December 2022

Franklin Templeton Fixed Income

Fixed Income Views

Volume 13—The markets vs. the Fed

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The macroeconomic environment has entered an uncertain and volatile turning point. We see increasing signs of weakness in economic growth, as activity begins to suffer the impact of tighter monetary policies, past adverse shocks to energy and supply chains, and high inflation, which has caused the erosion of purchasing power. The turnaround in the growth cycle is slow and gradual, however.

We expect the eurozone will enter a recession sooner than the United States, most likely already by the end of 2022, as Europe has suffered a harder blow from the energy crisis. Having said this, we see a number of factors that should help cushion the downturn. A milder start of the winter has allowed European countries to build up their reserves of natural gas, so that reducing their dependence on Russian gas for this season has proved less painful than expected. At the same time, European governments are deploying substantial fiscal help for both households and corporates. Finally, the labor market remains very tight.

The US economy also benefits from a still very tight labor market, which supports strong wage growth. Higher mortgage rates have hit the housing market, and consumers are reducing savings. But the substantial cushion of fiscal help received during the pandemic combined with strong pent-up desire for services and experiences continues to underpin consumption. We therefore forecast only a moderate recession in the second half of 2023.

Headline US inflation has peaked and has begun to decline as the energy price shock begins to fade and global supply shocks have started to normalize. This has rekindled market hopes that the Federal Reserve (Fed) might soon switch to a less restrictive stance—after the Consumer Price Index (CPI) prints for October and November, financial markets have scaled back their expectations for the terminal rate.

Core inflation measures, however, remain well in excess of 5%, and the same holds for measures of wage growth. We continue to expect that US headline CPI will end 2022 at about 6.5%, and that inflation pressures will remain elevated well into 2023. Bringing inflation below 5% and closer to the 2% target will require meaningful additional monetary tightening, in our view.

The Fed continues to face a difficult challenge. The recent market rallies caused a significant easing in financial conditions, which at the time of writing are no tighter than last June. The rally seems to have been encouraged also by some dovish remarks that Fed Chair Jerome Powell made at a Brookings conference at the end of November, and investors subsequently shrugged off Powell's much more hawkish tone in the December monetary policy press conference.

Financial markets continue to try to forecast the Fed rather than macro fundamentals; this makes the Fed's communication job very difficult and greatly increases volatility in asset prices. Given the high degree of uncertainty in the macro environment, we believe investors need to brace for this kind of volatility to persist into 2023.

Despite the high volatility—unprecedented in a highly liquid market like US Treasuries (USTs)—and the challenging macro environment with elevated inflation and a looming recession, we are quite constructive on the fixed income outlook. Higher interest rates imply that fixed income can now finally deliver income again, with attractive risk-return profiles in some segments of the asset class, particularly on short duration. We feel that a selective, research- and fundamentals-based approach can allow us to identify interesting opportunities. We believe benchmark yields have more room to rise, as we expect fed funds to peak in a 5.00%–5.50% range, but as they near this peak, and technical conditions stabilize, more investment opportunities will arise.

We are cautious on USTs, because markets seem to be pricing in what would be a significant reversal of rate hikes already in 2023, which we do not see as plausible. Opportunities should appear sooner on eurozone government bonds, as valuations appear attractive and European Central Bank (ECB) hawkishness should peak soon.

Overall, we think that as we enter 2023 volatility will remain the most formidable challenge for fixed income investors, as markets will keep second-guessing the Fed against a background of mixed activity and inflation data. The fixed income universe already presents some very attractive investment opportunities, and more will emerge in the coming months. However, given the volatility and the challenging and uncertain macro environment, an active approach to security selection is at the moment indispensable, in our view.

The slowdown in economic growth that we forecast should place more pressure on corporates and cause credit spreads to widen further from current levels. Consequently, we still prefer to move up in quality on US investment-grade (IG) issuers; we are also cautious on US high-yield (HY) issuers, although here, we see very interesting longer-term prospects given already attractive yields and favorable technical conditions. We are more bullish on European IG corporates, given strong fundamentals, with a bias to higher-quality credits; and on European HY corporates, given the attractive carry.

Other sectors that have been strongly challenged in 2022—like municipal bonds, emerging market (EM) sovereign debt and EM corporates—will present attractive opportunities as the monetary tightening cycle matures.

Summary

Macroeconomic themes

Headline growth is masking underlying economic weakness

Despite upside surprises in recent growth prints in both the United States and euro area, the underlying trends point to further deceleration ahead. We forecast mild recessions in both regions, with the euro area likely to contract by year end 2022 and the United States in the second half of 2023. However, the extraordinarily tight labor market and continued consumer strength in the United States and anti-cyclical government spending in the eurozone should provide some cushion for the slowdown and prevent a major economic downturn.

The battle for price stability is far from over

Both headline and core inflation will remain stubbornly high well into 2023, and central banks will need to feel confident prices are coming down to target in a sustained manner before moving off their stated policy path. We forecast inflationary pressures to remain elevated for longer than the market is anticipating and a prolonged period of tighter financial conditions. The greater risk is not tightening too much, but loosening too early and too quickly. Central banks will need to delicately calibrate between the risk of falling short of their mandates for an extended period of time and allowing inflation expectations to become entrenched and staying in restrictive territory for long enough to cause a more significant recession.

Strap in—more volatility ahead

Market volatility has been largely sentiment driven and not based on fundamentals, and will continue until markets absorb the message being explicitly stated by the Fed. The market has been trying to predict the central bank reaction function and test its resolve, not understanding that there has been a major paradigm shift—policymakers can no longer prioritize support to asset prices over bringing inflation back down to target. We believe yields have not yet peaked, particularly after recent rallies, based on the belief we will see a policy pivot. And we should expect to see continued elevated volatility in markets in the year ahead.

Portfolio themes

Stay in high-quality, liquid assets

We continue to believe high-quality, shorter-duration assets will outperform and provide greater protection from potential fundamental weakness and market sentiment-driven volatility. At the shorter end of duration on most fixed income instruments, investors are now being paid handsomely to hold more liquid segments, and higher-quality assets should remain more resilient in the face of a challenging macroeconomic environment and economic slowdown. We anticipate the coming year will have significant bifurcation, with higher quality asset classes and issuers being favored over weaker ones, which will continue to face increasing difficulties.

Be cautious on duration, but opportunities will arise

While risk assets repriced in the second half of the year, after the recent market rally we continue to believe limiting duration continues to be prudent to protect against rising yields, which are still below their ultimate peaks. It may still not be the point to go all in on large quantities of duration, but as yield levels become increasingly attractive and we near the end of the hiking cycle, opportunities will arise. It may be a matter of quarters, or maybe months, where these opportunities will present themselves. Still healthy fundamentals should also provide a tailwind for select opportunities as technical conditions stabilize.

Keep powder dry as prospects for fixed income have improved

While we anticipate volatility will persist into 2023 and risk assets have the potential for further downside given our view spreads still do not fully reflect an economic slowdown or contraction, we are more positive on the prospects for fixed income investments than we have been in some time. The level of yields now being generated have become more attractive, and fixed income assets should once again provide defensive characteristics in an economic slowdown as the pace and magnitude of rate hikes subside. We would continue to take advantage of market dislocations to add selective risk exposure and be ready to deploy capital as we gain greater clarity on the trajectory of US monetary policy and the extent of the global growth slowdown. We believe investors will need to continue to take an active approach in identifying and selecting potential investment opportunities that arise.

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)

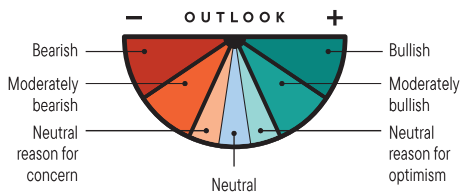
Municipal Bonds

Emerging Market (EM) Debt

Emerging Market Corporates

Global Sukuk

Understanding the pendulum graphic



Arrows represent any change since the last quarter end.

Franklin Templeton Fixed Income macroeconomic recap & outlook

US economy: Inflation and labor markets keeping Fed on the offensive

Executive summary—US economic outlook

- **Third-quarter (Q3) headline gross domestic product (GDP) growth masks underlying economic weakness.**
- **We expect further weakness in housing, but this is not a repeat of 2008.**
- **Is disinflation or even deflation coming from core goods?**
- **Given the tight labor market, core services inflation remains the larger concern.**
- **We anticipate a higher terminal rate than market consensus and believe fed funds will peak around 5.00%–5.50% and remain higher for longer.**
- **We remain moderately bearish on US economic indicators and continue to forecast a slowdown in economic activity in 2023 and a shallow recession in the second half of the year.**

Financial markets went into the November Federal Open Market Committee (FOMC) meeting hoping for a "pivot," a signal that the Fed would slow the pace of rate hikes and sometime in 2023 start cutting rates again.

However, after the widely expected fourth successive 75 basis point (bp) rate hike at the November meeting, not only was Fed Chair Powell careful not to commit to a slowdown in the pace of hiking, but he was also clear that the policy rate will ultimately have to rise higher than the 4.6% median rate projected in the September Summary of Economic Projections (SEP). That said, while Powell noted that the Fed had not done nearly enough yet, he left some uncertainty on what level of tightening is "sufficiently restrictive" to achieve the Fed's goals.

Meanwhile, the October CPI headline print of 7.7%—cooler than median consensus expectations and the lowest year-over-year (Y/Y) increase since the start of the year—further fanned market expectations that a downshift in the pace of hikes is coming.[1] Indeed, the minutes of the November FOMC meeting and a recent speech by Powell (delivered at the Brookings Institution) cemented expectations that the Fed will step down from its aggressive pace of tightening in December.[2] However, the mere indication of slower rate hikes has meant that, despite 300 bps of tightening since June 15, current financial conditions aren't any tighter than they were in mid-June this year.

As a result, much of the recent "Fed speak" has been a coordinated effort to push back against the market reaction to October CPI. While FOMC participants acknowledged the welcome deceleration in monthly core CPI inflation, they've also repeatedly emphasized that the terminal rate had now "become more important" than "the pace of further increases"—very much in line with Powell's November post-FOMC press conference. In fact, twice during the post-press conference, Powell emphasized that it was "very premature to think about pausing" and that the Fed is not actively thinking about it. He noted that not only will the Fed need to see inflation coming down decisively, but it would also want to see positive real rates. All this confirms the Franklin Templeton Fixed Income team's longstanding view that the policy rate will go higher than markets are pricing in and it will stay higher for longer, and investors should not expect rate cuts in 2023. We believe the fed funds rate will likely peak around 5.00%–5.50%, and markets still need to absorb this across the yield curve. Once at peak rate, we believe the Fed will signal a long pause as it gauges the impact of all the cumulative tightening on inflation and growth.

We project core CPI to remain at 6.5% through the end of this year, and to remain above 6% in the first-quarter 2023 and a little below 6% in the second quarter. Core Personal Consumption Expenditures (PCE)—the Fed's official target—will be somewhat lower, so that will allow the Fed some leeway, but Powell has previously acknowledged that the Fed does also look at CPI, because that is what matters to people.

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A US recession is more likely than not in our view, but it should be a mild one. The labor market is still extraordinarily tight and consumer spending is well supported by high savings. A mild recession, if still accompanied by high inflation, is unlikely to move the Fed off its stated path.

Headline growth masks underlying weakness

After contracting through the first half of the year, US GDP rebounded by a 2.9% quarter-over-quarter (Q/Q) seasonally adjusted annualized rate (SAAR) in the third quarter, with PCE-services, business investment and net exports propelling growth.[3] However, scratching beneath the surface shows net domestic demand (GDP less net exports and change in private inventories) grew by a rather anemic 0.3% Q/Q SAAR.

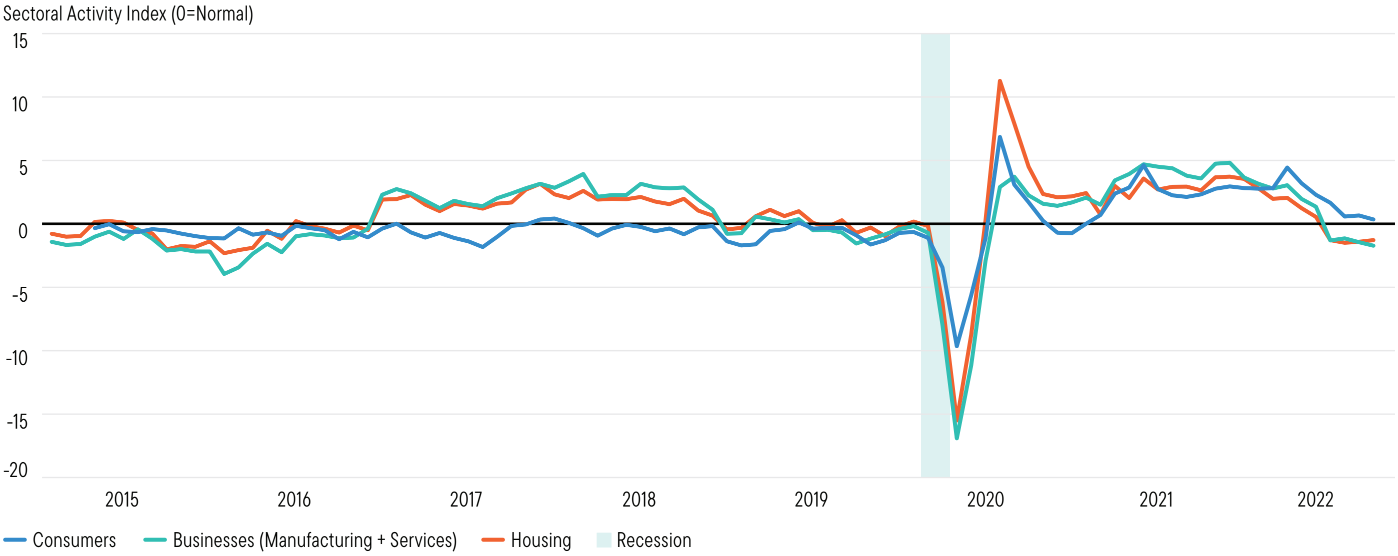
The continued lack of a build-up in inventories is confirmation that firms are hesitant to add inventory in anticipation of a slowing economy. Therefore, there is unlikely to be a much of an upside surprise from inventories in the coming quarters. Moreover, the decline in imports, while a positive for headline growth, is yet another indication that broader domestic demand has downshifted. Exports did provide a boost, however, that largely reflected the global reopening that occurred this past summer and an increase in energy exports to the rest of the world. However, we believe weak global demand combined with a relatively strong US dollar will significantly limit export growth, and therefore trade is unlikely to be the kind of tailwind it was in the third quarter going forward.

More broadly, a composite of survey and hard economic data shows that broader economic activity has lost momentum since March this year—just as the Fed began tightening monetary policy. The loss in momentum has been more substantial for housing and businesses (i.e., manufacturing and services), where activity levels have dipped below normal, though still above the levels seen in 2015–2016 when the US economy experienced a mild downturn.

Economic Activity Losing Momentum Across Sectors

Exhibit 1: Composite of Survey and Economic Indicators

January 2015–October 2022



Sectoral activity index: All indicators that go into the index are normalized/standardized such that 0 indicates the data is at its average. A reading below 0 means a majority of the variables that feed into the index were operating below average (and vice versa).

Sources: BEA, U.S. Census Bureau, Fed, University of Michigan, ISM, Federal Reserve Bank of Atlanta, Federal Reserve Bank of Chicago, Federal Reserve Bank of Dallas, Federal Reserve Bank of Kansas City, Federal Reserve Bank of New York, NFIB, NAR, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

Households have relied on excess savings from the pandemic, but monthly personal savings has been running below their pre-pandemic trend in recent quarters and we expect that to continue through the end of 2023. Excess savings could be exhausted between August and October 2023 (using the pre-pandemic growth trend)—however, excess savings could still be around US$1 trillion by the end of 2023.

There has also been a clear downshift in consumer conditions. However, weak consumer sentiment drove much of it, as expectations of inflation-adjusted incomes and personal financial situations have slid rapidly below normal. Hard economic data suggest that while the momentum for nominal consumer spending has slowed (from a particularly elevated level), it's still growing above its 2012–2019 average.[4] More importantly, there has not been a marked shift in momentum for real consumer spending. Spending in nominal and real terms has held up despite the drag from disposable income as fiscal transfers stopped and inflation took a toll on household budgets through late 2021 and much of 2022. Moreover, ongoing tightness in the labor market and the fact that the employment outlook (for households and employers) has not (yet) deteriorated to recessionary levels mean that household incomes remain well supported.

Households have relied on excess savings from the pandemic, but monthly personal savings has been running below their pre-pandemic trend in recent quarters and we expect that to continue through the end of 2023. Excess savings could be exhausted between August and October 2023 (using the pre-pandemic growth trend)—however, excess savings could still be around US$1 trillion by the end of 2023.[5] Aside from pandemic savings, households have also increasingly turned to credit in 2022. While spending via credit cards remains well above pre-pandemic levels, the pace has moderated. The decline in auto and other loans has been marked, but that may merely be indicative of the rotation from goods to services since overall PCE has held up rather well.[6]

Housing the next shoe to drop?

A little over a quarter of the US economy is interest-rate sensitive. Housing (which accounts for 14% of real GDP) remains most sensitive to interest-rate hikes, and recent data points further underscore the ongoing decline in housing market activity.[7] Existing home sales declined for the ninth straight month in October, the US homebuilder sentiment index declined for the 11th straight month (and weakened to the lowest level in a decade excluding April 2020) in November, and the MBA Mortgage Applications composite index is down 70% Y/Y and hovering near its lowest point in decades as of mid-November.[8]

Affordability for new buyers is now worse than it was in the run-up to the 2008 crash. Home price appreciation of around 40% over the last two years, coupled with mortgage rates that have nearly tripled their January 2021 levels (when it hit an all-time low of 2.65%), has brought affordability to its lowest level since the early 2000s.[9] Higher mortgage rates have most greatly impacted first-time homebuyers, who generally have lower savings and rely heavily on mortgages. Additionally, the weakness in housing is likely to have negative spillovers for household consumer durables, which make up another 2% of GDP and tend to lag the downturn in housing by a few months. Looking ahead, given that the full impact of the all the cumulative (and future) policy tightening has yet to be felt, we expect to see a further housing price correction.

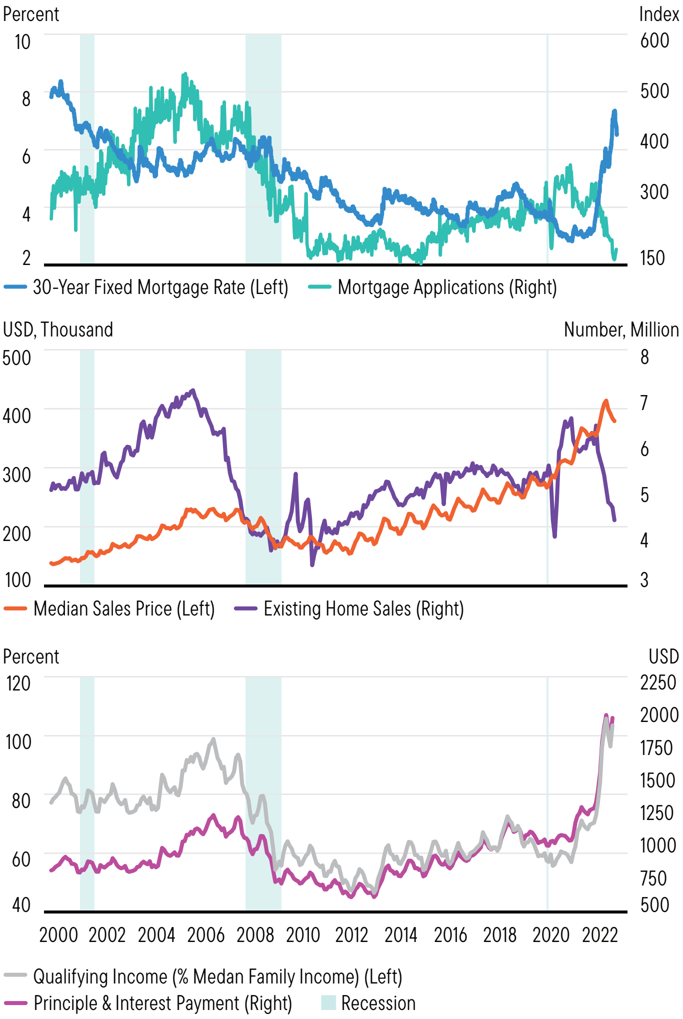
However, thus far there is little to suggest that the current housing downturn will generate the kind of negative spillovers to the wider economy seen in 2008. Fundamentally, the US housing market, while rapidly slowing, remains strong, with supply and demand dynamics providing support. Zoning regulations, supply chain bottlenecks, and a shortage of labor have led to an undersupply of homes in the United States for much of the last decade. Over-building, therefore, isn't the problem it was before the global financial crisis (GFC). In addition, a majority (406,000) of new homes sold are either under construction or yet to break ground and represent just a fraction (~8%) of housing demand.[10] Therefore, the chronic undersupply of homes is likely to put a floor on home price correction.

Furthermore, the quality of mortgage underwriting has improved substantially, subprime mortgages are a smaller proportion of total mortgage loans, and the share of adjustable-rate mortgages is only a fraction of what it was before the GFC. Household balance sheets are also much more deleveraged than at the onset of the GFC. Therefore, we expect the downturn in housing to be largely self-contained, and not become a source of systemic financial instability.

Housing Market Weakening but Conditions are Different than 2008

Exhibit 2: Housing Market Overview

January 2000–Latest Available Data*

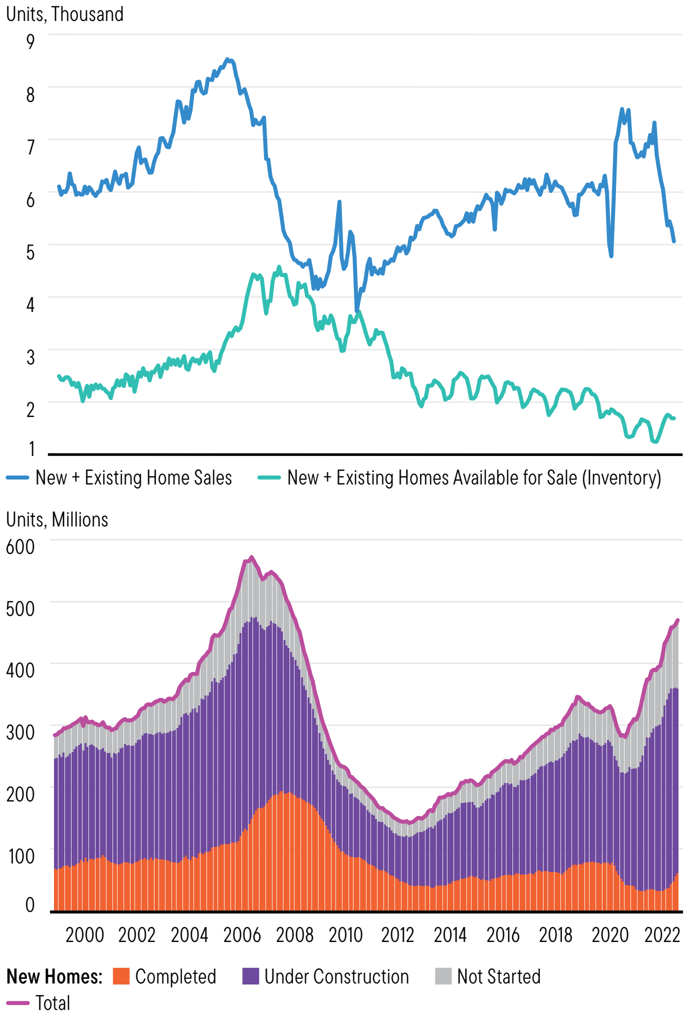


(Top chart) 30-year mortgage rate as of December 5, 2022; Mortgage applications as of November 25, 2022; (Middle chart) As of October 2022; (Bottom chart) As of September 2022.

Sources: U.S. Census Bureau, BEA, NAR, Bankrate, SPDJI, Zillow, MBA, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

Exhibit 3: Housing Supply and Demand Overview

January 1999–October 2022



Sources: U.S. Census Bureau, NAR, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

Disinflation or even deflation coming from core goods?

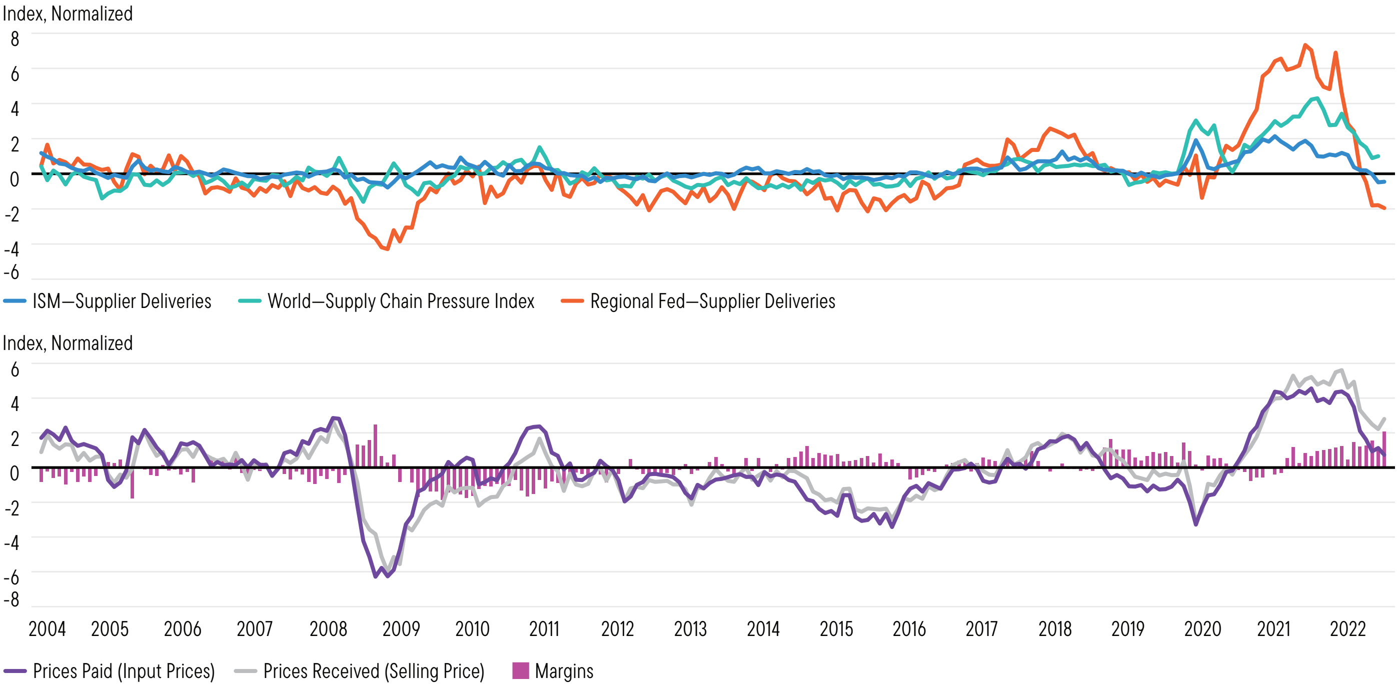
Global supply chains have continued to normalize over the past quarter. Container shipping costs have declined precipitously and are now back to levels last seen early in the pandemic. The backlog of ships outside the ports of Los Angeles and Long Beach that peaked above 100 in January 2022 have largely cleared over the past few months.[11] Institute for Supply Management (ISM) supplier delivery times and order backlogs have improved materially as well. We also note that the inventory-to-sales ratio, particularly for durable goods, and inventories-to-new orders from the ISM manufacturing survey, are back to pre-pandemic levels and could likely move higher as new orders slow and inventories rise further in response to consumers shifting their spending from goods to services. That should also add to the downward pressure for goods prices.

Additionally, US dollar (USD) strength has made imported goods cheaper for US consumers and firms. The trade-weighted USD and non-fuel import prices have historically moved quite closely, albeit with a lag. However, that relationship diverged over the past two years, likely reflecting supply chain issues. Assuming the historical relationship starts to re-emerge as bottlenecks fade, import prices are poised to slow further.

Normalizing Supply Chains and Rising Inventory-to-Sales Ratios Should Drive Goods Prices Down

Exhibit 4: Supply Chains and Input/Output Prices

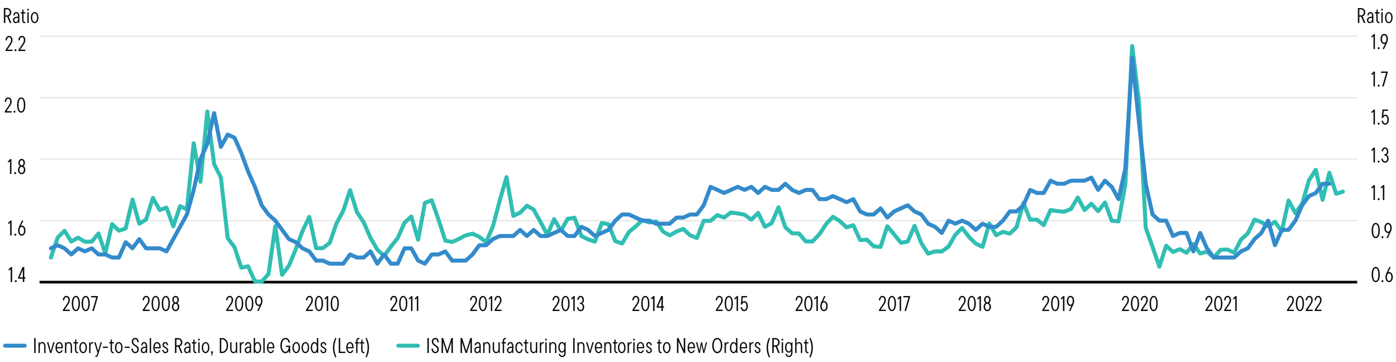
June 2004–November 2022



Sources: 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, U.S. Census Bureau, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

Exhibit 5: Inventory-to-Sales Ratios

January 2007–November 2022*



Inventory-to-Sales (left) as of September 2022; ISM (right) as of November 2022

Sources: U.S. Census Bureau, ISM, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

Lastly, with a range of non-energy commodity prices also coming down, sequential growth in the core final goods Producer Price Index (PPI) has continued to decelerate since March, while PPI for finished goods has slowed over the past quarter.[12] These declines are expected to further weigh on core goods inflation in the coming months. Moreover, the fall in core goods CPI in recent months suggests that the process of adjustment may already be underway.

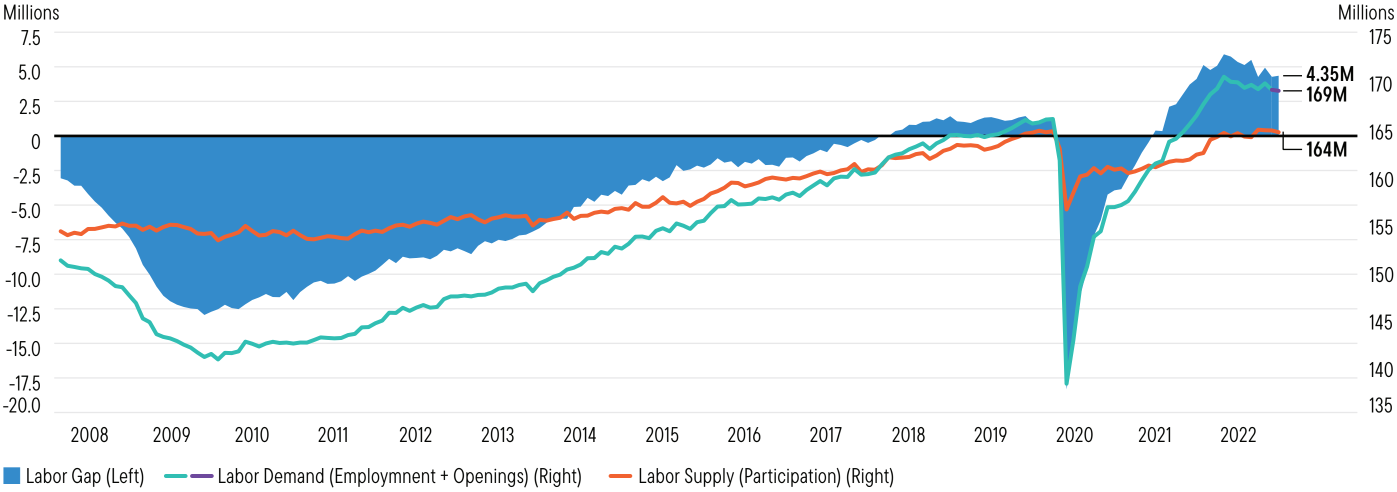
Core services inflation remains the larger concern

The US job market has continued to hum along with the unemployment rate still at a historically low level of 3.7% as of November and job gains averaging 272,000 over the past three months—still well above the average monthly gains seen between 2012–2019.[13] As of November, the excess demand for labor (Employment + Openings – Participation) stood at 4.35 million (1.55 million lower than the peak in March 2022) or 2.65% of the labor force. The longer the labor market remains tight and supply constrained, the stronger and more entrenched services inflation becomes.

Given the Tight labor Market, Services Inflation Becoming More Entrenched

Exhibit 6: Labor Demand vs. Supply

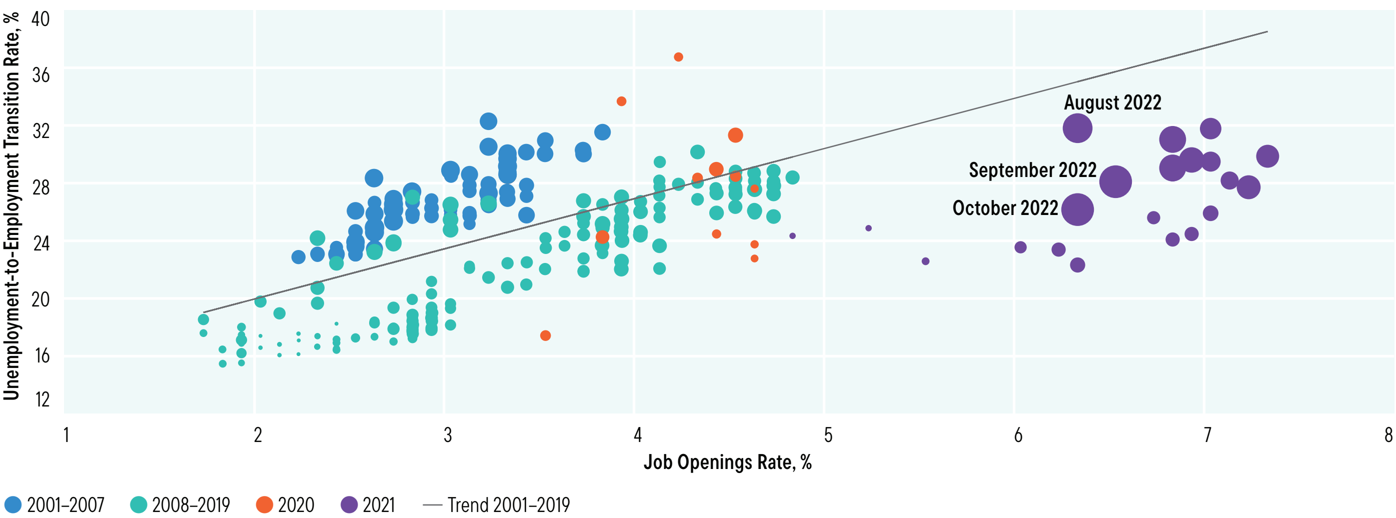
January 2008–November 2022



Sources: BLS, Fed, BEA, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

Exhibit 7: Job Openings and Transition Rate (%)

2001–October 2022



Sources: BLS, Federal Reserve Bank of Atlanta, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.
Dot size represents the level of Services Inflation Y/Y Change (%). The larger the dot, the higher level of services inflation (and vice versa).

The tightness in the labor market has kept up the pressure on nominal wage growth. Meanwhile, elevated wage growth has coincided with slumping productivity since the start of 2022. Wage increases without a commensurate increase in productivity will push up unit wage costs—unit labor costs (ULCs) are now over 13% higher since the beginning of 2020 and have accelerated since productivity dropped.[14] Strong wage growth along with slumping productivity will continue to add to firms' cost pressures, which may not only get passed onto consumers but also support a household switch in spending toward services.

Meanwhile, anecdotal evidence suggests the current inflation story is more than just wage-cost pressures. As consumers switch spending away from goods to services, a broad swath of service-oriented firms (e.g., airlines, food services, and hotels) are seeing that as an opportunity to raise prices. Neither hotel chains nor airline companies are seeing any signs that fundamentals are weakening. American Express, for example, added a record number of customers in the third quarter, and expects to see strong travel-related bookings. Likewise, Uber noted that October was one of the best months ever for ride bookings. Therefore, with demand for services/experiences remaining resilient due to the strong post-pandemic household balance sheets, it comes as no surprise that service-oriented firms are confident in raising prices either to protect margins, or because they simply can. This is one reason consumer prices have risen faster than wages since late 2021.

US economic outlook

We have further revised down our growth projections and continue to expect to see negative growth in the United States in the second half of 2023, along with an increase in the unemployment rate to above 5% by the end of the year. Overall, our growth forecasts remain weaker than consensus for the second half of 2023 given our expectations for inflationary pressures to remain elevated for longer and a prolonged period of tighter financial conditions.

Franklin Templeton Fixed Income: US Growth Outlook

Exhibit 8: Real US GDP Growth, Unemployment Rate, and Inflation-Rate Forecasts

As of December 2022

	Real GDP (% Q/Q AR)	Unemployment Rate (%)	CPI Inflation (% Y/Y)	Core CPI (% Y/Y)
2021-Q4	7.0%	3.9%	6.7%	5.0%
2022-Q1	–1.6%	3.6%	8.0%	6.3%
2022-Q2	–0.6%	3.6%	8.6%	6.0%
2022-Q3	2.6%	3.5%	8.3%	6.3%
2022-Q4	*0.8%*	*3.7%*	*7.4%*	*6.5%*
2023-Q1	*0.8%*	*4.1%*	*6.1%*	*6.2%*
2023-Q2	*0.0%*	*4.4%*	*4.4%*	*5.7%*
2023-Q3	*–0.7%*	*4.7%*	*3.9%*	*5.3%*
2023-Q4	*–1.5%*	*5.2%*	*3.7%*	*4.5%*

	Real GDP (annual)	Real GDP (Q4/Q4)
2021	5.9%	5.7%
2022	*1.9%*	*0.3%*
2023	*0.4%*	*–0.4%*

Italics indicates forecast

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

Euro-area economy: Back into recession

Executive summary—Euro-area economic outlook

- **Despite third-quarter headline GDP surprising to the upside, the underlying trends point to further deceleration.**
- **The European energy supply outlook has significantly improved.**
- **Inflation rates remain at historically elevated levels but should have peaked by year-end, however, risks remain skewed to the upside.**
- **We remain moderately bearish on euro-area economic indicators.**
- **We now forecast the euro area to enter a mild recession by the end of 2022 and the recovery to be slow.**

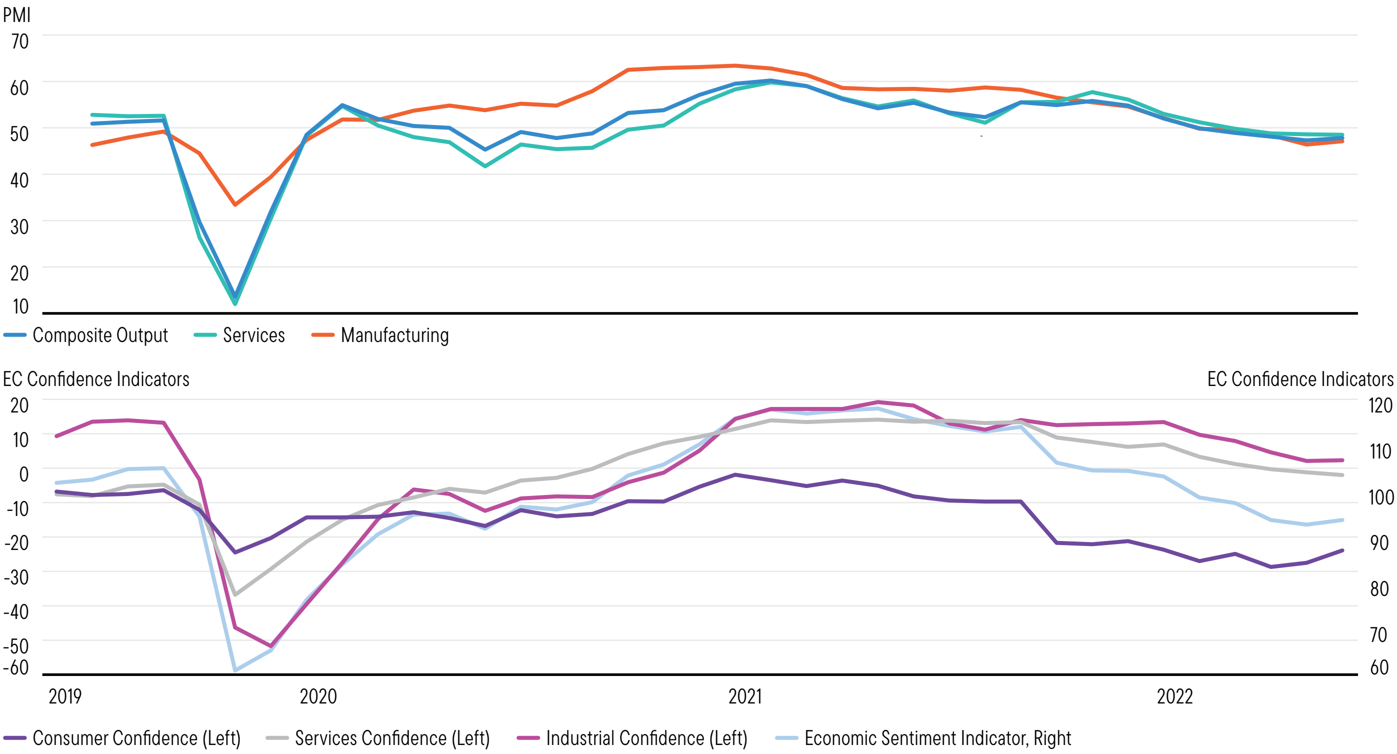
Euro-area real GDP slowed to 0.2% Q/Q in the third quarter, a significant slowdown from the 0.8% Q/Q posted in the second quarter, amid a challenged production sector environment and declining real consumption.[15] Germany and Italy surprised to the upside with Q/Q growth rates of 0.4% and 0.5%, respectively, while the French economy lost momentum and slowed to 0.2% Q/Q as consumption was flat and services showed a marked deceleration, signaling the income squeeze is already impacting households. Despite the third quarter being another upward surprise, driven mostly by the reopening effect, the underlying trend points to further deceleration over the next few quarters as the post-COVID rebound fades.

The downward growth trend observed over the past quarters, combined with the grim picture coming out from survey indicators, suggest that the euro-area economy is already shrinking. Purchasing Managers Index (PMI) and European Commission (EC) confidence indicators data depict a similar situation as the growth boost from services consumption has faded away while consumer confidence remains deeply negative—saving expectations have fallen back to pre-COVID levels, while uncertainty has been dragging down spending plans. Manufacturing production in Germany has shown resilience despite the energy cost squeeze Orders backlogs—especially in the auto sector—offered support, but the stock of orders reached its peak, and new orders continue to fall.[16] We expect a decline in industrial production between the fourth quarter of 2022 and the first quarter of 2023.

Survey Measures Suggest Activity Is Already Contracting

Exhibit 9: Purchasing Managers' Index and Confidence Indicators

January 2019–November 2022



Sources: SPDJI, Eurostat, DG ECFIN, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

Meanwhile, downstream financing conditions are quickly tightening for firms and household credit (i.e., mortgages), which will hit the housing market, but will likely have a more limited impact over disposable income given the large prevalence of long term fixed-rate mortgages (representing about 80% of total mortgages) in the European Union (EU), although country differences apply.[17]

As economic activity is already slowing down, we now forecast the euro area to enter a mild recession by the end of 2022. We expect real GDP will decline by 0.3% and 0.4% in the fourth quarter of 2022 and first quarter of 2023, respectively, leaving overall annual 2023 growth flat. Real consumption appears to be already challenged in some economies due to price pressures and a slowing services momentum out of the summer rebound. Despite the heavy uncertainty surrounding the economic outlook, investments proved resilient so far. Still largely anti-cyclical government spending has likely offered support, and is going to cushion the slowdown (at least in part) next year.

The eurozone labor market remains tight and is expected to remain resilient compared to past crises, although unemployment should increase from the current record low of 6.5% in October.[18] We expect the recovery to be slow given our expectation of a US recession in the second half of 2023, which is already weighing on weak export activity, although China's reopening might provide some relief.

On inflation, the Harmonized Index of Consumer Prices (HICP) should have peaked in October. Base effects, declining energy and commodity prices, and the effect of anti-inflationary measures will push headline inflation into a downward trajectory—we forecast Y/Y HICP to decline from over 10.4% in the fourth quarter of 2022 to 2.6% by the fourth quarter of 2023. However, we believe the balance of risk remains skewed to the upside, especially over the near term.

The European Central Bank (ECB) delivered a 75 bp interest-rate hike at its October meeting, as expected, bringing the deposit rate to 1.5%. The internal Governing Council political consensus remains firm regarding reaching the neutral rate in December, thus assuring at least a 50 bp hike at its next meeting.

...while German gas consumption was about 19% lower than the 2018–2021 average, industrial production (ex. construction) was only down 2.3%. The risk of rationing and of a more pronounced recession have thus abated. However, over the medium term, more action will be needed between gas savings and investments, as refilling gas storage for the 2023–2024 winter remains challenging amid scarce-to-nonexistent Russian supplies and rising international competition for LNG.

Further hikes into restrictive territory are now a necessary condition, in our view, and we forecast further increases in the first quarter of 2023 to bring the policy rate to 2.50% in March, despite the likely upcoming recession. This is consistent with ECB President Christine Lagarde's recent remarks suggesting that a mild recession (as we also expect) will not be sufficient for the ECB to stop hiking given it most likely will not be deflationary, especially considering the state of the labor market. Further hikes above 2.50% will depend on the reaction function second-round effects on price stickiness, wages and inflation expectations. Meanwhile, the balance sheet reduction process begun as targeted longer-term refinancing operations (TLTROs) will be repaid over the next quarters and quantitative tightening is soon approaching. Despite a significant re-absorption of excess liquidity coming in 2023, the starting point should reduce risks of abrupt market disruptions.

Not as cold a winter in the end

The European energy crisis has been somewhat alleviated over the past few months after a turbulent summer which saw significant cuts in Russian gas supplies and an intensification of the Russia-Ukraine conflict. Despite the latter still raging with no resolution in sight, the energy supply outlook has significantly improved due to a few factors:

1. Weather conditions have turned out to be particularly favorable throughout Europe, allowing a postponement of the heating season and governments to continue stockpiling gas.
2. Virtually all EU countries now have their gas stocks at full capacity, which resulted in gas prices dropping from their August peak. Although price levels and volatility remain at historical highs, the current level of gas stocks provides cushion for the coming winter.
3. Energy supply diversification efforts have already been made and more are planned over the next quarters. Liquefied natural gas (LNG) played a pivotal role as EU governments ramped up imports to replace about two-thirds of Russian gas supply.

Overall, this allowed for a significant departure from historical Russian gas reliance in a much faster manner than initially thought, while also not resulting into a 1:1 decline in industrial production. For example, while German gas consumption was about 19% lower than the 2018–2021 average, industrial production (ex. construction) was only down 2.3%.[19] The risk of rationing and of a more pronounced recession have thus abated. However, over the medium term, more action will be needed between gas savings and investments, as refilling gas storage for the 2023–2024 winter remains challenging amid scarce-to-nonexistent Russian supplies and rising international competition for LNG.

Fiscal policy remains center stage but will be more constrained

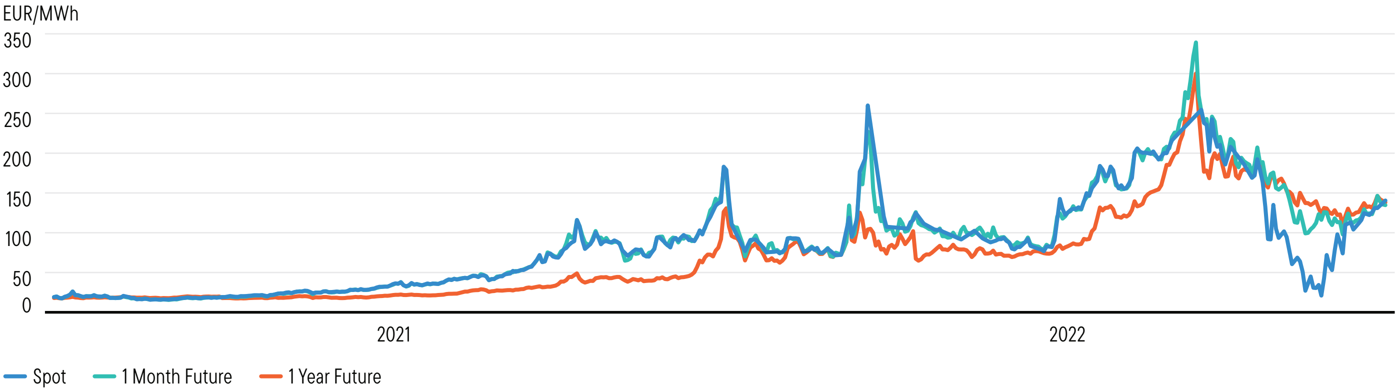
The European fiscal policy scene remains in focus as governments continue to announce anti-cyclical measures to shield consumers and businesses from the energy crunch, most of which will be rolled into 2023 with the new budget laws. The largest fiscal announcement came from Germany, flexing its fiscal muscles with a package worth up to €200 billion aimed at subsidizing gas consumption, on top of the previously announced €64 billion package, reaching a combined 7.4% of GDP.[20]

So far, coordinated EU-wide actions have been limited as the most contentious points, such as a gas price cap at the regional level, have not been resolved. The delicate and pivotal discussion on updating the obsolete EU fiscal framework will take place next year after being suspended since 2020. The current political fragmentation, amid a colder relationship between France and Germany and a new Italian government, will not facilitate an already complicated discussion while the growth and inflation upside on fiscal revenues will start to fade.

Gas Prices and Consumption Have Declined Without Dramatically Impacting Production

Exhibit 10: Gas Prices

January 2021–November 2022



Sources: Bloomberg, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

Exhibit 11: Gas Consumption vs. Industrial Production

2022 vs. 2018–2021 Average (%)

Sources: Eurostat, DESTATIS, Istat, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

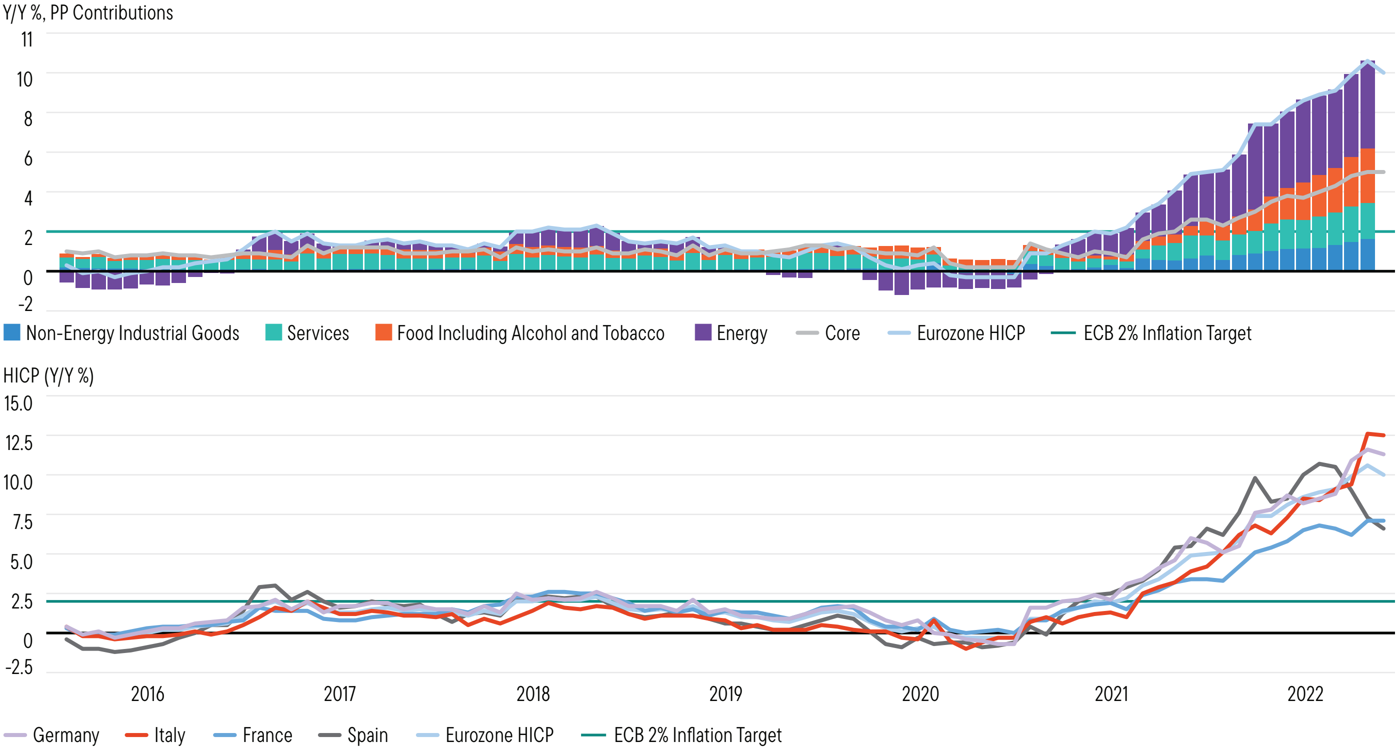
The battle for price stability is far from over

Euro area HICP eased to 10% Y/Y in November from 10.6% in October, marking the first decrease since June 2021. While food inflation continued to accelerate, to 13.6%, the decline was attributable to energy prices, which dropped from 41.5% to 34.9% on the back of declining oil and gas prices, as well as further government interventions in some countries. Nevertheless, core inflation remained stable at 5%, with goods and marginally declining services prices lending support. Going forward, we expect the reopening effect on hotels, recreational and restaurant activities to abate while second-round effects from wage pressures are likely yet to fully materialize on rents and other core services. We expect some deceleration in headline goods inflation as the pass-through of energy prices nears its end while supply bottlenecks keep gradually easing. Overall, price pressures keep broadening with more than 83% of HICP components having Y/Y rates above target in October.[21]

Inflationary Pressures Remain Elevated and are Broadening

Exhibit 12: Euro-Area Inflation

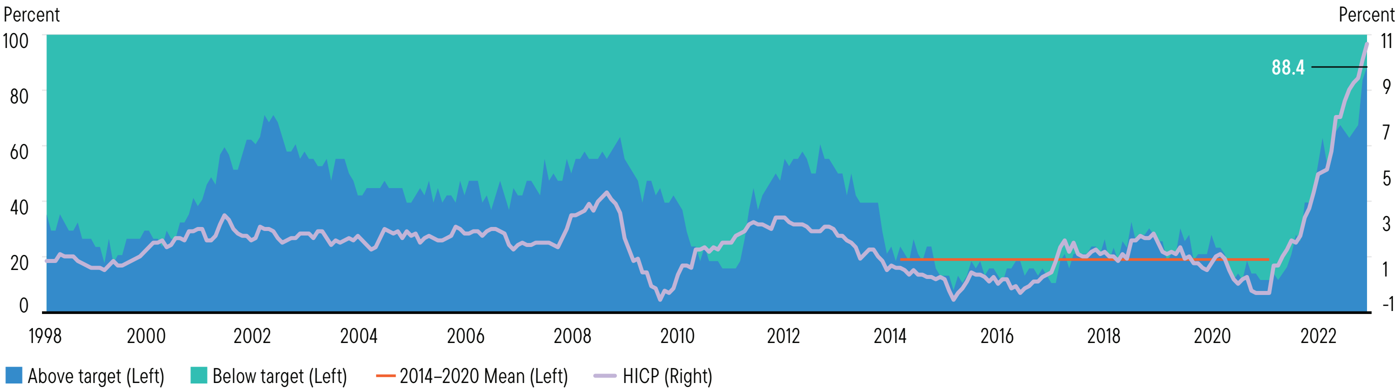
January 2016–November 2022



Sources: Eurostat, ECB, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

Exhibit 13: HICP Components vs. Target

January 1998–October 2022



Sources: Eurostat, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

Since the first hike, the ECB reaction function has moved away from forecasted inflation to weighing spot price developments and reacting to systematic upward surprises. Inflation is now (more credibly) expected to come down next year as energy prices recede but the rate at which headline inflation will stabilize remains very uncertain, leaving the open question of policy calibration amid declining but still above-target inflation rates. We believe that a set of indicators will guide policy decisions above 2.5%. The ECB will need to see a reassuring peak of core inflation, which will likely occur late in the first quarter or early second quarter of next year. The assessment of the second-round effects will also be important, especially wage inflation which appears to be slow to adjust to the new inflation regime. First indications point to significant upward adjustments of euro-zone pay-slips, especially in Germany, but distant from raising concerns on upcoming wage-price spirals. Inflation expectations will also remain center stage, as the ECB turned itself to consumers surveys, professional forecasters, and market expectations rather than its own poorly performing forecasts. The ECB will need to delicately calibrate between the risk of falling short of its mandate for too long and a potential overtightening, as reconciling the policy transmission lag with discredited forecasts will not be an easy task to accomplish.

Euro-area economic outlook

We have slightly revised down our growth projections and now forecast the euro area to enter a mild recession by the end of 2022. We expect base effects, declining energy and commodity prices and the effect of anti-inflationary shields to push headline inflation on a downward trajectory to reach an average of 2.6% Y/Y by the fourth quarter of 2023.

Franklin Templeton Fixed Income: Euro-Area Growth Outlook

Exhibit 14: Real Euro Area GDP Growth and Inflation-Rate Forecasts

As of December 2022

		% Q/Q					% Q/Q				
Euro Area	2021 (% Y/Y)	2022 Q1	*2022 Q2*	2022 Q3	*2022 Q4*	*2022 (% Y/Y)*	*2023 Q1*	*2023 Q2*	*2023 Q3*	*2023 Q4*	*2023 (% Y/Y)*
Real GDP (% Q/Q)	5.3%	0.6%	0.8%	0.2%	*–0.3%*	*3.3%*	*–0.4%*	*0.1%*	*0.3%*	*0.3%*	*0.0%*
HICP (% Y/Y)	2.6%	6.1%	8.0%	9.3%	*10.6%*	*8.5%*	*8.5%*	*6.9%*	*5.2%*	*2.5%*	*6.3%*

Italics indicates forecast

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

Sector settings

Overall Risk Outlook

As we enter the final stages of one of the most volatile years in the history of fixed income markets, which has led to some of the sharpest and broad-based drawdowns ever experienced across multiple asset classes, many of the challenges that have led to this difficult macroeconomic environment remain.

Inflation continues to be at or near multi-decade highs despite the rapid and aggressive synchronized monetary policy response from central banks and the tightening of financial conditions around the world, as well as the growing consensus that global economic activity is slowing down faster than expected and a recession is looming in several regions. Geopolitical issues may have faded from center stage but seem far from resolution and have increased in many cases, with the potential to destabilize the global economy in the years ahead in the same fashion that Russia's unexpected invasion of Ukraine sparked a severe energy crisis in Europe this year.

Despite these headwinds, the Franklin Templeton Fixed Income team is more constructive on the prospects for fixed income investments than we have been in some time. While elevated volatility will undoubtedly continue in the year ahead, the level of yields fixed income is now generating have become more attractive, in our view. Fixed income is finally delivering income again!

Fundamentals have weakened as tighter financial conditions and price pressures impact real incomes and purchasing power, but remain generally positive overall and will allow governments, companies and households to manage through a more challenging economic environment. We anticipate the coming year will have significant bifurcation, however, with higher-quality asset classes and issuers remaining resilient while weaker ones will face increasing difficulties.

Sentiment and technical conditions, which likely will remain challenged, continue to drive markets. Risk-free assets will continue to face elevated volatility until markets accept that we are in a paradigm shift where central banks are forced to prioritize restoring price stability over support for asset prices. Markets continue to try to predict central bank policy versus analyzing economic fundamentals—this has historically not

Overall Risk Outlook
continued

worked out well for the market. We believe financial markets continue to underestimate the extent and duration of the monetary policy tightening that will be needed.

Our outlook for risk assets has improved, while still acknowledging the potential for further downside given spreads still do not fully reflect an economic slowdown or contraction. We now believe fixed income markets are poised to have a better year ahead despite our expectations for a growth slowdown. While we continue to believe risk-free assets, along with duration-heavy segments of the fixed income universe, could remain volatile and periodically under pressure for the next few quarters, we are now closer to the end of the hiking cycle. Income-generating opportunities have increased, and healthy fundamentals should provide a tailwind for select opportunities as technical conditions stabilize. Currently, at the shorter end of duration on most fixed income instruments, investors are now being paid handsomely to hold more liquid segments, but it may still not be the point to go all in on large quantities of duration. However, it may be a matter of quarters, or maybe months, where that opportunity will present itself.

Selectivity will become increasingly important, and there has never been a better time for active management, in our view. We believe investors will need to continue to take an active approach to identifying and selecting investment opportunities that arise, and be cautious to not take on too much risk prematurely. The road ahead will be challenging, and investors will need to carefully calibrate their investment approach, but the opportunity in fixed income should provide major benefits for those who seek it.

The following sector settings reflect our six- to 12-month outlook on each asset class.

Sector	Outlook	Our viewpoint
US Treasuries		Since our last quarterly outlook, US Treasury (UST) yields have exhibited unprecedented levels of volatility due to sentiment-driven market reactions to economic data and Fed rhetoric. With inflation remaining near multi-decade highs and the Fed's foot squarely on the accelerator, UST yields rose, with the benchmark 10-year yield reaching an intraday high of 4.35% in October. Since then, yields have fallen rapidly after the October CPI print as the market seems eager to grasp for reasons to rally or any signs that the Fed will slow or reverse monetary policy tightening versus analyzing economic indicators or the Fed's explicit message that bringing inflation under control is the primary focus. As outlined above, it is our view that inflationary pressures will force the Fed not only to push the terminal rate higher, but to keep rates there for longer than the market anticipates. Under this scenario, the level and shape of the UST yield curve continues to make little sense to us.

Sector	Outlook	Our viewpoint
US Treasuries *continued*		To justify a 10-year yield in the mid-3% range, the market must feel that after reaching the terminal short-term rate, the Fed will be pushed into cutting fed funds almost as fast as it has raised it. This will only be warranted in the direst economic conditions. For the funds rate to reach 5.00%–5.50%, as we anticipate, and the 10-year US Treasury bond to stay where it is, that would mean an inversion of 100–200 bps—which we feel is unrealistic and predicated on a significant economic contraction. Acknowledging that yields have risen since our last outlook, we have upgraded our outlook on USTs to neutral with reason for concern, but we still feel that longer-term yields should rise over the medium term and the curve will steepen.
US Treasury Inflation-Protected Securities (TIPS)		In the first half of the year, the TIPS story was one of very large monthly inflation accruals, due to increased inflation rates, driving strong outperformance versus nominal USTs. As these accruals have fallen over the third quarter of 2022, changes in break-even (BE) inflation rates have been the more dominant driver of returns. As we have been saying for some time, these rates are inversely correlated with the market's confidence that the Fed will be successful in its fight to tame inflation. As this confidence ebbs and flows, these BE rates have swung wildly throughout the year, with five-year BE rates moving to an all-time high of 373 bps in March waiting for the Fed to react, then declining for the following six months as confidence was raised along with the fed funds rate by 300 bps in the effort to control inflation. This strong response has thus allowed BE rates to then fall to 2.16% by September. With recent BE rates now averaging around 2.5%, the market is signaling that the Fed will not only bring inflation under control, but it will also do it quickly.[22] Although this is not our base case, near term we would be somewhat hesitant to take either long or short portfolio risk positions on the longer-maturity end of the TIPS universe, as we expect volatility to remain elevated not only in TIPS but the UST market as well. However, our view remains that US inflation will remain more persistent or "sticky" than the markets have priced. Recent volatility also causes opportunities to arise, and we believe one is on the extreme short end of the curve where attractive 2% real yields have become available. We also favor small positions in the four- to five-year part of the curve. As such, we have raised our outlook to neutral with reasons for optimism and continue to tactically look for other entry points.
Eurozone Government Bonds		The European Central Bank (ECB) responded to surging inflation in Europe by delivering a cumulative 200 bps of hikes to its deposit rate between July and October of 2022, an historically aggressive policy action. We expect inflationary pressures to remain at historically high levels and broaden through cost-push adjustments, hikes in food prices, and a further pickup in wage growth on the back of a historically tight labor market. However, high energy prices as a result of Russia's war in Ukraine have been a large driver of inflation, with unseasonably mild weather throughout the region slightly alleviating the pressure. The combination of tighter financial conditions and the energy crisis has, in our view, already pushed the region into a mild recession that will likely last throughout the first quarter of 2023. Consequently, we believe that the peak of ECB hawkishness has been reached, and we expect the pace of hiking to slow, with a potential rate cut later in this coming year. With this in mind and yields and valuations now at more attractive levels, we have upgraded our view on rates from moderately bearish to neutral with reason

Sector	Outlook	Our viewpoint
Eurozone Government Bonds *continued*		for concern. Although the ECB has pledged to support periphery country yields through its "anti-fragmentation instrument," we have seen spreads between countries continue to widen and believe they will continue to be pressured and therefore prefer bonds from core countries.
Japanese Government Bonds		While the Bank of Japan (BoJ) has remained an outlier compared to its developed market peers on monetary policy this year, we think a pivot is likely to come in early 2023 (March or April 2023). Even as the central bank remains committed to its accommodative monetary policy stance, inflation has become more entrenched. All CPI indexes have been gradually rising, with even the most conservative estimate (CPI excluding fresh food and energy) touching 2.5% Y/Y in October.[23] CPI excluding fresh food is at 3.6% Y/Y, well above the bank's 2% target. The Tokyo CPI (a precursor to national CPI) for November clearly showed inflation is yet to peak. Although the government's newly introduced travel and energy subsidies (the latter which will be effective January 2023) is expected to push core CPI lower in the first quarter, the rise in services inflation on full reopening, a likely closure of the output gap and expected wage increases in the Spring negotiations of close to 3% prompt us to remain bullish on the domestic inflation story. Consequently, the dual action of currency intervention to prop up the yen while the central bank continues to strengthen its JGB purchases cannot be sustained for long, in our view. We therefore think that heightened inflationary pressures and the impact on households' expectations will prompt a tweak in the BoJ's current yield-curve-control (YCC) policy, most likely with a widening of the band for the 10-year yield from the current 0.25% on either side of 0%. While more severe tightening measures are unlikely in 2023, this tweak could possibly add to higher short-term 10-year yields. We have downgraded our outlook for JGBs given the risk profile is now skewed to the upside.
Agency Mortgage-Backed Securities (MBS)		Mortgage rates have significantly increased year to date, reaching a peak of 7.08% in early November before falling back to around 6.5% by early December—more than double the 3.11% rate to start the year.[24] As mortgage rates have increased, the origination coupon has trended higher—a majority of originations have been in 5.5% coupons, compared to a 2.0% current coupon in 2021.[25] Higher mortgage rates have eroded affordability and led to declining new and existing home sales—mortgage origination has fallen accordingly to US$2 billion daily on average in October, down from almost US$6 billion a day in January.[26] We anticipate mortgage origination to remain muted and limited to higher coupons, due to decreased affordability. As the Fed continues to wind down its balance sheet and decrease its support for markets, we expect spreads to widen by 5–10 bps over the next 12 months. Other demand sources, mainly money managers, would need to absorb approximately US$628 billion in net supply.[27] In recent quarters, money managers have, in fact, added MBS to their portfolios, moving from underweight allocations to even weight. While we currently view the Fed's selling of its MBS balance sheet positions ahead of the maturity date (rather than the current runoff) as a remote possibility, if the inflationary environment remains higher than expected, then balance sheet selling rhetoric could increase. We expect MBS volatility to remain high prior to Fed meetings and macroeconomic data releases. Amid the high interest-rate environment, we favor conventional 30-year securities over 15-year securities as the latter are relatively overvalued, in our view. Against this backdrop, we have retained our neutral outlook for the sector.

Sector	Outlook	Our viewpoint
Non-Agency Residential Mortgage-Backed Securities (RMBS)		Fundamentally we believe, the US housing market remains solid, with supply and demand dynamics still supportive of another year of positive, albeit rapidly slowing, home price growth. Inflation expectations and interest rates have increased dramatically since the beginning of the year, consequently leading to higher mortgage rates, which in turn have eroded affordability and led to declining new and existing home sales. Our US housing model is projecting home price appreciation (HPA) to remain positive but moderate around current levels over the next 12 months, with the potential to trend towards negative territory, after increasing by around 40% over the past two years.[28] Heavier supply and slower prepayment levels, which have led to wider new issue spreads for the sector, have impacted the asset class. While declining forbearance requests, strong underwriting standards, and a healthy labor market should keep mortgage credit performance relatively stable in the near-term, the smaller size of the RMBS sector relative to other fixed income sectors can act as a technical headwind with higher volatility in spreads, in our view. While we maintain our neutral outlook on the sector, we continue to opportunistically add exposure while favoring an overweight positioning relative to the benchmark.
Commercial Mortgage-Backed Securities (CMBS)		Although valuations for CMBS have started to look marginally attractive to us, we remain cautious on CMBS conduit transactions, which represent the largest investment opportunity within the asset class and typically have 50%-80% exposure in the office, retail and hotel sectors, where we have a negative outlook on sector fundamentals.[29] We do find pockets of value in single-asset single borrower (SASB) transactions, where we are positive on the collateral type, geographic location and/or the expected cashflows. From a property sector perspective, we are cautiously optimistic on the industrial sector, although we believe much of the optimism has already been priced into market valuation. Against the backdrop of persistent housing affordability challenges, we are positive on multifamily fundamentals, although excess supply in some metro areas remain a concern. Issues that are plaguing the retail environment are secular in nature, such as online shopping gaining market share at the expense of "brick-and-mortar" stores, muted rent growth, and elevated vacancies. The hotel sector is susceptible to economic downturns as it generally does not operate on long-term leases. Office fundamentals remain challenged as well, due to headwinds such as uncertainty surrounding future utilization of office space in the aftermath of COVID-19. We maintain our neutral with reason for concern outlook for the sector, and favor exposure up in the capital structure on the CMBS stack.
Asset-Backed Securities (ABS)		Asset-backed securities (ABS) spreads have continued to widen throughout 2022 and will likely move moderately higher over the medium term on the back of broad market volatility, in our view. We see credit fundamentals weakening as delinquencies and net loss rates have started to increase from the historic lows reached over the past few years. Tighter financial conditions and slower economic growth, a result of the Fed's fight against inflation, will pose liquidity challenges, and credit performance may suffer. A more significant worsening is probable among subprime borrowers as inflation most adversely affects lower income households amid a higher cost of living. We therefore maintain our neutral outlook for the sector and favor a defensive position with a preference for shorter duration bonds that are higher in the capital structure, as well as those backed by prime auto and credit card receivables.

Sector	Outlook	Our viewpoint

US Investment-Grade (IG) Corporates

The US investment grade (IG) corporate bond market has posted significant negative year-to-date total returns, hurt by both higher government bond yields and wider credit spreads. Investors have reacted to changing expectations about the magnitude of Fed rate hikes, how inflation and growth will respond, and when the Fed may pause tightening or even start to cut rates. Credit spreads have been volatile but remain above five- and 10-year averages, with current spread levels at least partially pricing in a period of slower growth, in our view.[30] On the positive side, valuations in the sector have become more attractive to us, and as yields have moved higher demand from investors has increased. The higher current level of US Treasury yields may also act as a risk buffer if the economy slows more than the market expects, helping to limit total return losses from any weakness in credit spreads. Overall corporate fundamentals remain generally strong in our view, providing most investment-grade companies substantial flexibility to manage through a more challenging economic environment. Amid continued market uncertainty, we remain moderately bearish on the sector as tighter overall financial conditions will result in slower growth and deteriorating fundamentals. Our base case calls for spreads to widen further in the coming months, although the magnitude will be highly dependent on how the global economy responds to central bank policy actions. We continue to favor moving up in credit quality and, in some cases, looking for lower dollar-priced issues, while also taking advantage of new issues or any market dislocations to add exposure.

European Investment-Grade Corporates

The global rise in interest rates and the energy crisis the war in Ukraine triggered has put the euro investment grade (Euro IG) corporate bond market on track toward its worst year ever in terms of performance. The ECB's termination of its IG corporate bond buying program along with increased interest rate volatility amid rising bond yields has led some investors to aggressively sell euro IG bonds, thereby putting pressure on overall demand and liquidity in the sector. Consequently, spreads have increased considerably since the beginning of the year. Euro IG yields have reached as high as they were during the euro debt crisis, thereby making the asset class look attractive from a valuation perspective.[31] Fundamentals remain resilient as firms have been able to pass on input price increases to consumers, leading to limited profit margin deterioration. Most corporate issuers have continued to report solid balance sheets and strong credit metrics. We believe it is time to be more constructive on the asset class, as current valuations are already pricing in the impending deterioration in macroeconomic factors, higher wages, and energy prices. Therefore, we have upgraded our outlook to moderately bullish, although we generally continue to favor higher-quality credits. We also recommend that investors take an active approach to identifying and selecting investment opportunities that arise.

US High-Yield (HY) Corporates

Technical conditions have been in the driver's seat, with limited new issue supply for most of the year and strong inflows into the asset class the past few weeks keeping spreads contained. In addition, with most US high-yield (HY) bonds trading at deep discounts to par given the steep rise in UST yields, the loss in the event of a default should be less than experienced in past cycles. Moreover, the "pull to par" for the vast majority of bonds that do not default should be a powerful force over the coming years considering the average HY bond matures in just over 5.5 years.[32]

Sector	Outlook	Our viewpoint
US High-Yield (HY) Corporates *continued*		This dynamic also means that US HY spreads are not as tight as they might appear nominally. We do believe the default rate is likely to move higher from current low levels, but do not expect it to move significantly above the long-term average absent a severe recession, which is not our base case. We maintain our moderately bearish outlook for the sector for now, as spreads are likely to have more of a widening than tightening bias from here, though over a multi-year horizon we believe the case for US HY is compelling given historically attractive yields, as well as the foregoing considerations.
European High-Yield (EHY) Corporates *continued*		Credit spreads and interest rates have remained volatile during the past quarter despite fundamentals that held up better than expected during the spring months. Dispersions have remained relatively modest so far this year, but as demand starts softening and overall yields remain high, we would expect higher-leveraged issuers to underperform as we head into 2023. On the positive side, supply chain head-winds have started to unwind. Most raw materials prices and freight rates have been declining in recent months, and the availability of previously difficult-to-source components, such as semiconductors, has improved. This, along with a stronger euro, should all play in favor of European-based companies. Market technicals remain slightly negative as high risk-free rates are preventing inflows into the asset class. Higher prevailing yields are also constraining primary market supply. Away from the corporate world, we have seen good supply from financial issuers, which are net beneficiaries of increasing interest rates. We continue to find the sector attractive, particularly recently issued high coupon bonds. On the other hand, non-financial corporates have been increasingly coming to the bond market to buy back existing bonds well below par, reaffirming our positive stance for low priced/low coupon bonds issued by strong corporate entities. Selectively, we are also finding investment opportunities in cyclical companies with solid balance sheet ratios. Despite recent spread tightening, we maintain our moderately bullish stance on the asset class, based on the attractive carry, which is expected to more than offset future higher default losses. A further sudden increase in interest rate volatility would be the biggest risk to our outlook.
Floating Rate Loans		Bank loans continue to outperform most other asset classes on a year-to-date basis.[33] Although fundamentals have remained healthy in the loan market overall, bifurcation persists. While investors have generally responded positively to better-than-expected earnings, weaker-than-expected earnings and ratings down-grades have on occasion elicited higher negative investor reactions than what we would have expected, especially at the lower end of the credit quality spectrum. Primary market activity has been muted as loan prices remained at discounted levels. Similarly, demand is subdued as loan funds have experienced persistent redemption activity. We expect that flows will likely remain negative given fears of a recession, and more investors are looking past expected rate hikes toward an eventual Fed pause or pivot. As economic conditions weaken further, we expect the loan default rate to increase with a longer, drawn-out default cycle that could extend beyond the next 12 months. We believe expectations for "higher for longer" rates will stress higher- leveraged, cyclical and secularly challenged loan issuers with weakened interest coverage as LIBOR/SOFR increases and EBITDA (earnings

Sector	Outlook	Our viewpoint
Floating Rate Loans *continued*		before interest, taxes, depreciation and amortization) declines. In the near term, we anticipate a continuation of volatility and bifurcation in credits. While the fundamental impact of the rate hikes is still ahead, the overall macroeconomic weakness will have a finite life, in our view. Therefore, we believe that after hitting wides in early 2023, loan spreads may tighten toward the end of 2023. Against this backdrop, we continue to believe investors need to focus on security selection. We favor a higher quality bias and high selectivity on CCC-rated credits, while re-examining conviction levels in loans at the receiving end of the ongoing bifurcation. We also favor maintenance of liquidity buffers to protect against spread widening, as well as de-risking of portfolios from lower-quality issuers in cyclical industries. We maintain our moderately bearish outlook on the sector.
Collateralized Loan Obligations (CLOs)		With essentially flat total returns year-to-date in 2022, CLOs have performed far better than many other credit sectors across the fixed income universe, primarily due to their floating-rate nature.[34] The difficult macroeconomic environment and heightened volatility have led to spreads widening to levels only seen during the COVID-19 crisis in early 2020. They have recovered marginally since then, but both US and euro CLO secondary spreads are currently wider than their five-year averages by about 1.5 standard deviations.[35] While year-to-date issuance has held up reasonably well despite the macroeconomic volatility, we expect marginally lower supply in 2023 compared to 2022, balanced by potentially softer demand. Although fundamentals have begun to deteriorate this year and will likely continue to worsen, we believe most of those concerns are already priced in. In the near term, we expect CLO spreads to remain rangebound with a bias for tightening, while over the medium-term, increased macroeconomic clarity should drive spreads marginally tighter both in the United States and in Europe. Due to the ongoing uncertainty, we remain neutral on the asset class, and favor securities that are higher in the capital structure.
Municipal Bonds		Municipal bonds (munis) have seen significant negative total returns year-to-date in 2022 amid heightened market volatility, and the sector is on track to have the worst annual performance on record. The drawdown was even more pronounced among taxable issues and was driven primarily by the sharp increase in UST yields and the long duration profile of the sector. On the positive side, however, we believe municipal bonds now offer very attractive nominal yields, especially considering their high credit quality. Fundamentals remain robust, with most issuers going into this period of slowing economic growth with ample reserves. Strong management will be crucial as we see possible areas of concern over the next few years due to labor shortages and wage inflation, higher borrowing costs and the upcoming end to federal COVID-19 aid. However, this year's selloff has provided an opportunity for us to find solid credits at attractive valuations. Furthermore, supportive technical conditions, with very limited supply particularly in the taxable muni space, leads us to remain moderately bullish on the asset class.

Sector | Outlook | Our viewpoint

Emerging Market (EM) Debt

This year has been incredibly challenging for EM debt, with the asset class on track for one of the worst years on record in terms of performance.[36] Returns have been driven primarily by the Fed's aggressive monetary tightening and the strength of the US dollar, which have combined to create tighter external financing conditions for EM sovereigns. This has exerted downward pressure on the sector, particularly for those countries that are very reliant on foreign capital and with weaker fiscal buffers to be able to offset this factor. In terms of technical conditions, the sector has seen significant fund outflows, while new issuance has been extremely low. We believe that the heightened levels of financial stress will require strong policy adjustments across countries in order to ensure they are able to service international debt and maintain imports of critical goods. Volatility will likely persist over the near-term until we gain more clarity on the trajectory of US monetary policy and the extent of the global growth slowdown. Nevertheless, the value we are seeing in the asset class leads us to retain our neutral with reasons for optimism outlook, particularly over the longer term.

Emerging Market (EM) Corporates

Global macro factors have continued to be the key driver of emerging market corporate bond performance throughout 2022. With spreads widening and yields increasing substantially year-to-date, we see strong relative value in the asset class particularly once the end of developed market (DM) tightening cycles comes into sight.[37] When inflation starts to moderate, the higher expected growth across emerging markets (EMs) and strong corporate fundamentals will likely draw investor interest to the sector. Robust corporate balance sheets and low net leverage point to the likelihood of a muted default cycle outside of a few concentrated countries and sectors. We have upgraded our outlook to neutral with reason for optimism while acknowledging that the outlook for the very near term is uncertain. In this challenging environment we continue to recommend a thorough, bottom-up investment approach focused on identifying issuers with strong cash flow generation, legal protections for bond holders, environmental, social and corporate governance (ESG) credentials, and finding mispriced risk while prioritizing a high level of diversification.

Global Sukuk

The Global sukuk sector's defensive characteristics have stood out during a challenging year, demonstrating resilience in the face of extreme interest rate volatility and a general emerging market bond selloff. We anticipate continuing pressure on the sector from a challenging macroeconomic environment and potentially weaker oil prices, but fundamentals remain strong and refinancing needs are relatively muted. Despite all the headwinds, spreads remain at relatively low levels as commodity-exporting countries—which constitute the majority of sukuk issuers—benefit from a natural buffer to high inflation through exposure to rising oil prices.[38] The improvement in sovereign fiscal balances has improved credit profiles, but the relative resilience of spreads is now a potential risk. As a result, it is reasonable to expect credit spreads to widen from current levels, dampening potential returns. The more meaningful risk, however, continues to reside in rising benchmark rates, likely alongside continued upside surprises in inflation. However, an approaching recession may challenge this scenario, limiting the time rates stay elevated. With absolute yields now at levels not seen in two decades (excluding the financial crisis), we believe valuations provide a compelling rationale for the attractiveness of the sector, particularly for higher-quality issuers. However, we remain cautious and moderately bearish on the sector due to elevated global risks.

Endnotes

1. Source: Bureau of Labor Statistics (BLS).
2. Source: Brookings Institution, November 30, 2022.
3. Source: Bureau of Economic Analysis (BEA).
4. Sources: Franklin Templeton Fixed Income Research, BEA.
5. Sources: Franklin Templeton Fixed Income Research, BEA.
6. Sources: Federal Reserve.
7. Source: BEA.
8. Sources: National Association of Realtors (NAR), National Association of Home Builders, Mortgage Bankers Association (MBA).
9. Sources: Franklin Templeton Fixed Income Research, Bankrate, MBA, NAR, US Census Bureau.
10. Sources: Franklin Templeton Fixed Income Research, US Census Bureau, NAR, Macrobond.
11. Sources: US Energy Information Administration (EIA), Baltic Exchange, CPB, Container Trades Statistics, Ltd., Macrobond.
12. Source: BLS.
13. Sources: BLS.
14. Sources: BLS, BEA, Macrobond.
15. Source: Eurostat.
16. Sources: German Federal Statistical Office (Statistisches Bundesamt), Macrobond.
17. Sources: Franklin Templeton Fixed Income Research, ECB, Macrobond.
18. Source: Eurostat.
19. Sources: Bundesnetzagentur, Eurostat, Macrobond.
20. Source: Bruegel.
21. Source: Eurostat.
22. Source: Bloomberg.
23. Source: Ministry of Internal Affairs and Communications.
24. Source: Freddie Mac—Primary Mortgage Market Survey. As of December 1, 2022.
25. Source: Franklin Templeton Fixed Income Research.
26. Sources: Bank of America Merrill Lynch, US Federal Reserve, eMBS (Mortgage-Backed Securities OnLine: Black Knight).
27. Source: Franklin Templeton Fixed Income Research.
28. Source: Franklin Templeton Fixed Income Research.
29. Source: Franklin Templeton Fixed Income Research.
30. Source: Bloomberg.
31. Source: Bloomberg Euro-Aggregate Corporates Index.
32. Source:ICE Bank of America US High Yield Constrained Index.
33. Source: JP Morgan.
34. Source: JP Morgan. As of December 2, 2022.
35. Source: Franklin Templeton Fixed Income Research, JP Morgan.
36. Source: JP Morgan Emerging Market Bond Index (EMBI) Global Diversified
37. Source: ICE Bank of America Emerging Market Corporate Plus Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.
38. Source: Dow Jones.

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Notes

Notes

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