Health uncertainty vs. economic uncertainty: The need to safely restart growth
As many now find themselves reading this paper from the confines of their home, under a government-mandated “quarantine” intended to slow the spread of a novel coronavirus, there is no question that the world has fundamentally changed since last year—even from just two months ago. This paper therefore provides a substantial update to our macroeconomic outlook and sector views compared to our previous deep dive.

To halt or at least slow the spread of the virus, a number of governments across the world have suddenly shut down large parts of their economies, causing an enormous degree of disruption in just a small amount of time. With more than a third of the planet’s population under some form of restriction, the shutdowns have impacted people in a much more tangible and palpable fashion than past crises—for the first time in living history, entire economies came to a halt—and routine, daily activities were no longer allowed. Substantial restrictions on global travel have compounded the impact, inflicting substantial damage on global supply chains.

Governments and central banks have immediately stepped in with powerful fiscal and monetary policy expansions; these will be very helpful in cushioning the short-term damage, but the recovery prospects hinge crucially on how quickly economic activity can resume.

We are now entering this crucial phase: some US states and European countries are beginning to cautiously relax their restrictions on economic activity. Uncertainty remains high, but we have some encouraging signs: various countries such as South Korea, Taiwan, Australia and New Zealand have demonstrated the ability to contain and even eliminate the spread of this novel coronavirus, despite their relative proximity to the original epicenter. Other countries and US states seem to have been able to slow contagion with more moderate restrictions to economic activity. Scientists and researchers around the world have shown progress on the development of a vaccine, antiviral and antibody therapeutics, and treatment regimens.

The fear that reopening the economy will cause contagion to accelerate anew lingers, however; some policymakers are therefore proceeding with great caution. Finding the right path to safely reopen the economy—restarting economic activity while preventing a new wave of contagion strong enough to overwhelm health care systems—is now the crucial priority for policymakers. It is inconceivable to believe that the world can stay in stasis until a vaccine is developed and mass produced at scale in order to inoculate the entire global population. The priority must be to identify a strategy to restart global economic activity while maintaining appropriate precautions to safeguard public health, which will likely require widespread testing capacity, contact tracing, serology testing and some form of continued social distancing measures.

Policymakers face a difficult tradeoff between health uncertainty and economic uncertainty. If policymakers succeed in safely restarting the economy over the coming couple of months, the massive policy stimulus in the pipeline can still fuel a robust recovery. If instead the current shutdown is prolonged, or if initial steps to reopen the economy are reversed, the structural
damage to the economy would be much more serious, and the recovery prospects correspondingly dimmer. And the adverse economic (and health) consequences will continue to fall disproportionately on the most vulnerable sections of society.

In an environment with such a high degree of uncertainty, active management has become even more critical as dislocations and extreme panic can create opportunities but also cause indiscriminate market movements. Deep fundamental analysis and security selection will be required to find the most attractive opportunities going forward, in our view. Fixed income investors should prepare for further periodic bouts of volatility in the quarters ahead, but we think investors will be well served by not panicking and by continuing to invest for the long term.

In this paper we discuss:
1. US and euro area macroeconomic overview and outlook
2. Scenario analysis for growth going forward
3. Sector outlook

We have analyzed the US situation and outlook in a separate white paper to which we refer the reader for greater detail: “US Macro Outlook: Now Let's Bend the Economic Growth Curve.”
The pandemic, the fallout, and a “shock and awe” policy response

In what now feels like a distant memory, the US economy started 2020 on a positive note with the signing of a limited phase-one trade deal with China, leading to a revival in business sentiment. The labor market continued to show strength, with job gains defying consensus expectations even up until February and with the unemployment rate hovering around 50-year lows.

However, the final week of February brought about a rude shock to financial markets as the COVID-19 pandemic, a tail-risk scenario that up until then had largely been considered a regional Asian issue, went global. With the pandemic (and corresponding panic) spreading through major population and commercial centers across the United States, 43 states (307 million people or 93% of the US population) issued statewide shelter-in-place, stay-at-home, or shutdown orders. As of May 1, 12 states started to ease restrictions and allow certain “non-essential” businesses to reopen, with 236 million people or 70% of the US population still under some form of lockdown.

The first signs of the health crisis morphing into a follow-on economic crisis started to become apparent as early as March 9 as high frequency data indicated that businesses in the leisure & hospitality (specifically food & accommodation) and wholesale & retail trade sectors started to pull back sharply. Fewer local businesses remained open as firms cut back their employees and hours worked. By the first week of April, jobless claims soared by a little over 16 million (reaching over 36 million over the eight-week period ending May 9), while consumer expectations turned sharply lower. Likewise, the New York Federal Reserve’s Survey of Consumer Expectations also worsened as consumers’ expectations around missing minimum debt payment and higher unemployment in a year from now spiked. Small businesses that are likely to be hit the hardest saw rapid deterioration in optimism, while business uncertainty shot up. The manufacturing sector wasn’t spared either as the US Federal Reserve’s (Fed’s) regional indexes for future manufacturing registered substantial drops.

**CONSUMER AND BUSINESS UNCERTAINTY RISES**

Exhibit 1: Consumer expectations turn sharply lower and business uncertainty spikes

**New York Fed Survey of Consumer Expectations**
June 2013–March 2020

**NFIB Business Surveys**
January 2006–March 2020

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**Debt Delinquency Expectations, Mean Probability of Missing Minimum Debt Payment over the Next 3 Months (lhs)**

- 2013: 18.5% (Jun-13)
- 2014: 17.9% (Jun-14)
- 2015: 17.6% (Jun-15)
- 2016: 16.9% (Jun-16)
- 2017: 16.3% (Jun-17)
- 2018: 15.1% (Jun-18)
- 2019: 15.0% (Jun-19)
- 2020: 16.0% (Mar-20)

**Job Separation Expectations, Mean Probability of Losing a Job (lhs)**

- 2013: 56.3% (Jun-13)
- 2014: 55.8% (Jun-14)
- 2015: 55.4% (Jun-15)
- 2016: 54.6% (Jun-16)
- 2017: 53.9% (Jun-17)
- 2018: 53.2% (Jun-18)
- 2019: 52.7% (Jun-19)
- 2020: 60.0% (Mar-20)

**Unemployment Expectations, Mean Probability of Higher Unemployment Rate 1 Year from Now (rhs)**

- 2013: 49.2% (Jun-13)
- 2014: 48.6% (Jun-14)
- 2015: 48.1% (Jun-15)
- 2016: 47.8% (Jun-16)
- 2017: 47.4% (Jun-17)
- 2018: 47.1% (Jun-18)
- 2019: 46.9% (Jun-19)
- 2020: 55.9% (Mar-20)

**NFIB Small Business Optimism Index**

- 2006: 110 (Jun-06)
- 2007: 109 (Jun-07)
- 2008: 104 (Jun-08)
- 2009: 96.4 (Jun-09)
- 2010: 92.0 (Jun-10)
- 2011: 91.5 (Jun-11)
- 2012: 92.4 (Jun-12)
- 2013: 92.5 (Jun-13)
- 2014: 93.1 (Jun-14)
- 2015: 93.5 (Jun-15)
- 2016: 94.4 (Jun-16)
- 2017: 94.5 (Jun-17)
- 2018: 94.3 (Jun-18)
- 2019: 94.3 (Jun-19)
- 2020: 89.5 (Jun-20)

**NFIB Small Business Uncertainty Index**

- 2006: 30 (Jun-06)
- 2007: 32 (Jun-07)
- 2008: 33 (Jun-08)
- 2009: 33 (Jun-09)
- 2010: 34 (Jun-10)
- 2011: 37 (Jun-11)
- 2012: 40 (Jun-12)
- 2013: 43 (Jun-13)
- 2014: 44 (Jun-14)
- 2015: 44 (Jun-15)
- 2016: 43 (Jun-16)
- 2017: 43 (Jun-17)
- 2018: 43 (Jun-18)
- 2019: 43 (Jun-19)
- 2020: 51 (Jun-20)

**Recession**

- Source: FTI Fixed Income Research, NFIB Macrobond. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges.

The virus represents both a supply shock—as people are forced not to work and supply chains are disrupted by the need for social distancing—and a demand shock—as incomes plunge, people are unable to go out and consume, and economic uncertainty surges. Against this backdrop, our outlook for the US economy has darkened considerably through the first half of 2020 as economic activity was so abruptly curtailed.

The current crisis has been compared to the global financial crisis (GFC) and the Great Depression. But there are some crucial differences.

One major difference has been the speed with which policymakers have acted this time. Back in the GFC period, even though Washington allocated roughly US$2 trillion toward the crisis, the final big rescue package (the US$787 billion American Recovery and Reinvestment Act or ARRA) wasn’t signed into law until February 2009, one and a half years after a major financial institution reported a severe mortgage-related distress (August 2007). This year in March alone, Congress passed three laws allocating about the same amount of money for the pandemic-induced economic crisis (with subsequent stimulus measures and supplemental bills now totaling over US$3.25 trillion). This time, the lion’s share of the relief package—the Coronavirus Aid, Relief, and Economic Security (CARES) Act worth US$2.2 trillion—was signed into law a mere two weeks after US President Donald Trump declared a national emergency. In fact, since March 15, the Fed has far surpassed previous crisis measures to not only support financial market functioning, but also enacting measures that unlock up to US$2.3 trillion in lending to support households, employers, financial markets, and state and local governments. The Fed’s balance sheet has already expanded to a new record high of nearly US$6.7 trillion by the end of April.

The recent fiscal and monetary moves are an even starker contrast to the Great Depression. The policy response at the outset of the Great Depression was subdued. Little fiscal stimulus was enacted, while the Fed allowed the money supply to contract precipitously. It was only after President Franklin Roosevelt assumed office in March 1933 and Congress passed the Emergency Banking Act, which among other things introduced deposit insurance, that the banking crisis to came to an end, four years after the start of the crisis.

The second important difference is that this recession has been engineered by policymakers to halt contagion, rather than being due to any fundamental imbalances in the real economy or the financial sector.

Cash transfers: A bridge to recovery

The multi-pronged policy approach of direct cash payments to households and expanded unemployment benefits under the CARES Act has sought to provide a financial lifeline through this period of income loss. The unemployment data showed a clear and disturbing trend: the impact of the coronavirus-driven shutdown is disproportionately affecting low skilled, low income, and income-poor families with children. Moreover, the Federal Reserve Board’s 2016 Survey of Consumer Finances shows that roughly 25% of US families have less than US$400 in liquid savings, making them particularly vulnerable to income and/or expense shocks. Meanwhile, 60% of...
the families do not have a liquid savings cushion that could last up to three months; this includes most married families with children and even higher-income families.

Therefore, given the devastating effects the pandemic is having on families, immediate broad-based cash assistance (that phases out gradually at certain income thresholds) made good policy sense. In fact, according to the Penn Wharton Budget Model, the lowest income group is expected to see after-tax income rise by 46%.

### LIQUID SAVINGS BY SELECTED CHARACTERISTICS OF US FAMILIES

**Exhibit 3: New York Fed Survey of Consumer Finances**

<table>
<thead>
<tr>
<th>At least $400</th>
<th>At least 3 months saved</th>
<th>At least 6 months saved</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>All Families</strong></td>
<td>76%</td>
<td>40%</td>
</tr>
<tr>
<td><strong>Usual Income</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quartile 1</td>
<td>51%</td>
<td>17%</td>
</tr>
<tr>
<td>Quartile 2</td>
<td>72%</td>
<td>31%</td>
</tr>
<tr>
<td>Quartile 3</td>
<td>86%</td>
<td>43%</td>
</tr>
<tr>
<td>Quartile 4</td>
<td>96%</td>
<td>68%</td>
</tr>
<tr>
<td><strong>Age Group</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Under age 35</td>
<td>73%</td>
<td>29%</td>
</tr>
<tr>
<td>Age 35–55</td>
<td>75%</td>
<td>33%</td>
</tr>
<tr>
<td>Over Age 55</td>
<td>79%</td>
<td>50%</td>
</tr>
<tr>
<td><strong>Family Status (under 55 only)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Single without children</td>
<td>72%</td>
<td>34%</td>
</tr>
<tr>
<td>Married without children</td>
<td>78%</td>
<td>34%</td>
</tr>
<tr>
<td>Married with children</td>
<td>79%</td>
<td>35%</td>
</tr>
<tr>
<td>Single with children</td>
<td>59%</td>
<td>15%</td>
</tr>
</tbody>
</table>


### RELIEF REBATE IN THE CARES ACT

**Exhibit 4: Individual economic relief rebate by filing status**

As of March 27, 2020

<table>
<thead>
<tr>
<th>Dependents</th>
<th>Rebate Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married filer</td>
<td>$2,900</td>
</tr>
<tr>
<td>Head of household</td>
<td>$2,200</td>
</tr>
<tr>
<td>Single</td>
<td>$1,700</td>
</tr>
<tr>
<td>$0.00</td>
<td>$1,200</td>
</tr>
<tr>
<td>$95,000</td>
<td>$112,500</td>
</tr>
<tr>
<td>$148,500</td>
<td>$198,000</td>
</tr>
<tr>
<td>$75,000</td>
<td>$112,500</td>
</tr>
<tr>
<td>$150,000</td>
<td>$198,000</td>
</tr>
</tbody>
</table>

**Phase-out starting points at 5% per dollar of qualified income**

93.6% of U.S. tax filers will get a check


What to make of US unemployment data?

Temporary layoffs accounted for nearly 80% of the 1.35 million US job losses in March, while permanent job losses accounted for about 180,000. The fact that temporary layoffs accounted for the lion’s share of the increase in the unemployed and roughly 26% of total unemployed—an all-time high—offers a sliver of hope that the pandemic-induced hit to employment might be followed by a quick recovery.

The previous high in temporary layoffs happened in the 1982 recession—engineered by the Paul Volcker’s Fed to tame inflation; back then, most temporarily laid off workers were re-hired over the next 15-month period. A similar employment recovery is still possible, but as we argued above, it will depend on the duration of the shutdowns.

A considerably darker US outlook for the first half of 2020

The table and chart (on page 7) show our outlook for growth through the end of 2021 under three different scenarios and the comparison with pre-crisis trend growth. (For further detail on our economic growth forecasts, please see the April 2020 paper titled “US Macro Outlook: Now Let’s Bend the Economic Growth Curve”.) The advance estimate of Q1 GDP shows that the rate of contraction, at –4.8%, was not as deep as we anticipated. However, the depth of the near-term contraction is unlikely to be fully realized in Q1/Q2 advance estimate GDP reports, since the US Bureau of Economic Analysis (BEA) estimates for many of the GDP components are mainly based on judgmental trends and incomplete source data, which will eventually be replaced by actual source data in later vintages.
The first scenario is essentially a counterfactual of the trajectory for growth and jobs without any fiscal stimulus. The second scenario assumes that there is a mild pass-through of the fiscal spending, while the third scenario assumes a significantly strong pass-through. Under all three scenarios, the outlook for the second quarter (Q2) is broadly the same: the quarter-on-quarter (q/q) annualized growth rate for Q2 falls by between 29% and 30%.

The stronger recovery scenarios detailed in Exhibit 6 also assume that the Paycheck Protection Program (PPP) has the intended consequences of businesses keeping their workers on payrolls even while they’re idled, thereby minimizing the “search cost” of hiring workers once the economy reopens and leading to more front-loaded job gains.

Overall, in all three scenarios, we do not expect the economy to reach its pre-crisis trend growth level by the end of next year, and even with our baseline expectation for employment to start to stabilize by July, three million newly unemployed will still be out of the workforce. Given the surge in unemployment in the leisure & hospitality and wholesale & retail trade sectors, we assume they will also see the quickest pace of recovery. Unlike the post-GFC recovery, we are also assuming a stronger/steeper slope of recovery for a majority of sectors (with the notable exception of transportation & utilities).

**FRANKLIN TEMPLETON FIXED INCOME GROWTH OUTLOOK**
Exhibit 6: Real US GDP Growth (% Q/Q AR) Recovery Scenarios
As of May 2020

<table>
<thead>
<tr>
<th>Scenario 1</th>
<th>Scenario 2</th>
<th>Scenario 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No Fiscal Stimulus</td>
<td>Moderate Pass Through of Fiscal Stimulus</td>
</tr>
<tr>
<td>Q4-2019</td>
<td>2.1%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Q1-2020</td>
<td>-8.7%</td>
<td>-8.7%</td>
</tr>
<tr>
<td>Q2-2020</td>
<td>-29.9%</td>
<td>-29.2%</td>
</tr>
<tr>
<td>Q3-2020</td>
<td>10.3%</td>
<td>16.3%</td>
</tr>
<tr>
<td>Q4-2020</td>
<td>8.0%</td>
<td>11.0%</td>
</tr>
<tr>
<td>2020 (Annual)</td>
<td>-5.7%</td>
<td>-4.9%</td>
</tr>
<tr>
<td>Q1-2021</td>
<td>6.0%</td>
<td>7.2%</td>
</tr>
<tr>
<td>Q2-2021</td>
<td>5.4%</td>
<td>6.2%</td>
</tr>
<tr>
<td>Q3-2021</td>
<td>3.3%</td>
<td>3.4%</td>
</tr>
<tr>
<td>Q4-2021</td>
<td>2.6%</td>
<td>2.7%</td>
</tr>
<tr>
<td>2021 (Annual)</td>
<td>2.7%</td>
<td>4.6%</td>
</tr>
</tbody>
</table>

Italics indicates forecast.
Source: Franklin Templeton Fixed Income Research. There is no assurance that any estimate, forecast or projection will be realized.

The GDP contraction during the first quarter of the GFC in 2008 (following the bankruptcy of Lehman Brothers in September 2008) was eventually revised to be more than twice as large as what was initially reported (−8.4% revised quarterly GDP decline vs. −3.8% advance estimate for Q4 2008). We therefore do expect the GDP decline in Q1 2020 to edge closer toward our forecast for −8.7% by the time the third estimate is released.

It is the shape of the recovery (Q3 2020 through Q4 2021) that changes under each scenario.

The stronger recovery scenarios detailed in Exhibit 6 also assume that the Paycheck Protection Program (PPP) has the intended consequences of businesses keeping their workers on payrolls even while they’re idled, thereby minimizing the “search cost” of hiring workers once the economy reopens and leading to more front-loaded job gains.

Overall, in all three scenarios, we do not expect the economy to reach its pre-crisis trend growth level by the end of next year, and even with our baseline expectation for employment to start to stabilize by July, three million newly unemployed will still be out of the workforce. Given the surge in unemployment in the leisure & hospitality and whole sale & retail trade sectors, we assume they will also see the quickest pace of recovery. Unlike the post-GFC recovery, we are also assuming a stronger/steeper slope of recovery for a majority of sectors (with the notable exception of transportation & utilities).

**Euro area growth takes a historic hit**
We believe the cost of the COVID-19 crisis to the euro area (EA) will be substantial, since not only have EA governments shut down large sections of their economies at the same time, but also because a large share of these economies are heavily reliant on the services sector (60%–70% of gross domestic product [GDP] in EA countries), which has suffered the largest negative impact. While a temporary halt in consumption may lead to pent-up demand for goods, this will not be possible for services—that economic output will be permanently lost. While retail sales of services, online sales, transportation, etc. may revive faster,
more discretionary activity such as car sales, small retail sales, catering, tourism and real estate services will likely bear the brunt for longer. Hence, we believe the economic damage done by this coronavirus-induced crisis is likely to prove substantial for the region and last for several quarters.

The COVID-19 outbreak spread rapidly across Europe, with countries such as Italy, Spain and the United Kingdom particularly hard hit. In response, government restrictions became increasingly drastic, bringing widespread economic disruption. Economic indicators plunged across Europe, with the Eurozone Composite Purchasing Managers’ Index falling to 13.5 in April, well below the February 2009 trough of 36.2, along with confidence indicators across every sector dropping in many cases to historic lows. The magnitude of these declines and the absolute level of activity suggest a sudden stop in activity that is unmatched in history, even relative to the GFC.

Our expectation is for the recovery in Europe to take a very shallow path, with Q2 2020 GDP declining by a record level followed by a rebound in Q3 on the demand side (namely private consumption and inventories). By contrast, we expect supply constraints to lift off only gradually as the services sector will lag the recovery in manufacturing. Economies that are intensive in financial services (such as Germany and the Netherlands) will be less disrupted than others that are heavily reliant on construction and tourism, such as Spain, Italy and France, which are leading tourist destinations and where the construction and tourism sectors average as much as 5% and 14% of their respective output. Supply-side constraints also stem from trade and mobility restrictions. Note that over 50% of EA trade is done within that area, which means different countries in lockdown at different times lengthen/deepen the consequences of each domestic lockdown. Adding to this, despite every effort from policymakers, we believe unemployment will grind persistently higher given the number of companies that likely will not survive this crisis.

Policy response: Whatever it takes (again) approach will make or break the euro area

The COVID-19 crisis has forced EA governments to unleash unprecedented fiscal aid packages, with the estimated aggregate size of discretionary stimulus packages to be €276 billion or 2.6% of EA GDP. In most member states, the measures focused on financing additional health expenditures directly related to the COVID-19 outbreak and mitigating the financial consequences of the drop in economic activity on enterprises and people (i.e., partial unemployment, tax and social contribution deferrals, suspension of mortgage repayments, etc.). Crucially, several governments have announced guarantees for bank lending to corporations, totaling an estimated €1.3 trillion (or 12.7% of EA GDP) but projected to grow to €2 trillion. Germany leads the fiscal effort with as much as €600 billion in guarantees. France also launched an unlimited backstop of (at minimum) €300 billion, and Spain provided €100 billion of guarantees for corporate loans to cover working capital. All of these guarantees are complementary to the European Central Bank’s (ECB’s) improved targeted longer-term refinancing operations (TLTRO III) facility, which began in September 2019, and should help banks maintain their credit supply, especially to smaller firms.

The European Commission (EC) also activated the general escape clause of the Stability and Growth Pact (SGP) and 0.6% of GDP worth of unused funds from the European Union (EU) budget. Previously, a major impediment for a genuine and coordinated countercyclical fiscal response in Europe was that member states with ample fiscal space (i.e., Germany) were reluctant to spend, while those in need of structural easing were limited to do so as they were.
THE ECONOMIC COST OF COVID-19 WILL BE SIGNIFICANT, ESPECIALLY IN THE SERVICES SECTOR

Exhibit 8

Historic Plummeting in the Euro Area PMIs
June 2017–April 2020

Confidence Has Also Been Hit Across All Sectors
January 2014–April 2020

The Services Sector Will Take Longer to Recover
May 2017–April 2020

Spain and Italy Will Suffer the Most from Travel Restrictions
2018

Source: Markit, Eurostat, FT Fixed Income Research.
Health uncertainty vs. economic uncertainty: The need to safely restart growth

Longer term, the ECB will be a key factor helping the market to absorb the increased supply burden given the €1 trillion in available funds for net purchases, which should support the market and contain sovereign default risk, namely in the periphery.

On the monetary policy front, the ECB strengthened its quantitative easing program to €1.1 trillion and launched the Pandemic Emergency Purchase Programme (PEPP) with an overall envelope of €750 billion (of 6.5% of GDP) for the remainder of 2020. The PEPP is in addition to the existing Asset Purchase Programme (APP) of €240 billion.

The ECB refrained from formally relaxing their 33% issue share limits or the capital key allocation that govern public asset purchases across countries. However, the PEPP is flexible regarding the time profile, asset composition and geographic distribution of purchases. It has also allowed for the purchase of debt securities with minimum remaining maturities of 70 days (vs. 1 year under the Public Sector Purchase Programme or PSPP). Eventually, we believe the ECB will allow for sizable deviations, at least during the net purchase phase of PEPP. In addition, non-financial commercial paper will now be eligible for the Corporate Sector Purchase Programme. The flexible Additional Credit Claims (ACC) collateral framework will flex even further to include corporate claims, which will ensure the €1.2 trillion increased capacity in TLTRO III can be fully accessed by banks.

The decisive and flexible actions by the ECB have delivered a clear message that it stands ready to do “whatever it takes” to fight this crisis and have backstopped the rates market, the heart of the transmission mechanism.

These monetary policies provide enough financing for EA governments and enhances—along with the Eurogroup’s aid package—the perception of EA solidarity.

A deep recession for the euro area, followed by a gradual recovery

The table and chart (on page 11) show our outlook for growth through the end of 2021 under three different scenarios. We expect the lockdowns to sink the EA economy into deep recession in the first half of 2020, before a recovery in the second half of the year. These scenarios are derived using an alternate methodology given the idiosyncrasies of individual member states’ economies, calculating the quarterly GDP readings of the EA’s main economies (Germany, France, Italy and Spain) assuming a steep q/q GDP decline in Q2 and a rebound in the second half of 2020 fueled by fiscal stimulus and a progressive comeback of manufacturing activity.
Under our baseline scenario we find that the EA economy could fall by 20% q/q in Q2, and by 12.6% year-over-year (y/y) in 2020, before rebounding by 5.5% y/y in 2021. The results under our adverse scenario are even more daunting but overall, we conclude that the recession looks far from being V-shaped in the region, looms deeper than during the GFC, and that Italy and Spain will be hit hardest. Under our positive and adverse scenarios, we add +/-10 percentage points to our baseline GDP decline in Q2 and extrapolate GDP growth rates ranging from –8.0% y/y to a jaw-dropping –17.8% y/y for this year.

Overall, we can extract four main key points from our scenario analysis. First, the recovery in the region looks far from being V-shaped and is conditional on the duration of the lockdowns. Second, the hit to the EA economy under our base and adverse case scenarios looks more severe than during the GFC of 2008–2009, subtracting 5.7 and 7.8 percentage points, respectively, from real GDP growth during Q1 2020–Q2 2021. Third, the economy is unlikely to reach the pre-crisis nominal GDP levels until mid-2022, at the earliest. And fourth, this recession is expected to take its biggest toll on Italy and Spain, where the lockdowns have been lengthier and more severe, followed closely by France. By contrast, we expect a speedier recovery in northern Europe (Germany, Austria, the Netherlands and Belgium), with the rebound in activity expected by late May/June as their economies start gradually lifting their flexible lockdowns and allowing a resumption in activity of their main industries.
Sector Settings

Given the unprecedented disruption we have experienced in global fixed income markets and the high degree of uncertainty regarding potential policy and economic reopening strategies in the quarter ahead, the sector settings presented below reflect our three-month outlook for the asset class. However, we continue to find value and pockets of opportunities in all sectors, as detailed in the commentary below.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Outlook</th>
<th>Our viewpoint</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Treasuries</td>
<td>![Outlook Icon]</td>
<td>While US Treasury yields fell significantly across the curve to at or near all-time record lows during the past quarter’s flight to safety, and the Fed cut its policy rate back to the effective zero lower bound, this crisis once again reaffirmed US Treasuries’ status as the world’s investment of choice during periods of market distress and volatility. At current valuations, upside potential is somewhat limited unless the United States joins much of its developed market peers in experimenting with negative yields—which is not our baseline expectation—while rates should remain range-bound for the foreseeable future. Given the likelihood of further periodic bouts of volatility going forward, the continued purchase of US Treasury securities by the Fed in the latest round of QE, and the unquestionable intention of the Fed to extend bond purchase plans and support market function with a “by any means necessary” approach, we believe the sector offers value to investors as a perceived safe-haven asset, a hedge against volatility in other spread sector exposure, and a source of liquidity when more attractive opportunities arise. We favor lengthening duration and have upgraded our rating to neutral.</td>
</tr>
<tr>
<td>Treasury Inflation-Protected Securities (TIPS)</td>
<td>![Outlook Icon]</td>
<td>Performance for TIPS was challenged during the past quarter due to an unprecedented liquidity-driven disruption in Treasury markets, an indiscriminate selloff across sectors, and the escalation of the coronavirus-induced crisis causing economic growth and inflation expectations to plummet. We believe TIPS, as high-quality assets, should recover as liquidity conditions continue to normalize with ongoing Fed purchases, and as longer-term inflation expectations increase from their current extremely depressed levels. Even as inflation expectations remain at their lowest levels since the GFC, especially in the shorter maturities, we believe the sector is under-valued longer term and we continue to find opportunities due to mispricing. While this crisis has extended timeframes for inflation to recover toward target or pre-crisis levels, we believe that the drop in inflation expectations currently priced into TIPS exceeds our estimate for the impact this crisis will have on growth and inflation over the next five to 10 years and that breakeven levels are inconsistent with the fundamental backdrop. At current valuations, it would not be necessary for inflation to surge higher, but rather only for downward pressures to alleviate and breakeven levels to move into a more normalized range for the sector to potentially generate solid returns. We also believe the market may be underestimating the potential inflationary effect of massive fiscal and monetary stimulus/rescue packages, as well as the likelihood of increased in-sourcing and changing supply chains that will result from the current crisis. However, we have reduced our rating to neutral with reasons for optimism.</td>
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<tr>
<td>Eurozone Government Bonds</td>
<td>![Outlook Icon]</td>
<td>Demand for European government bonds (EGBs) is likely to remain strong, and our expectation is that negative or extremely low yields will remain supported given the persistence of a non-price sensitive buyer in the form of the ECB, which will be a key factor in helping the market absorb the significantly increased supply burden. The size of the latest QE program demonstrates the ECB will remain extremely accommodative, continue to provide liquidity to the market, and seek to keep rates low for the foreseeable future. We remain neutral with reasons for optimism. Many European countries were on a negative growth trend prior to the crisis, keeping rates well anchored. Still, the impact of the COVID-19 crisis has been widely different in European economies, with Germany seemingly less affected, and Spain and Italy more acutely affected. Germany had lower debt-to-GDP entering the crisis, while an eventual exit from the crisis will hit Spain and Italy much harder due to their greater economic reliance on services and tourism, which should cause a further increase in their respective fiscal deficits. On the rates front, we favor semi-core EGB spreads and view the solid ECB backstop and encouraging signs of stabilization from broad credit markets as supportive. Longer-dated French government bonds (OATs) and Finnish government bonds offer value over duration-matched German Bunds as relative spreads.</td>
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<td>Eurozone Government Bonds</td>
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<td>have demonstrated underperformance versus periphery spreads, which have rallied notably since the launch of the PEPP. Despite the illiquidity discount Finland typically holds during times of volatility, current spread levels are comparable to those seen during the eurozone debt crisis and are difficult to justify at present. We remain more prudent on the remainder of the EA periphery. While we believe the sizeable ECB purchases will prevent returning to pre-PEPP spread levels, periphery valuations are trading rich and offer limited upside potential. Italian government bond (BTP) spreads have been volatile, with future valuations weighed down by the deterioration of economic and fiscal indicators, and we favor the wings of the curve, particularly on the very long end given yields we view as attractive relative to other long-dated bonds. In addition, while the European yield curve remains steep, the prior attractiveness and yield pickup of holding EGBs and hedging into the US dollar (USD) has been reduced given that US rates have now also reached an effective zero lower bound.</td>
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<td>Japanese Government Bonds</td>
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<td>The Bank of Japan (BoJ) expanded monetary stimulus measures and restarted QE. It committed to unlimited purchases of Japanese government bonds (JGBs)—eliminating guidance and upper limits on the annual pace of purchases—to keep borrowing costs suppressed and attempt to support the market amid the deteriorating economic backdrop in the face of the COVID-19 pandemic. The BoJ also reiterated it would not hesitate to take additional easing measures if necessary. We believe the BoJ’s extremely accommodative monetary policy stance is largely symbolic, however, as it has fallen well short of its prior stated purchase pace guidance for the past several years, and there remains little monetary policy ammunition remaining given current negative policy rates. The central bank also sharply cut its economic forecasts. While it remained committed to bringing core inflation above its 2.0% target, it now projects the Consumer Price Index to fall into negative territory in fiscal year 2020 and acknowledged achievement of this goal will take time. JGBs should remain well supported given the likelihood of a temporary acceleration of central bank purchases, which will offset the increase in issuance to fund spending, and the sector continues to serve as a hedge against global volatility in a year when we anticipate increased bouts of global risk aversion. Given limited upside potential at current levels but continued value as a perceived safe-haven asset, we slightly have reduced our rating to neutral with reasons for concern. We also continue to favor Japanese yen exposure as a hedge against global volatility, although the strong historical inverse correlation to increased risk aversion was not as effective during the most recent period.</td>
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<td>Agency Mortgage-Backed Securities (MBS)</td>
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<td>March 2020 was an exceptionally volatile month within the MBS sector. Spreads widened the most since the GFC, then sharply tightened after the Fed announced a massive support program to boost liquidity and provide stability in the MBS market. The Fed's active participation in the sector has been supportive of the asset class, and spreads have returned to a more normalized level, albeit still trading wider than pre-GFC levels. Since the announcement, the Federal Reserve System Open Market Account (SOMA) has absorbed a large share of market supply, purchasing US$617 billion as of May 7. We believe Fed buying will continue, keeping spreads well-supported and range-bound. The overall housing sector is facing opposing forces, which are leading to market uncertainty. While the low-interest-rate environment continues to be a tailwind and seasonal purchases have been strong, social distancing and other measures as a response to the COVID-19 pandemic could lead to lower housing activity. Prepayment risk remains elevated as mortgage rates are near record lows, and more than two-thirds of the agency MBS universe has an incentive to refinance, leading to high levels of refinance applications. However, two factors may keep prepayments muted over the short term: forbearance requests related to the COVID-19 crisis have picked up, and capacity constraints combined with the disruptions related to the crisis could lead to fewer refinance applications being processed each month. Despite the near-term constraints for refinancing, we prefer to be positioned down in coupon (in the 2.5%, 3.0% and 3.5% coupons) to mitigate prepayment risk over the coming year. We also prefer 30-year securities over 15-year securities and conventional 15- and 30-year sectors over Ginnie Mae 30-year securities. We have slightly upgraded our rating to neutral as we believe that the sector will continue to benefit from Fed purchases and represents a solid carry trade. Although our view is offset somewhat by elevated prepayment risk and relatively tight spreads.</td>
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<td>Non-Agency Residential Mortgage-Backed Securities (RMBS)</td>
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<td>Non-agency RMBS experienced severe dislocations during the past quarter, with spreads widening by a large margin in tandem with broader credit markets. Price action was significantly outsized for credit risk transfer (CRT) securities, which are general obligations of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Many CRT deals experienced price declines of 20%–35% despite projections that they were unlikely to result in loss under all but the most extreme scenarios. Since bottoming in late-March, actual loss schedule CRT bond prices have since recovered almost 70% and we...</td>
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The volatility of the COVID-19 pandemic has severely impacted CMBS, with spreads widening over the entire stack and steepening the credit curve. The sector received some stabilization through the Fed’s accommodation of AAA CMBS for the Primary Dealer Credit Facility (PDCF), as well as inclusion of the asset class in the eligible securities for the Term Asset-Backed Securities Loan Facility (TALF). However, the Fed’s programs support only approximately 15% of the commercial real estate (CRE) market and a significant number of properties may come under considerable pressure without additional relief measures to blunt the impact. CMBS issuance remains frozen and, unsurprisingly, hotels and retail have been the hardest hit as discretionary spending plummeted and foot traffic declined after states implemented shelter-in-place measures. We believe that office buildings with large exposure to co-working spaces will see vacancies increase as these businesses generally operate on short-term leases. The multifamily sector will also feel pressure as widespread job losses and increasing vacancies will make rent collection more difficult. Absent any direct support from the Fed, we expect vacancies to rise, operating incomes to decline and cap rate spreads to widen. These factors, in conjunction with an uptick in delinquencies, should put considerable downward pressure on CRE prices. The sector received some stabilization from government measures, although not directly supporting the CRT markets, will also ease liquidity concerns in other sectors which should eventually benefit the liquidity of CRTs. With lower rates producing faster prepayments and spreads broadly moving wider, some drop in prices was expected, but the movements we saw far exceeded our expectations given the underlying credit fundamentals of the cashflows. Continued faster prepayments in this lower rate environment should continue to increase protection to senior cashflows. However, capacity constraints to process applications remain and are further exacerbated with loan officers working remotely. Eventually, we expect applications to be processed, resulting in faster prepayments, although they are likely to be spread over a few months rather than a single month. In the near term, we expect an increase in delinquencies as people face hardship due to stay at home orders. CRT securities now represent the predominant form of non-guaranteed debt issuance related to recently originated residential mortgage loans in the United States. The loans underlying these transactions are of significantly higher quality—higher credit scores, lower debt-to-income (DTI), and lower loan-to-value (LTV) ratios—than the loans issued during the GFC. We favor seasoned vintages of CRTs, which offer defensive characteristics. These securities have years of home price appreciation locked in and credit support that has steadily increased as prepayments have deleveraged the structures. Given the uncertain macroeconomic environment and increased risk of economic fallout from the massive scale of the US lockdown, we have reduced our rating to neutral but continue to believe the sector offers value.

We expect the ABS market will remain under pressure for the foreseeable future, the extent of which hinges upon how long the COVID-19 pandemic keeps consumers sheltered in place. The significant uptick in unemployment and the accompanying decline in consumption caused by the sudden shutdown of the economy will weigh heavily on the previously strong fundamentals within the sector. The sector was boosted by the Fed’s launch of the TALF and the inclusion of consumer ABS in the program, which will help keep the primary market functioning by enabling new issuance. However, given the overhang from the coronavirus crisis, we do not anticipate spread tightening in the near future. Implications from TALF on consumer ABS sectors will be bifurcated between sectors that are TALF-eligible and those that are not. The TALF program sets a floor price on securities issued under the program by offering a “put” back to the Fed at par (subject to a relevant haircut) if volatility were to return to the market. Thus, prices for TALF-eligible sectors will have a floor, while non-TALF-eligible sector spreads have the potential for more volatility. We remain neutral given the expected deterioration in fundamentals, and we favor allocating risk capital up the capital structure, with a strong preference for top-tier issuers with trusts who have exhibited sound fundamental performance over various credit cycles.
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<td>US Investment-Grade Corporates</td>
<td>![Outlook Icon]</td>
<td>The global collapse in economic activity caused by COVID-19, coupled with the steep drop in oil prices, has drastically eroded corporate profits and driven volatility in the investment-grade credit market. USD investment-grade corporate spreads have rebounded since the widest spreads of late March, but the Bloomberg Barclays US Corporate Index remains near recessionary levels. We believe most investment-grade companies have the financial capacity to weather a short-to moderate-term business disruption, although companies in the most impacted industries may face diminished longer-term business prospects. Many issuers have bolstered liquidity through new bond issues and/or bank line draws, which should help sustain them over the coming months, but the timing and progress in restarting economic activity will be a key factor in forecasting how quickly companies recover. Rating agencies have already aggressively downgraded many of the most affected credits, which has been an additional market hurdle. While the fundamental outlook is challenging, market technicals became more balanced in April and May. The Fed’s announcement of primary and secondary market purchase programs for investment-grade bonds and exchange-traded funds (ETFs) brought the market back from an extreme period of illiquidity, narrowing bid-offered spreads and opening the market to record levels of new issuance. We are upgrading our rating from moderately bearish to moderately bullish based on more attractive valuations and Fed support for the market, although valuations are now closer to near-term fair value given the high degree of uncertainty over the duration and severity of the crisis. We expect continued demand for investment-grade corporates as a source of relatively safe yield. We currently favor higher-quality companies in less economically sensitive industries such as supermarkets, utilities, and pharmaceuticals, although we are also taking advantage of volatile market conditions to add bonds of select cyclical issuers at valuations we view as attractive. We believe credit curves should continue to steepen, given the Fed’s mandate to support the front end of the market.</td>
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<td>European Investment-Grade Corporates</td>
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<td>Visibility into earnings and cash flows for European investment-grade corporates has diminished significantly since the onset of COVID-19 volatility, and the focus has turned to each corporation’s ability to weather or survive this crisis. Companies have reacted quickly to improve liquidity positions, and management teams have announced reductions in operating costs and investments, dividends cuts/cancellations, and suspension of share buybacks. The pandemic-induced recession should materially weaken European investment-grade corporate fundamentals this year despite these self-help measures; however, this fundamental weakness will be offset by very accommodative monetary policy and supportive fiscal measures. Valuations have bounced back from March lows, but the euro investment-grade sector remains compelling, in our view. Current spreads offer a good buying opportunity to us, particularly for highly rated issuers, and we have upgraded our rating to moderately bullish. Our outlook reflects what we believe to be attractive valuations and strong technicals with a partial offset for the sharp credit deterioration. Selectivity within credit quality and sector exposure will be essential in this environment. We favor ECB-eligible securities, and non-cyclicals over cyclicals. Senior bonds issued by state-owned entities should also benefit from direct state support. We are cautious on highly leveraged credits in the BBB space and prefer senior preferred paper within the financial space. Extended or rolling lockdowns across Europe remain a risk to our outlook, as further delays to economic recovery would put additional pressure on corporate balance sheets.</td>
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<td>US High-Yield Corporates</td>
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<td>The dual shocks of the COVID-19 pandemic and the collapse in oil prices precipitated a sharp decline in the US high-yield market in the first quarter of 2020, with spreads briefly reaching their highest level since the GFC. As the Fed announced massive support programs with unprecedented speed, spreads quickly reversed and tightened to levels below those reached during the European sovereign crisis in 2011 and the energy downturn in 2016, a trend that accelerated following the once-unthinkable announcement on April 9 that the Fed would directly support portions of the high-yield market. We believe this amount of tightening is overdone, and therefore we remain moderately bearish. The current US high-yield market is being driven primarily by technical factors, including record recent inflows from mutual funds and ETFs and large pools of money entering the market in an opportunistic fashion, on the belief that the Fed will provide substantial support to the high-yield market. However, a close reading of the details of the announced Fed programs makes clear that their support is actually quite limited—of note, the 10% individual issuer limit means that the Fed can’t buy more than 10% of the sum total of fallen angels downgraded after March 22, 2020, which is expected to potentially amount to more than US$300 billion over the next 12 months, a quarter of the size of the existing US high-yield market. We also believe that the Fed will not extend further support to the US high-yield market unless there is significant deterioration in the technicals. Therefore nothing precludes a widening from current spread levels, which in our view do not appropriately price in the expected sharp spike in defaults, nor the sizable wave of fallen angels that could lead to price dislocations.</td>
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Health uncertainty vs. economic uncertainty: The need to safely restart growth

Outlook -continued

Our viewpoint

Additional technical pressure is likely to come from heavy new issuance as companies rush to bolster their liquidity, with net new issuance year-to-date (YTD) already up 70% over the comparable year-ago period and likely to continue as we move further through earnings season and issuers exit blackout periods. Given this technical backdrop, combined with a deteriorating fundamental picture, we see the need for careful credit selection. We are finding value in select new issuance, even though the call protection at times leaves something to be desired. In addition, although BBs have outperformed YTD, we favor an “up-in-quality” bias given the recessionary environment, with an awareness for potential fallen angels that could reprice certain sectors. Over the short run, we are moderately bearish and would expect spreads to widen, but we are more constructive looking out over the next 12 months and expect spread tightening in our base case economic scenario. We believe that attractive opportunities can still be found in the asset class, but careful research and consideration are more important than ever.

Earlier this year, we felt that European high-yield spreads did not compensate for the expected slowdown in European economic growth and increase in default rates. Over the past three months, through the unfolding of the COVID-19 pandemic and over significant spread widening, we continue to believe spreads remain unattractive considering the enormous social and economic challenges facing European governments in the coming months. Default rates are expected to rise sharply over the next 12 months on the back of lower economic growth, challenging the most leveraged capital structures. Our view is that current spreads are not pricing in such a meaningful rise in default rates, nor any pressure on European sovereign yields despite increasing government debt ratios, so we have maintained our moderately bearish rating. We expect technicals to remain challenged for at least another quarter, with more fallen angels expected to drop from investment grade into high-yield territory and retail/institutional demand to initially focus on lower risk asset classes. Over the longer term, however, declining investment-grade and European sovereign yields, supported by ECB action, should drive demand for European high-yield bonds. We prefer BB credits and would avoid both low single B and CCC subordinated issues, particularly out of leveraged buyout (LBO) structures. Within the leisure sector, most issuers are either too leveraged or not large enough to sustain periods of closures lasting more than four months, so we would avoid exposure to the sector. As consumers/corporates cut their budget plans, we are also avoiding automotive suppliers and small industrials/basic materials issuers.

The magnitude of the widening and the subsequent tightening of loan spreads over the course of March broke records, not only in terms of size but also in terms of the velocity of such moves. We began the year moderately bullish on the sector; however, as we look ahead we are highly cautious on the loan market, not least because of the underlying fundamental risks that have accumulated through the past cycle—risks we have noted for several years. Now that the global economy is in a recession, we believe the change in loan fundamentals will lead to elevated defaults among the most vulnerable loan issuers in the near to intermediate term and recoveries will likely be lower relative to long-term averages. The CARES Act provisions so far do not support most of the loan market, and while there will likely be incrementally more support in the future, fundamental improvement in demand will be the most critical driver of recovery in the loan market. We are skeptical of the recent recovery in loan prices because while the early wave of price gains was concentrated in a subset of loans where fundamentals provided a rationale, it has since given way to price movements in issuers where investors are seeking price appreciation without adequate information about how fundamentals are likely to play out, particularly in vulnerable sectors such as retail, gaming and leisure. Many of these issuers may be able to keep employees on the payroll and renegotiate rent and postpone tax payments (all of which bring only temporary benefits), but they still must meet their debt service obligations. We believe as the full fundamental impact of a slow return to normalcy becomes more evident, we could see periods of material spread widening in the lower-quality part of the loan market and an increasing preference for higher-quality loan issuers, which should intensify the bifurcation. In such an environment, while we are cautious on the broader loan market and have reduced our rating to bearish, we believe periods of volatility will bring attractive investment opportunities to our preferred portion of the loan market and that investor activity over the coming months may yield additional investment opportunities at more attractive levels. Until then, we remain highly selective and biased toward higher-quality loan issuers in more recession and COVID-19 resilient industries.

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Our viewpoint

Collateralized Loan Obligations (CLOs)
Rating agencies have been quick to react to the ongoing stresses permeating the bank loan market, and loans have faced a torrent of downgrades, particularly in COVID-19 affected sectors. These fundamental loan issues are also causing fundamental deterioration in CLOs, as they are breaching their CCC bucket thresholds, eating away at junior overcollateralization (OC) cushions and, in the most extreme cases, diverting cashflows from equity holders to pay down senior tranches. Despite looming OC breaches and CLO downgrades, we continue to remain optimistic regarding the resilience of the CLO structure. The structural features of CLOs provide protection to investors in times of distress, particularly in the senior parts of the capital structure. Historically, the bulk of CLO losses have occurred in the below-investment-grade tranches, while BBB and higher-rated tranches have experienced extremely low defaults, and AA and AAA tranches have had no losses. Importantly, the structural protections for CLO 2.0 investors have improved significantly compared to CLOs issued during the pre-crisis period. CLOs now have shorter reinvestment periods, limitations on reinvesting principal proceeds after the reinvestment period, and 90%–95% minimum allocations to senior secured loans. We continue to believe senior investment-grade tranches have enough subordination that they will remain principal safe. However, single A and BBB tranches will continue to face mark-to-market moves as well as potential downgrades (particularly at the BBB level) as COVID-19 stresses continue. Without a defined exit scenario from the current coronavirus-induced crisis and minimal Fed support for the asset class, we favor higher-quality exposure at the top of the stack (AAA and AA rated), which could benefit as investment-grade securities rally and where valuations remain attractive to us, with the current discount margin more than two standard deviations away from the one-year and five-year mean. US and European CLOs at the top of the stack have historically experienced lower volatility, have decreased downgrade risk, and principal impairment risk has been remote. We have upgraded our rating on high-quality CLOs to moderately bullish, while we expect lower-rated tranches will continue to face mark-to-market moves and potential downgrades in the medium to longer term.

Municipal Bonds
As volatility due to the COVID-19 outbreak picked up across financial markets, the municipal bond market was initially undisturbed. However, as shelter-in-place orders expanded, the market struggled to find liquidity, much of the market saw steeply discounted prices, and wide bid-ask spreads were largely indiscriminate across the spectrum of sector, rating, geography, and security provisions. Commensurate with eroding market conditions, cash flows into the municipal bond market turned sharply negative, which was a noted reversal of the record positive flows in 2019 and the first two months of 2020. This flow reversal hit high-yield municipal bonds particularly hard, a risk we highlighted earlier this year. The municipal bond market managed to regain its footing in late March thanks to improved buying activity across the yield curve driven in part by investor anticipation of the US$2.2 trillion CARES Act. The 30-year AAA Municipal Market Data ("MMD") scale has nearly returned to pre-crisis levels and remains very attractive relative to US Treasury levels, in our view. However, the market is extremely fractured, tempering our rating to neutral. Price dislocations are resulting in attractive valuations in certain sectors with positive long-term prospects, while many other sectors face headwinds, including credits highly concentrated in tourism, oil and gas, transportation, retail sales, and governments with very high fixed costs (debt, pensions and retiree health care) and limited financial flexibility. We favor longer maturity offerings with longer dated call provisions to harness excess yield, while accessing more liquidity versus intermediate offerings. Selectivity is—and will increasingly be—vital within sector, ratings and structure. The taxable segment of the market is likely to have higher volatility than tax-exempts given its greater fragmentation.

Emerging Market (EM) Debt
Mirroring other global credit markets, the demand, supply and oil shocks facing the global economy have brought significant stress to EM debt over the quarter and have threatened to push EM growth to extremely negative levels—worse, in many cases, than experienced during the GFC. The COVID-19 pandemic came at an inopportune time for EMs in many respects: growth was already slow, inflation relatively weak and monetary policy on an accommodative setting. Nevertheless, EM policymakers have moved quickly and aggressively to support the welfare of their populations, to protect their financial systems, and to channel liquidity to parts of their economies suffering from an abrupt halt in business. Measures adopted by developed market central banks, multilateral lenders, and within the asset class itself have stabilized some aspects of the market, but significant uncertainty remains. Our moderately bullish rating is founded on the outlook that economies begin to resume normal activity levels over the course of 2020, pulled along by similar recoveries in developed market economies as lockdown measures are reversed. Risks around an extended economic drag due to additional waves of COVID-19 and resulting shutdowns and a failure for commodity markets to follow the path implied by futures markets are significant; therefore, we expect a difficult period in the short term for EM debt. Without a buyer

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Emerging Market (EM) Debt
continued

of last resort in EM credit, liquidity is also a factor with the potential to exaggerate changes in asset prices, as has been the case in recent months. However, looking beyond the near term, our positive outlook for EM debt remains largely intact as the temporary factors that have unsettled financial markets subside, supporting the compression of risk premia back to more normal levels. The open-ended commitment of developed market central banks and multilateral lenders will provide ongoing support for risk assets in general. However, the scale of the shock will likely result in an increase in defaults and restructurings across both sovereign and corporate sectors, though this should not represent a significant portion of the asset class. Currently, any scope for a broad private sector debt relief program is very limited, although this will grow if the recovery of the global economy stalls.

Emerging Market (EM) Corporates

Although we expect defaults in EM corporates, which have been very low for several years, to rise sharply in 2020 as a result of the demand, supply and oil shocks stemming from the COVID-19 pandemic, we consider this default risk to be priced in at current spread levels. As a result, we remain moderately bullish. EM corporates started the year in a relatively strong position: leverage and ability to service debt have been respectable for a while and appear to be less stretched than in developed markets. Nevertheless, EM corporates have their own set of challenges, and many of these have become more apparent as a result of the COVID-19 pandemic. On the health side, most EMs are behind the developed world in terms of infection curves and have less advanced health care systems, which represents a tail risk for the asset class, notwithstanding their demographic advantage in terms of relatively younger populations. EM corporates are also sensitive to weaker commodity prices, even if most energy exposure is sovereign-linked in some way, implying that many business models and balance sheets could come under further pressure in coming months. For these reasons we anticipate EM corporate spread tightening could lag developed market corporates in the near term. There also continues to be a need for the weaker liquidity of the asset class to be factored into pricing. It will take time for confidence to return and for capital to flow back into the asset class, which should ultimately restore liquidity to pre-crisis levels.

Thinking ahead to a world recovering from the pandemic—likely short on growth but long on debt and political conflict—we suspect that investors in EM corporates will focus attention and capital on rewarding the most sustainable balance sheets and business models. We favor well-run, privately owned companies over bloated state-owned enterprises that require ongoing sovereign support to sustain overleveraged balance sheets. Specifically, we favor Chinese investment-grade names and believe they provide relative stability and a strong liquidity profile. We are incrementally more cautious on corporates from countries that will either struggle severely from the impact of the virus were it to take hold given weak fiscal positions, such as India, or where authorities are not taking action quickly enough, such as Mexico or Brazil. By sector, we find value in select subordinated debt of banks, notwithstanding growing evidence that capital securities are likely to recover close to zero in a resolution.

Endnotes
1. Source: US Census Bureau, Population Division, FTI Fixed Income Research
2. Ibid
3. Ibid
4. Fiscal impulse is a financial term which measures the change in the government budget balance resulting from changes in government expenditure and tax policies.
5. There is no assurance that any projection, estimate or forecast will be realized.
6. Eurostat. FT Fixed Income Research. There is no assurance that any projection, estimate or forecast will be realized.
7. Ibid
8. Source: SIFMA TRACE, as of April 20, 2020
Fixed Income Views: Franklin Templeton Fixed Income conducts a team-wide Quarterly Research & Strategy 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. From a bottom-up perspective, we provide readers with condensed high-level summaries of our sector views. These macro and sector recommendations are utilized to guide asset class conviction and portfolio construction.

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Notes
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