FRANKLIN TEMPLETON

TOO MUCH OF A GOOD THING?

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In this issue

Developments in the first months of the year have confirmed the cautiously optimistic outlook we outlined in our previous Quarterly Views and have shifted the balance of macro and investment risks for the near and medium term. Vaccination campaigns have rapidly picked up pace in the United States and several other countries, setting the stage for reopening businesses in the coming months. In early January, US Democrats took control of the Senate by winning both run-offs in Georgia and have launched the largest peacetime fiscal expansion on record; they approved a US$1.9 trillion fiscal stimulus bill, including a wide range of payments to households and states, and they are now discussing a US$3 trillion infrastructure package. Meanwhile, the US Federal Reserve (Fed) has reiterated that regardless of the magnitude of fiscal stimulus, it will maintain its extremely accommodative stance until the labor market recovery has extended to disadvantaged categories and inflation has been running above target for some time.

With household finances already at high levels and an economy that has thus far demonstrated its ability to rebound, we believe this unprecedented onslaught of policy stimulus greatly increases the chance that the US economy will overheat over the course of this year and next. The reflation debate, still dormant three months ago, is now in full swing. The consensus still gravitates around the Fed's reassuring official view: inflation expectations will remain well-anchored, wage pressures will remain moderate, the inflation rebound will be temporary and the Fed will smoothly adjust policies once it has reached its targets. That would be great, but we believe it would now be foolhardy to ignore the risks—the government is providing a staggering amount of stimulus to an already-recovering economy, at a time when commodity prices are already rising, reflecting both the global recovery and supply constraints caused by the pandemic. The inflation rebound might exceed expectations; if it does, and policy remains highly accommodative, inflation expectations might rise beyond what the Fed expects. Meanwhile, a very significant rise in public debt will compound macro uncertainty.

Fixed income markets have begun to price in some of these risks. Yields on 10-year US Treasuries (USTs) have jumped, exceeding even our ahead-of-consensus expectations, and most analysts have raised their year-end yield forecasts. Yields have stabilized for now, with markets in a wait-and-see phase, but we think risks remain skewed toward a further above-consensus rise, and limiting duration exposure remains a key element of our investment strategy.

As we foreshadowed in our last quarterly outlook, the ability to move ahead with vaccination campaigns is proving a key differentiator across countries, giving the global recovery a significant degree of unevenness. Europe in particular has disappointed—its vaccination campaign lags far behind the United States and United Kingdom, and major countries including France, Germany and Italy have been forced to impose a new round of lockdowns that will inevitably delay the continent's recovery. Since Europe's fiscal stimulus pales in comparison to the United States, and the European Central Bank (ECB) appears more internally divided and less decisive than the Fed, the eurozone's recovery will likely be not only delayed but less dynamic. As a consequence, we see less inflation and interest-rate risk in Europe than in the United States. Bond yields will feel some pull from the upward drift in UST yields, but with weaker domestic drivers. Overall, we therefore, maintain a constructive view on European fixed income markets and favor a somewhat longer duration profile compared to the United States. We also think that perceived divisions within the ECB might lead investors to misprice rate-hike expectations, creating pockets of opportunity in periphery government bonds. The slow vaccination campaign and delayed recovery also leads us to be more cautious on the European high yield sectors more directly exposed to COVID-19 restrictions; rates volatility could create interesting select buying opportunities in the European investment grade corporate bond market.

The more robust US macro outlook also makes us more optimistic on the prospects for global growth and for emerging markets (EM). While Europe's lagging pace of recovery constitutes a drag, stronger US momentum will add to China's already entrenched recovery, and to the progress already made in Asia in bringing infections under control. The resurgence in commodity prices testifies to the improved global growth outlook, though supply constraints are also contributing. Stronger global growth will help EMs to repair their balance sheets and bolster debt fundamentals; commodity exporters should be especially favored. At the same time though, the likely upside in UST yields represents a significant potential source of stress for EM debt, as already evidenced by the poor start of the year in both hard currency and local currency bonds, which brought back painful memories of the 2013 "Taper Tantrum."[1] Security selection and fundamental analysis will be crucial to identifying the most attractive opportunities for yield pick-up.

Overall, we expect that the coming months and quarters will see a consolidation of a robust recovery in the United States and in the global economy at large, with Europe catching up in the latter part of the year. Together with vaccinations, fiscal policy plays a key role in this recovery, notably in the United States.

Overall, we expect that the coming months and quarters will see a consolidation of a robust recovery in the United States and in the global economy at large, with Europe catching up in the latter part of the year. Together with vaccinations, fiscal policy plays a key role in this recovery, notably in the United States. Going forward, we believe markets will increasingly focus on whether this can be too much of a good thing—whether the massive fiscal stimulus, enabled by an extremely stimulative monetary stance, will cause the economy to overheat and inflation pressure to build beyond central bank's expectations and desires. We do not expect inflation to get out of hand, but given that policymakers have now pulled all stops, we suspect that managing their desired inflation rise will prove harder than they think and claim. This could easily bring heightened stress and volatility to financial markets where prolonged massive monetary easing has already contributed to stretched valuations across asset classes.

We continue to see select opportunities in the market, with the operative word being "select." As we have noted multiple times since the start of the crisis, active management will continue to play a critical role in walking the knife edge between improving fundamentals and rich valuations. We believe deep fundamental analysis and security selection, along the lines detailed in the Sector Settings section of this outlook, will be required to navigate these markets. Fixed income investors should also remain nimble and prepared to handle heightened volatility ahead, as we get ready to discover whether the much-awaited reflationary recovery could prove too much of a good thing.

Sector settings

Overall Risk Outlook

US Treasuries

US Treasury Inflation-Protected Securities (TIPS)

Eurozone Government Bonds

Japanese Government Bonds

Agency Mortgage-Backed Securities (MBS)

Non-Agency Residential Mortgage-Backed Securities (RMBS)

Commercial Mortgage-Backed Securities (CMBS)

Asset-Backed Securities (ABS)

US Investment-Grade Corporates

European Investment-Grade Corporates

US High-Yield Corporates

Euro High-Yield Corporates

Floating Rate Loans

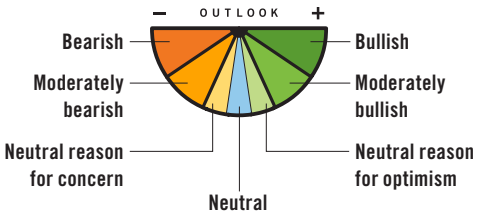
Collaterized Loan Obligations (CLOs)

Emerging Market (EM) Debt

Emerging Market Corporates

Municipal Bonds

Understanding the pendulum graphic



Arrows represent any change since the last quarter end.

Franklin Templeton Fixed Income macroeconomic recap & outlook

The big reflation bet

A sharp increase in US economic activity has now become the base case for financial markets as prospects for a return to normalcy improve. Since the recovery got underway in the third quarter (Q3) of 2020, markets have moved ahead of the economy and the reflation trade has continued in 2021, supported by the accelerating pace of vaccine deployment and the passage of the US$1.9 trillion American Rescue Plan (8.4% of gross domestic product [GDP]).[2] The yield on the 10-year US Treasury breached 1.70% (the highest level since last January), the yield curve steepened significantly (with the 2-year/10-year spread the widest in over five years),[3] equity markets continued to reach new all-time highs, and overall commodity prices have surged—signaling agreement with the reflation narrative.

The catalysts for this narrative?

This reflation consensus is being fueled by three catalysts:

- The economy has already showed its ability to bounce back when restrictions were first lifted in Q3 2020; last year's fiscal support boosted household savings to record levels, and consumers have plenty of pent-up desire to spend.
- There is a growing sense that the pandemic may finally be coming under control, as cases trend lower across the United States, and as positivity and hospitalization rates more than halved since the peak in January 2021. The pace of vaccinations has continued to gain speed, averaging about 2.9 million doses administered/day, with over 150 million administered (or 29.2% of the population) having received at least one dose by the March 31.[4] States across the nation are moving forward with plans to lift stay-at-home orders and allow businesses to reopen, though the pace at which restrictions are removed varies from state to state.
- Both fiscal and monetary policymakers are determined to err on the side of "overheating" the economy; they believe insufficient stimulus contributed to a sluggish post-global financial crisis (GFC) recovery and are determined not to repeat the same mistake. Therefore, despite an unprecedented peacetime fiscal stimulus, the Fed has pledged to keep monetary policy extremely accommodative, with zero interest rates and asset purchases at least at their current pace of US$120 billion/month until the labor market has fully recovered and inflation has been running above the 2% target for some time.

But what does the economic data tell us about the current dynamic of the recovery?

The consumer

US retail sales started 2021 with a bang, surging 7.6% month-over-month in January after three consecutive months of decline due to the winter surge in cases and business restrictions.[5] The January increase reflected both the gradual easing of restrictions as well as the latest round of US$600 stimulus payments and the additional US$300 in federal unemployment insurance benefits.

Overall retail sales have now pulled well above pre-crisis levels (11% above the level in February 2020), but with a 2-percentage point shift away from services to goods. Overall spending (as measured by the Personal Consumption Expenditures or PCE Index), which includes the services sector as well, is still 2.6 percentage points below its pre-crisis level. With another stimulus package that includes a US$1,400 direct transfer (beginning to be disbursed in March), an extension of US$300/week unemployment insurance benefits with expanded eligibility and extended maximum duration of 79 weeks, as well as the expansion of the child tax credit, demand and spending will continue to get pushed into goods until mobility fully recovers and consumers feel confident enough to resume spending on in-person services.

This sharp distinction between sectors that the restrictions have impacted most and those that benefited from remote working and online shopping is also reflected in a growing divide between households where individuals retained their jobs and those that lost jobs and incomes, and between consumer expectations of those with a college degree (where expectations have stabilized) and those without (where expectations continue to fall). As a consequence, while the University of Michigan Consumer Expectations Index climbed higher in March, it still remains significantly below its pre-crisis level in February 2020, and expectations of future personal finances worsened.[6]

Rising inflationary expectations represent another headwind for consumer sentiment. The year-ahead inflation rate stood at 3.1% in March, up from 2.5% at year-end 2020, with the bottom and middle-third income groups expressing the greatest concern.

Inflation expectations have been likely pushed higher by the 25% increase in average gas prices paid year-to-date (YTD) (reaching a 21-month high of US$2.87 per gallon in March) and food (grocery prices increased 3.5% year-over-year in February).[7] A continued increase in inflation expectations could further dent consumer sentiment.

However, the additional rounds of fiscal stimulus over the coming quarters should more than offset these headwinds and push excess savings even higher (US$2 trillion or ~10% of GDP in January), assisted by the continued V-shaped recovery in wages and salaries. The overall financial health of consumers (on aggregate) has remained intact due to government support, and in stark contrast to the post-GFC period, we anticipate household net worth will continue to rise in the coming quarters after hitting a record US$130.2 trillion (754% of disposable income) in the fourth quarter of 2020.[8]

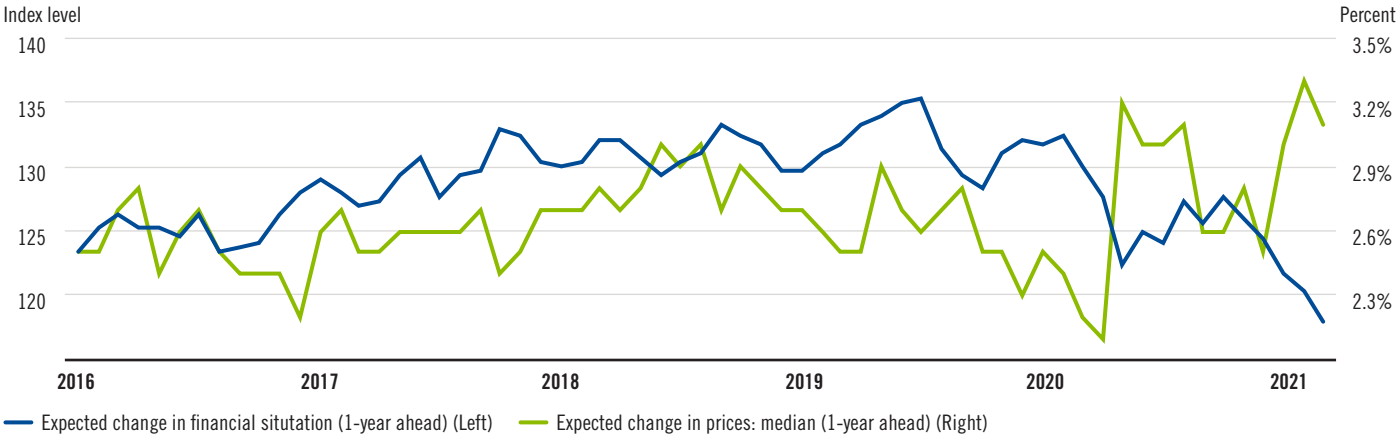
The labor market

US payrolls rose 379,000 in February 2021, beating consensus expectations, after three months when a winter wave of COVID-19 cases and severe weather across much of the United States held back hiring. The headline figure somewhat masked the true strength of February's job gains as the services sector added 513,000 jobs, with leisure and hospitality alone adding 355,000 (+286,000 for restaurants) in what may be a precursor for a surge in the coming months. Other sectors that saw solid job gains include manufacturing, retail trade, professional and business services, and health care, while severe weather-related disruptions likely held down construction jobs, which in turn also led to a decline in the aggregate weekly hours worked. However, the continued acceleration in hiring of temporary help workers—historically, a reliable leading indicator for overall job growth—bodes well for the labor market.[9]

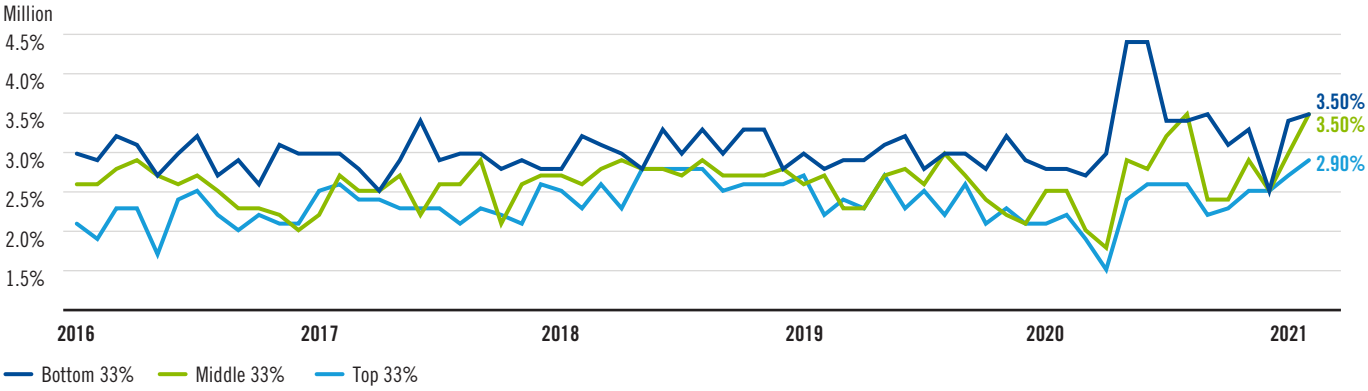
Institute for Supply Management (ISM) reports for January and February are also consistent with stronger labor demand than the headline jobs number suggests, as the employment

INFLATION CONCERNS HAVE IMPACTED CONSUMER EXPECTATIONS

Exhibit 1: Personal financial situation and inflation expectations
January 2016–February 2021



One year ahead median inflation expectation—by income group



Sources: Franklin Templeton Fixed Income Research, University of Michigan.

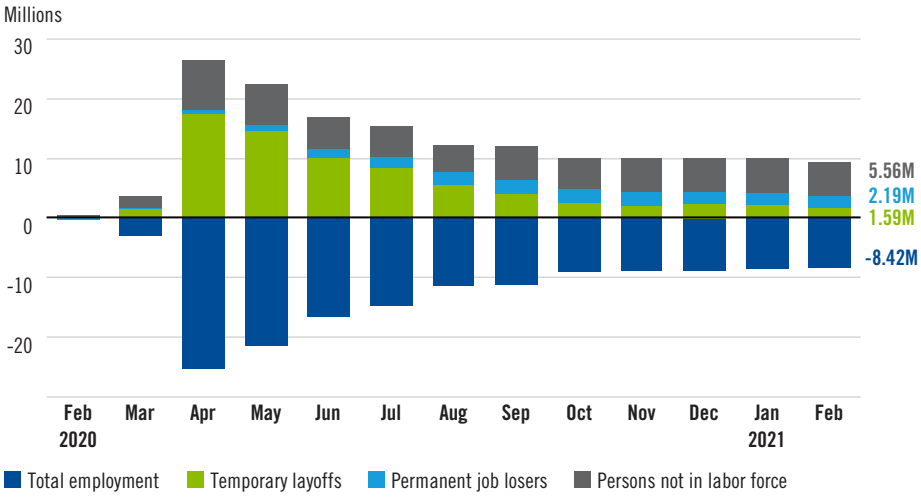
component for manufacturing and services remained firmly in expansionary territory and higher than the crisis-period cyclical peaks in 2020.[10] Anecdotal evidence also suggests that firms are struggling with short-term labor supply issues. This may partially be due to sectoral reasons—workers in leisure and hospitality might be unable to transfer into different sectors or may not want to if hiring is likely to pick up later this year—and partly because of the large number of workers who have chosen to disengage from the workforce owing to health reasons or lack of childcare options. Such supply constraints will likely ease as the pandemic continues to be brought under control.

The Fed wants to see a much stronger and broad-based recovery in the labor market, and that will take time. Non-farm payrolls remain almost 9.5 million below their February 2020 level,[11] while measures such as the underemployment rate or U-6 (11.1%), labor force participation (61.4%) and employment-to-population ratio (57.6%) have plateaued over the past few months, indicating continued slack on the labor market. Meanwhile, long-term unemployment (those unemployed for 27+ weeks) stands at 4.15 million (~42% of total unemployed), while those not in the labor force are still 5.66 million in excess of the February 2020 level. The Fed has also emphasized that it's only in the later stage of a labor market recovery that the benefits extend to workers with lower skill levels and minorities, as had been observed before the pandemic struck.

While a lot more progress is needed for the labor market to fully heal, February's job gains confirm that as vaccinations accelerate and the economy reopens, job creation should quickly pick up pace, particularly in the high contact services sectors.

EMPLOYMENT SITUATION COMPARED TO PRE-CRISIS LEVELS

Exhibit 2: Employment and unemployment by reason—in excess of February 2020 level
February 2020–February 2021



Sources: Franklin Templeton Fixed Income Research, BLS.

Where to watch for (dis)inflation?

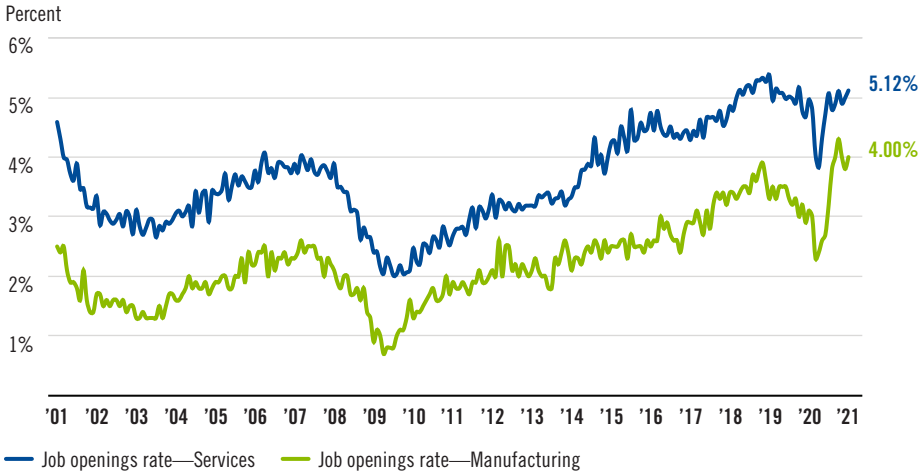
To gauge whether this time we will see a significant and sustained rebound in inflation, three factors deserve close attention: wages, commodity prices, and fiscal policy.

Services sector—worker shortage driving up wages?

Job openings in the services sector continue to surprise to the upside and have quickly reverted to 2017–2018 levels in stark contrast to the post-GFC labor market dynamics. Of note, the V-shaped recovery in openings was before the fiscal stimulus of December—further economic reopening alone will likely push job opening levels to the 2018–2019 range. If job openings—particularly in services—stay strong as demand recovers, wages could well rise faster-than-anticipated. There is already some evidence of this occurring.

LABOR DYNAMICS: JOB OPENINGS HAVE QUICKLY REVERTED TO 2017–2018 LEVELS

Exhibit 3: Services and manufacturing job openings
January 2001–January 2021



Sources: Franklin Templeton Fixed Income Research, US Bureau of Labor Statistics.

While the jump in hourly wages in March and April last year was explained by the loss of jobs among low-wage workers (a composition effect), service sector wages may now be getting a boost from a shortage of workers. The shortage will likely be ameliorated as workers become more confident of returning to work, but whether labor supply can improve as fast as labor demand will be an important determinant of wage dynamics.

Given the abundance of job vacancies, a V-shaped recovery in wages and salaries (excluding government transfers), and an ever-growing stockpile of excess savings, once the economy does fully reopen and demand recovers, this massive fiscal stimulus could easily cause a textbook demand-pull inflation.

Oil price rally

West Texas Intermediate crude oil prices have risen to around US$60 a barrel—a 23%+ increase year-to-date and the highest level in over two years. The Fed will likely look through an increase in food and energy prices, claiming that those are likely to be transitory. However, several factors suggest the recent variation in oil prices might be more permanent.

First, optimism over global growth and a speedier US economic recovery have led to a macro repricing of oil. Second, OPEC+ has indicated firm commitment to its oil output policy, which involves deep supply cuts as oil markets work off massive inventories and spare capacity. Third, the pandemic-led financial damage inflicted on oil majors such as Exxon, Chevron and BP have meant that shale-related focus has shifted to maximizing cash-flow at the expense of future capacity expansion plans.

Therefore, the OPEC+ supply cuts and a more restrained US oil production in the face of an anticipated demand boost as economies fully reopen is likely to fuel increasing energy costs going forward. In turn, inflation expectations could climb higher on a more sustained basis without triggering a significant increase in realized core-personal consumption expenditure (PCE) outcomes until much later (second-derivative effects of higher energy prices filter through a later stage).

Rising input costs

Other commodity prices are also on an upswing. The latest manufacturing PMI expanded at the fastest pace in three years (60.8 in February from 58.7 in January) and the gauge of material costs accelerated the most since 2008, including the ninth consecutive month of rising raw materials prices owing to supply constraints. Rising raw material costs are being recorded globally, with euro-area manufacturers reporting the steepest increase in input costs in almost a decade. The CRB Raw Industrials Spot Price Index has risen over 25% since February 2020 (and for 11 consecutive months after the precipitous decline in March 2020), and while some of this strength is attributable to the –4.1% decline in the trade-weighted dollar over the same period, it is also in part due to the rebound in global economic activity and demand.[12] A weaker US dollar has certainly resulted in non-petroleum import prices rising since the pre-crisis period, after price inflation had remained in a negative trend throughout 2019 and early 2020.

Additionally, the increase in overall producer prices continues to move in close correlation with the ISM Manufacturing Business Prices Index, with a 0.72 correlation between the two measures since 2005.[13] A continued increase in commodity prices and the possibility of a weaker US dollar could therefore translate into higher input/producer prices for businesses—we are already seeing a consistent move up in core Consumer Price Index (CPI) goods inflation.

Fiscal stimulus designed for a post-GFC style recovery?

Given that the Phillips curve has flattened over the last decade and that the economic and political scarring from the GFC run deep, policymakers view the risk of doing too much as much less serious than the risk of doing too little. However, the economic situation today is unlike the period following 2007–2009. A little over 13 million jobs, or 60% of those lost, have been added back in less than a year in an economy that has not yet fully reopened. For comparison purposes, in the aftermath of the GFC it took roughly 4 years to add 60% of the jobs lost. But while job openings are quickly reverting to pre-COVID-19 levels, the latest rounds of fiscal stimulus, both in terms of size and targeting, seem designed for a post-GFC situation.

Given the abundance of job vacancies, a V-shaped recovery in wages and salaries (excluding government transfers), and an ever-growing stockpile of excess savings, once the economy does fully reopen and demand recovers, this massive fiscal stimulus could easily cause a textbook demand-pull inflation.

How pronounced and durable the rise in inflation will be will depend on wage dynamics, the reaction of inflation expectations, and the policy reaction. Those who expect the rise in inflation to be moderate and temporary note that inflation expectations remain anchored and that wage inflation rose at most a little over 3% in the past decade even when the unemployment rate dropped to record lows. However, inflation expectations might shift even higher if actual inflation rises and policymakers maintain a very loose policy stance—as they have pledged to do. And, wage dynamics will crucially depend on the differential speed in recovery of labor demand and labor supply.

Overheating also seems likely to partially take the form of asset price appreciation. With the stockpile of excess savings set grow larger, a smaller percentage will eventually find its way into spending—there are only so many vacation days one can take to make up for travel foregone during the pandemic. Therefore, savings will likely see a level shift up and get pushed into financial assets.

US economic outlook

The US economy is poised to experience the highest levels of real GDP growth in nearly four decades in 2021; the staggering amount of fiscal stimulus, combined with upwards of US$2 trillion in excess savings after the next round of government transfers, could fuel the strongest consumption boom in decades. The table on the next page shows our updated outlook. All three scenarios represent the varying degrees to which we expect vaccine distribution, prior and additional fiscal support, the associated consumer spending, and President Joe Biden's tax policy to affect growth, unemployment and inflation. Our expectation is that the most likely outcome would be between our baseline and upside scenarios, biased toward the upside scenario, with strength in the services sector and households' propensity to consume being the differentiating factor between the two scenarios.

The US economy is poised to experience the highest levels of real GDP growth in nearly four decades in 2021; the staggering amount of fiscal stimulus, combined with upwards of US$2 trillion in excess savings after the next round of government transfers, could fuel the strongest consumption boom in decades.

Out of the US$1.9 trillion allocated toward the American Rescue Plan, US$1.2 trillion is expected to be deployed in fiscal year 2021. Support for individuals and households in the form of stimulus checks and unemployment insurance (UI) benefits accounts for US$640 billion of the expected deployment for fiscal year 2021, while support to businesses, restaurants and airlines, and state and local governments accounts for US$560 billion. Although we do not expect actual deployment of fiscal stimulus to be less than the projected levels, the difference in growth projections between our baseline and upside scenarios are a function of how quickly (or what proportion of) the direct income support to low-income households and the unemployed gets spent. Since the marginal propensity to consume tends to be higher for low-income households, our expectation for growth is to skew to the upside. However, the baseline scenario assumes that lower-income households use a greater proportion of the direct payments and UI benefits to save and/or pay down existing debt relative to the upside scenario.

The baseline scenario assumes a continued moderate-to-strong pace of vaccine distribution. While tax policy would be far less intrusive compared to the downside scenario (described below), there could still be potential for higher corporate taxes, while other measures may be targeted more towards taxing the wealthy—an increase in the top income bracket tax rate, estate taxes on a "stepped-up basis" and capping itemized deductions for the wealthiest taxpayers. The current bill includes tax increases mainly aimed at corporate income, executive compensation and limitations on business and non-corporate deductions.

Although we would classify this as low-probability, the downside scenario represents a situation where the size of outlays disappoints and a stronger version of the Biden Administration's tax agenda comes to fruition—corporate taxes revised up to 28%, higher taxes on capital gains and a payroll tax of 12.4% on earnings above US$400,000. In anticipation, firms could pull back on hiring and investment, which in turn would slow the recovery process.

The upside scenario assumes that the pandemic is largely brought under control, both in terms of spread and vaccine uptake. Tax policy is more diluted compared the prior two scenarios—a minimum corporate tax

FRANKLIN TEMPLETON FIXED INCOME: US GROWTH OUTLOOK

Exhibit 4: Real US GDP growth (% quarter-over-quarter [Q/Q]), unemployment rate and inflation rate scenarios

As of March 2021

	Real GDP (% Q/Q AR)			Unemployment Rate (%)			CPI Inflation (% Y/Y)		
	Downside scenario	Baseline scenario	Upside scenario	Downside scenario	Baseline scenario	Upside scenario	Downside scenario	Baseline scenario	Upside scenario
2020–Q4	4.3%	4.3%	4.3%	6.7%	6.7%	6.7%	1.2%	1.2%	1.2%
2021-Q1	*4.2%*	*5.3%*	*6.4%*	*6.2%*	*6.0%*	*5.9%*	*1.5%*	*1.7%*	*1.9%*
2021-Q2	*5.0%*	*8.3%*	*10.2%*	*6.0%*	*5.6%*	*4.9%*	*2.3%*	*2.8%*	*3.2%*
2021-Q3	*3.7%*	*5.6%*	*7.1%*	*6.0%*	*5.4%*	*4.3%*	*2.0%*	*2.6%*	*2.7%*
2021-Q4	*4.8%*	*6.7%*	*8.0%*	*5.6%*	*4.4%*	*3.9%*	*1.8%*	*2.2%*	*2.4%*
2022-Q1	*3.3%*	*3.2%*	*3.0%*	*5.5%*	*4.5%*	*3.9%*	*1.6%*	*2.2%*	*2.3%*
2022-Q2	*3.2%*	*3.0%*	*2.9%*	*5.3%*	*4.3%*	*3.9%*	*1.8%*	*2.1%*	*2.1%*
2022-Q3	*3.0%*	*2.2%*	*2.0%*	*5.1%*	*4.2%*	*3.7%*	*1.9%*	*2.0%*	*2.0%*
2022-Q4	*4.2%*	*3.2%*	*2.9%*	*4.7%*	*4.0%*	*3.5%*	*1.9%*	*1.9%*	*2.0%*

	Real GDP (Annual)		
	Downside scenario	Baseline scenario	Upside scenario
2020	–3.5%	–3.5%	–3.5%
2021	4.8%	6.1%	6.9%
2022	3.8%	4.3%	4.7%

	Real GDP (Q4/Q4)		
	Downside scenario	Baseline scenario	Upside scenario
2020	–2.4%	–2.4%	–2.4%
2021	4.4%	6.5%	7.9%
2022	3.5%	2.9%	2.7%

Italics indicates forecast.

Source: Franklin Templeton Fixed Income Research.

hike, payroll taxes on earnings above US$400,000, increases in top income tax rates, capping itemized deductions for the wealthiest, and doubling tax on foreign earnings (or some combination of these measures).

Across all three scenarios, we expect quarter-over-quarter annualized growth to pick up in the second quarter (Q2) of 2021), followed by slower sequential growth in Q3 on account of a higher base effect, with the economy ending 2021 on a stronger note owing to the holiday season. Due to particularly low base effects, we expect to see inflation accelerate across all scenarios in Q2 2021, with an average year-over-year growth of 2.3% and 2.5% under the baseline and upside scenarios, respectively. Average inflation in the baseline and upside scenarios, however, converge back to roughly 2% in 2022.

Europe: a double dip—less than originally anticipated but likely to last longer

Euro-area real GDP contracted in Q4 2020 amid a resurgence of the pandemic and the reintroduction of more stringent lockdowns. The –0.7% Q/Q decline (or a –4.9% Q/Q annualized rate) nevertheless proved, once again, better than consensus forecasts (–2.4%), ECB projections from December (–2.2%), and our previous forecasts (–2.0%). France surprised to the upside, with real GDP decreasing only –1.4% Q/Q versus the –4.0% projected by French authorities, while Germany and Spain avoided a negative print and stagnated at relatively flat Q/Q growth rates (of 0.3% and 0.4%, respectively). Italy was the only "Big Four" country falling close to gloomier expectations, with a –1.9% Q/Q real GDP contraction.[14]

Household consumption declined 3.0% Q/Q in Q4 2020 after registering a record 14.1% surge in Q3 2020, while private investment rose 1.6% and provided a positive boost after growing 13.9% in the previous quarter. Net external demand contributed negatively to GDP as the 3.5% rise in exports was offset by a 4.1% increase in imports. Private consumption has remained relatively resilient, signaling a readaptation of consumption behaviors in the new pandemic world, which has been somewhat underestimated.

The reintroduction of social distancing restrictions has been widely differentiated between, and even within, countries as measures were targeted at the regional level to prevent overloading of local health care systems. Nevertheless, the differing rate and approach to economic openings of non-essential retailers have played a crucial role in output—the different levels of lockdown stringency and resulting consumption levels are feeding an uneven recovery from pre-crisis real GDP levels.

Recent PMI figures confirm our view that the sectoral recovery would be uneven, with manufacturing remaining in expansionary territory (strengthening to a three-year high of 57.9 in February) since July 2020 while services, persistently crippled by extended virus-related restrictions, continued to contract (registering 45.7 in February) for the sixth consecutive month. The strong recovery in external demand, with the largest increase in new export trade since January 2018, further sustained manufacturing performance in Q4 2020. The euro-area current account balance closed the year at 2.2% of GDP, reverting to pre-crisis

levels due to a sustained rise of the goods surplus in Q4 2020 (up to 3% of GDP).[15]

A delayed recovery

After a strong resurgence during the holidays and at the start of the year, with the spread of the new virus variant B.1.1.7, which was first identified in the United Kingdom and now reported in 43 of 53 countries in the region,[16] COVID-19 cases are now receding in several euro-area countries, in line with the global trend. Pressure on the European health care system has eased somewhat, with COVID-19-related hospitalizations significantly decreasing in countries such as the United Kingdom and leveling off from prior peaks in France, Spain and Italy (although slightly deteriorating in the most recent weeks).

The progress toward containment has been uneven throughout the economic bloc and partially reversed in early March, although there were alarming new spikes in cases in countries such as Italy, Greece, the Czech Republic and Poland and a reversal of the downward trend in others, such as Germany, France, Sweden and the Netherlands. Overall new cases rose 15.3%[17] in the region to just over one million in the first two weeks of March, the first increase in new infections after six weeks of decline.

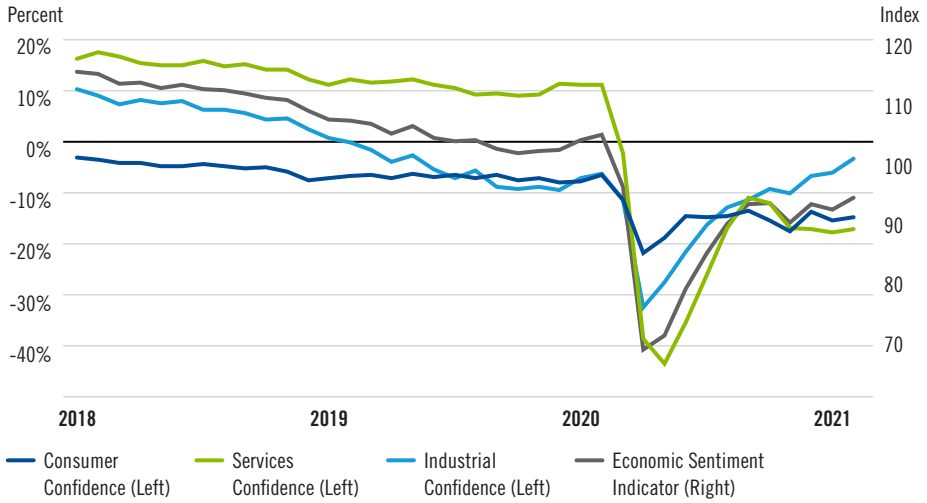
The recent intensification of the pandemic has led to new economic restrictions. Italy announced new coronavirus restrictions across half of the country's 20 regions, including major cities such as Rome, Milan, and Venice starting March 15, which bars mobility outside of essential errands and closes shops and restaurants. France imposed curfews and other social restrictions, including the requirement for written permission for being out from Friday evening to Monday morning, and Spain remains under a nationwide curfew until early May. Different levels of containment measures are likely to continue in most euro-area countries for at least the first half of 2021.

Growth in the first quarter of the year is expected to be under pressure as the new lockdowns are likely to result in further contraction. Although some level of adaptation to virus-related measures is cushioning the region from harsher outcomes, growth in Europe still crucially hinges on the evolution of the pandemic and the policy response to it. The strength of the positive momentum in the euro-area industrial sector will likely not be enough to balance weak consumer and services sector confidence, which will inevitably weigh once again on first quarter headline's growth.

WEAK CONSUMER CONFIDENCE OFFSETS STRENGTH IN EURO-AREA INDUSTRIAL SECTOR

Exhibit 5: Economic sentiment, industrial/services confidence, consumer confidence indicators

January 2018–February 2021



Sources: Franklin Templeton Fixed Income Research, European Commission (DG ECFIN).

Vaccine deployment challenges

The beginning of the vaccination campaign in early 2021 around the globe sparked enthusiasm for the resolution of the pandemic crisis. The United Kingdom was a first-mover, approving its first COVID-19 vaccine on December 2, and is leading the rest of Europe with over 35 million doses administered (amounting to roughly 46% of the total population) as of March 31. While Europe was one of the first regions hit hard by the pandemic last spring, vaccine deployments have been problematic from the start amid supply issues and poor administrative capacity. Compared to other regions of the world, the overall 11% share of the total EU population that has received at least one vaccine dose as of March 28[18] (or 69 million total doses administered) is lagging far behind.

The slow rollout of vaccines in the European Union is partly attributed to a delayed start. The European Medicines Agency (EMA) took until December 21 to approve Pfizer's vaccine, 20 days after the United Kingdom, and did not approve Moderna until January nor AstraZeneca, a critical supply source for the European vaccine campaign, until the end of January.

Vaccine approvals have been only one part of the problem—uncertainty regarding supply levels and export

restrictions led to precautionary stockpiling in countries such as Germany to ensure second doses were available, reducing overall inoculation rates. Production hiccups by several producers, lastly AstraZeneca cutting deliveries by the end of March to 40 million (from an original goal of 80–100 million), make forecasts regarding herd immunity thresholds increasingly uncertain. Moreover, several European countries temporarily halted the rollout of the AstraZeneca vaccine on concerns raised by some cases of blood clots; after a quick investigation, the EMA reiterated that the vaccine is safe, and distribution has resumed, but the episode will likely increase fear of vaccines among EU populations and might reduce the uptake and delay the pandemic resolution. Moreover, poor administrative capacity shown so far from European health authorities has led to a lethargic vaccination program and reports of unused vaccine inventories in some countries abound.

Supply is expected to substantially increase in Q2 and Q3, in line with the initial European Commission (EC) official guideline of inoculating 70% of the adult population by the (end of) summer of 2021. Reaching this goal, however, would also require a far greater degree in efficiency in administering all the available doses as they arrive, as certain EU countries would need to increase the vaccination pace by two to eight times from what has been witnessed so far. Therefore, organizational bottlenecks pose downside risks to meet the EC's 70% goal.

Euro area economic outlook

In light of the above, we updated our euro-area economic forecasts for 2021. The euro area will likely take an extended period to revert to pre-pandemic levels, but the economy remains on track for a recovery in the second half of 2021. The table below shows our updated outlook. We now expect euro area real GDP to rebound by 4.1% in 2021 and by 3.9% in 2022.

The baseline scenario assumes some sort of local/regional restrictions to remain in place through the first half of 2021, partly delaying the recovery and resulting in a downward revision to first-quarter growth. A more robust vaccine rollout throughout Europe will allow for widespread economic reopening and a sustained rebound in consumption of services from the third quarter onwards. The upside scenario assumes an anticipated reopening resulting in a stronger growth rate beginning in the second quarter, while the downside scenario reflects risks of stricter restrictions until the summer.

The spread of new virus variants remains concerning and generates high uncertainty, especially in relation to international travel and the 2021 tourist season. Asynchronized vaccine rollouts and contagion curves might require governments to introduce restrictions on foreign travel (such as mandatory quarantine periods upon returning from certain countries), further impairing the normalization of tourism flows across borders. Such restrictions would pose downside risks to all three scenarios, which would materialize in a weaker third quarter and further deepen the uneven recovery across euro area member states.

An erratic path for euro area inflation

Euro-area consumer price inflation remained stable at 0.9% in February after jumping sharply in January (to an 11-month high) following five months of negative readings.[19] The principal drivers of the rebound in January were technical factors, such as the reversal of the summer German VAT tax cut and a largely underestimated contribution from delayed winter sales in France and Italy. We expect inflation to have a more erratic path in 2021 due to the mix of energy prices base effects, technical factors, and a new weighting scheme which should

FRANKLIN TEMPLETON FIXED INCOME: EURO-AREA GROWTH OUTLOOK

Exhibit 6: Real euro area GDP growth scenarios

As of March 31, 2021

		% Q/Q					% Q/Q					
	2019 (% Y/Y)	2020-Q1	2020-Q2	2020-Q3	2020-Q4	2020 (% Y/Y)	*2021-Q1*	*2021-Q2*	*2021-Q3*	*2021-Q4*	*2021(F) (% Y/Y)*	*2022(F) (% Y/Y)*
Baseline scenario	1.3%	–3.7%	–11.7%	12.4%	–0.6%	–6.8%	*-0.9%*	*1.2%*	*3.0%*	*1.3%*	*4.1%*	*3.9%*
Downside scenario							*-1.2%*	*0.6%*	*2.7%*	*1.1%*	*3.1%*	*3.3%*
Upside scenario							*-0.6%*	*2.5%*	*2.3%*	*1.5%*	*5.1%*	*4.5%*

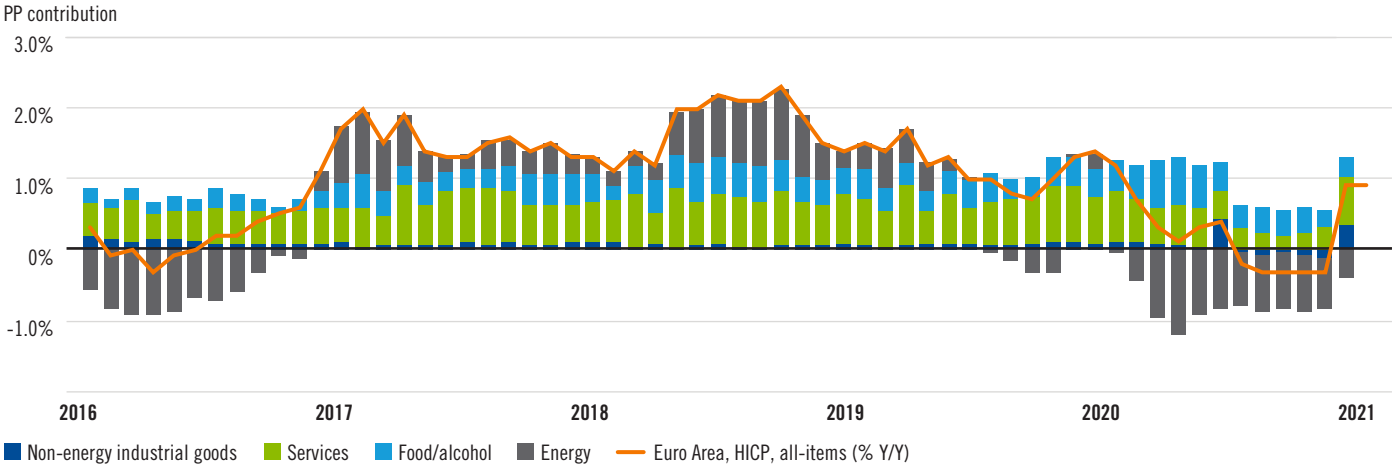
Italics indicates forecast.

Source: Franklin Templeton Fixed Income Research.

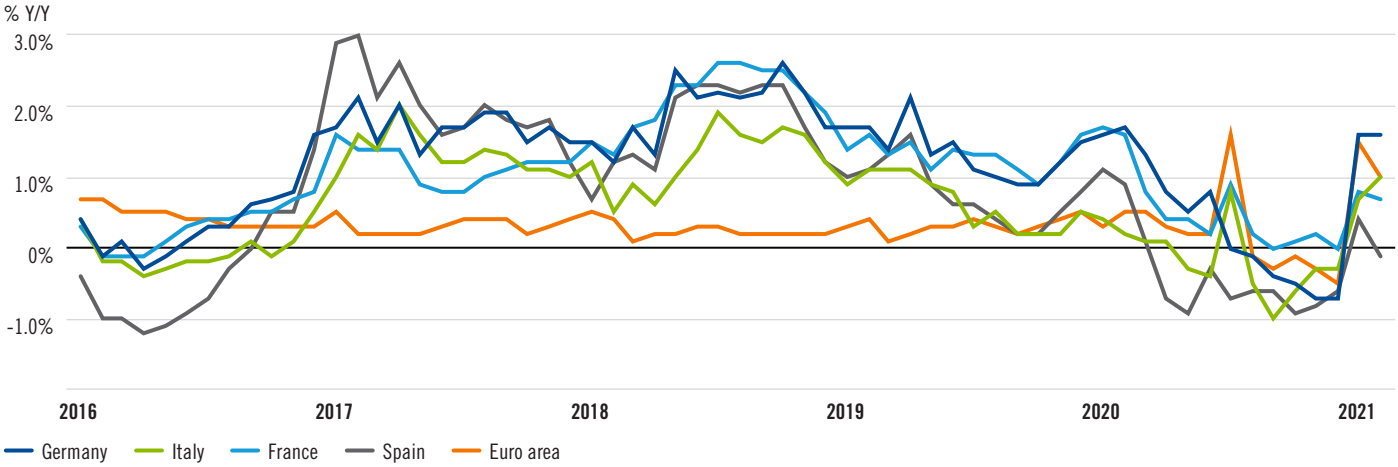
INFLATION HAS MOVED FROM A FLAT TO AN ERRATIC PATH

Exhibit 7: Inflation contributions

January 2018–February 2021



HICP—Harmonised Index of Consumer Prices



Sources: Franklin Templeton Fixed Income Research, Eurostat.

overweight volatile items such as food and underweight services such as transportation and leisure items.

The ECB has clearly indicated that monetary policy will look beyond supply-side shocks to inflation's path. The shift in focusing its reaction function to preserve accommodative financing conditions suggests that the ECB expects, as we do, that disinflationary demand forces from income losses and uncertainty will prevent core inflation from converging to target over the short to medium term. In the March press conference, the ECB left its monetary policy stance unchanged but promised to boost asset purchases under the Pandemic Emergency Purchase Programme over the next quarter in order to keep "favorable financing conditions," signaling a discomfort with rising yields. The step-up of asset purchases is welcomed and clarifies the ECB's intentions to support the recovery via a prolongation of active and "substantial" interventions in the bond market.

Nevertheless, the delay of the intervention amid signals of disagreement of governing council members over the reaction function leaves uncertainty over policy's decisiveness in the medium term, in our view. This flags the risk that, if European long-term yields should be dragged up further by a renewed updrift in US yields, the ECB's reaction might not be quick and decisive enough to prevent them from rising.

Sector settings

Overall Risk Outlook

Risk sentiment improved in dramatic fashion during the first quarter of 2021 as focus quickly shifted from concerns about the COVID-19 pandemic after a winter resurgence to the potential for a broad global economic recovery fueled by accelerating vaccine campaigns and staggering amounts of additional fiscal stimulus. In the United States, the rapid decline in coronavirus infections and the rapid pace of vaccinations has allowed a number of states to begin considering reopening their economies. Other countries around the world have also made important inroads against the virus, contributing to confidence that a global recovery will gradually take hold. Though progress is still uneven. Europe in particular still lags behind in its vaccination efforts, and several major EU countries have launched a new round of lockdowns (e.g., France, Germany, Italy) that will delay the recovery. The United Kingdom has moved fast on vaccinations but has nonetheless decided to maintain tight restrictions until the summer. Even in these cases, however, the expectation is that both infection rates and business activity will improve considerably in the second half of the year.

Against this background, reflation expectations have quickly gained ground. This has been especially the case in the United States, where an economy already primed for a rebound, with very strong household finances, is now benefiting from an unprecedented peacetime fiscal stimulus and a central bank that is committed to maintain monetary stimulus at record levels and allow the economy to run hot for a while before considering a course correction. Inflation concerns have now entered the mainstream debate, and while the consensus is still for a gradual and moderate increase in inflation, economists and investors have begun to contemplate the risk of a more significant rise in price pressures. These concerns have already driven up yields across global fixed income markets much faster than even our above-market consensus projections.

Meanwhile, the combination of a more positive global growth outlook and abundant liquidity from central banks that maintain their monetary policy settings at crisis levels has led to valuations that are becoming increasingly stretched across multiple spread sectors.

On balance, we retain a slightly optimistic outlook on risk assets given the potential for a further steepening of the yield curve, and continue to favor shorter duration fixed income assets with relatively less sensitivity to rising rates. While many asset classes have already priced in a strong and sustained recovery, over the next six to twelve months, we continue to find risk assets more attractive than risk-free assets.

The sector settings on the following pages reflect our six-to-twelve-month outlook on each asset class.

Sector	Outlook	Our viewpoint
US Treasuries		At the end of last year, 10-year US Treasury (UST) yields stood at 0.91% and the expectation implied by market pricing was for yields to reach a mere 1.12% by year-end 2021. As expectations rose for the passage of a third unprecedented stimulus package and vaccination campaigns accelerated and paved the way for a broad reopening of the economy, growth estimates were revised up sharply and strengthening reflation expectations led to a material repricing of yields. The 10-year UST note yield rose quickly and breached 1.75% by mid-March, the highest level since January 2020, before the full impact of the coronavirus pandemic on the global economy was realized. Despite increasing concerns regarding financial stability and a sharp rise in inflation expectations, a very accommodative US Federal Reserve (Fed) continues to signal that it will keep policy rates anchored at the effective lower bound and maintain its policy of extraordinary monetary support until the economy has fully recovered, jobs and wage gains have extended to disadvantaged categories, and inflation has been running in a sustained way above its 2% target. With the Fed allowing the economy to run hot to compensate for past periods of muted inflation, markets have been forced to revise their pricing for year-end and now expect 10-year yields to rise above 1.80%. We believe investors should be prepared to see year-end rates exceed even these revised projections, and despite the recent rise in long-term yields and the subsequent bear steepening of the yield curve, we remain cautious on the duration outlook and have downgraded our view on Treasuries to moderately bearish.
US Treasury Inflation-Protected Securities (TIPS)		Since the beginning of the year, we have seen break-even (BE) inflation rates increase rapidly in the US Treasury Inflation-Protected Securities (TIPS) market, especially those in the intermediate portion of the yield curve, taking five-year BE rates to the highest level since 2008. It is our belief that the combination of unprecedented fiscal stimulus, a very accommodative Fed, and an economy poised to rebound as vaccination campaigns pave the way for reopening businesses may have a more sustained impact on inflation dynamics. Supply-side disruptions and the global recovery have already pushed up commodity prices, from oil to copper to steel, as well as a variety of other input prices, from semiconductors and electronic components to corrugated boxes. The Fed has repeatedly stated it will maintain the current course of very accommodative monetary policy until it determines that the economy has moved back to full employment and that inflation has settled above their 2% inflation target in a durable manner. Although we still see substantial slack in the labor market, the unemployment rate has already dropped quite quickly, and job openings remain high (at around 2017–2018 levels). We have already seen consumers' estimates of future inflation rise substantially, partly due to higher gasoline prices and grocery costs. In our view, central bankers might be underestimating how difficult it will be to deal with increased levels of inflation, especially if inflation expectations become unmoored, and we therefore maintain a modestly positive view of the asset class. Despite the significant increase in inflation expectations and BE rates, BE rates may continue to rise over the next year, and we remain neutral with reasons for optimism on the sector. We continue to pay close attention to duration exposure, as TIPS have the dual consideration of BE rates and duration changes which may affect performance.

Sector	Outlook	Our viewpoint
Eurozone Government Bonds		European bond markets fell sharply to start 2021 as investors became more concerned about the potentially inflationary effects of a strong worldwide economic recovery and renewed interest in the reflation trade led to yields and real interest rates rising across the region. Against this backdrop, benchmark 10-year German Bund and French OAT yields rose considerably to levels not seen since last June. With the notable rise in long-term yields threatening to thwart any recovery from the region's double-dip recession, the European Central Bank (ECB) indicated concerns about the risk of tighter financing conditions and ramped up its emergency bond purchases. In this type of environment, we believe the ECB will remain highly accommodative and will continue its asset purchasing programme, which has flooded the market with liquidity. Nonetheless, we believe it will be some time before Europe returns to pre-pandemic levels of economic activity and, as a result, do not forecast interest rates rising in the eurozone for at least five years. For comparison purposes, Europe took over a decade to revert to pre-crisis output levels after the global financial crisis (GFC). Renewed restrictions in much of the euro area following a spike in new COVID-19 cases, which are likely to be extended into the summer, and a problematic rollout of vaccine campaigns are further delaying an economic rebound. Fiscal policy in the region is likely to provide sustained support to economic growth and allow countries to maintain more expansionary policy measures. Political developments also bode well for stability in the euro area, in particular the formation of a new government in Italy under former ECB Chair Mario Draghi that is pushing for reforms at both the European and Italian levels. We believe there will be more centralization of control, which will help Europe become much more investible for the global audience and allow for additional large EU issuance of pan-European debt. In addition, we believe the chances of durable inflation in the eurozone remains very low. Overall, we are constructive on European bond markets and continue to favor a longer duration profile and see new potential opportunities within the market based on mispricing of rate-hike expectations. While benchmark European government bonds will likely offer limited return potential, we continue to believe there are other pockets of opportunity in the periphery which should continue to be well-supported.
Japanese Government Bonds		Growth in Japan is projected to contract in the first quarter of 2021, after rebounding strongly during the second half of 2020, due to January's state of emergency declaration which depressed economic activity and consumer spending. Despite the slowdown, the 10-year Japanese government bond (JGB) yield rose to 0.16% in February, the highest level since October 2018, in alignment with sovereign bond yields worldwide on expectations of a broad global economic recovery. The Bank of Japan (BoJ) left interest rates unchanged during its March meeting and maintained the target for the 10-year JGB at around 0%, as widely expected, but introduced yield-curve control flexibility by widening the tolerable band for fluctuations in 10-year JGB yields to around ± 25 basis points (bps) from the target level (from ± 20 bps since July 2018 and ± 10 bps when first introduced in September 2016). The central bank also introduced "fixed-rate purchase operations for consecutive days" which will allow it to purchase unlimited amounts of JGBs to cap increases in yields and noted no intention to seek to steepen the yield curve. The BoJ also reemphasized its commitment to support the economy with additional stimulus if needed by introducing a new "Interest Scheme to Promote Lending," which would offer lending incentives that would increase if policy rates were cut, signaling to the market that it would ease monetary policy if required despite already being deep in negative territory. As inflation has remained negative in recent

Sector	Outlook	Our viewpoint
Japanese Government Bonds *continued*		months despite significant and sustained fiscal and monetary stimulus since last April, we do not expect interest rate hikes for the next several years. Given this backdrop and the upward pressure on yields in other government bond markets, JGBs have become relatively more attractive as the BoJ continues to anchor long-term yields close to its target and we maintain a neutral view.
Agency Mortgage-Backed Securities (MBS)		The relatively low level of yields at the start of the year left approximately 80% of the mortgage universe 50 bps "in-the- money" to refinance their mortgage loans. After the selloff in rates, the percentage of borrowers with an incentive to refinance has declined substantially, to approximately 60% of the agency MBS universe, which is supportive of the sector.[20] However, despite mortgage rates reverting to their nine-month highs, refinance applications have remained stubbornly high, and we believe prepayments should remain elevated over the next three to six months. The Fed continues to purchase US$40 billion/month of agency MBS, now owning approximately 30% of the overall agency market, which we expect to continue through the rest of the year at a reduced pace as prepayments decrease. As prepayments begin to slow down in the medium term, we expect the runoff from the Federal Reserve's portfolio to reduce, which could lead to widening of spreads from their current tight levels. Also, as the economy normalizes, talk related to tapering of quantitative easing purchases could lead to further widening of spreads. The involvement of the Fed in the market should keep spreads somewhat range-bound, though, as well as benefit the lower coupons and their associated mortgage dollar rolls with positive carry. Given the prepayment risks in the near term, combined with spreads tighter than their 10-year averages, we believe that spreads need to be wider than their current levels to compensate for the risks in the asset class. We continue to prefer 30-year securities over 15-year securities, generally favor conventional 30-year and conventional 15-year securities prepayment characteristics over Ginnie Mae (GNMA) 30-year securities and are biased slightly up in coupon with an overweight in the 2.5% and 4.5% coupons given the recent selloff in rates.
Non-Agency Residential Mortgage-Backed Securities (RMBS)		Fundamentally, housing remains strong and housing activity firm. In February, on a year-over-year (Y/Y) basis, existing home sales decreased 6.6%, new home sales increased 8.2% Y/Y and mortgage applications increased 9.8%. The Federal Housing Finance Agency (FHFA) Purchase-Only and S&P CoreLogic Case-Shiller Home Price national indices (both seasonally adjusted) gained 11.4% and 10.4% for the calendar year 2020.[21] Based on our home price appreciation (HPA) model, we now forecast HPA of 4.3% through December 2021. In comparison to the GFC, even if the 2.7 million properties that are currently under forbearance were to enter the inventory of existing homes as foreclosed properties, the net supply would be about half of what was experienced at peak supply during 2007–2008, when home prices depreciated by 30%. The significant move in rates may eventually impact housing affordability and could negatively impact HPA, as well as translate into slower prepayment speeds which can slow structure deleveraging. Both factors are modestly credit negative. Overall spreads in various RMBS sectors have largely recovered from their March 2020 wides, but early fixed severity deals which do not contain natural disaster language have continued to lag. We favor RMBS holdings with significant locked-in home equity, where slower prepays due to lock out and higher rates should allay negative convexity concerns and boost returns for premium priced securities. Despite headwinds in the market, we still expect select non-agency RMBS to provide consistent risk-adjusted returns and are neutral on the sector.

Sector	Outlook	Our viewpoint
Commercial Mortgage-Backed Securities (CMBS)		Fundamentals in the commercial real estate (CRE) sector continue to be challenged. Net operating income (NOI) growth turned negative in the fourth quarter (4Q) 2020, the first time 4Q NOI growth has been negative since 2010.[22] Vacancies were also elevated in the hotel, retail and office sectors, and demand remains tepid. Stricter implementation of lockdowns from potential virus variants, a lack of direct support to CRE sponsors and a decline in non-discretionary spending may continue to impact certain property types, such as retail and hotels. Approximately $2.3 trillion of CRE mortgage loans will mature over the next five years and any dislocation in valuations or worsening fundamentals could result in higher delinquencies. CMBS conduit delinquencies (30+ days), at 7%, already are reaching elevated levels. However, appraisal-based property prices have increased in 2020 due to low transaction volume, with stronger performing sectors like industrial and multifamily rebounding close to pre-crisis levels.[23] A record amount of investors targeting attractive CRE investment may also potentially act as a backstop for valuations. Looking forward, we believe certain geographies which are characterized by lower taxes, enjoy higher than average population growth and are attractive destinations for tech companies will see higher growth in commercial property prices. From a sectoral standpoint, industrial, multifamily and Class A office are likely to outperform other property types. Valuations in the CMBS market have moved in a direction largely looking through any of the current and future issues ailing the sector, with AAA last cashflow (LCF) spreads over swaps reaching their post-GFC tights. Given current valuations, we do not favor below-AAA exposure, and in AAA LCFs we prefer deals with lower exposure to hotel and retail sectors. Overall, we continue to believe downside risks outweigh upside potential at these levels and maintain a bearish outlook on CMBS.
Asset-Backed Securities (ABS)		The ABS market remains relatively insulated from rate moves as the bulk of ABS paper is concentrated in the very short end of the yield curve and spreads remain at recent record tight levels, consistent with broader credit markets. Total household debt increased by US$206 billion (up 1.4% quarter over quarter (Q/Q) and up 4.4% year over (Y/Y) in the fourth quarter, driven by growth in mortgage debt. On a Y/Y basis, non-housing balances were down 0.7%, driven by an 11.7% decline in credit card debt, partly offset by increases in auto and student loan balances (up 3.2% and 3.1%, respectively).[24] Additional stimulus will be a definitive positive for consumer performance for 2021. While secondary spreads for a variety of ABS sectors are trading near or at multi-year tight levels, we expect these sectors to have relatively stable spreads and continue to believe sectors trading wider than pre-crisis levels could experience spread tightening as the economy rebounds. Although likely with additional volatility, travel-related sectors such as aircraft and containers stand to be the main beneficiaries. With the credit curve relatively flat we continue to prefer up in the capital structure and avoidance of floating rate deals without clear LIBOR fallback language. While fundamentals have shown signs of deterioration in below-prime borrowers, this has yet to have a material impact on bond cash flows, and ABS continues to offer incremental yield pickup over Treasuries. We remain neutral on consumer ABS overall and favor three-year and in AAA fixed rate benchmark issuers.

Sector	Outlook	Our viewpoint
US Investment-Grade (IG) Corporates		US IG corporate bonds continue to benefit from strong demand as investors look to the asset class as a relatively safe source of yield. Corporate fundamentals have broadly stabilized or improved since the depths of the COVID-19 downturn, although recovery in some sectors remains slow. Corporate leverage remains at elevated levels, but earnings growth should enable a rebound in credit metrics across most of the IG credit universe over the coming quarters. However, we are closely monitoring how issuers choose to deploy excess liquidity and whether they utilize free cash flow to repair their balance sheets. Credit spreads have rallied significantly and are at or below their pre-crisis levels, and are approaching the lowest levels since the 2008–2009 global financial crisis, reflecting a very supportive economic and risk outlook for the remainder of 2021. We expect demand to remain generally strong, with yield-oriented investors increasing allocations as yields rise and foreign investment to continue given the prevalence of low or negative yields in many regions. However, we would expect some caution due to possible further total return losses stemming from rising longer-term UST rates. We believe that the medium-term risk environment remains generally positive, helped by strong growth prospects, supportive fiscal and monetary policy, and a visible path toward containment of COVID-19 cases as we go through 2021. There remains some uncertainty about the US political climate and potential US regulatory and tax policy changes that may impact corporate borrowers. While we have a constructive medium-term view, we believe the market has embraced a best-case recovery scenario; spreads have already discounted most positive economic developments and are now fairly valued at best. Our base case calls for flattish spreads over the remainder of the coming year, with arguably more downside than upside risk, especially in the case of a disorderly move higher in rates or a faster than anticipated tapering of Fed policy. We are neutral on the sector given tighter valuations, but remain generally comfortable with fundamentals and market technicals. We favor select intermediate bonds, including BBB rated issuers, while taking advantage of new issues or any market dislocations to add exposure.
European Investment-Grade (IG) Corporates		European IG corporate fundamentals should improve after deteriorating since the last quarter of 2020 due to renewed lockdowns in European countries, as sales and earnings bounce back. While the outlook from management teams has been rather encouraging, they remain cautious for the time being. It will take time to see the positive impact of the vaccine rollout on the economic recovery, and we expect companies will remain conservative in keeping excess cash available on the balance sheet and focusing on deleveraging by further cutting costs to protect margins and/or selling assets. Merger & acquisition activity and shareholder distributions could increase, though, jeopardizing credit metrics. European fiscal authorities have extended their supportive measures, such as furlough schemes and state guarantees, until the end of the third quarter and the ECB's Pandemic Emergency Purchase Programme (PEPP) remains in place until March 2022. The ECB's sponsorship was strong in 2020, purchasing large amounts of Euro IG corporate bonds through the PEPP and the Corporate Sector Purchase Programme (CSPP), which supported spreads. However, recent ECB purchases have declined, implying a lack of interest for the euro IG market. The most significant threat to spreads would be a taper or a halt of the ECB's corporate bond purchases, but we feel this is unlikely in the foreseeable future. If spreads were to widen abruptly, we expect the ECB to support the market by increasing its purchases. Low yields have been an issue for the euro IG asset class, mostly due to a large part of

Sector	Outlook	Our viewpoint
European Investment-Grade (IG) Corporates *continued*		the market trading at negative yields. We view higher rates as healthy, making euro IG more attractive, in particular short and intermediate maturities. However, if rates volatility rises, spreads will widen, which should represent a buying opportunity for investors looking for quality yield when rates stabilize. We remain neutral on the sector with reasons for optimism, based on improving fundamentals and still supportive technicals. We continue to favor non-financials over financials, due to improving fundamentals and large cash positions on the balance sheet. In our view, ECB eligible credits will supply some risk-off protection, as these securities should outperform in volatile market conditions.
US High-Yield (HY) Corporates		Given an improving macroeconomic outlook from accelerating vaccine distribution and the passage of an additional large-scale fiscal stimulus package, we believe US HY corporate bonds stand to benefit and remain constructive on the asset class. Credit fundamentals should start improving meaningfully by the second quarter of 2021 as the precipitous lockdown-related drops of the corresponding year-ago quarter are cycled and fiscal stimulus kicks in while life starts to normalize as vaccination rates climb substantially. Default rates should continue to fall from an October peak in excess of 6% toward 2% during the second half of 2021, where they are likely to stay through at least 2022 as wide-open capital markets have allowed many troubled issuers to build up liquidity buffers and push out maturities. While increases in US Treasury (UST) yields could lead to bouts of volatility, we believe there is room for further spread compression to absorb a relatively orderly rise in rates given that spreads remain materially wide of historical and post-GFC tights across ratings tiers. History has shown that spreads can remain at lows for extended periods of time, and we believe current conditions are conducive to such an outcome. Having said that, we believe credit selection will be more important than ever in 2021 given that the flood of money into the asset class over the past year has led to some mispricing of risk at the issuer level.
Euro High-Yield (EHY) Corporates		Despite negative developments regarding the COVID-19 pandemic and increasing concerns about rising global interest rates, EHY corporate spreads have continued to tighten in the first quarter of 2021. Although a quick rise in the long-term interest rates may cause some sector reallocation, we ultimately believe such volatility could be beneficial for dedicated EHY investors as the more speculative buyers exit the market and we would therefore use volatility as a buying opportunity to increase exposure. While the vaccine campaign has helped keep market volatility somewhat muted, EHY spreads continue to benefit from an everlasting technical bid for euro-denominated higher- yielding assets. Although not as high as forecasted in April/May of last year (>8% default expectations), EHY default rates have increased to a 10-year high at year-end 2020.[25] Going forward, we expect the number of defaults to decline during the next 12 months but, equally, we expect recoveries to come down due to a lower level of support from shareholders, banks and governments. In the context of historically low spreads and yields, we believe a cautious stance is due and retain our neutral recommendation on the sector. From a tail-risk standpoint, we believe the major risk will continue to be the containment of COVID-19 rather than increasing global bond yields. While companies and consumers have learnt how to deal with current mobility restrictions, high leverage multiples, increasing operating expenses and lower government and shareholder support will test the capital structure of the weakest issuers if growth comes below expectations. We remain cautious with regard to directly exposed COVID-19 sectors,

Sector	Outlook	Our viewpoint
Euro High-Yield (EHY) Corporates *continued*		as Europe continues to lag in its vaccination rollout, and we believe current credit spreads discount a rather optimistic scenario with regard to the recovery. In our view, the manufacturing sector that, for large part, has thrived during the pandemic may experience challenges, including margin pressure, over the next year caused by increasing supply chain disruptions, lack of shipping space to Asia, and higher commodity prices. We favor callable bonds offering a positive yield, select BB exposure to longer duration bonds following recent underperformance, and remain neutral on GBP-denominated high yield securities.
Floating Rate Loans		Since the beginning of 2021, floating-rate bank loans have continued to build on the positive momentum they saw toward the end of last year. Spreads have been tightening and we believe the asset class is in the early stages of a rates-driven technical recovery and share fundamental tailwinds with other credit sectors. After suffering from heavy outflows in 2020, investor interest in the sector has rapidly improved starting in December in response to rising US Treasury (UST) yields and increasing concerns regarding the potential for inflation. We expect robust inflows into the loan market as capital activity has historically been strongly correlated with upward moves in 10-year UST yields. Demand from collateralized loan obligations (CLOs) has also bolstered support for loan prices, as new CLO volume has exceeded the pace from last year. Fundamentals have been slowly but steadily recovering from the unprecedented declines in revenue and cash flow that followed the Q2 2020 shutdowns, albeit still not to pre-COVID-19 levels in most cases. We expect these improving trends to continue through the remainder of 2021. Despite sequential improvement in EBITDA, leverage has continued to increase in many sub-sectors, but going forward we expect an inflection in leverage starting in first quarter 2021 as companies face easier year-prior comparables. The floating-rate bank loan market showed more resiliency than many expected, with defaults peaking at 4.5% by par amount in November despite the global economic shutdown before ending January 2021 at 4.1%, providing increased comfort to investors in the asset class.[26] We expect defaults to continue to decline on improving fundamentals and technicals, and gradual improvement in corporate fundamentals will allow issuers to service debt and maintain adequate liquidity as well as help issuers to extend maturities and/or raise incremental capital to extend liquidity runways. With this favorable technical and fundamental backdrop, we expect continued spread tightening and are finding opportunities to add exposure to attractive credits and industries that are better positioned to benefit from the broader economic recovery. We have upgraded our outlook to moderately bullish but stress that current market conditions in no way suggest an indiscriminate buying of the broader loan index; security selection remains of paramount importance with a focus on capital structures, liquidity profiles, upcoming maturities and the sustainability of business models in a post-COVID-19 world. We favor B-rated loans and selectively adding exposure to COVID-19-impacted sectors that have lagged the broader recovery but are expected to accelerate as the economic rebound progresses.

Sector	Outlook	Our viewpoint
Collateralized Loan Obligations (CLOs)		Collateralized loan obligations (CLOs) lagged the initial recovery in other credit sectors post-crisis but have had strong performance through the end of last year and into 2021. Primary market activity has been robust in both the US and Europe with structures having reverted to the longer reinvestment periods typical pre-crisis and new issue spreads nearing all-time tights in both markets. Secondary spreads for all investment-grade tranches have also fully recovered to their pre-crisis levels as well, although they remain above the all-time tights reached in first quarter of 2018. With the significant improvement in market sentiment, CLO assets continue to trade up along with the broader move in the loan market and the amount of distressed and lower priced loans is now lower than it was pre-crisis. With upgrades exceeding downgrades, we anticipate this improvement will continue to flow through to ratings-driven metrics, which have been somewhat slower to improve and tend to lag in an improving economy. This strong performance has brought a level of comfort back to AAA investors, and demand has been strong, outstripping supply, pushing new issue AAA spreads tighter. We remain constructive on the CLO sector and favor those at the top of the ratings stack (AAA/AA/A/BBB), which remain attractive given the expected increase in rates and its relative value versus other high-quality alternatives. However, with spreads not far off their all-time tights, the likelihood for further spread compression is diminished, particularly in the United States. In the new issue market, we favor CLOs with longer non-call periods, which have more potential to trade above par as spreads tighten. In the secondary market, while difficult to source, we have a preference for CLOs trading at a discount and would look to add on weakness in the market.
Emerging Market (EM) Debt		After EM debt posted one of the strongest quarters in recent times in the fourth quarter of 2020 on the back of positive vaccine news and a decisive US presidential election, in the first two months of 2021, hard-currency EM debt has recorded its worst start to the year in over twenty years on a total return basis. Local-currency EM debt performed similarly but has experienced far worse starts in the past. This weakness is, however, almost entirely due to the significant upward move in USTs since the beginning of the year and the asset class's high sensitivity to core rates. EM debt has seen only modest spread widening accompanying the rise in benchmark rates, but the latter has raised concerns of a possible repeat of the 2013 "Taper Tantrum." But, in contrast to 2013, the largest issuers' external positions now are healthier and the pandemic has, in many cases, led to stronger current account balances. Government finances have mostly weakened, but the largest increases in government debt have occurred in countries that can rely on their local markets for funding, such as Brazil and South Africa. Countries with the most concerning government debt statistics tend to be small, and risk for further contagion is therefore limited. Throughout 2020, EM debt fundamentals weakened as a consequence of the COVID-19 crisis. However, given the stronger economic outlook for the global economy and the reflationary benefits this will bring in terms of balance sheet repair for most EM countries, we retain our positive outlook for the asset class and are moderately bullish. For those countries that are unable to adjust quickly enough to the changing landscape, we continue to expect strong multilateral support but are wary of the potential for programs such as the G20 Common Framework to create frictions for bondholders. We continue to believe that borrowing across EM sovereigns will be orderly and self-regulating, having passed the 2020 stress test in funding. Strong technical conditions for the asset class in 2020 came from the inflow of funds from investors seeking to enhance yields versus low or negative home market interest rates.

Sector	Outlook	Our viewpoint
Emerging Market (EM) Debt *continued*		As developed market government yields rise, perhaps the greatest risk to the EM sector is that the marginal investor will no longer need to utilize EM debt to meet yield requirements and will therefore divert funds from the sector. For now, we are still comfortable that developed market interest rates will remain at levels where EM assets continue to be relatively more attractive.
Emerging Market (EM) Corporates		The COVID-19 crisis has once again demonstrated the relative resilience of EM corporate debt. Last year, the EM corporate high-yield default rate peaked well below the US default rate, and recoveries were substantially higher. We believe that this is best explained by a combination of EM corporate sector mix, sovereign support and a healthier starting point in terms of credit fundamentals. Having deteriorated in the first half of 2020, EM corporate credit fundamentals rebounded in the second half of the year, reflecting stronger EBITDA and cash generation against a backdrop of appreciating commodity prices and improving global aggregate demand. Net leverage ticked up over the year but remains manageable at around 2.0×, and well below the United States on a rating-adjusted basis. This trend of improving fundamentals gives us confidence that the EM corporate high yield default rate will moderate from the year-end 2020 level of 5.0% toward 3.0%.[27] The primary market was busy for the majority of last year—in contrast to the EM sovereign world—and we expect this to remain the case in 2021 as corporates look to refinance existing debt and term out their maturity profiles. The demand for new issuance in external markets has been insatiable, with issuers able to attract large order books for bonds that price on the cusp of fair value. The key risks that we see for EM corporate bonds going forward are situated at the macro and geopolitical level. Capital outflows similar to the "Taper Tantrum" of 2013 pose a risk, but with short-end rates anchored, ample liquidity assured and EM current account balances in surplus, we do not expect material outflows from the asset class. Indeed, global liquidity conditions continue to encourage a hunt for yield that will benefit those fixed income assets that offer an attractive spread pick up for their risk. While the sharp steepening of the UST yield curve has been a drag on performance in 2021, this has been largely offset by a further tightening of spreads which has left the yield to worst of the index only modestly above its five-year low. However, EM corporates continue to look appealing from a relative value basis as the spread pick up over US corporates is visible in each ratings bucket, and in the higher quality end of the spectrum this spread pick up comes with a substantially lower duration, which helps to reduce volatility. We retain a positive view on EM corporates as an asset class whose short duration and spread cushion makes it well-placed to absorb the current bout of UST volatility and ultimately post a positive return over the next 12 months, and we remain moderately bullish.
Municipal Bonds		The municipal (muni) bond market kicked off 2021 with a very similar tone to 2020. Feverish technical conditions pushed investment-grade (IG) yields to their generational lows and inflows in the first quarter of 2021 were four times higher than historical norms. Ratios of muni bond versus UST yields set record lows with the 10-year AAA ratio reaching 54% and the 30-year AAA ratio hitting 68% during February 2021 after averaging 97% and 105%, respectively, over the past 10 years. However, as UST yields moved higher funds flows turned negative, putting some selling pressure on the market and leading to modestly higher ratios. Despite the recent correction of the muni market, we believe the supply/demand technical support for the market, with limited supply of tax-exempt bonds,

Sector	Outlook	Our viewpoint
Municipal Bonds *continued*		will be the primary directional force in the municipal market and will support valuations for the foreseeable future. Increasing household wealth, strong credit quality, state and federal tax advantages and lower historical volatility will continue to attract investors and keep demand elevated. Fundamentals have also improved during 2021. Projected deficits for many muni issuers have been lower than initially projected as strong consumer spending improved tax receipts. Additionally, the American Rescue Plan passed in March contained US$350 billion to support state and local governments. However, for the first time in six years municipal bond rating downgrades exceeded upgrades with five times the dollar amount downgraded vs. upgraded. While it is reasonable to expect the downgrade/upgrade balance to remain biased toward the downside, we do not expect any meaningful changes to bankruptcies in 2021 given the pre-crisis strength of most issuers, the speed of budget recovery in 2020 and favorable federal policies. We remain neutral with optimism for the tax-exempt market and believe it still has value for investors that can take advantage of the tax-exemption. The taxable muni bond sector has followed a somewhat similar path with strong demand and low supply, but unlike tax-exempt muni bonds, have much higher sensitivity to interest rate movements and have seen a contraction of taxable muni spreads with the recent rise in UST yields. We continue to believe taxable muni bonds offer value to investors seeking high income and a strong credit profile while simultaneously participating in mild spread tightening. Our approach to muni-bond credit remains cautious and we are biased toward the upper end of the high-grade municipal bond universe but see selective spread opportunities in the lower high-grade market.

Endnotes

1. The phrase, taper tantrum, describes the 2013 surge in U.S. Treasury yields, resulting from the Federal Reserve's (Fed) announcement of future tapering of its policy of quantitative easing. The Fed announced that it would be reducing the pace of its purchases of Treasury bonds, to reduce the amount of money it was feeding into the economy. The ensuing rise in bond yields in reaction to the announcement was referred to as a taper tantrum in financial media.
2. Sources: Franklin Templeton Fixed Income Research, Bureau of Economic Analysis.
3. Source: Federal Reserve. 2-year/10-year spread references the difference between the 10-year Treasury Constant Maturity and 2-year Treasury Constant Maturity yield.
4. Source: Our World in Data (CC BY 4.0).
5. Sources: Franklin Templeton Fixed Income Research, US Census Bureau.
6. Sources: Franklin Templeton Fixed Income Research, University of Michigan.
7. Sources: Franklin Templeton Fixed Income Research, American Automobile Association, US Bureau of Labor Statistics.
8. Sources: Franklin Templeton Fixed Income Research, Federal Reserve.
9. Sources: Franklin Templeton Fixed Income Research, US Bureau of Labor Statistics.
10. Sources: Franklin Templeton Fixed Income Research, Institute of Supply Management.
11. Sources: Franklin Templeton Fixed Income Research, BLS.
12. Sources: Franklin Templeton Fixed Income Research, Commodity Research Bureau, ICE. As of March 30, 2021.
13. Sources: Franklin Templeton Fixed Income Research, Institute of Supply Management.
14. Sources: Franklin Templeton Fixed Income Research, Eurostat.
15. Sources: Franklin Templeton Fixed Income Research, Markit, Bloomberg.
16. Sources: Franklin Templeton Fixed Income Research, World Health Organization.
17. Source: Our World in Data (CC BY 4.0).
18. Source: Our World in Data (CC BY 4.0).
19. Sources: Franklin Templeton Fixed Income Research, Eurostat.
20. Sources: Franklin Templeton Fixed Income Research, Fannie Mae, Freddie Mac, eMBS.
21. Sources: National Association of REALTORS, US Census Bureau and US Department of Housing and Urban Development, New Residential Sales, The Mortgage Bankers Association (MBA), Federal Housing Finance Agency FHFA House Price Index for Census Divisions and US., S&P Dow Jones Indices.
22. Source: Morgan Stanley.
23. Source: JP Morgan.
24. Sources: Franklin Templeton Fixed Income Research, Federal Reserve Bank of New York.
25. Source: Standard & Poor's.
26. Source: Credit Suisse.
27. Sources: Franklin Templeton Fixed Income, JP Morgan, Bank of America.

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Notes

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