

FEBRUARY 2020

# 2020—Will the economy survive the politics?

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FIXED INCOME VIEWS



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**New year, new decade—we're off to the races. None of the doom-and-gloom predictions materialized in 2019. Trade tensions did not spiral into out-of-control trade wars, new tariffs did not have a major macroeconomic impact, the US economic expansion did not halt and China's economy did not stall. The lesson learned is that last year, too many people worried too much about the wrong things.**

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In 2020, we believe the right investment decisions will revolve around three key factors: the potential for volatility from US politics, the ongoing tug-of-war between the financial markets and the US Federal Reserve (Fed), and the dangers of adaptive expectations.

We will again face significant volatility from multiple sources, including political uncertainty, geopolitics and the media's instinct to hype every risk that emerges. We believe US politics will be the main source of volatility as we head toward the 2020 US presidential election, as uncertainty on the course of future economic policy will weigh heavily on markets. Regardless of who wins, US public spending and debt are likely to keep growing, which would make valuations for many risk assets look even more stretched.

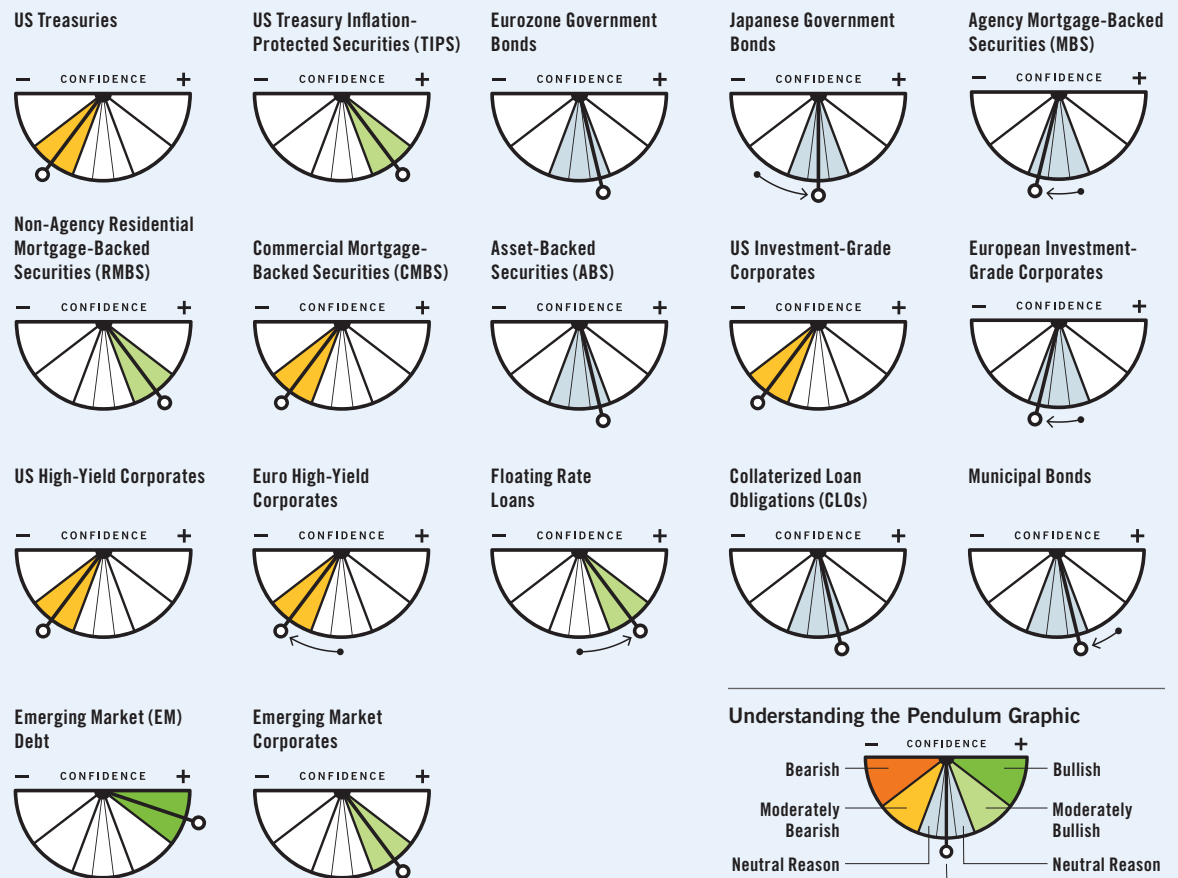
The tug of war between the markets and the Fed is also likely to resume. In 2019, when the markets put the pressure on, the Fed capitulated and lowered interest rates. Several asset classes rallied during the year despite weakening fundamentals, with the Fed's interest-rate cuts playing the determining role.

The Fed will aim to keep short-term rates anchored at current levels; too accommodative for what we expect to be another year of healthy real US gross domestic product (GDP) growth. We also expect inflation will rise above the Fed's 2% target—the question is by how much. Even a moderate increase in consumer inflation might push long-term rates up more than markets expect. The idea that inflation is no longer a concern, widely embraced by policymakers and analysts, is a dangerous assumption.

We do not forecast any dramatic shifts in the macro outlook in 2020; if anything, we believe the consensus remains too pessimistic. Global growth should remain on an even keel, but risks remain elevated and investors should prepare for, and be ready to capitalize on, periods of significant volatility.

The risk that has featured most prominently in the last few weeks is the recent coronavirus outbreak, which originated in China. The information available to date is limited and allows only a very preliminary assessment. So far, the virus's mortality rate appears to be lower than the SARS outbreak of 2003 (at 3% versus 9%). The coronavirus seems to be more highly contagious, however, spreading at a faster pace—the count of affected individuals and fatalities could therefore rise significantly in the coming months, and the mortality rate might be worse than its initial estimates. At this stage, the information available on the virus as well as the prompt reaction of health services and authorities in China and around the world, seem to suggest that the risk of significant global contagion is limited. Even if contagion is contained relatively rapidly, a negative impact on China's growth in the first half of the year is probably inevitable, through lower consumption and travel. Global tourism is also likely to suffer a temporary setback. Should the outbreak worsen significantly, factory closures might also impact global supply chains to some extent. At this stage, the most likely scenario appears to be a moderate temporary hit to Chinese and global growth, which should be partially cushioned by policymakers' accommodative stance. If that is the case, risk appetite should rebound after an initial period of concern.

## Sector settings



Arrows represent any change since the last quarter-end.

# Franklin Templeton Fixed Income macroeconomic recap & outlook

## Record long expansion in the United States likely to carry on

The US economy started 2019 on an ominous note as financial conditions tightened sharply toward the end of 2018. While the Fed's first pivot away from rate hikes in January brought a degree of calm, a further flaring up of US-China trade tensions in May, followed by yield curve inversions in August, led many to sound the recession alarm. The Fed soon pivoted for the second time, delivering three 25-basis-point policy rate reductions starting in July, thus quelling market concerns of an imminent recession, while also pushing real interest rates, both long and short, back into negative territory.

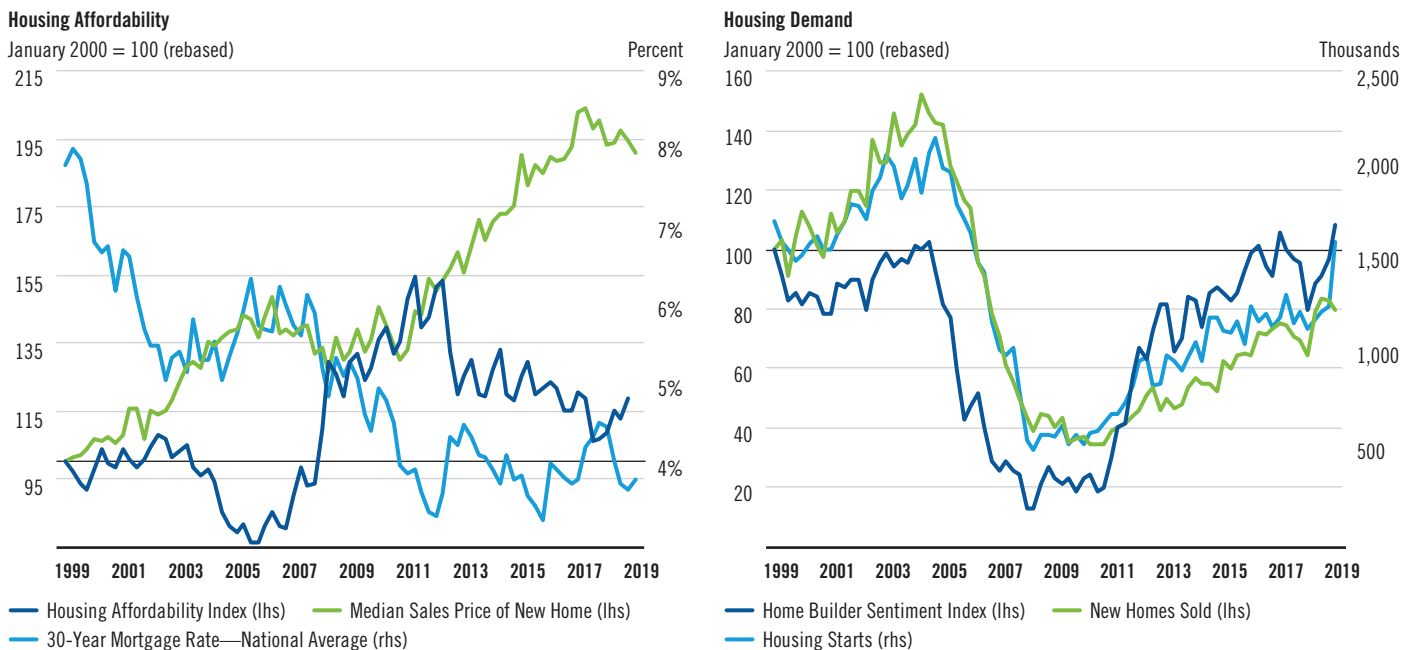
As discussed in our previous views, concerns over an inverted yield curve-led recession were overblown. Unlike inversions that preceded prior recessions, the inversion this time was largely a function of a significant drop in term premiums, which in turn was the result of divergent monetary policies between the Fed and particularly the European Central Bank (ECB) and the Bank of Japan (BoJ). The yield curve has steepened since then, and recent economic data, particularly on the consumer side, have also helped to dispel fears of an impending US recession. Thanks to a tight labor market and steady wage growth, consumers have continued to see an increase in their real purchasing power. The US labor market continues

to defy expectations in the face of global trade and economic uncertainty, as the unemployment rate fell to a multi-decade low of 3.5%, while the job openings rate continues to hover around its recent highs.<sup>1</sup>

Meanwhile, aside from the consumer and labor market, the role of the housing market in powering the US economy cannot be emphasized enough (Exhibit 1). Housing demand had been subdued through much of 2018 as mortgage rates remained above 4%, while house prices rose to well above the peak reached during the housing bubble. Weak housing demand eventually pulled down housing sale prices, while mortgage rates fell significantly. This, combined with solid jobs and

## UPTURN IN US HOUSING MARKET

**Exhibit 1: Housing market playing a key role in powering the US economy**  
December 1999–December 2019



Source: National Association of Realtors, U.S. Census Bureau, Bankrate.com, National Association of Home Builders. As of December 2019 or latest available data.

incomes as well as the Fed's pivot on rates, made home purchases more affordable for households and aided the upturn in housing starts and home-builder sentiment, the latter of which reached its highest level since 1999.<sup>2</sup>

However, while the upturn in housing has resulted in residential investment contributing positively to overall GDP, business or non-residential investment, the other big driver of the economy, has remained anemic. The ongoing uncertainty created by trade tensions has led to lower business investment and a manufacturing sector-specific recession. From a capital expenditures (capex) perspective, the Institute for Supply Management's semiannual survey conducted in late November suggested US manufacturers will reduce capital spending in 2020 by 2.1%, which if realized would be the first annual decline since 2009.<sup>3</sup>

As we consider our outlook for the US economy, we expect the economy's 11-year expansion to continue, but we see the potential for a tale of two halves. The US economy starts 2020 on surer footing, and growth will likely pick up in the first half of 2020, driven by US consumers, the housing sector and government spending, with consumers continuing to have an outsized effect on overall economic growth. The Fed's dovish policy stance and a still-strong dollar will likely provide a supportive environment for consumer spending. However, there is potential for a marginal slowdown in the year's second half given political uncertainties, though we believe overall GDP will remain relatively steady for 2020.

We attribute this view to several factors. First, even though trade-related uncertainties may have abated for the time being, China's compliance with the

recent phase one agreement will set the tone for trade relations in an election year. Unsatisfactory progress would require US President Donald Trump to decide between escalating the dispute or risk appearing less willing to challenge Beijing—a risk we think he will be keen to avoid in the middle of a reelection campaign. A fourth round of tariffs on China, if enacted, would affect US\$160 billion in imports, a majority of which would be key consumer electronics such as smart-phones and laptop computers, for which at least 75% of US import demand is met by Chinese imports.<sup>4</sup> Price inflation in these areas would have a far greater direct impact to a majority of Americans than previous rounds of tariffs, a risk the current administration can ill-afford going into the November election.

The consumer remains in good financial health, and despite the unprecedented duration of the current economic expansion, we see no imbalances in the household sector that are likely to trigger economic overheating. On the corporate side, even though debt as a percentage of cash flow is at a historic high for non-financial companies, capex hasn't become excessive as it has in the past and continues to trend below cash flow (typically, capex as a percentage of cash flow becomes excessive prior to recessions).

We now expect the Fed to adopt a wait-and-watch stance in 2020 for two reasons. First, slightly stronger growth, driven in part by consumer spending, housing, government spending and the Fed's "insurance cuts" seen last year, will likely offset the weakness from sluggish capex and manufacturing, which in turn should keep the Fed on pause. Secondly, as highlighted earlier, we see wage and price pressure continuing to build in the months ahead, which should push the Fed's preferred gauge

of inflation, the core personal consumption expenditures price index, closer to the 2% target. We believe staying put on rates will be too accommodative for what is expected to be another year of healthy real US GDP growth. However, the Fed can give itself additional cover with its ongoing monetary policy strategy review—likely to favor some form of average inflation rate targeting, which would imply greater tolerance for a period of above-target inflation.

While we expect the Fed to stand pat on rates through 2020, the outlook for monetary policy and in effect the economy hinges largely on whether Washington and Beijing can make further progress on trade, or at least avoid straining tensions further. We also expect yields to climb higher from their current levels, with a continued build-up in wage and inflationary pressure driving the 10-year Treasury note's yield up from its current levels, ranging between 2.5% to 3.00% by the end of 2020 (see Exhibit 2 on the next page). With the ECB and the BoJ expected to be in easing mode at least for the first half of 2020, global growth only just starting to bottom out, and a yet to be resolved trade dispute, yields will likely be closer to the lower end of our expected range as the search for yield and/or flight to safety continues.

## Not (yet) a turning point for European yields

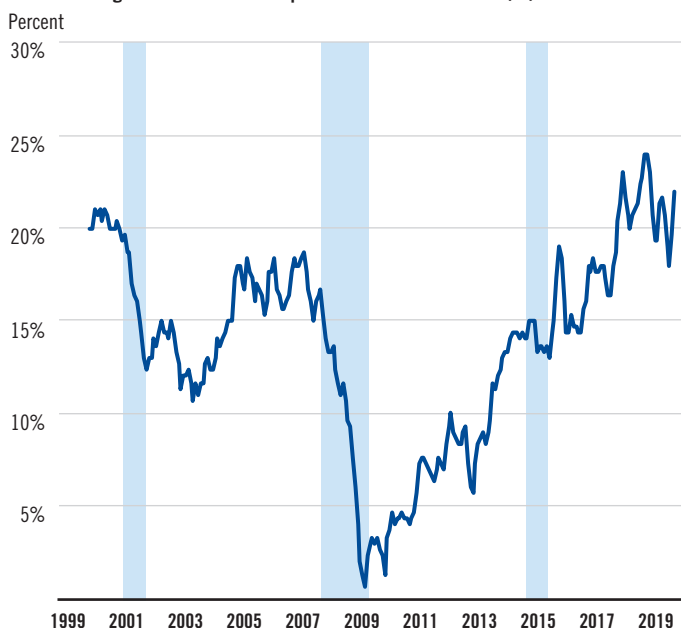
Economic data continue to point to underlying weakness in the eurozone as the contraction in manufacturing activity provides a persistent drag on the moderate expansion of the services sector. Given our expectation that the external environment will remain challenging, economic weakness is likely to extend into next year. We expect European GDP growth to remain steady

## SIGNS OF RISING INFLATIONARY PRESSURE

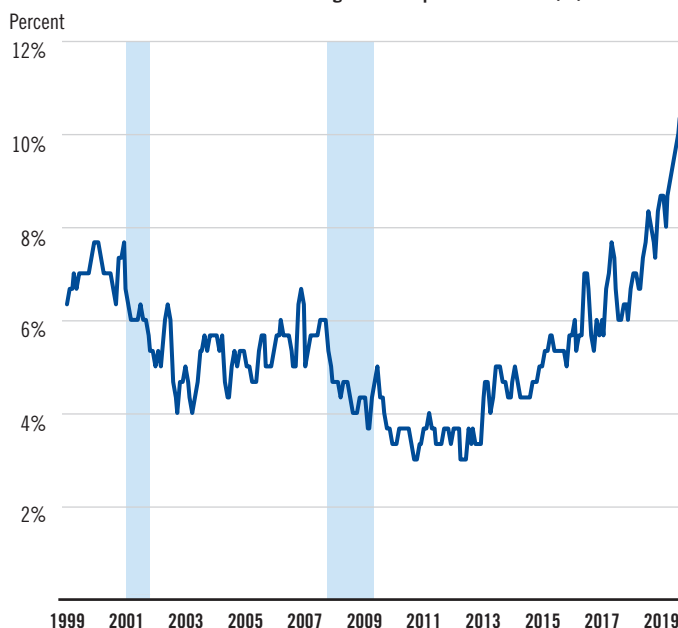
### Exhibit 2: Tight labor markets beginning to fuel acceleration in labor costs

January 2000–November 2019 (3-month moving average)

NFIB: Planning to Raise Worker Compensation in Next 3-Months (%)



NFIB: Small Business Cost of Labor as Single Most Important Problem (%)



Source: National Federation of Independent Business. Shaded area indicates US recession. As of November 2019.

at 1.1% year-over-year and headline inflation to remain well below the ECB's target of 1.9%.<sup>5</sup>

As economic data continue to disappoint, eurozone governments with fiscal space have come under growing pressure from policymakers to come to the rescue and implement fiscal expansions, particularly as monetary policy runs out of road. The rhetoric from former ECB President Mario Draghi calling for fiscal policy to play a more active role grew notably in the final months of his tenure, and new ECB President Christine Lagarde appears to be heading in the same direction. Without a common European budget, the eurozone must rely on the ability—and political willingness—of individual nations to spend more. While we believe that fiscal headroom remains ample, it is limited to very few countries, such as Germany given its budget surplus and the lowest debt-to-GDP ratio among

major advanced economies.<sup>6</sup> While some fiscal easing in the euro area is to be expected in 2020, we foresee no “fiscal bazooka” on the horizon. We find Germany's fiscal expansion short of being ambitious, since the government remains reluctant to use its available fiscal space even without suffering the risk of breaching its constitutional rule and the provisions of the Stability and Growth Pact (SGP). By contrast, fiscal policy is already at the limit of what is feasible in most other European Union member states like France, Belgium, Italy and Spain, and is unlikely to stimulate growth unless Brussels turns a blind eye to fiscal slippage.

With the ECB having restarted its quantitative easing (QE) program last November, we anticipate most of the government bond issuance in 2020 to be absorbed by QE purchases. Absorbing the remainder should not be challenging for the broader market in the absence of a severe economic/

political shock, given healthy demand from investors. On the yields front, we ultimately believe that the combination of a moderate fiscal expansion and a relatively dovish ECB policy will prove insufficient to raise growth and inflation expectations meaningfully in 2020, and we expect the recent rise in German Bund yields and European inflation swaps to be contained over the coming quarters.

In 2020, we expect negative yields to persist and eurozone spreads to remain supported as yield-seeking behavior intensifies and relative political stability materializes. Our baseline scenario for European rates in 2020 assumes (1) euro area stagnation (with scope for a shallow upswing), (2) no reflation, (3) high global uncertainty, (4) little fiscal expansion, (5) no ECB policy changes, and (6) small (even negative) net European government bond supply. With little scope to ease fiscal policy



and the macro backdrop unlikely to surprise significantly to the upside for the region, we expect any additional spread tightening to be confined largely to the periphery, with core Europe treading water. A lack of meaningful progress in Brexit negotiations during this year's transition period may also prove to be a source of market uncertainty in the quarters ahead.

## Asia turns to fiscal stimulus for support

Prospects for economic growth and sentiment in Japan have rebounded from the depressed levels reached during the latter half of 2019 on concerns about trade disruptions and the global manufacturing slowdown. The International Monetary Fund (IMF) recently upgraded its forecast for Japan's GDP growth in 2020 to 0.7% (up from 0.5% forecast in October) in addition to revising its 2019 estimate to 1.0% (from 0.9%), reflecting healthy private consumption, robust capital expenditures, historical revisions to national accounts and a larger-than-expected ¥13.2 trillion fiscal stimulus package announced in December.<sup>7</sup> The fiscal stimulus seeks to counteract the negative impact from Japan's consumption tax hike in October.

The BoJ left rates unchanged at both its December 2019 and January 2020 meetings, with minutes showing some disagreement in opinions among the members over whether additional stimulus was needed to boost private consumption versus the rising cost of prolonged easing. Overall, monetary policy is likely to continue to be guided with an easing bias, as economic forecasts remain relatively muted and concerns linger over downside risks from the slowdown in the global economy and a continued lack of contribution from overseas demand.

We continue to believe the BoJ will remain in an accommodative monetary stance as there are few catalysts on the horizon that signal a full-fledged recovery and shift into a new growth phase. However, with policy rates close to their effective lower bound and interest rates still in negative territory, there are limited options from a monetary policy perspective. We do continue to believe Japanese yen exposure can help suppress volatility in portfolios and has potential for appreciation, particularly during bouts of global risk aversion, which we believe may be more prevalent in the year ahead.

South Korea, Asia's fourth-largest economy, revealed last summer its most expansionary budget since the global financial crisis, cut its key policy rate twice during the second half of 2019, and announced a 12% increase in spending (approximately US\$51.2 billion) focused on infrastructure and housing construction—but it is still expected to record its weakest annual growth rate in a decade. Consumer inflation also set a record low as consumer demand remained weak and export controls from Japan hit the economy hard. Elsewhere, India detailed proposals to invest US\$1.4 trillion in the country's infrastructure over the next five years, with government debt estimates already topping its adopted target of 60% of GDP. The IMF recently estimated India's economic growth to have fallen below 5% in 2019 due to a slowdown in domestic demand amid stress in the nonbank financial sector and weak rural income growth, but it projects growth to improve to 5.8% in 2020, supported by monetary and fiscal stimulus and subdued oil prices.<sup>8</sup>

With nearly half of global central banks having cut interest rates in the fourth quarter of 2019, the world remains extraordinarily awash with liquidity, which should provide support for Asian

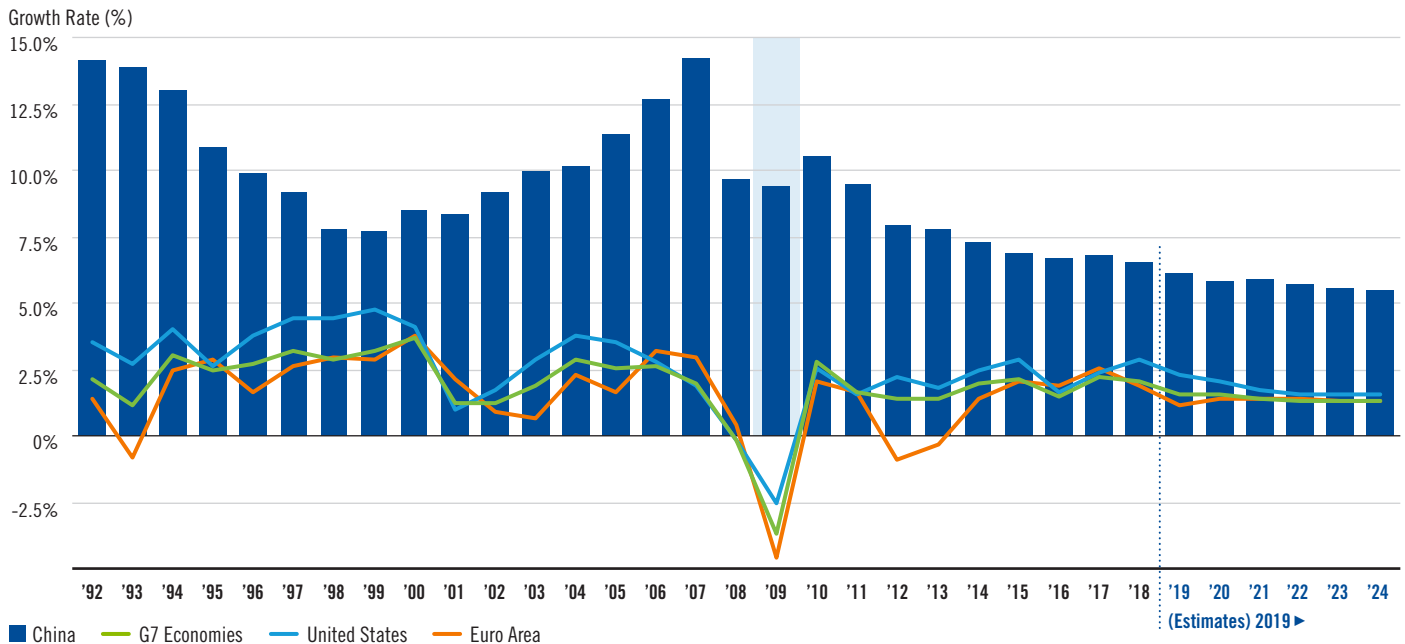
economies. Widespread fiscal stimulus in the region may also provide a temporary boost in growth, but calls into question the sustainability of an economic recovery. Central banks hope that this combination of monetary and fiscal support and fewer global headwinds produces the stabilization that they are after. The question remains as to how fixed income markets might react if growth and inflation should show signs of picking up. The signs are that policymakers could prefer to allow a reasonable amount of momentum to build, rather than risk puncturing any potential cyclical rebound.

## Are emerging markets providing a safe haven?

While the ramp up in trade rhetoric and lower headline growth rates caused much concern about the state of the economy, China announced GDP growth of 6.1% for 2019, which was in line with market expectations. While this headline growth rate was the lowest annual reading since 1990, a more benign global economic environment and progress made in US-China trade negotiations have signaled a growing optimism that the economy may have bottomed out, with the IMF recently upwardly revising its forecast for China's 2020 GDP growth to 6.0% (from 5.8% in October).<sup>9</sup> Downside risks remain elevated, though, with the recent de-escalation of US-China trade tensions potentially being short-lived, social unrest and popular uprisings growing in severity, a new coronavirus spreading through the country and potentially impacting tourism and business activity, and a historic accumulation of heavy debt load in the corporate sector all potential sources of volatility and economic slowdown in the year(s) ahead. China's ratio of corporate debt-to-GDP remains significantly higher than that

## CHINA GDP GROWTH: NOTHING TO SEE HERE

**Exhibit 3: Growth remains well above developed market economies**  
1994–2024 (Estimated)



Source: International Monetary Fund. There is no assurance that any projection, estimate or forecast will be realized. Shaded area indicates global recession. As of October 2019.

of most developed and emerging economies, and the world's second-largest economy ended 2019 with record corporate defaults, with more than 150 onshore companies missing debt payments totaling over 130 billion yuan (US\$18.7 billion).<sup>10</sup>

Much of the negative headlines surrounding China and the very public trade spat with the United States have overshadowed the Chinese government's deliberate rebalancing of its economy toward one less dependent on trade and driven primarily by domestic consumption, which provides a significantly less volatile path toward sustainable growth (see Exhibit 3). China, after booming for nearly three decades, inevitably needed to transform its economy and implement reforms more aligned with its status as a global economic superpower. We believe concerns over a growth slowdown (albeit a growth rate still a multiple of that of most developed economies) have been overstated.

Trade war fears have also been overblown in terms of the impact on both the global and Chinese economies, and we in fact believe the economic and strategic competition between the United States and China will only grow more intense as China keeps investing in advanced technologies; the global shift to greater nationalism will also prove long-lived. While President Trump's aggressive 140-character approach to trade policy has at times caused volatility, it is important to recognize that regardless of how elections and politics on both sides of the Pacific play out in the years ahead, the global trade environment has changed in a structural fashion.

The outlook for emerging markets remains positive, as the continued loose monetary policies of central banks around the world keep global liquidity high and increasing growth differentials are likely to attract capital flows for the foreseeable future. The most significant tail risks still emanate from the

developed world, while economic data in many emerging economies have strengthened, with several emerging markets showing signs of a rebound in growth in the years ahead.

The global economy will again face significant volatility from multiple sources, including political uncertainty and geopolitics, with additional unforeseen sources of uncertainty likely to arise during the course of 2020. Overall, we do not expect any dramatic shifts in the macro outlook in 2020 but recommend investors carefully consider portfolio allocation strategies. Given the higher risk of volatility and market corrections in the year ahead, investors should be especially selective in their risk exposure and maintain some "dry powder" in liquid assets to deploy when bouts of volatility provide more attractive buying opportunities.



# Sector Settings

## Sector

## Conviction

## Our viewpoint

### US Treasuries



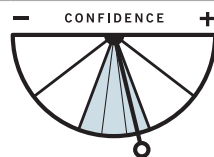
We continue to have a negative view on US Treasuries and remain moderately bearish. We believe the US Treasury market continues to be overly dependent on the Fed and expectations that it will ease policy or step in with further balance sheet expansions if pressured by markets. Despite strong labor markets, reduced uncertainty about trade and global growth, and signs of rising inflationary pressure, Treasury yields remain near historic lows. We continue to believe longer-term Treasury valuations are extremely overvalued and investors face far greater downside risk than upside potential at current levels. We remain cautious on lengthening US duration and favor other high-quality, liquid sectors as better alternatives to US Treasuries.

### Treasury Inflation-Protected Securities (TIPS)



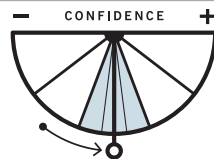
We believe the market may be underestimating the potential for inflation to rise above market expectations, and we are moderately bullish. Trend wage growth remains strong, and unemployment rates have continued to march lower, even during the limited recent volatility in the US economy. Job growth continues to be far above the levels required to keep unemployment steady and the U-6 unemployment rate (which includes discouraged and other marginally attached workers) has fallen to 6.7% as of the end of December, the lowest figure ever recorded. The Fed recently indicated that a push to achieve target inflation on a symmetric basis was being “actively” considered by central bankers, suggesting it would be more tolerant of an overshooting of the current 2% inflation target. If the Fed does pursue a higher inflation range policy, it would highlight a dovish shift in tone. We believe current breakeven levels are underestimating the potential for a rise in inflation over the next few years, and we are finding what we consider attractive entry points in the 5- to 10-year portion of the curve.

### Eurozone Government Bonds












Our expectation is that negative yields will persist and eurozone spreads will remain supported in 2020, and we remain neutral with reasons for optimism. With the macro backdrop unlikely to surprise significantly to the upside, we see a clear risk of a bullish correction in German Bunds as the persistence of negative yields encourages duration extension and a bias for a flattening of the Bund yield curve. We favor being long duration in German Bunds also as a hedging strategy against political risk in Germany and a deterioration of global risk appetite that would see eurozone periphery curves sell off. A flatter Bund curve could also materialize if global demand disappoints further, which would cast doubts on Germany's potential to uplift its key export sectors. Tight valuations could discourage demand for long-dated French government bonds (OATs) if the bear market turns, and we prefer less exposure to French duration. Spain has been trapped in a political deadlock, unable to pass legislation and a renewed budget, and while the economy has not suffered greatly from it, confidence has started to fade over the willingness of the government to pass structural reforms. While Spain could further converge toward the semi-core, we believe it may underperform the rest of the periphery and favor reducing Spanish duration exposure. We believe Italy offers the greatest potential for spread compression in peripheral Europe, as political risk is re-priced and it moves more in line with ratings. Looking into 2020, we believe the Italian BTP-Bund has room for additional tightening. Renewed ECB QE will also support other periphery curves, but returns will likely come from carry rather than capital gains in the year ahead.

### Japanese Government Bonds



The BoJ has reiterated it will continue to use all available resources to bring inflation above its 2.0% target in a stable manner and remains ready to pursue additional monetary policy easing measures, if necessary, to meet its objective. The BoJ has signaled cautious optimism that economic conditions would improve and raised its economic growth forecasts, while maintaining guidance that it is committed to keeping rates at current low levels. With policy rates close to their effective lower bound and interest rates still in negative territory, there remains limited upside in Japanese government bonds, and we remain neutral. We continue to favor Japanese yen exposure as an effective hedge against global volatility in a year when we anticipate increased bouts of global risk aversion.

Sector	Conviction	Our viewpoint
Agency Mortgage-Backed Securities (MBS)		MBS fundamentals remain supportive, although low expected returns, poor carry on mortgage dollar rolls, elevated prepayment levels, and historically tight spreads lead us to a slightly cautious stance—thus we have reduced our rating to neutral with reasons for concern. With the Fed essentially exiting the MBS market because of reduced reinvestments as part of its balance sheet normalization plan, there will be total supply of US\$500 billion to be absorbed by the market in 2020. We expect this supply to put technical pressure on the market and cause modest spread widening but believe MBS spreads will continue to trade in a relatively tight range in the coming year. We favor 30-year securities over 15-year securities and conventional 30- and 15-year sectors over Ginnie Mae (GNMA) 30-year securities. We are positioned in down-in-coupon segments to mitigate prepayment risk. Based on our proprietary Agency MBS Optimizer, we estimate total return potential to be more muted in 2020 than in 2019.
Non-Agency Residential Mortgage-Backed Securities (RMBS)		We continue to have a favorable view on the non-agency RMBS sector, which is backed by healthy housing and consumer credit fundamentals, and we are moderately bullish given fundamentals and technicals. We expect RMBS to continue to provide the highest risk-adjusted return potential across the various securitized sectors. Our exposures are heavily concentrated on last cashflow (LCF) tranches of credit risk transfer (CRT) transactions, where we expect continued positive excess returns over the next 12 months. In repurchasing mortgage loans (RPL), we continue to favor securities at the top of the capital structure which are well protected, and in prime MBS our focus remains on investor-backed deals and new genres of private label deals, which generally have a flatter S-curve <sup>11</sup> than typical prime collateral. Based on our proprietary home price appreciation (HPA) model, we expect home prices to increase by 3.0%–4.0% over the next year, which should remain supportive for RMBS valuations.
Commercial Mortgage-Backed Securities (CMBS)		Fundamentally we remain moderately bearish on commercial real estate (CRE) given stretched fundamentals and tighter valuations. We are later in the credit cycle, many major metro city prices have far surpassed pre-financial crisis levels, effective rents are slowing and vacancies are on the rise. We believe CRE price appreciation is likely to slow to 4.0%–6.0% for 2020. While still positive, this rate of appreciation would be substantially lower than in previous years. Technically, given our macro view of higher yields for the US 10-year Treasury note by the end of 2020, we believe there could be a bid on CMBS originating from yield-sensitive buyers, but we believe valuations remain on the full side of fair and foresee more downside risks. We favor investments higher in the capital structure.
Asset-Backed Securities (ABS)		We remain constructive on consumer fundamentals and select portions of the ABS market for 2020 and remain neutral with reasons for optimism. Our expectation for continued economic growth and low unemployment in the United States leads us to be positive on structured consumer credit. An accommodative Fed should help keep spreads well supported in the near term. Overall, we expect prime ABS sectors to trade in a narrow range for 2020, but ultimately the ABS markets will take its cues from broader macro sentiment and the performance of other credit sectors. ABS credit fundamentals remain healthy, with favorable delinquency trends across major consumer asset classes. We expect the credit curve will remain flat as many market participants opt for the pickup in incremental yield in sound transactions. Risks to our view for consumer ABS sectors are potential exogenous shocks ranging from disruptions in trade policy to LIBOR reform. We prefer allocating risk capital to prime benchmark issuers in both the credit card and auto sectors and prefer to stay up in the capital structure (issues rated AAA) in the 2-3 year part of the curve, while avoiding sectors such as container and student loan ABS that are most vulnerable to trade policy and legislative reform risk.
US Investment-Grade Corporates		We continue to take a cautious approach to the sector and remain moderately bearish. While we remain broadly comfortable with fundamentals, especially given our view of moderate economic growth in 2020, corporate profits have been uneven, and many companies have made little progress in reducing aggregate sector leverage. Tight labor markets and more restrictive trade policies may squeeze profit margins going forward. Market technical factors, particularly overseas demand for US corporates, should be supportive as investors continue to seek sources of yield perceived as relatively safe. Our biggest concern is valuations, which have become even more stretched in recent months. Adjusted for ratings, duration and dollar price, spreads are near the tightest levels of the past two credit cycles. We still believe that investment-grade corporates offer modest carry relative to government bonds, but spreads are unlikely to tighten much further, and the potential for increased volatility and significant widening exists, especially as investors react to US presidential election developments. We continue to favor select BBB issues versus single A issues and believe, with most sector and names trading rich to recent history, issue selection and credit curve positioning will be the most important drivers for returns. We prefer using periodic market volatility to buy liquid, higher beta cash bonds during selloffs.

Sector	Conviction	Our viewpoint
European Investment-Grade Corporates		<p>After a strong performance in 2019, we believe European investment-grade corporate valuations leave little room for fundamental disappointment, and we have reduced our rating to neutral with reasons for concern. Downside risks are numerous, primarily political and difficult to quantify (such as US trade policy, geopolitical tensions in the Middle East, lingering political risks in Europe, the US presidential election and EU-UK trade negotiations). Although the ECB's corporate bond purchase program remains supportive for spreads, its positive effects could fade away over the course of this year. We therefore see more downside if macro uncertainties arise or growth disappoints. We continue to favor non-cyclicals over cyclicals, particularly at the low end of the BBB spectrum, and BBBs over BBs. We also favor European over US issuers, with valuations of US credits in the euro market at historical highs and European issuers historically being more conservative than their US peers.</p>
US High-Yield Corporates		<p>Overall valuations reflect the expectation that the current benign environment will continue indefinitely and fail to provide adequate compensation for any increased volatility, and we remain moderately bearish. Based on expected default losses and the historical liquidity premium required by the high-yield market, one could argue that spreads are approximately 100 basis points too tight at current levels. However, while we do expect spreads to move wider, the global search for yield may keep them from getting all the way back to fair value. Nevertheless, and notwithstanding our generally favorable fundamental and technical view, valuations leave us with a somewhat cautious outlook for high yield in the coming year. With the non-distressed portion of the market starting the year around a 4.5% yield, factoring in an expectation of higher rates as well as wider spreads, and incorporating probable default losses leaves us forecasting the potential for a below coupon, low single-digit return in 2020. We continue to believe single-B bonds offer the best risk/reward profile among the rating buckets, although individual security selection remains paramount and this too is becoming a bit of a crowded trade. We view BBs as generally rich, and also with the highest duration profile of any rating bucket, and we continue to find select opportunities in CCCs. In the 11th year of the cycle, however, we are wary of being too exposed to the lowest quality part of the market even though aggregate valuations admittedly look somewhat cheap.</p>
Euro High-Yield Corporates		<p>As euro high-yield credit spreads approach the historic lows reached in November 2017, we have become more cautious and have reduced our rating to moderately bearish. Our downgrade is mostly driven by the lack of upside potential and the historically low coupons prevailing in the euro high-yield market. We equally anticipate fundamentals to remain challenging in a few industries. We expect default rates to slightly increase, as some leveraged capital structures are unlikely to be able to produce the free cash flow/EBITDA (earnings before interest, taxes, depreciation and amortization) growth needed to meet the down-ratcheting of leverage covenants. However, buoyant equity multiples, low interest charges and abundant liquidity, in addition to the ECB's Corporate Sector Purchase Programme bid, will prevent default rates from rising meaningfully in 2020. Recovery rates are expected to remain low (option value for subordinated bonds) as management teams seem to prefer the route of selling assets, looking for waivers rather than going for an early restructuring. Market liquidity remains poor, making bid-ask spreads even more relevant in the current low yielding environment. We prefer reducing exposure to higher beta names, instead favoring short-dated bonds, or bonds trading to call with a positive yield, from highly rated issuers. We also favor highly rated subordinated banking paper and select B rated corporate issuers, where wider spread widening may present attractive buying opportunities. We continue to expect issue size and rating to play a more important role than sector positioning.</p>
Floating Rate Loans		<p>We begin 2020 with a constructive outlook on loans, driven by continued health in the US economy combined with expectations of continued Fed support and improvement in loan market technicals—which we believe should serve to offset the widely reported long-term deterioration in credit fundamentals, at least in the near term, and we have increased our rating to moderately bullish. Collateralized loan obligation (CLO) issuance should continue at healthy levels, albeit lower than in 2019, and should be supported by decelerating outflows from retail funds. Further, loans should see low default rates in the near term, driven by a manageable maturity wall, still healthy interest coverage levels and an absence of financial covenants. Overall, we believe the loan market offers attractive investment opportunities in the near term. Our outlook for later in the year is less sanguine as the impact of US elections, potential tariff outcomes and geopolitical issues on broader credit markets remains to be seen. We continue to prefer more conservative positioning and favor higher-quality issuers with appropriate capital structures and tighter documentation. We believe periods of strength in the near term will allow market participants to de-risk portfolios, while periods of volatility will provide opportunities to add exposure to the market at attractive levels.</p>

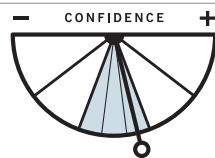


## Sector

## Conviction

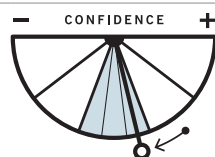
## Our viewpoint

### Collateralized Loan Obligations (CLOs)



Fundamentals have deteriorated along with underlying bank loan fundamentals, and idiosyncratic risk has elevated, resulting in more downgrades than upgrades by rating agencies based on weak earnings and non-compliance with deleveraging plans and higher CCC exposures in CLOs. However, CLO structures still provide significant protection, and current CCC levels are far from breaching the junior overcollateralization (OC) test, and we remain neutral with reasons for optimism. Bank loan defaults remain near the low end of the range in the post-crisis period but are expected to increase modestly going forward. While we do not anticipate higher CLO defaults, this may temporarily influence the price of CLO bonds. Technicals remain supportive, with supply expected to be constrained in 2020 given a persistently challenging arbitrage. On the demand side, stable rates will provide a tailwind for CLO investment, and demand from Japan (a major source of demand) remains present but will likely slow given heightened scrutiny from Japanese regulators. 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 relatively in-line with their historical trading ranges. However, we continue to caution investors that CLOs are not immune to spreads widening within the loan market, and broader credit market selloffs—which are now more likely—could lead to increased volatility. We favor US CLOs, where spreads now look more attractive compared with EUR CLOs as the value of EURIBOR floor has diminished. We also continue to favor the highest quality CLO buckets, namely AAA as spreads have lagged and look attractive to us relative to corporates and other tranches. We also believe that A-BBB spreads present value, but we are approaching mezzanine tranches with increasing caution, recognizing that such opportunities are increasingly susceptible to the fundamental deterioration in underlying loans.

### Municipal Bonds



Moving into 2020, we believe municipal bonds can continue to provide a number of benefits for tax-sensitive investors. However, following the strong results in 2019, we expect total return potential to be muted in 2020, with income largely driving performance in the asset class, and we have reduced our rating to neutral with reasons for optimism. We see little change to the performance dynamics of the municipal bond market and strong demand, low supply, and high taxation provide firm footing for prices. After a record-setting year for inflows into the sector in 2019 (triple the historical annual average), a change in the direction of flows is likely to have a marginal impact to municipal bond prices but a backlog of demand will remain supportive for the foreseeable future. As the US presidential election approaches, we anticipate increased volatility that could provide attractive opportunities, but our posture is slightly defensive, and we continue to recommend a risk-off strategy in favor of high-quality issuers from the most established sectors. Given the tightness of credit spreads and coupon spreads, we are also wary of a liquidity trap should the market sell off at any point. We prefer higher-quality sectors such as select state general obligation bonds, 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—AAAs and AAs.

### Emerging Market (EM) Debt

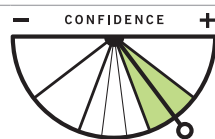


We recognize that 2019 brought the asset class strong results that are unlikely to be repeated in the next 12 months. However, the outlook for EM debt remains strong, with the most significant risks still emanating from outside of the asset class, such as the US interest-rate environment and the valuation of the dollar. Based on a relatively benign view for the external environment and still attractive absolute valuations versus other global fixed income sectors, we continue to remain bullish overall. Our view is that other factors such as global trade and commodity prices will not overly impact EMs in a negative way, while country-specific situations such as in Argentina will not contaminate the market outside of the country, given these are idiosyncratic and not systemic factors. We believe the relatively wider historical valuation of hard currency sovereign EM debt makes this still the most attractive segment, with local currency EM debt still subject to greater potential volatility and less attractive historical valuations in rates. We continue to favor shorter duration in most markets as we carefully monitor country-specific events. Potential economic uncertainty in the United States, particularly during the second half of 2020, does increase the likelihood of weakness in the US dollar, which would be highly beneficial to local currency EM debt returns. However, unless clear signals of such weakness start to reveal themselves, our bias will be toward hard currency.

## Sector

### Emerging Market Corporates

## Conviction



## Our viewpoint

We see several supportive factors for the asset class as we begin 2020 and remain moderately bullish. The EM growth slowdown, combined with some technical factors, did impact aggregate earnings in 2019, but overall EM corporate fundamentals remain solid, with net leverage in check and substantially lower than that of the United States. Defaults will likely rise this year from unsustainably low levels, but we find that refinancing profiles are generally manageable. We also assume a more benign EM growth outlook in 2020, aided by monetary policy easing in many countries. We expect China, the largest country in our universe by far, to further fine-tune its policy response to slower growth, while carefully opening up its market and tackling moral hazard. We are less constructive on EM corporates than EM sovereigns for relative value reasons, but we would expect that the former's higher quality and lower duration would mean that it would do less badly in a down market. Aside from absolute valuations, we consider the key negative or risk factors for the asset class to be the sensitivity to higher US Treasury yields and weaker commodities, the patchy liquidity and technicals, and the unpredictable governance and legal frameworks of the companies and the countries in which they operate. We favor the BB rated part of the market, where, unlike US and Europe, EM corporates offer attractive relative value. We also favor short duration positioning and continue to avoid many of the large state-owned enterprises that dominate the index, which look set to have another challenging year, in our view.

## Endnotes

1. Source: US Bureau of Labor Statistics, as of December 2019.
2. Source: National Association of Home Builders Market Index, as of January 2020.
3. Source: Institute for Supply Management, as of December 2019.
4. Source: United States International Trade Commission. Latest available data.
5. Source: Eurostat, Bloomberg, as of December 2019.
6. Source: Eurostat, CEIC, International Monetary Fund, as of latest available data.
7. Source: International Monetary Fund, as of January 2020.
8. Ibid.
9. Ibid.
10. Source: Bloomberg, as of December 31, 2019.
11. S-curve characterizes prepayment rates as a function of the economic incentive to refinance.

**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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