggests that this time may be different. We looked back at the time periods the US10Y–US3M[1] (10y–3m) spread first inverted before each of the prior two recessions and then examined how the slope of the yield curve changed in the four quarters prior to that first inversion. The yield curve inversions prior to the 2001 and 2008 recessions were driven by a rise in short-term rates, as seen in Exhibit 1.

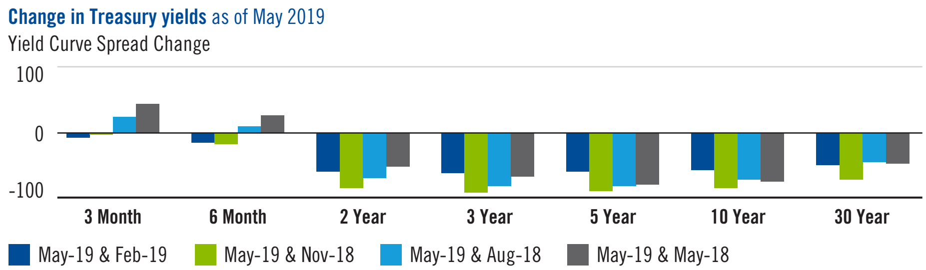
This time instead—the 10y–3m first inverted in May 2019—a sharp fall in longer dated rates has caused the inversion. Yes, shorter dated rates have risen, but only marginally; the inversion has been driven by the falling yields for Treasuries across all other maturities—in sharp contrast to what we've seen previously.

NATURE OF THE YIELD CURVE INVERSION IS DIFFERENT THIS TIME

Exhibit 1: Change in yields across the US Treasury curve—Trailing 4 quarter change prior to past three yield curve inversions







Source: Franklin Templeton Capital Market Insights Group, Bloomberg, Macrobond.

Given that financial conditions are relatively calm compared with prior episodes and domestic macroeconomic fundamentals remain strong, we believe that the current compression in yields is largely a symptom of the more globalized bond market and unconventional monetary policy in other developed markets—namely, that of the European Central Bank (ECB) and Bank of Japan (BOJ). Both banks' negative interest-rate policies have depressed their longer dated government bond yields, making comparable US Treasuries that much more attractive—especially as the US dollar has strengthened. Overall, the US bond market is no longer driven exclusively by US business cycles and Fed policies. Fixed income markets worldwide are still being distorted by the major role that central bank policy continues to play.

Furthermore, relative to other major developed economies, the US economy is fundamentally stronger, thus offering a positive economic growth-rate differential as well.

Don't worry about a US recession—yet

There is little to no evidence of an imminent recession in US economic data. Despite the uncertainty brought on by persistent trade tensions and a contentious political environment, the US economy, particularly the consumer, remains robust. Consumer spending powers roughly two-thirds of US economic output, and strong labor markets have ensured that consumers continue to provide the primary impetus for growth. The third quarter yet again saw consumers contributing the most to headline GDP growth. Even though consumer spending has moderated from a 4.6% annual rate in Q2 to 2.9% in the third, this was still well above the trend growth seen in consumer spending over the past decade.[2] The consumer is still king.

The University of Michigan's consumer sentiment and consumer expectations indexes saw a mild decline in August but rebounded in September and October. Although The Conference Board's measure of consumer confidence saw a mild decline in October, it has remained at a historically high level. Employee wages and salaries averaged roughly 4.7% growth in 2017, 5% in 2018 and a solid 5.2% during the first three quarters of 2019. Given that core personal consumption expenditures (PCE) year-over-year growth has held steady between 1.5% and 2% over the past 2–3 years, inflation-adjusted wage growth has also been increasing healthily. Similarly, the personal savings rate stood at 8.3% in the third quarter of 2019—much higher than during the previous two recessions, as shown in Exhibit 2. Consumers, who've thus far been the primary drivers of the US growth, remain in good financial health.

October's jobs report confirmed a still-robust labor market, with employers adding 128,000 jobs. This figure was likely weighed down by a now-settled strike against General Motors, which led to thousands of workers being temporarily counted as unemployed. Moreover, job growth estimates for August and September were revised up by a combined 95,000, suggesting a healthier labor market than previously thought. The unemployment rate at 3.6% remains at a 50-year low. Payroll gains thus far this year have averaged 167,000 workers per month, lower than in 2018 but well above the 100,000 needed to keep the unemployment rate stable.[3]

HEALTH OF THE US CONSUMER

Exhibit 2: Savings rate, wage growth and core PCE
January 1990–September 2019

Source: US Bureau of Economic Analysis (BEA).

But it's not all clear skies either

The ongoing escalations in trade tensions, however, have led to a slump in US manufacturing. The Institute for Supply Management's purchasing managers' index (PMI) showed the manufacturing sector remained in contractionary territory (below the 50 watermark) in October for the third successive month. The manufacturing employment index has also cooled off significantly. This is also mirrored in the manufacturing employment data, where job gains have sharply leveled off since mid-2018, even as the broader labor market has remained tight.

Regional surveys[4] from the Fed show that expectations around future capital expenditure have also receded, reflecting trade uncertainty and slower global demand. The National Federation of Independent Business's survey on small businesses shows that actual capital expenditure has gradually declined, while expectations of future expenditure have seen a sharp drop through much of 2018 and 2019. As a result, production of manufacturing machinery has slowed, which in turn is reflected in non-residential fixed investment—particularly, business equipment.

The US economy saw similar (if not worse) levels of business pessimism in 2015–2016 as manufacturing activity fell and business investment declined. Much of this was in response to a sharp drop in oil prices, which in turn led to a drying up of investment related to the energy sector. Although consumer sentiment also took a hit, strong consumer spending—which grew at roughly 2.7% during that period[5]—still helped the US economy avoid an outright recession.

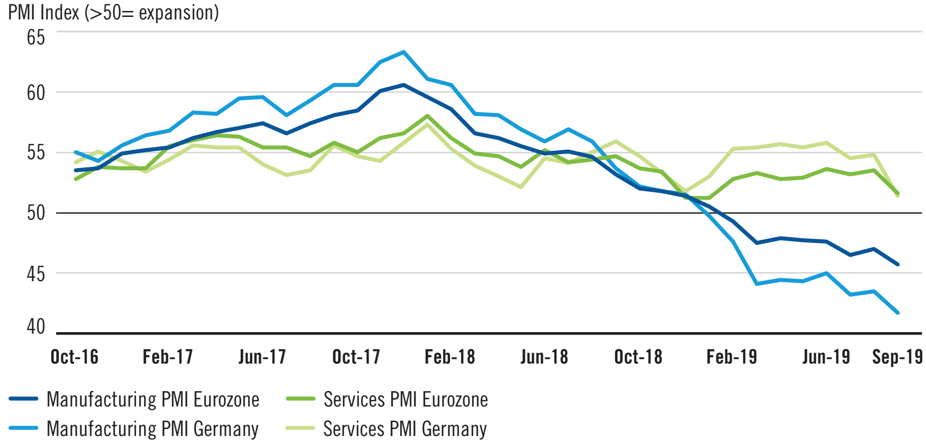
We believe strong household consumption will once again help the US economy avoid a recession, but should trade tensions persist or even intensify, they will take an increasing toll on business confidence and investment. In this regard, an additional cautionary note is that domestic policy uncertainty is likely set to increase as the 2020 presidential campaign gathers steam, given the very stark differences in the policy positions of the two major parties.

Eurozone outlook is clouded with political uncertainty

Our outlook for the eurozone remains subdued, and we expect a further deceleration in growth by year-end, due partly to uncertainty stemming from trade tensions and Brexit. The main source of weakness remains the manufacturing sector. This is seen in the July–September PMI in Exhibit 3, where services held up better. However, business expectations continued to be weak in September (with the index at 91.3) signaling that the weakness in industry is starting to spill over.

EUROZONE OUTLOOK IS SUBDUED

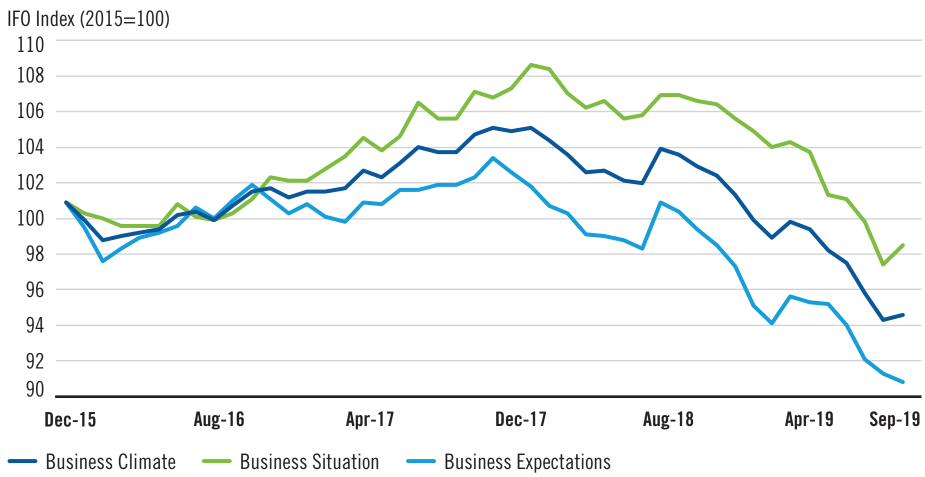
Exhibit 3: PMI indicates weakening conditions in eurozone
October 2016–September 2019



Source: Markit Economics, (IHS Markit Eurozone Manufacturing PMI, Eurozone Services PMI, IHS Markit/BME Germany Manufacturing PMI, IHS Markit Germany Services PMI).

GERMANY'S CONFIDENCE INDICATORS HAVE DECLINED TO RECORD LOWS

Exhibit 4: Business climate, situation, and expectations (seasonally adjusted, 3-month moving average)
December 2015–September 2019



Source: ifo Institute Business Climate Survey.

We believe Germany has entered technical recession and continues to face downside risks to growth from weakening global demand (see Exhibit 4). Special attention will have to be given to Germany's automotive sector, which has already taken a big hit, particularly if the United States imposes tariffs on European Union cars. Germany alone exports 58.3% of all European cars to the United States.[6] The weakness in German data has made a fiscal stimulus package more likely, but the government remains on the sidelines, and we believe any stimulus is likely to be limited in size. Ultimately, we expect European authorities to soften their approach on fiscal slippage and incentivize fiscal easing in Europe via the issuance of Green bonds. This option would spare the German government a loss in popularity from changing its *schwarze Null*, or zero budget deficit policy, and prevent peripheral countries like Italy and Spain from re-entering the European Commission's Excessive Deficit Procedure. However, the details and timing of any alternative fiscal stimulus plan still need to be ironed out and may face some challenges given the lack of a shared European fiscal framework.

Italy suffered another bout of political volatility during the summer. The newly formed Five Star Movement-Democratic Party (M5S-PD) government is likely to adopt a more cooperative stance with European authorities, which will support market sentiment. Nonetheless, we expect economic activity to stagnate this year, and downside risks remain elevated. Italy's medium-term fiscal outlook remains challenging, undermined by a combination of a high debt, weak growth and low productivity. Public debt at end-2019 is projected at 134% of gross domestic product (GDP),[7] and we see further increases ahead given the lack of room for significant budget savings. For now, low interest rates are helping preserve debt sustainability, but longer term, we fear concerns could return if nominal GDP growth continues to disappoint.

Conversely, the fiscal and growth outlook remains positive in Spain, and we expect the current political impasse to be short-lived. Under a no-policy-change scenario, we still envisage some fiscal consolidation, with the deficit expected at 2.3% in 2019 (from 2.5% in 2018) and public debt falling below 97% of GDP (from a peak of 100.4% of GDP in 2014).[8] On the growth front, domestic demand remains robust and supported by strong, but moderating, business sentiment.

Asia paints a mixed picture

Japan's economy surprised to the upside in the second quarter despite expectations that its economy was particularly vulnerable to the ongoing weak trade environment. Household and capital expenditure increases offset declining exports, and labor markets continue to be exceptionally strong, with the unemployment rate unexpectedly rising to 2.4% in September but still up only slightly from the 27-year low of 2.2% it hit in July and August.[9] The sustainability of Japan's economic rebound remains uncertain. The decline in export activity, sharp deterioration in the health of the manufacturing sector, and economic sensitivity to a number of industries most in focus during trade discussions make the growth trajectory tenuous at best. Japan's recent consumption tax hike on goods and services, from 8% to 10% on October 1, could also have a chilling impact on consumer spending.[10]

The BOJ continues to anchor 10-year Japanese government bonds at 0% in a fight to boost persistently low inflation.[11] To maintain that yield target, the BOJ has a standing bid in the market and recently bolstered its forward guidance to reinforce the message that it stands ready to take measures for further monetary easing if economic conditions warrant.

China's 6.0% headline growth rate in the third quarter was the lowest quarterly reading since records began in March 1992,[12] and risks are growing that it could moderate further in the year ahead due to headwinds created by a slowing global economy and the ongoing trade dispute with the United States. The policy response has pivoted from prioritizing stability of the credit-to-GDP ratio and deleveraging to one that is more supportive of growth and channeling liquidity to weaker parts of the economy, specifically the small-medium-enterprises (SMEs) sector that has been impacted from the pull-back in shadow banking. While leverage issues and ongoing social unrest pose potential risks to the outlook, we believe that China's economy will be better able to absorb trade disruptions than the market fears.

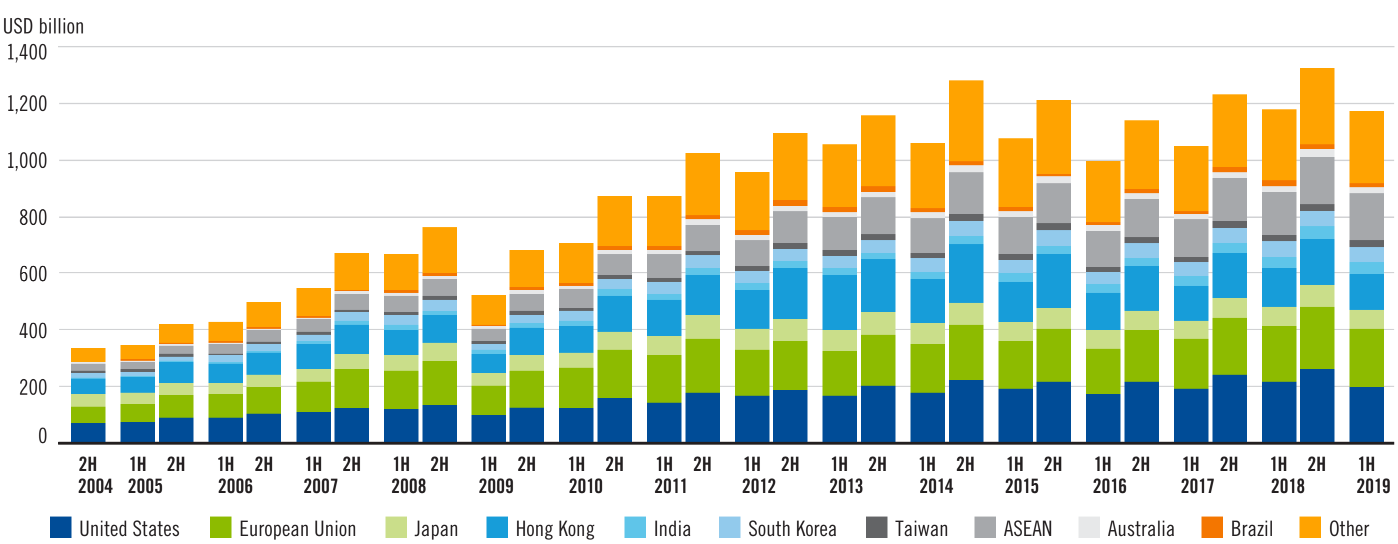
Since the onset of elevated US-China trade tensions, overall Chinese export activity has remained relatively stable, and while exports to the United States have declined, this has been largely offset by increased export activity with alternate trade partners such as the European Union and ASEAN economic community (see Exhibit 5).

It is important to note that China's growth is now less dependent on trade than it was a decade ago and the economy has been re-balancing with domestic consumption as the key underlying driver. Asian economies such as South Korea, Singapore, Malaysia,

CHINA OFFSETTING LOWER US EXPORTS WITH STRONGER EXPORTS ELSEWHERE

Exhibit 5: Total China exports by region

December 2004–June 2019



Source: General Administration of Customs, China Customs, 2019 the Philippines and Vietnam are closely connected to China's global supply chains, and many more rely on China as a market for exports. However, China's trade issues with the United States do not necessarily spell disaster for its Asian neighbors. In fact, the imposition of tariffs seems to have accelerated a process that was already underway—the relocation of lower value-added manufacturing from China to Southeast and East Asia.

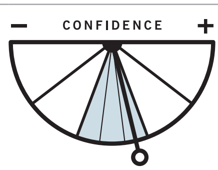
Emerging market policymakers taking matters into their own hands

The weakening global growth outlook, ongoing trade tensions and idiosyncratic spillovers have continued to create volatility in emerging markets and impacted economic conditions across many economies. While growth forecasts have been revised lower over the past few quarters, the International Monetary Fund (IMF) continues to expect GDP growth of 3.9% in 2019 and 4.6% in 2020 for emerging markets.[13] We believe growth across emerging markets will continue to disappoint, with most large emerging economies growing below economists' estimates of long-term potential and below policymakers' aspirations. This is in part driven by continued uncertainty about Chinese and US relations, but also by weaker developed market growth. In addition, China's more restrained approach to stimulus than in past cycles has reduced positive spillovers to aggregate emerging markets growth, especially in emerging Asia.

To fight this slowdown, emerging market policymakers are taking matters into their own hands. The dovish pivot by the Fed and continued accommodative stance by most developed economy central banks have provided greater scope for emerging market central banks to ease monetary policies, as well as support local currencies versus the US dollar. Monetary easing has been joined by fiscal support in many countries.

We believe underlying long-term financial fundamentals remain strong for much of the emerging markets universe, underpinned by stronger sovereign balance sheets and greater fiscal discipline. Capital inflows and high liquidity levels among investors, along with the fact that many upcoming maturities have already been refinanced, provide additional technical support. In our view, risk of contagion from economies under pressure, such as Turkey and Argentina, is lower than it had been in 2018, and we do not believe it is a high-risk concern at this stage of the cycle.

Sector Settings

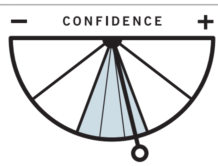
Sector	Conviction	Our viewpoint
US Treasuries		We believe the US Treasury market is concentrating on the Fed which, in turn, is focusing on market expectations rather than fundamental economic data. The market's estimate of future Fed action gives no indication of where the economy is headed and, in our opinion, the US Treasury yield curve currently is not a reliable predictor of an imminent recession but rather market expectations on the future path of rates. Longer-term Treasuries are pricing in a dire economic forecast and multiple rate cuts that we do not anticipate will come to fruition. We view longer-term Treasury valuations as stretched and believe investors face downside risk at current levels. We remain cautious on lengthening US duration at these levels. **Treasury Inflation-Protected Securities (TIPS)** While inflation currently remains benign and under the Fed's target, if we look at wage growth combined with the impact of US-China tariffs, at some stage we may have to consider a rise in inflation. Mid- to longer-term US TIPS provide some upside potential at current breakeven levels.
Eurozone Government Bonds		We believe government bond markets are still distorted by the major role that central banks continue to play. The outlook for the eurozone remains subdued and further accommodative monetary policy, along with a potential corresponding fiscal response, is likely in the quarters ahead in the macro and inflation outlook for the euro area. We believe the weak macro and inflation backdrop will keep German Bund yields low (and negative) for longer, or at least unlikely to sell off meaningfully. If the ECB delivers additional stimulus measures, we should see some more flattening as it remains the only risk-free curve in Europe. The quantitative easing (QE) trade has potentially a little more room to run, but it is now likely that returns will come from carry rather than capital gains. We therefore favor staying long duration in Germany. In Italy, we favor a neutral duration stance following the strong rally and spread compression observed since June. Italy has demonstrated that technical trends (driven largely by ECB dovishness) have outweighed debt sustainability and political woes. We continue to favor duration exposure in Spain, since it offers an attractive spread in an environment of negative yields and minimal spreads among core countries.

Sector	Conviction	Our viewpoint

Japanese Government Bonds

Japan suffered from the worst 10-year debt auction in three years in September as the BOJ announced plans to reduce its longer tenor government bond purchases and the Government Pension Investment Fund (GPIF) pivoted toward buying more foreign debt. We expect continued monetary accommodation from the BOJ and believe it would provide further stimulus in its efforts to reach its inflation target of 2%. Comments made following the last BOJ meeting support this belief, as it was clearly signaled that the central bank would not hesitate to take additional easing measures and deepen negative rates if necessary. The BOJ modified its forward guidance to state that it expects short- and long-term interest rates to remain at present or lower levels as long as needed to achieve its price target. We continue to believe Japanese yen exposure can help suppress volatility in portfolios and also has potential for appreciation, particularly during bouts of global risk aversion.

Mortgage-Backed Securities

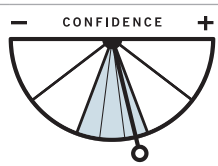


Agency Mortgage-Backed Securities (MBS)
With MBS spreads at the tighter end of their long-term historical range, we remain relatively neutral on MBS but are opportunistically adding agency MBS during periods of volatility. We expect prepayments to remain elevated going into year-end and favor down-in-coupon segments with a concentration in 30-year Fannie Maes and Ginnie Maes.

Non-Agency Mortgage-Backed Securities
We continue to have a constructive view on mortgage credit health, and supply and demand trends have supported strong home price appreciation (HPA) post-global financial crisis (GFC). We expect home prices nationally to continue to appreciate but the pace to slow over the coming 12 months as affordability has been stretched. At an aggregate level, American households are far more financially stable compared to pre-crisis metrics, with the deleveraging since the crisis, along with tighter underwriting standards, keeping credit quality in check. Importantly, originators appear increasingly sensitive to credit trends and have quickly tightened standards to keep delinquencies and defaults contained. We do note the historically long US economic expansion has had an uneven impact across wage earners and credit spectrums. Given our relatively positive view on housing, we prefer exposure to the residential mortgage-backed securities (RMBS) sector through seasoned credit risk transfer (CRT) structures, where fundamental and technical forces remain positive. We do not anticipate material risk in bond duration extending.

Commercial Mortgage-Backed Securities (CMBS)
Our outlook on the CMBS sector remains cautious as valuations are slightly elevated, but closer to long-term averages. We do see areas of opportunity and continue to favor industrial and multi-family backed agency CMBS.

Asset-Backed Securities

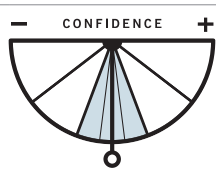
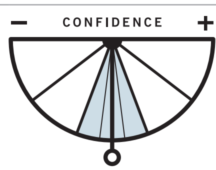


Asset-Backed Securities (ABS)
We continue to have a constructive view on consumer credit health, though we are observing pockets of weakness, particularly with lower credit borrowers. In our view, spreads in most consumer credit asset-backed securities are relatively tight, but opportunities exist in credit card and auto ABS compared to similar-rated investment-grade securities.

Credit Card ABS
Trust delinquencies and losses are not rising to the same extent as overall bank credit card portfolios, and overall delinquencies and charge-offs are steady and remain well below pre-GFC levels. We have seen that lenders are watchful of any rise in delinquencies and have been quick to take corrective actions by proactively tightening underwriting standards.

Student Loan ABS
Student loan debt has grown significantly since the GFC and has reached a point where the debt burden has started affecting consumer behavior in ways of savings, borrowing ability, and important life events such as starting a family and homeownership. Although various income-based payment options have helped stabilize delinquencies, the overall debt burden remains. We are cautious on the student loan ABS segment and believe other securitized sectors provide better risk-adjusted return potential in the current environment.

Auto Loan ABS
There are definite signs of deterioration in auto credit, mostly driven by subprime auto loans. While we do not believe subprime auto is the next “crisis in the making,” we are struck by the similar deterioration in lower credit spectrums across consumer credit sectors. Certain prime auto ABS, however, have continued to provide both relative value and diversification benefits to investor portfolios.

Sector	Conviction	Our viewpoint
US Investment-Grade Corporates		We continue to take a cautious approach to the sector as we believe fundamentals, while still generally supportive, face headwinds from slower global growth and geopolitical uncertainty. Earnings have been moderately weaker, and there continues to be no real progress in reducing aggregate sector leverage. Technical factors, particularly overseas demand for US corporates, might improve as global bond yields have moved downward and central banks have turned more dovish. Valuations remain below recent averages and seem to have more downside risk than upside potential at these levels. We continue to believe that investment-grade (IG) corporates offer decent carry relative to government bonds, but spreads are unlikely to tighten much further at this point of the cycle and the potential for increased volatility and significant widening exists.
European Investment-Grade Corporates		Our outlook for the sector is relatively neutral, although we believe the Euro IG credit sector still offers good value relative to European sovereign debt. With the ECB starting corporate bond purchases on November 1, we believe spreads could tighten from current levels by year-end, partially offset by supply. Seasonality is mostly favorable between now and year-end, with December normally benefiting from declining supply as well as year-end capital inflows. However, US tariffs on European products, in particular European autos, are a major risk to our projections, while the risk of a "no-deal" Brexit has been postponed for now. Valuations for Euro IG credit leave little room for fundamental disappointment, particularly at this stage of the cycle. We continue to favor non-cyclicals over cyclicals and BBB rated bonds over BB rated bonds.
US High-Yield Corporates		We continue to take a cautious approach to the sector as we believe there is more downside risk than upside potential at current levels. While credit fundamentals have deteriorated only slightly from very solid levels and technicals remain strong, there is a likelihood that both will weaken somewhat as trade disputes and political uncertainty weigh on growth. Our base case does not envision a recession in the next year, but based on our bottom-up assessment the default rate is likely to rise to the long-term average or slightly above over the next six months before declining back to current levels in the second half of 2020. In our view, current valuations do not adequately price in these considerations. With BB rated bonds mostly trading tight and CCCs generally not as appropriate at this point in the cycle, we view single-B bonds as the best place to find opportunities, subject to careful security selection.
Euro High-Yield Corporates		In the context of weaker European macroeconomic fundamentals and strong technical factors (supported by wider investor participation in the euro high-yield market and lower year-to-date supply), we are looking to be playing the asset class opportunistically. Valuations for BB issuers remain stretched, but we do not foresee significant spread widening from current levels. We expect demand for large, long-dated bonds (particularly non-cyclical corporate/financial hybrids) to remain strong while demand for small single-B/CCC issuers is likely to remain weak as investors try to avoid the price volatility associated with earnings disappointments in this tier of the market. Given investor reluctance to take on lower-rated credit risk, we are focused on less-liquid issuers that have been disproportionately punished but ultimately enjoy sound business models and sustainable capital structures.
Floating Rate Loans		**Floating Rate Loans** While risks in the loan market have grown over the last few years, there continue to be some pockets of opportunity for us to remain constructive in the medium term. We believe the risk of elevated defaults in loans is muted over the next year given favorable maturity profiles and still healthy interest coverage. However, the loan market has recently faced technical headwinds driven by caution among the collateralized loan obligations (CLOs) investor base combined with rising rating agency downgrades of lower quality loan issuers. This has led to increasing bifurcation across the credit quality spectrum, a trend we expect will continue over the near term. The loan market has nearly doubled in size from 2006 and has arguably moved higher on the risk spectrum with a larger share of lower-rated, loan-only and covenant-lite deals, which we believe will shape the next default cycle. However, we expect the default cycle to unfold more slowly this time, driven by a manageable maturity wall and a general dearth of financial covenants to bring borrowers to the table sooner. Furthermore, we believe fears of distress in the loan market spilling over to the broader economy are overblown. We continue to maintain a conservative portfolio and are more biased toward BB and high single-B credits with a focus on leverage profiles, capital structure and documentation. We believe periods of volatility should provide opportunities to add exposure in this part of the market while providing some insulation from credit stress should market conditions continue to deteriorate.

Sector | **Conviction** | **Our viewpoint**

Floating Rate Loans continued

Collateralized Loan Obligations (CLOs)
Deterioration in lower quality loans has led to spread widening in CLOs, particularly lower down the stack. While improvements in the current CLO structure should provide enough subordination to protect BBB and above tranches in times of distress, tail risks are increasing and spreads remain vulnerable. On a relative value basis, CLOs continue to offer spread pickup over similarly rated securitized sectors, and spreads at the top of the stack are fair versus their historical trading range, in our analysis. In the United States, we anticipate more spread widening as bifurcation within the loan market continues; however, a technical bid in Europe may provide some support, particularly in the AAA rated tranche. Overall, we continue to favor AAA and AA rated CLOs but caution that CLOs are not immune to spread widening within the loan market and broader credit market selloffs—which could lead to increased volatility.

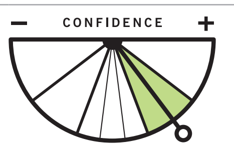
Municipal Bonds

Under the backdrop of solid US economic growth and healthy consumer activity, we believe market technicals and fundamentals are supportive of municipal prices and continue to recommend a selection of intermediate-to-long-term maturities. The tax exemption of municipal bonds can add value to a client portfolio, regardless of the rate environment. Most often investment returns are compared on a pre-tax basis, ignoring the powerful benefits of tax-free income generated from owning municipal bonds. Our income-focused municipal bond strategy is added insulation against rising interest rates. On top of the protective layer of income, our posture is slightly defensive. Due to narrow credit and quality spreads, we prefer higher-quality sectors such as select state general obligation bonds (GOs), water and sewer, transportation, high profile higher education, and utilities. Similarly, our opinion of ratings selection favors the higher echelons of the investment-grade universe—AAA/AAs. Yields and spreads on higher rated credits within the states carrying the highest income tax rates have moved tighter, reducing the attractiveness to audiences outside of in-state residents. We are pursuing 5% coupons and other premium structures, when appropriately priced. Looking at the taxable municipal bond market, a relative yield advantage exists versus US Treasuries and corporate investment grade bonds towards the front of the curve. We favor maturities/durations between 2–3 years in the higher investment grade-rated and sector spectrum in states that are projected to have more moderate bond supply.

Emerging Market Debt

Hopes for a trade deal that would alleviate pressure on emerging market (EM) risk assets have now faded, with some wondering if the United States will be inclined to compromise before the next presidential election. However, many emerging economies have reduced their sensitivity to global trade conditions and macroeconomic shocks, and EM debt is receiving technical support from the shift in the interest-rate environment. The sizable moves in the US Treasury curve have not seen corresponding moves in EMs, and with the collapse of short-term spreads the steepness of EMs' curves has increased substantially. The reduced appetite for taking duration risk has led the long end in EMs to underperform relative to the short end. The reduction in absolute yields for EMs and the anticipated next moves in the US yield curve have reduced the attractiveness of the longer part of the curves, and we continue to favor shorter duration in most markets. We continue to see opportunities in the sector and recommend carefully monitoring country-specific events.

Emerging Markets Corporates



Our moderately positive view on hard currency EM corporates is based on a combination of macro and micro factors, such as easier financial conditions, strong corporate fundamentals, low default rates, a manageable refinancing profile and what we regard as attractive relative valuations. EM corporates are generally of higher quality and lower beta than their sovereign counterparts. However, the sector is also illiquid and technically driven, and therefore prone to overreaction in times of stress. EM corporates continue to offer reasonable spread concessions to EM sovereign curves and developed market corporates, and overall we believe the sector looks attractive on a hold-to-maturity basis given similar default and recovery rate comparisons. We favor a well-diversified mix of corporates, by country, sector and quality—picking up yield in some weaker names where we have conviction, while recognizing the lower volatility and superior liquidity of bonds issued in some higher-rated EM countries. We lean toward a shorter duration stance.

Fixed Income Views: Franklin Templeton Fixed Income conducts a periodic team-wide investment forum, driven by independent macroeconomic, fundamental sector, and quantitative research, to explore and collaborate on economic and investment outlook. These Fixed Income Views reflect the outcome of this investment forum. An evaluation of macroeconomic conditions and developments across the world's regional economies serves as the backdrop of our investment process, with an eye toward identifying potential changes in fiscal and monetary policies, market risk premiums and relative valuations that drive portfolio positioning. From a bottom-up perspective, we provide readers with condensed high-level summaries of our sector views.

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About Franklin Templeton Fixed Income

Franklin Templeton has been among the first to actively invest in many sectors of the fixed income markets as they have evolved—covering corporate credit, mortgage-based securities, asset-backed securities and municipal bonds since the 1970s, international fixed income since the 1980s and bank loans since the early 2000s. Over 170 investment professionals globally support the portfolio managers, who oversee more than US$169 billion in assets under management. Being part of an established investment group at Franklin Templeton gives the portfolio managers access to experts across different areas of the fixed income market, helping them to diversify opportunities and risks across multiple sectors.

Our global reach through Franklin Templeton Investments provides access to additional research, trading, and risk management resources. Portfolio managers have opportunities to exchange insights with other investment groups, and collaborate with an independent risk team that regularly examines risk analytics to help identify and address areas of excessive risk exposure within our portfolios.

Endnotes

1. The yield curve spread between the 10-year and three-month curves. When the number goes negative, that's an inversion.
2. Source: US household spending, Bureau of Economic Analysis, Q3 2019.
3. Source: Employment data, Bureau of Labor Statistics, October 2019.
4. Source: Regional Federal Reserve (Dallas, Kansas, NY, Philadelphia) Manufacturing/Business Outlook Surveys, September 2019.
5. Source: US household spending, Bureau of Economic Analysis, Q4 2016.
6. Source: Eurostat, as of 2018.
7. Source: Italy public debt-to-GDP projection, OECD Economic Survey estimate, April 2019.
8. Source: European Commission, Spring forecast, May 2019.
9. Source: Japan unemployment data, Internal Affairs and Communications Ministry, September 2019.
10. Source: Japan consumption tax, Ministry of Finance, Japan, 2019.
11. Source: BOJ 10-year rate anchor, Bank of Japan.
12. Source: China GDP, National Bureau of Statistics of China.
13. Source: Emerging markets' growth, IMF, October 2019.

Indexes are unmanaged and one cannot directly invest in an index. They do not include fees, expenses or sales charges. There is no assurance that any estimate, forecast or projection will be realized. **Past performance is not an indicator or a guarantee of future results.**

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. The price and yield of a MBS will be affected by interest rate movements and mortgage prepayments. During periods of declining interest rates, principal prepayments tend to increase as borrowers refinance their mortgages at lower rates; therefore MBS investors may be forced to reinvest returned principal at lower interest rates, reducing income. AMBS may be affected by borrowers that fail to make interest payments and repay principal when due. Changes in the financial strength of a MBS or in a MBS's credit rating may affect its value. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size and lesser liquidity. Investments in fast-growing industries like the technology sector (which historically has been volatile) could result in increased price fluctuation, especially over the short term, due to the rapid pace of product change and development and changes in government regulation of companies emphasizing scientific or technological advancement. Changes in the financial strength of a bond issuer or in a bond's credit rating may affect its value. High yields reflect the higher credit risks associated with certain lower-rated securities held in the portfolio. Floating-rate loans and high-yield corporate bonds are rated below investment grade and are subject to greater risk of default, which could result in loss of principal—a risk that may be heightened in a slowing economy.

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