FRANKLIN TEMPLETON

July 2025

Franklin Templeton Fixed Income

Fixed Income Sector Views

Uncertain times, cautious moves

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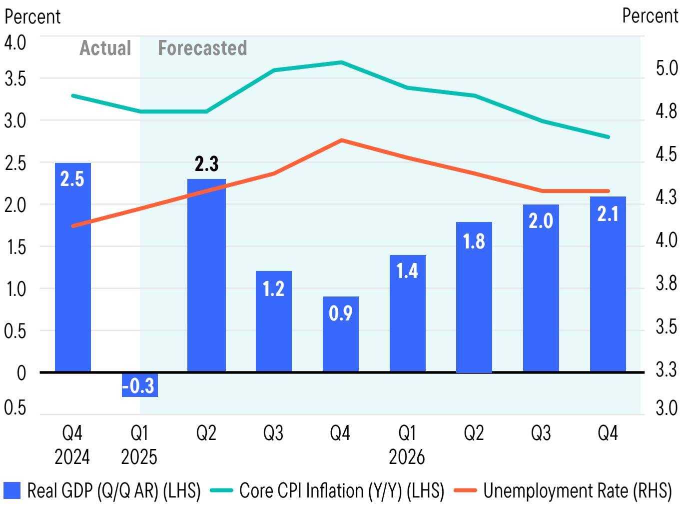
Executive summary

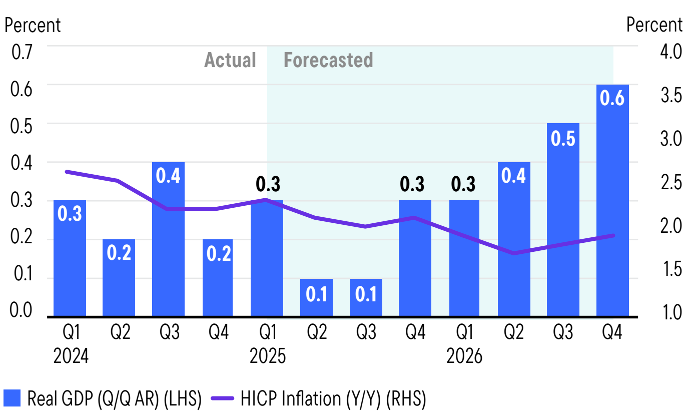
We have moderately downgraded our outlook for the US economy, projecting slower growth, higher inflation and increased unemployment due to a still uncertain US trade policy. Due to the lack of clarity on tariffs, the US Federal Reserve (Fed) has taken a wait-and-see attitude toward implementing additional rate cuts, a stance we believe will continue through the end of the year. Increased US tariffs will likely have negative growth implications for many developed countries, including China and the euro area. We are cautious about taking wholesale spread risk in fixed income markets due to current tight levels. We are also being judicious about duration as we are still looking for intermediate and long US Treasury (UST) yields to rise.

US Economic Forecasts



Sources: US Census, NAR, Macrobond. Analysis by Franklin Templeton Fixed Income.
As of June 24, 2025. There is no assurance any estimate, forecast or projection will be realized.

European Economic Forecasts

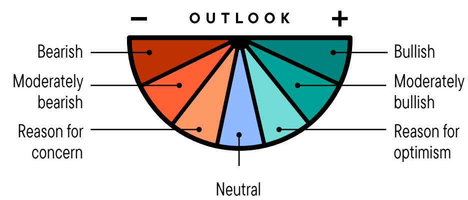


Sources: Eurostat, NAR, Macrobond. Analysis by Franklin Templeton Fixed Income.
As of June 24, 2025. There is no assurance any estimate, forecast or projection will be realized.

Fixed income outlook dashboard

Outlooks for fixed income sectors are based on our analysis of macroeconomic themes and the technical conditions, fundamentals and valuations for each asset class. We rate each sector from bearish to bullish to express our projections for relative returns over the next 6–12 months. There is no assurance any estimate, forecast or projection will be realized.

Understanding the pendulum graphic



6–12 – Month Outlook/Sector	Prior Quarter View
Moderately Bullish	
Tax-exempt municipal bonds	Moderately bullish
US Treasury inflation-protected securities	Moderately bullish
Neutral/Optimism	
Floating-rate loans	Reason for optimism
Mortgage-backed securities	Reason for optimism
US high-yield corporates	Reason for optimism
Neutral	
Asset-backed securities	Neutral
Emerging markets corporates	Neutral
Emerging market sovereign debt	Neutral
Global Sukuk	Neutral
Non-agency residential mortgage-backed securities	Neutral
Neutral/Concern	
Collateralized loan obligations	↓ Neutral
Euro high-yield corporates	↓ Neutral
Euro investment-grade bonds	Reason for concern
US investment-grade corporates	Reason for concern
Moderately Bearish	
Euro government bonds	↓ Neutral
Commercial mortgage-backed securities	↓ Neutral
Japanese government bonds	↑ Bearish
US Treasuries	Moderately bearish

Third quarter 2025 market backdrop

Since the November 2024 presidential election of Donald Trump and moving into the first part of 2025, bold wide-stroke plans from the new administration—such as tariff policy, immigration and cost cutting efforts—caused considerable consternation for the market. Since then, we have started to see more fleshed-out plans for fiscal spending. In her latest On My Mind: Stop me if you think you've heard this one before, FTFI CIO Sonal Desai lays out both positive and negative impacts on economic growth stemming from the passage of President Trump's "One Big Beautiful Bill." If tariffs remain near 10%, it would roughly be equivalent to a 2.0% sales tax, in our estimation. On the positive side, the lower corporate and individual tax rates that President Trump enacted in his first term were made permanent. This should bolster consumer and business confidence, leading to upside potential for economic growth. Increased fiscal spending will likely provide additional short-term stimulus to the economy. However, geopolitical risks, such as the expansion of the Russia-Ukraine war and resurgence of military actions in the Middle East, remain a legitimate overhang to the market as it could restoke volatility across global markets.

Outside the United States, global economies are facing their own uncertainties. Without the full resolution of US trade policies, large trading partners, such as the European Union and China, are facing potential economic downturns. Recent negotiations between members of the North Atlantic Treaty Organization (NATO) require members to increase their military spending to 5% of their gross domestic product (GDP). These additional outlays will likely have their own impact on growth and inflation. China's economic expansion projections continue to decline, and Japan is having a difficult time taming inflation.

Looking across the fixed income market, we have identified a number of parameters that we are closely monitoring:

Path of the Fed

- In her recent report, Sonal Desai lays out her argument that the Fed is unlikely to cut interest rates anytime soon. Despite recent signs of cooling inflation, the current backdrop of elevated uncertainty from tariffs will likely lead the Fed to prioritize inflation over growth.

Overly tight spreads

- There was some widening of spreads in April 2025, but since then, spreads have returned to near multi-decade tights, leaving little room for downside risks both systematic and idiosyncratic.

Declining US dollar (USD)

- Since the inauguration of President Trump, the US dollar continues to weaken despite strong demand for USD-denominated assets. We feel that this phenomenon is partially due to international investors diversifying their portfolios away from USD assets by hedging out currency risk.

Third quarter 2025 portfolio themes

In tune with the above factors, we have constructed our portfolios looking at individual risk factors and how they roll up into portfolio exposures. We lean on our dedicated credit researchers in each fixed income sector to identify strong risk/reward characteristics between subsectors and issuers. With these recommendations, our portfolio and risk management teams construct portfolios rightsizing risk. Key themes are:

Limit the potential impact of spread deterioration

- With tight spreads and full valuations, we still don't feel that investors are compensated for taking on wholesale credit risk across most sectors. We prefer shorter-duration spread products that can still provide improved income and carry, while limiting capital depreciation in the event of widening spread.

Diversification still pays

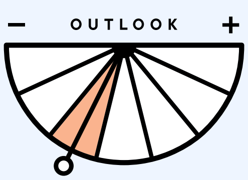
- When appropriate, we look to diversify our allocations, avoiding risk concentrations using a holistic approach to risk balancing across portfolios.

Be nimble with our duration exposure

- With our preference for shorter-maturity spread assets, we utilize a number of more liquid instruments to move our duration exposure closer to the stated benchmarks. Although we do not currently have a strong view toward duration positioning, we continuously reevaluate the interest-rate environment.

Despite increased clarity across both macroeconomic and market conditions, uncertainty remains. We choose not to trade headline-to-headline in our portfolios but rather look for sustained trends across markets to seek to take advantage of volatility as it often opens opportunities to gain from dislocations in fixed income markets.

Overall risk outlook



Neutral with reason for concern

We have become wary under current economic and market conditions since our last publication and, therefore, have downgraded our overall risk sentiment to neutral with reasons for concern. Although economic conditions in the United States have held up, so far, we do expect there is likely to be some weakening toward the end of this year. The spread widening we saw across many fixed income sectors post "Liberation Day" has largely been retraced, and spreads have returned close to their 20-year tights, stretching valuations. We are closely monitoring technical conditions, which remain strong, as we are seeing some signs that international interest in US dollar-denominated assets may be waning as the dollar continues to devalue against world currencies. In our opinion, the market is underestimating fiscal, geopolitical and economic risks that are likely to continue to add to both uncertainty and volatility in the market. However, we are finding pockets of opportunities for assets in sectors that have lagged the market, taking advantage of our experience in managing through a wide range of market conditions.

Key sector viewpoints

Moderately bullish

Municipal (muni) bonds
We continue to have a favorable view toward both the taxable and tax-exempt municipal bond markets. Limited supply and ample demand continue to support the taxable muni bond market. The declining value of the US dollar makes taxable muni bonds more attractive to non-US investors, just adding to demand. The tax-exempt muni bond market has seen positive inflows of funds, partially due to muni bonds keeping their tax-exempt status in the "One Big Beautiful Bill" fiscal spending package. We believe that the still-elevated yields—which can be particularly appealing on a tax-adjusted basis—should continue to draw investor interest. Fundamentals remain strong as issuers are addressing the implications of a slowing US economy. Municipalities are in a strong position to be able to deal with potential challenges, in our view. That is why we continue to expect stability in this sector over the medium term and see investment opportunities across maturities as well as across the credit spectrum.

Moderately bearish

Commercial mortgage-backed securities (CMBS)
Commercial real estate (CRE) has been showing signs of improvement (New York office properties in particular given the solid leasing momentum) and rising transaction volumes are providing more price transparency. Nonetheless, we believe the sector will likely face more headwinds as higher interest rates, increased rate volatility and tighter credit conditions could weigh on the sector. Particularly, while we believe upcoming fiscal stimulus could help, the increased likelihood of stagflation given the tariffs presents a detrimental scenario for CRE and CMBS and causes us to change our outlook to moderately bearish from neutral. While we believe generic spreads don't currently reflect new risks, we nevertheless believe CMBS still offer good opportunities for security selection when utilizing detailed loan level analysis, particularly when considering relative value to other sectors.

Moderately bearish

Japanese government bonds (JGBs)
Our overall expectations that the Bank of Japan (BoJ) will continue to increase its policy rate in order to combat inflation has not changed. We have upgraded our outlook from bearish to moderately bearish in recognition that the BoJ has acknowledged that supply and demand for longer-term yields has caused 30-year yields to reach their highest levels in over 25 years. We think that the recent selloff in the long end of the JGB curve may have prompted the authorities to consider a more nuanced approach. Yet, while this may prove to be a relief in the short term, uncertainty regarding pace and outlook could be detrimental in the long term. Overall, we maintain a steepening bias for the curve. With a supplementary fiscal budget almost a given at this point, worsening the supply and demand dynamics is likely at a time when demand is already weak. The BoJ commentary so far gives us no reason to believe that the central bank will scale back its purchases, in fact the scaling back in bond buying is set to advance in the next quarter. As we continue to expect more rate hikes on the horizon, we see room for the front-end rates to remain high.

Moderately bearish

US Treasuries (USTs)
The current landscape of heightened volatility and uncertainty keeps us moderately bearish on USTs. Yield continues to trade in wide ranges as the benchmark 10-year UST yield moved from 3.99% in early April to 4.60% by late May. We feel that the market is somewhat unsure of where it wants to be as both economic news and fiscal policy announcements drive the market day-to-day. This alone would warrant a cautious stance on our duration exposure. Additionally, the current fiscal spending bill will require significant issuance of USTs, which should put upward pressure on yields, especially if foreign demand sours. Our base case is for intermediate- and longer-term yields to migrate higher toward the second part of the year. We are positioning our portfolios to prepare for additional volatility, using options, where appropriate, to lessen our exposure to rising UST yields.

Sector settings overview

Moderately bullish	**Muni bonds**	Credit fundamentals and technical conditions remain strong. Healthy investor demand and relatively attractive yields lead us to remain moderately bullish on tax-exempt muni bonds.
	US Treasury-inflation protected securities (TIPS)	Inflation accruals are higher than in the first quarter, supporting valuations, which has us keep our modestly bullish stance.
Neutral with reason for optimism	**Floating-rate loans**	While we expect fundamentals to remain relatively stable, though bifurcated, higher-for-longer rates, policy uncertainty and market volatility could continue to pressure ratings in the near term.
	Mortgage-backed securities	Fundamental and technical outlook for the sector remain favorable with attractive relative value versus investment-grade (IG) corporates.
	US high-yield (HY) corporates	We remain broadly constructive, believing that tariff-related economic volatility presents only moderate incremental risk to the range of market outcomes over the longer term.
Neutral	**Asset-backed securities (ABS)**	Given the prevailing uncertainties on policy (tariff and tax), possible headwinds could impact collateral performance and seller/servicer risks, especially for the bottom of the capital stack.
	Emerging market (EM) corporates	We believe this sector still offers pockets of value and diversification opportunities. Valuations are enhanced by the strong fundamental outlook for issuers and our expectation of a low high-yield default rate for the rest of the year.
	EM sovereign debt	EM debt spreads should grind modestly tighter through the second half of the year, reflecting strong fundamentals and supportive supply/demand dynamics. We prefer the higher-yielding part of the market, although prioritizing portfolio diversifiers over market beta.
	Global Sukuk	With geopolitical and economic events fueling volatility, we favor an increase in defensive allocations to higher-quality global Sukuk issues.
	Non-agency residential mortgage-backed securities	Given rich valuation and modest home-price growth expectations, we are neutral on the sector and favor opportunities near the top of the capital stack amid heightened macroeconomic uncertainty.
Neutral with reason for concern	**Collateralized loan obligations (CLO)**	Although CLO credit fundamentals have improved, a slower economy, increased tariffs and higher interest rates could lead to continued downgrades and default risk for lower-rated loan issuers.
	European HY corporates	Spreads are likely to trade range-bound, underpinned by abundant liquidity that is supporting supply and demand, while a solid European banking sector should offset pressure from signs of earnings deterioration in other sectors.
	Euro IG corporates	Tight valuation levels offer a limited spread cushion to mitigate market volatility, notwithstanding resilient credit fundamentals and supportive technical factors, with spreads expected to widen moderately from current levels.
	US IG corporates	Strong demand and solid fundamentals support US IG bonds, but tight spreads lead us to favor shorter-maturity, high-quality issuers, short maturities and lower dollar-priced bonds.
Moderately bearish	**European government bonds**	While the European Central Bank still contends with downside risks to growth and inflation in the near term, expected fiscal loosening and geopolitical uncertainty call for a tentative pause.
	Commercial mortgage-backed securities	While CRE has been showing signs of improvement, higher interest rates, increased rate volatility and tighter credit conditions could weigh on the sector.
	JGBs	We have upgraded our outlook to moderately bearish. Supply and demand dynamics on the long end of the curve are being addressed by the BoJ, helping to stabilize yields.
	USTs	The market is impacted day-to-day by both economic news and US President Donald Trump's policy announcements driving yield changes. We are cautious on duration at current levels.

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.

Editorial review

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About Franklin Templeton Fixed Income

Franklin Templeton has been among the first to actively invest in many sectors of the fixed income markets as they have evolved—covering corporate credit, mortgage-based securities, asset backed securities and municipal bonds since the 1970s, international fixed income since the 1980s, bank loans since the early 2000s and digital assets since the 2010s. Over 145 investment professionals globally support the portfolio managers, who oversee more than US$135 billion in assets under management. Being part of an established investment group at Franklin Templeton gives the portfolio managers access to experts across different areas of the fixed income market, helping them to diversify opportunities and risks across multiple sectors.

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

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Diversification does not guarantee a profit or protect against a loss.

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