September 2023

Franklin Templeton Fixed Income

Fixed Income Views

Volume 16—Soft landing? Central banks trying to thread the needle

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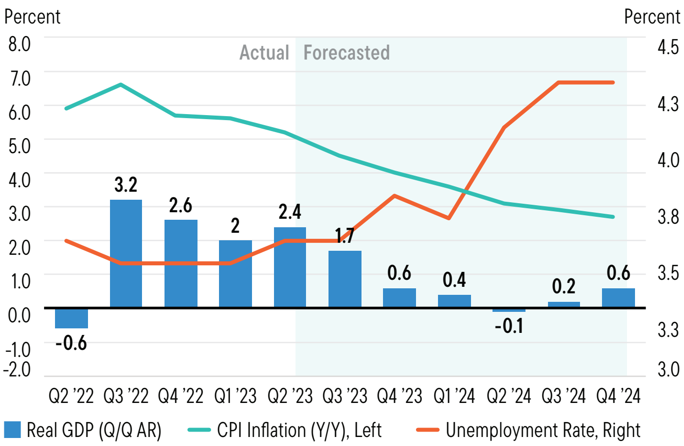
Executive summary

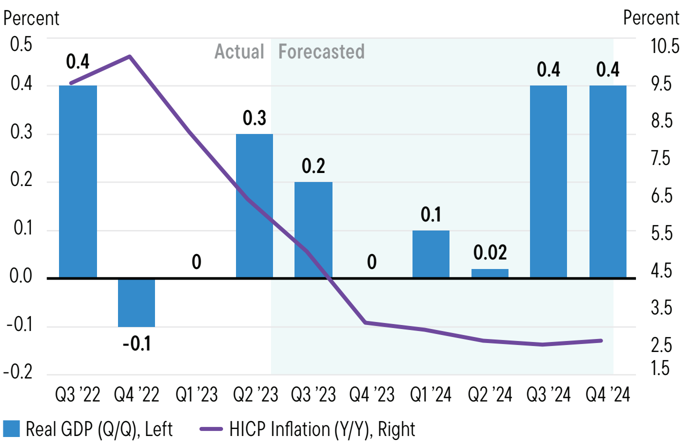
Since our last publication, we have upgraded our view on both the US and euro area (EA) economies, and we are no longer projecting a technical recession in the former. Where we break from market consensus is in our view on the US Federal Reserve's (Fed's) path to monetary policy normalization. The market appears to be confident in the Fed's ability to orchestrate a "soft landing" that would allow the Fed to cut interest rates throughout next year. We feel the trajectory of disinflation in both the United States and EA will flatten—and central banks are thus likely to keep rates higher for longer.

Spreads in fixed income sectors are pricing in a quite sanguine environment, with levels leaning toward long-term averages, much tighter than previous periods of stress.
We retain the view that both active portfolio management and superior security selection will be the main drivers of returns for investors.

US Economic Forecasts



European Economic Forecasts



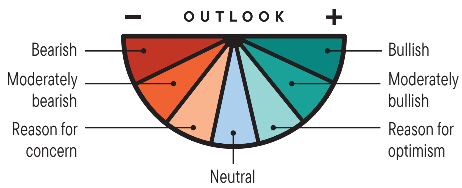
Sources: US Census, NAR, Macrobond. As of June 30, 2023. There is no assurance any forecast, projection or estimate will be realized.

Fixed income outlook dashboard

Outlooks for fixed income sectors are based on our analysis of macroeconomic themes and the technical conditions for each asset class. We rate each sector from bearish to bullish to express our outlook over the next six to 12 months.

6–12 Month Outlook / Sector	Prior Quarter View
Moderately Bullish	
Tax-Exempt Municipal Bonds	↑ Reason for Optimism
US Treasury Inflation-Protected Securities	Moderately Bullish
Reason for Optimism	
Emerging Market Sovereign Debt	Reason for Optimism
Euro Investment-Grade Bonds	Reason for Optimism
Neutral	
Asset-Backed Securities	Neutral
Collateralized Loan Obligations	Neutral
Emerging Markets Corporates	Neutral
Euro High-Yield Corporates	Neutral
Eurozone Government Bonds	↑ Moderately Bearish
Floating-Rate Loans	↑ Reason for Concern
Mortgage-Backed Securities (MBS)	Neutral
Non-Agency Residential MBS	Neutral
US High-Yield Corporates	↑ Reason for Concern
Reason for Concern	
Commercial Mortgage-Backed Securities	Reason for Concern
US Treasuries	↑ Moderately Bearish
Moderately Bearish	
Global Sukuk	Moderately Bearish
US Investment-Grade Corporates	Moderately Bearish
Bearish	
Japanese Government Bonds	↓ Reason for Concern

Understanding the pendulum graphic



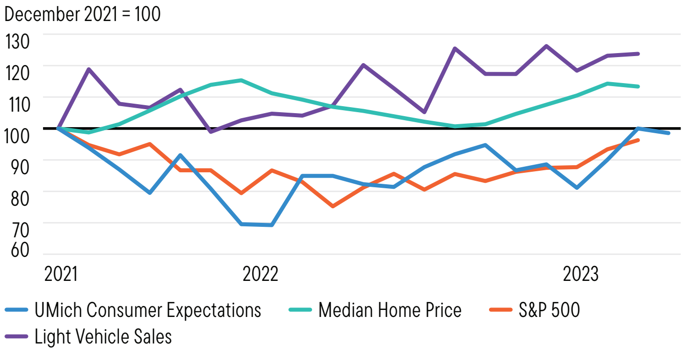
Macroeconomic themes

Economic conditions have remained resilient

US gross domestic product (GDP) growth held firm at a 2.4% annualized pace in 2023's second quarter.[1] Consumer sentiment is rebounding, home prices and equity markets have continued to climb, and job layoffs have fallen materially since their January peak. The recovery in sentiment complicates the Fed's process of taming inflation and raises the question of whether Fed policy is sufficiently restrictive now, or if the Fed will need to hike rates further and keep them there for a longer time frame. Elsewhere in the EA, while economic growth has continued to show resilience as well, sentiment indicators are trending downward, in a divergence from the United States.

Broader Economy has Held Firm

December 31, 2021–June 30, 2023



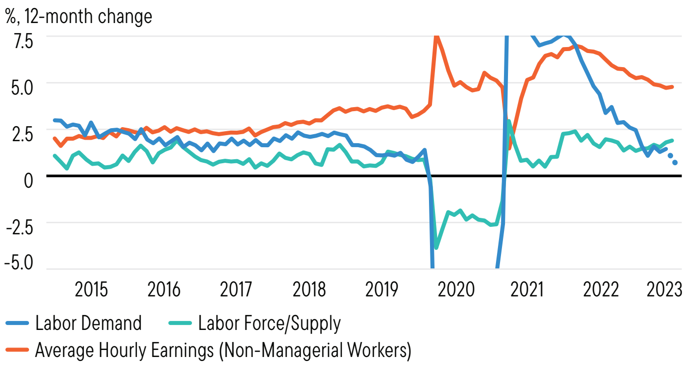
Sources: Franklin Templeton Fixed Income Research, TCB, University of Michigan, S&P Global, U.S. Census Bureau, FHFA, NAR, BEA, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

Wages remain a driving factor for inflation

With US headline inflation expected to moderate further during this year, real wages and real disposable income should continue to rise. Wage gains are also progressing strongly in Japan. As the US labor market imbalance gradually softens, however, there is likely to be less upside pressure on nominal wages, which in turn will limit how high real wages will rise despite the decline in headline inflation. While private consumption spending is expected to slow during the rest of the year, we still think real wage and disposable income growth will help support the consumer sector, which should help prevent the US economy from slipping into a recession in the second half of the year.

US Labor Market Imbalance and Wage Correction Still Have Some Ways to Go

September 30, 2014–June 30, 2023



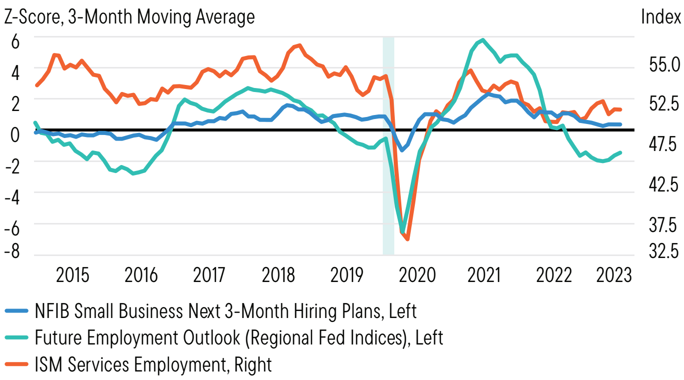
Sources: Franklin Templeton Fixed Income Research, BLS, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

Upbeat employment expectations

With the easing of employment jitters after the banking turmoil, the New York Fed's Survey of Consumer Expectations indicates that consumers remain confident in their ability to hold onto their current jobs. Small businesses report significant difficulty in filling vacancies, and the hiring outlook continues to hover around historic levels. Overall, still-strong employment expectations and declining inflation have also led to a rebound in consumer expectations. A tight labor market, still-elevated wage growth and a decline in headline inflation have meant rising real hourly wages have turned more positive. Since February 2022, inflation has decelerated, leading to a rise in aggregate purchasing power.

Services and Small Business Employment Holding Up Well

September 30, 2014–June 30, 2023



Sources: Franklin Templeton Fixed Income Research, ISM, Federal Reserve Bank of Dallas, Federal Reserve Bank of Kansas City, Federal Reserve Bank of New York, Federal Reserve Bank of Philadelphia, Federal Reserve Bank of Richmond, NFIB, MRA, University of Michigan, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

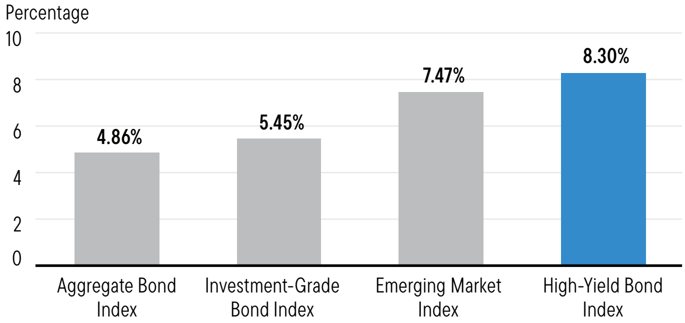
Portfolio themes

Interest-rate carry adds to performance

- Overall bond yields have increased during the past year, with the benchmark 10-year US Treasury (UST) note's yield climbing over 150 basis points (bps).[2] Current yields are the highest they have been since the beginning of the global financial crisis, opening the potential for good income opportunities for bond investors.
- Prudent sector and security selection can be a consistent contributor of additional returns as higher-risk sector spreads provide additional monthly yields versus the broad bond market (interest rate carry). Our dedicated credit research teams seek to identify securities that have strong risk/reward characteristics that can potentially provide incremental income each month, benefiting the performance of our funds.

Index Yield-to-Worst

As of July 31, 2023



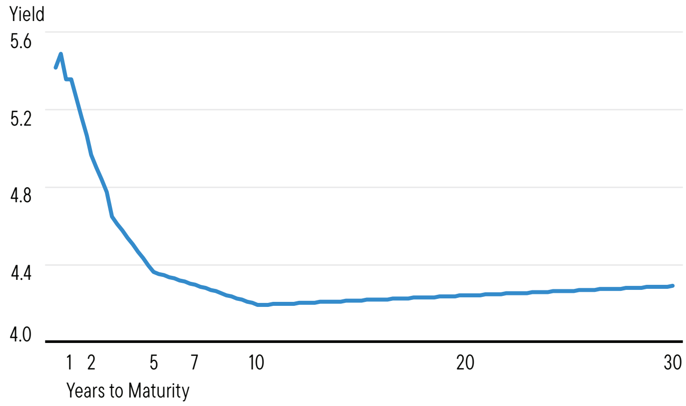
Source: Bloomberg. The aggregate bond index is represented by the Bloomberg US Aggregate Bond Index; The aggregate bond index is represented by the Bloomberg US Corporate Bond Index. The investment-grade bond index is represented by the Bloomberg US Corporate Bond Index. The high-yield bond index is represented by the Bloomberg High-Yield US Corporate Bond Index. Yield-to-worst is the lowest yield available on bonds with early retirement options. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

Being mindful of yield curve positioning

- The UST yield curve remains deeply inverted despite signs the US economy is not in dire straights. Current yields past one year suggest the Fed is likely to be forced into cutting the fed funds target rate at a significant pace to battle a contracting economy despite projections of a "soft landing."
- With our view that the Fed will keep interest rates higher for longer, we prefer our duration exposure to be focused on the shorter end of the yield curve to take advantage of higher yields. We also believe that longer-date UST yields are likely to rise and have positioned our portfolios for the curve to steepen (less inversion) over the medium term.

US Treasury Yields

As of August 14, 2023



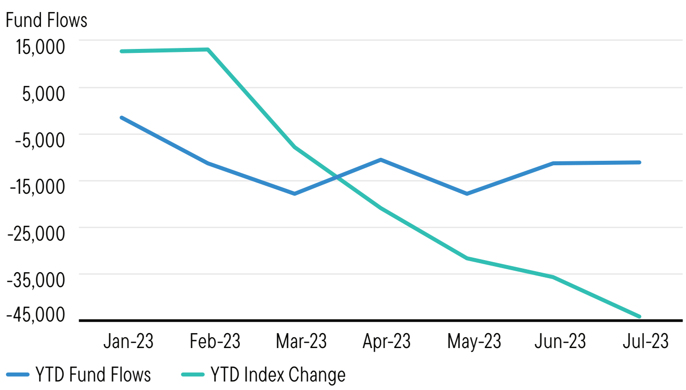
Source: Bloomberg.

Market conditions have turned positive

- We saw widespread selling across almost all fixed income spread sectors as many investors became wary due to concerns of a potential global recession. Since that time, higher yields and more confidence in central banks delivering a "soft landing" have brought funds back into the asset class.
- This has been met with limited net supply for the year as issuers face higher financing costs.
- The graph suggests US high-yield bond fund flows have stabilized, while low issuance has caused a drop in the size of the overall market.

High-Yield Fund Flows and Index Growth

January 1, 2023–June 30, 2023



Source: Barclays. Bloomberg High-Yield US Corporate Bond Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

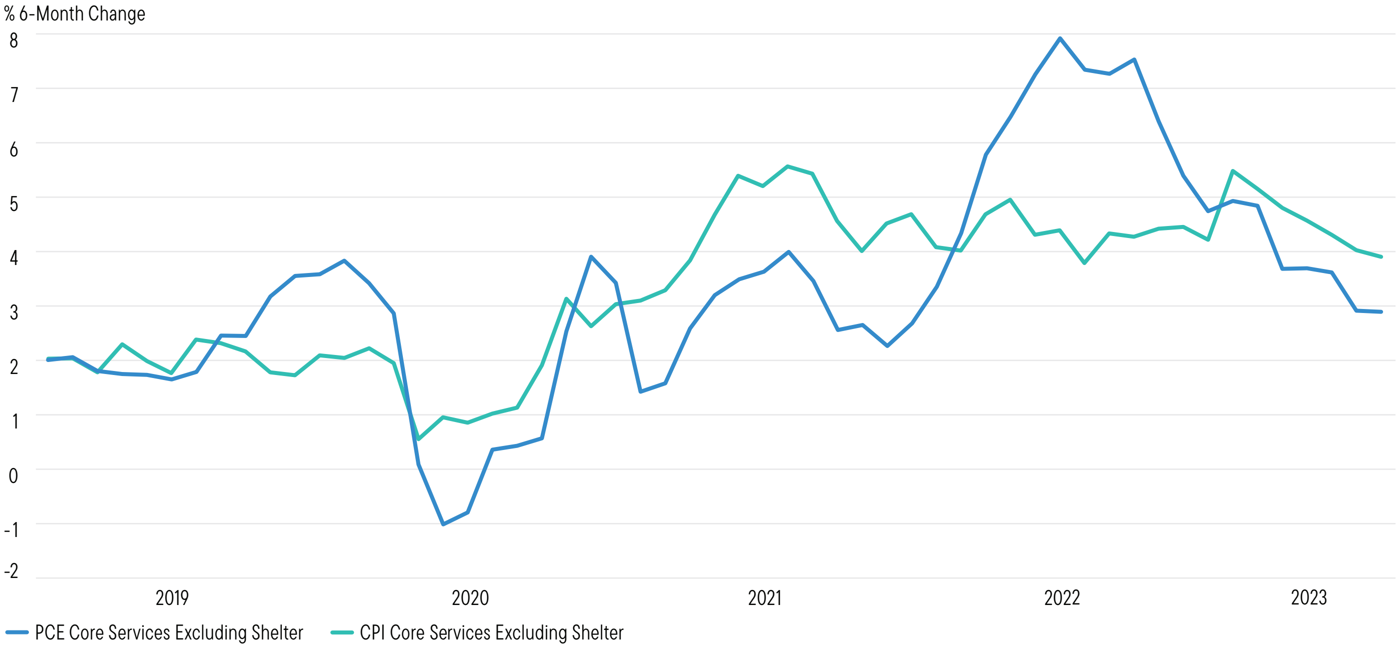
US economic review

More questions than answers

- With a pause in June and a 25-bp increase of the fed funds target rate in July, the Fed remains steadfast in its goal of bringing US inflation down to its 2.0% target. The Fed continues to pursue a data-dependent reaction function, closely watching US economic conditions to guide its future decisions.
- Although we have seen a rapid drop in headline inflation measures, the Fed is more focused on "supercore" inflation, which excludes food, energy and shelter prices. This measure, which is over half the core personal consumption expenditures (PCE) basket, has yet to fall below 4.0%.[3] The future for the supercore measure remains uncertain because it is the labor market that holds the key to understanding the category since wages are the largest cost for non-housing core-services companies.
- There has been some progress in terms of bringing the labor market into better balance, but the correction process still has some ways to go. Job growth has averaged 150,000 over the past three months, still above the Fed's 100,000 estimate of natural job growth. The pace of the labor market correction hasn't been quick enough to bring year-over-year wage growth closer to 2.5%–3.0%—a level Fed Chair Jerome Powell has said he would like to see. Despite a small decline in quit rates, consumers appear to remain confident in their ability to hold onto their current jobs.
- Falling inflation levels and a strong job market have raised real wage growth, adding fuel to the fire of consumer consumption. Real PCE has continued to rise as fast as it's ever done in the past 23 years. Household balance sheets, on aggregate, do not appear to be cash constrained. That means that even though one can expect a weakening in consumer spending (especially purchases of big-ticket items) in response to higher benchmark interest rates, it is unlikely to face a sharp, sudden drop because of cash constraints.
- Overall, while there has been significant progress on headline inflation, getting it to fall faster to the Fed's 2.0% goal remains a significant challenge. We think the Fed may favor doing more and hike by 25 bps in September or November, taking the real policy rate up to 1.9% by year-end and 2.2% by end-2024.

Supercore PCE and Consumer Price Index (CPI) Still Remain Above Their 2012–2019 Averages

January 1, 2019–June 30, 2023



Sources: Macrobond, Franklin Templeton Fixed Income Research. Important data provider notices and terms available at www.franklintempletondatasources.com.

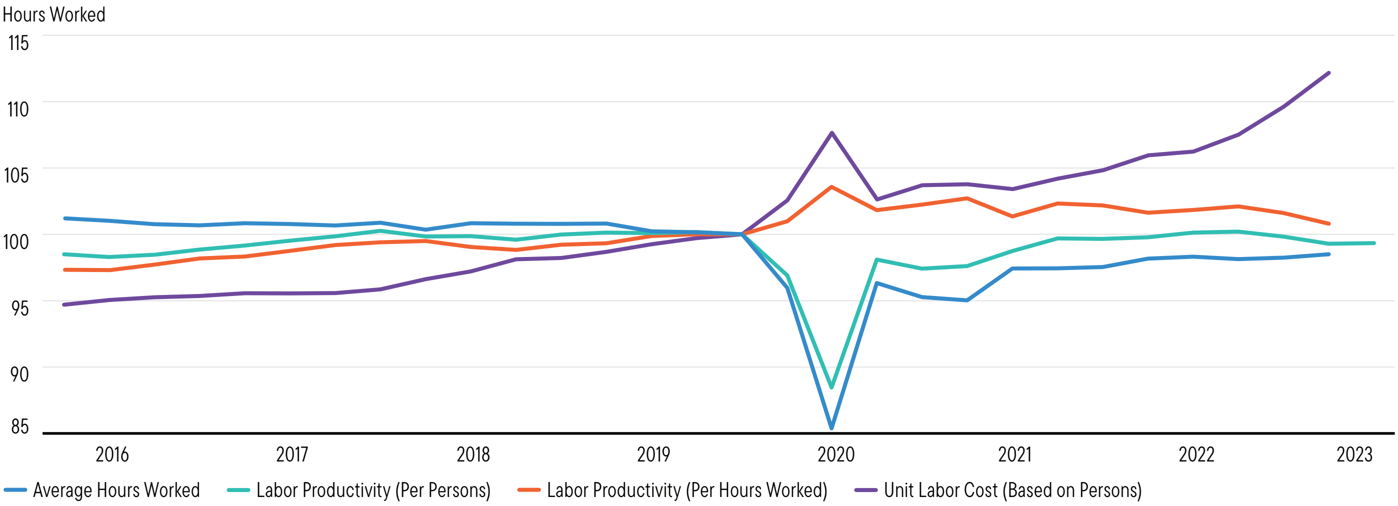
Euro area economic review

The labor market remains center stage

- The EA economy has continued to show resilience, posting a better-than-expected 0.3% quarter-over-quarter increase in real GDP during the second quarter of 2023. Nonetheless, internal demand has appeared weak overall, though services spending has remained robust.
- Looking ahead, we believe services consumption should support the region's economy during the third quarter of 2023 (Q3), helped by tourist spending over the summer months. However, sentiment indicators are trending down and are implying some softening in growth. For example, the HCOB Eurozone Composite Purchasing Managers' Index (PMI) reached a 33-month low in August, with a 46.7 reading.[4] We therefore expect only marginal growth in Q3, followed by broadly flat readings over the subsequent near-term quarters.
- Headline inflation continues to move lower amid significant declines in food and energy prices. Core inflation, on the other hand, remains sticky. Indeed, since January 2023, the annual rate rose by 0.2 percentage points, reaching 5.5% in July.[5] Core services inflation has continued to increase, too, but we believe this should peak with the August end to the tourist season before decelerating toward the latter part of the year.
- The labor market is still tight by historical standards and remains a driving force of inflationary pressures. Wages continue to rise in order to catch up with the losses in real income seen over the past year and a half. Combined with increasing unit labor costs (ULCs), this poses an immediate concern for a central bank striving to get inflation back to its target level.
- The labor market participation rate has returned to pre-pandemic levels, while unemployment reached a record low of 6.4% in June and July.[6] Reassuringly, however, the job-vacancy ratio seems to have peaked in 2022 and is now gradually declining, as are labor shortages. This should lead to some easing in the job market and lessen the pressure on wage growth.
- We will be closely monitoring labor productivity, which has remained subdued since the COVID-19 pandemic due to both labor hoarding and compositional shifts in employment. A pick-up in productivity, against a backdrop of rising wages, has the potential to exacerbate inflationary risks over the medium term. However, we still expect wages to stabilize to levels consistent with the European Central Bank's (ECB's) 2% inflation target by the end of 2024.
- Considering ULC developments and with the monetary policy transmission mechanism front of mind, we feel that the ECB is likely to err on the side of caution and keep policy rates high for as long as it can. Considering the central bank's recently announced move toward data dependence, we believe it could opt for a pause in September. Nevertheless, we still think that future rate hikes beyond September are a possibility, especially if the labor market proves resilient.

Employment has Outperformed Real GDP Growth Since the COVID-19 Pandemic

January 1, 2016–June 30, 2023



Sources: Eurostat, ECB, Macrobond, Franklin Templeton Fixed Income Research. Important data provider notices and terms available at www.franklintempletondatasources.com.

Special topic: Making a case for active corporate bond portfolio management

We believe skillful active management of corporate credit portfolios can potentially enhance performance and help offset the risk and return volatility associated with passive investment vehicles, including index exchange-traded funds (ETFs), over the long term.

- Actively managed corporate bond funds allow portfolio managers to regulate risk allocations such as sector and rating exposures, duration positioning, and security selection, which can provide risk management and potentially enhance performance over the medium and long term when compared to passively managed index funds and ETFs.
- A common theme across our corporate credit portfolios is our preference of staying up in credit quality and de-risking from issuers that we believe are facing challenging circumstances. As an active manager, we have the discretion to exclude or underweight over-leveraged companies or industries with what we consider unattractive outlooks, whereas passive funds are forced to own these issues since they track the total index. The evolution of Fed interest-rate changes continues to lead to both changing risk appetites and potential bouts of market volatility. Active managers, in our view, have the ability to best take advantage of market dislocations by selectively investing in undervalued assets, whereas passive managers are unable to do so.
- In the investment-grade corporate bond market, we believe credit fundamentals have remained generally strong. In our view, risk appetites have swung decidedly bullish, setting the stage for a potential widening in spreads through year-end, which could lead to lower valuations. With current spread levels tighter than longer-term averages, they leave little room for any downside surprises. Although yields remain generally attractive to us across the credit curve, we generally favor investing in higher-quality securities, while also taking advantage of the new issue market and any market dislocations to add exposure. This level of flexibility is unavailable to passive managers whose strict mandate can expose investors to unneeded risk.
- While the high-yield corporate credit sector has also remained fundamentally sound to us, with credit metrics appearing healthy versus historical levels, we expect some profit margin erosion associated with a slowing global economy. Costs, including wage expenses, continue to rise. In our view, companies will increasingly be unable to raise their prices in order to keep pace with these higher costs. Amid the current high interest-rate environment, our diligent research has helped us identify and avoid issuers with sizable bank borrowings that are tied to short-term interest rates. These companies will continue to experience rising interest expenses, hurting their profitability, especially those that have not hedged their interest-rate exposure.
- In the senior secured floating-rate bank loan market, we believe the broader index includes a number of problematic issuers that carry unsustainable cash burns and/or near-term maturities. These issuers may be constrained in their refinancing options, increasing the likelihood of defaults. Our active approach has favored focusing on higher-rated loans and de-risking portfolios away from lower credit quality issuers, especially in cyclical industries that are vulnerable to a slowdown in demand.
- Our active approach to corporate credit portfolio management is driven by our highest conviction research ideas as a key alpha source. Our ability to manage duration, sector and security concentrations and our longer-term investment horizon allow us to be contrarian during bouts of volatility.

Sector settings overview

Setting	Sector	View
Moderately Bullish	**Municipal Bonds (munis):**	Elevated yields combined with the sector's relatively high credit quality should continue to support investor demand for munis. Meanwhile, new issuance will likely remain limited throughout the year, providing an additional tailwind.
	US Treasury Inflation-Protected Securities (TIPS)	We believe low breakeven inflation rates make TIPS an attractive hedge against any reacceleration in US inflation rates.
Reason for Optimism	**Emerging Market (EM) Sovereign Debt**	While acknowledging that spreads on EM debt have tightened since March, we retain our preference for EM high-yield issues, given progress on external financing agreements and policy adjustments toward economic orthodoxy. EM central bank easing amid disinflation should continue to support local-currency bonds, although individual country selection will be a key differentiator.
	European Investment-Grade (IG) Corporates	We believe euro IG bonds provide attractive carry in this interest-rate environment, but spreads remain tight. Fundamentals continue to be positive but are likely to deteriorate in a slowing European economy.
Neutral	**Asset-Backed Securities**	We expect a more modest pace of deterioration in credit metrics for the remainder of the year. The recent abatement of inflation and tighter lending standards should be supportive of near-term performance.
	Collateralized Loan Obligations (CLOs)	Although fundamentals have begun to deteriorate in the underlying loans which collateralize CLOs, we believe some of those concerns are already reflected in current valuations. We expect US CLO spreads to remain rangebound with a bias for tightening as macroeconomic views become less negative.
	Emerging Market Corporates	We continue to see pockets of attractive relative value compared to EM sovereigns and US corporates, most notably in the BBB and BB rated part of the universe. Credit fundamentals may have peaked in certain sectors as profit margins have compressed, but balance sheets are conservatively positioned and should support the underlying credit quality of the asset class.
	European High-Yield Corporates	We have maintained our neutral stance on the asset class and believe current high yields are attractive enough to compensate for potential increases in default rates.
	Eurozone Government Bonds	The ECB's hiking cycle seems to be reaching its end, but a resilient labor market will likely keep the central bank hawkish over the near term.
	Floating-Rate Loans	Technical conditions have remained benign, and fundamentals have held up better than generally expected. We are increasingly constructive amid a more sanguine macroeconomic outlook. We would, however, reiterate the importance of prudent credit selection in this environment.
	Mortgage-Backed Securities (MBS)	We expect housing fundamentals to continue to slow but remain supportive, prepayment risk to be negligible, and the MBS index to be near full extension as macroeconomic conditions, particularly low unemployment, remain relatively healthy.
	Non-Agency Residential Mortgage-Backed Securities	We expect a continued decline in home prices that is being attenuated by supportive supply and demand dynamics; although US home price appreciation has slowed, a lack of inventory, along with steady household formation, should keep the housing supply and demand mismatch supportive of home prices.
	US High-Yield Corporates	With UST yields likely to be higher for longer, we expect the default rate to rise from historically low levels; refi issuance to pick up after issuers had held off, hoping rates would come down; and credit metrics to gradually deteriorate from historically strong levels. While these factors have the potential to push spreads modestly wider, for longer-term investors, yields around 8.5% should still generate attractive risk-adjusted performance, in our view.

Sector settings overview *continued*

Reason for Concern	Commercial Mortgage-Backed Securities	Commercial real estate prices are expected to continue declining in general over the coming year due to higher interest rates, tighter credit conditions and more conservative cash flow growth assumptions. We expect concerns over fundamentals will continue to result in elevated spread volatility.
	US Treasuries (USTs)	We are constructive on the shorter end of the yield curve but feel curve inversion is still too deep, given the Fed's trajectory. This leads us to maintain a steepening bias.
Moderately Bearish	Global Sukuk	We still see sizable risks in the Sukuk market, including the impact of lower energy prices and higher interest rates. With concern for potentially wider spreads going forward, we are positioned in higher quality credits that we believe have the financial buffers to manage slowing economic activity.
	US Investment-Grade (IG) Corporates	Valuations in the IG corporate market appear to be full, with spreads not positioned for any potential market downturn. Our base case is for modest spread widening over the medium term. Yields, however, remain elevated and fundamentals strong, in our view.
Bearish	Japanese Government Bonds (JGBs)	The Bank of Japan (BoJ) has yet to make substantial moves to address increasing inflation. Yields are most likely to move higher over the medium term, making JGBs unattractive, in our assessment.

Overall risk outlook

Reason for concern

Although there have been several bumps along the way, fixed income spread sectors, almost without exception, have benefited from improved risk appetite as they have posted strong excess returns year-to-date. We have witnessed higher spread volatility, but so far this year, spreads have trended tighter. Better-than-forecasted global economic conditions have blunted concerns as to the impact slowing economies will have on fundamentals, whether in the corporate credit, emerging market (EM), or US housing sectors. In our view, the market has moved too far in many sectors, pricing in a near-perfect economic landing without any major worries over issuers' fundamental positions. This has led to an asymmetric risk profile in which there does seem to be room for further tightening, and there exists the potential for a selloff on any adverse news. However, we are finding value in certain select positions in EM and high-yield corporate debt that our dedicated credit analysts have selected which have strong risk/reward profiles. As we have witnessed over the past year, investors seem willing to withdraw funds from fixed income sectors on bad news in fear that they will be the last one out the door. While most fixed income spread sectors appear to us to be fairly valued, we do see some pockets of opportunities. Focusing on higher-rated, lower-duration assets will allow us to take advantage of strong interest-rate carry, potentially adding to our performance without exposing the portfolios to unwanted spread widening risk. We also look to use our duration positioning as a hedge against widening spreads. Regarding foreign exchange (FX), we maintain a relatively neutral position in the US dollar, reflecting the mature state of the country's monetary policy cycle. In our view, the euro will likely appreciate over the medium term considering ongoing central bank policy tightening, and conversely, we feel the Japanese yen will continue to struggle given the BoJ's slow response to persistent inflation. As we navigate through the upcoming developments in the economy and Fed policy, we believe there will be better entry points in some sectors to add to risk, and, therefore, we have maintained our overall risk outlook as neutral with reasons for concern.

Key sector viewpoints

Moderately bullish

Municipal Bonds (Munis)
Tax-free munis have witnessed positive performance year-to-date, though underwhelming investor demand continues to pose a challenge. After record-breaking outflows in 2022, funds have not yet fully returned to the asset class. Anecdotal feedback suggests that asset allocators retain high cash and cash-equivalent balances, which we believe investors may want to put to work in the tax-exempt muni sector, particularly if and when the UST yield curve flattens. Technical conditions are more supportive for taxable munis, where demand from a global audience seeking high-quality US-domiciled fixed income is being met with restricted new issuance. The elevated yields on offer will likely continue to draw investor interest, especially if the US dollar stabilizes and hedging costs decline. More generally speaking, muni issuer fundamentals remain stable, with robust balance sheets that are supported by significant "rainy-day" funds that were bolstered by federal COVID-19 aid, increased during the pandemic recovery, and maintained with conservative budgeting and fiscal discipline. Though revenue growth may slow with easing inflation, we remain optimistic that most state and local governments are well positioned to manage through a period of below-trend economic growth. We have therefore upgraded our outlook to moderately bullish (from neutral with reason for optimism) and believe there are opportunities to find value across the credit spectrum.

Reason for optimism

Emerging Market (EM) Debt
Driven by lower-quality issues, spreads on EM debt have tightened since March based on valuations, the securing of a path forward for sovereign restructurings between China and the multilaterals, and a general willingness to extend multilateral support. Our preference for EM high-yield bonds remains intact, given limited room for spread compression within EM IG securities. Developments on financing agreements have been encouraging, and policy adjustments toward economic orthodoxy in certain countries have added to investor confidence. EM central bank easing amid disinflation should continue to support local-currency bonds. However, as developed market central banks reach peak rates, the evolving interest-rate differential is likely to become more nuanced, with individual country selection likely to be a key differentiator. Risks to this outlook include election outcomes in Argentina and Pakistan going into year-end, as well as worries around China's growth and property sector contagion. China's policy response has been lackluster so far, but we expect further support measures to be implemented if the situation were to deteriorate substantially. Fund flows across EM debt have been weak this year, while nascent signs of a revival during midsummer proved short-lived. Supply levels should start to pick up on a seasonal basis, helping to stimulate a more balanced technical picture.

Reason for concern

US Treasuries (USTs)

Since our last publication, we have seen a steady increase in UST yields, with the benchmark 10-year UST yield moving to an intraday high of 4.35%, the highest level since November 2007.[7] Although these yields approached our previous projections, we have increased our expectations due to a number of factors, including better-than-expected economic growth, persistent inflation, and unfavorable technical conditions in the market. Supply in USTs is fueled by high budget deficits, which will test the market's appetite for bonds. According to the Congressional Budget Office, the US fiscal deficit will reach 5.4% in 2023 and increase to 5.8% the following year.[8] To maintain this level of spending, the government will need to issue substantially more debt. This will have to be added to stiff rollover needs as 30% of USTs mature in the next 12 months and 66% of all debt will mature by the end of 2027.[9] This added supply will need to be absorbed by the market. Foreign investors have been quite active in buying USTs due to their relatively high yields versus those in Europe and especially Japan, but as these central banks move their policy rates higher while the Fed is reaching its terminal rate this differential will lessen and foreign demand will soften. Our view is that the current curve inversion is pricing in a substantial loosening of monetary policies due to a weakening economy, which is inconsistent with our current Fed outlook that calls for the potential of additional rate hikes and no cuts until at least the third quarter of next year. The Fed has repeatedly said it would continue to err on the side of caution and maintain rates higher for longer in order to prevent a rekindling of inflation pressures. However, at current levels, UST yields appear relatively attractive to us, especially on the shorter end of the curve, and we have upgraded our outlook to neutral with reason for concern. The concern is driven by longer-term yields, which are still too low, in our assessment. We feel somewhat comfortable with durations to be like that of benchmarks, but we continue to maintain a steepening bias in our positioning as we look for yields to rise on the longer end of the UST curve.

Moderately bearish

US Investment-Grade (IG) Corporate Bonds

US IG corporate bond returns have been shaped by a dynamic market risk landscape, as investors have reacted to resilient economic growth, falling inflation, a continued strong labor market and hawkish Fed policy moves. Recent months have seen tighter credit spreads due to investor optimism regarding a potential soft landing and improved financial sector stability. Corporate bond yields remain attractive to us, which has brought more investors into the asset class, bolstering the market's technical conditions. Corporate fundamentals also remain generally strong to us, providing most IG issuers with substantial flexibility to manage through a period of slowing growth. However, current spread levels are just around long-term averages, leaving little room for adverse surprises, prompting us to maintain a cautious approach to IG credit. We expect market conditions to remain uncertain, so our base case calls for spreads to widen in the coming months, although the magnitude will depend on how the global economy responds to tighter monetary conditions and how central banks further adjust policy based on incoming data.

Bearish

Japanese Government Bonds (JGBs)

We have significantly downgraded our outlook for JGBs to bearish (our lowest level) as we see that the market is in an unstable equilibrium with the BoJ's ongoing loose monetary policy versus the current domestic inflation picture and other developed market yields. Inflation measures have exceeded the BoJ's 2.0% annualized target for 15 consecutive months, with widespread inflation pressures across most of the domestic market and wage growth beginning to accelerate. At its July meeting, the BoJ loosened its grip on 10-year JGB yields by allowing a soft limit at 1.0%, which could be seen as the first step in scrapping its yield curve control program, but we do not see this as a near-term goal for the bank. We feel the market may force the BoJ's hand by putting pressure on the 10-year yield, negatively impacting the yen and causing the bank to intervene in the currency market as it did last summer. This will lead the market to a binary outcome dependent on the BoJ's response. The central bank can loosen policy to allow rates to increase or remain steadfast in controlling yields. If it chooses the latter, the value of the yen will be determined by the interest-rate differentials between other developed economies, leading to lower exchange rates which will have the byproduct of importing additional inflation. Given the BoJ's cautious policy stance thus far, we feel the transition to normalized monetary policy will be slow. In our view, JGB yields have nowhere to go but up with increased uncertainty. Therefore, we feel our bearish outlook is justified under current market conditions.

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

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

Endnotes

1. Source: “Gross Domestic Product, Second Quarter 2023 (Second Estimate) and Corporate Profits (Preliminary),” Bureau of Economic Analysis, August 30, 2023.
2. One basis point (bp) is one one-hundredth of one percentage point (1/100% or 0.01%).
3. Based on the six-month percentage change in supercore PCE.
4. Source: S&P Global, HCOB Eurozone PMI survey data, 5 September 2023.
5. Source: Eurostat, Harmonized Index of Consumer Prices (HICP), flash estimate, 31 July 2023.
6. Source: Eurostat, seasonally adjusted unemployment rate, data as of June 2023.
7. Source: Bloomberg.
8. Source: Congressional Budget Office.
9. Source: “Assessing the Costs of Rolling Over Government Debt,” Federal Reserve Bank of St. Louis, June 2, 2023.

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Notes

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