PERSISTENT, THE NEW TRANSITORY

October 2021

VOLUME 8 | FRANKLIN TEMPLETON FIXED INCOME VIEWS

In this issue

Supply-side driven inflationary pressures have gained increasing prominence during the course of the third quarter. The global economic recovery has remained overall on track, with robust growth in most world regions. In the United States, second quarter gross domestic product (GDP) growth missed expectations, but the economy still expanded at the fastest pace in 70 years and both real and nominal GDP exceeded the pre-COVID peaks (by one and five percentage points, respectively).[1] The recovery continues to be driven by consumer spending, with the anticipated rotation from goods to services well underway, while business equipment investment has picked up in anticipation of stronger future consumer demand.

Household spending drove a healthy recovery in Europe as well, with consumers responding strongly to the gradual easing of activity restrictions. The euro area expanded by 2.2% quarter-over-quarter (Q/Q), with peripheral countries such as Italy and Spain outperforming core economies like France and Germany; Europe's largest economy in particular disappointed, held back by supply constraints hitting the auto industry. The euro area's economy remains some 3% below pre-COVID levels.[2]

The fast-spreading COVID Delta variant drove a sharp rise in new cases across several countries and US states, with increasing reports of "breakthrough" cases (which represent fully vaccinated individuals who have contracted the virus). This brought back concerns for the economic outlook. However, even in areas experiencing spikes in new cases, hospitalization and death rates remained largely stable or rose much less than infections. This confirms that vaccines remain very effective in preventing serious adverse health effects from COVID, reducing the risk of extreme pressure on health care systems. The share of fully vaccinated population has now reached 54% in the United States, over 62% in the European Union (EU), 65% in the United Kingdom, and over 70% in Canada.[3] Vaccination rates tend to be even higher among the most vulnerable, notably the elderly.

Thanks to the protection offered by vaccines, authorities in both Europe and the United States have refrained from re-imposing severe limitations on social and economic activity; restrictions have mostly targeted large social events like concerts, reducing the adverse impact on the economy. The focus has shifted on requiring proof of vaccination (or a recent negative COVID test) for participating in a range of activities (such as indoor eating at restaurants or going to work) in order to further boost vaccine uptake. Restrictions have been more significant in some Asian countries where vaccination rates are lower, compounding the ongoing disruption of global supply chains. Overall, developments on the pandemic front could slow the global recovery somewhat but do not threaten to derail it, in our view.

The disruption of global supply chains, however, persists, with companies continuing to report shortages of components and significant delays in deliveries, all contributing to building pressure on prices. Other signs also indicate that the supply side struggles to catch up with demand. In the United States, the labor market recovery remains lackluster. The transition rate from unemployment to employment remains consistently below trend even as job openings hold at record highs (see the US economic review section below); sectors like leisure and hospitality, retail trade, transportation and warehousing, and manufacturing, continue to display high employee quit rates and high wage growth.

Overall, this macroeconomic outlook confirms the main pillars of our investment strategy approach: With inflation risks tilted to the upside, we continue to favor shortening duration; we remain moderately bearish on both US Treasuries and eurozone government bonds, and in the euro area we expect peripheral government bonds to prove more vulnerable once the ECB starts reducing the pace of asset purchases. We remain neutral on Japanese government bonds.

With supply chain disruptions persisting, and employers still facing a shortage of workers, US inflation rates remain elevated. In August, headline Consumer Price Index (CPI) inflation ran over 5% year-over-year (Y/Y) for the third consecutive month, even as the month-over-month (M/M) rate slowed.[4]

High rates of inflation pose a double risk. First, they are eroding purchasing power, which could undermine consumption. Higher prices have held real wages and salaries at the December 2020 level, negating the benefit of the significant rise in nominal wages.[5] Second, persistently high inflation rates are beginning to feed into higher inflation expectations, as we warned in our last quarter's publication. The Federal Reserve Bank of New York's August 2021 Survey of Consumer Expectations, for example, showed three-year ahead inflation expectations at a new high of 4%, with one-year ahead expectations above 5%. The University of Michigan Survey also indicates that consumers expect a further erosion of purchasing power ahead. Consumer inflation pressures are beginning to become more broad-based even as some of the initial outliers (like used cars) have slowed. Slow burning pressure from rising house prices into rents is also likely to sustain inflation dynamics going forward. We believe inflation risks remain biased to the upside compared to markets' and policymakers' expectations.

Persistently elevated inflation rates have likely contributed to the Federal Reserve's (Fed's) decision to open the door to a fourth quarter taper announcement. In its September meeting, the Federal Open Market Committee (FOMC) indicated that if economic progress continues broadly as expected, a "reasonably good" September jobs report would be sufficient for the Fed to start tapering before the end of the year, with the aim of completing the taper by mid-2022. In our view, a formal taper announcement is most likely in November. The September FOMC meeting, however, also confirmed a deep rift on the timing for interest rate moves, with half of FOMC members now expecting rate hikes to begin next year and half seeing it only in 2023—though the median view implicit in the dots has become noticeably more hawkish over the past several months.

Price pressures have risen in the euro area as well, with headline inflation reaching 3% in August, above expectations and the highest since 2011.[6] As in the case of the Fed, the European Central Bank's (ECB's) official message remains dovish, insisting that high inflation will prove transitory; but disagreements among central bank members have also increased and will likely be exacerbated by the fact that inflation has risen particularly sharply in Germany, where base effects are likely to push it north of 4% in the coming months.

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We remain moderately bullish on emerging markets (EM) government and corporate debt. EMs have lagged behind in both vaccinations and economic activity, but we believe they are set to

benefit from the robust synchronized economic recovery in the main developed markets. The recent approval of an additional US$650 billion International Monetary Fund (IMF) Special Drawings Right allocation will provide added support. Net supply of EM corporate debt has been easily absorbed, and we believe the carry versus developed market corporates remains attractive.

We continue to find attractive investment opportunities in US municipal bonds, both tax-exempt and taxable, with support from market technicals (including lower primary issuance) and fundamentals, as a rapidly recovering economy and elevated stock market valuations combine to improve local public finances. We have upgraded our view on euro high-yield corporates, as the improvement in economic conditions and corporate earnings has not yet been reflected in any meaningful compression in spreads. We also continue to see selected investment opportunities in US high-yield corporates, as credit fundamentals have improved meaningfully over the last two quarters.

We believe an active fixed income investment management approach remains essential: sectors and individual companies are being affected in a very differentiated way by a range of factors including the lifting of COVID-related restrictions, the influence of residual pandemic fears on consumer behavior, component shortages and other supply chain disruptions, policy and regulatory changes and technological innovations—as well as market technicals. Research-driven selection of sectors and individual names therefore remains key to a successful investment approach. Finally, as we warned already in our third quarter publication, investors need to be prepared to navigate significant bouts of volatility as markets keep scrutinizing the likely timing of monetary policy changes.

Macroeconomic themes

- **Economic recovery remains entrenched**
  High vaccination rates in most developed economies have provided an effective barrier against the resurgence of COVID infections, keeping hospitalization and death rates anchored even where new cases have risen significantly due to the Delta variant. We believe this will allow governments to continue to rely on targeted pandemic-control measures rather than more wide-spread activity restrictions. A robust global recovery therefore remains on track, in our view.

- **Supply-side inflation pressures become increasingly important**
  Global supply chain disruptions continue to cause delivery delays and shortages of components that are putting upward pressure on prices. In the United States, the pace of labor market recovery remains uneven, leaving many companies to face hiring difficulties and fueling faster wage growth in several sectors. We expect these supply-side factors will keep inflation higher for longer and keep inflation expectations relatively elevated.

- **Central banks get ready to adjust policy stance**
  A resilient recovery and higher inflation rates are gradually pushing major central banks closer to adjusting their policy stance. This comes with more internal debates among those who are more concerned about the potential risk of loose policy to inflation and financial stability, and those who favor giving more prolonged support to the recovery in activity and jobs. Overall, we expect the Fed to start tapering later this year, with rate hikes likely to begin next year—especially if our expectations on inflation prove correct.

Portfolio themes

- **Active management and selectivity remain the top priority**
  Currently rich valuations and the risk of rising rates pose a hard challenge to investors, while sectors and individual companies stand to be affected in very different ways by a range of macro and technical factors, from the easing of pandemic-related restrictions to shifts in consumer behavior to policy and regulatory changes. Research-driven assessment of the fundamentals of different potential investment opportunities remains essential.

- **Capitalize on the benefits of improving macro conditions on select sectors**
  The global macro environment continues on an improving trend, but its beneficial impact will be unevenly distributed. We see interesting opportunities in US municipal bonds, supported by improving local public finances; in emerging markets, which should benefit from the synchronized recovery in large developed economies; and in selected euro high-yield sectors on the back of recovering activity which has not yet been reflected in spread adjustments.

- **Position to handle increased volatility**
  Valuations across a wide range of markets are historically high; major central banks play a significant role as price-insensitive buyers in a number of asset classes and are now debating the timing and pace of a change in policy stance. Together with the residual pandemic uncertainty, ongoing supply side disruptions and geopolitical uncertainty, this creates the potential for significant bouts of volatility in asset prices; investors need to be prepared to handle this higher volatility and adjust their portfolios accordingly, where appropriate.

Sector settings

Overall Risk Outlook

– OUTLOOK +

US Treasuries

– OUTLOOK +

US Treasury Inflation-Protected Securities (TIPS)

– OUTLOOK +

Eurozone Government Bonds

– OUTLOOK +

Japanese Government Bonds

– OUTLOOK +

Agency Mortgage-Backed Securities (MBS)

– OUTLOOK +

Non-Agency Residential Mortgage-Backed Securities (RMBS)

– OUTLOOK +

Commercial Mortgage-Backed Securities (CMBS)

– OUTLOOK +

Asset-Backed Securities (ABS)

– OUTLOOK +

US Investment-Grade Corporates

– OUTLOOK +

European Investment-Grade Corporates

– OUTLOOK +

US High-Yield Corporates

– OUTLOOK +

Euro High-Yield Corporates

– OUTLOOK +

Floating Rate Loans

– OUTLOOK +

Collaterized Loan Obligations (CLOs)

– OUTLOOK +

Municipal Bonds

– OUTLOOK +

Emerging Market (EM) Debt

– OUTLOOK +

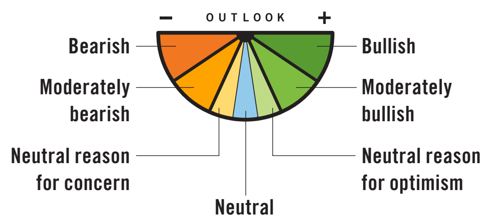
Emerging Market Corporates

– OUTLOOK +

Global Sukuk

– OUTLOOK +

Understanding the pendulum graphic



Arrows represent any change since the last quarter end.

Franklin Templeton Fixed Income macroeconomic recap & outlook

US economic recovery still on solid footing, but risks loom ahead

After the solid start in the first quarter of 2021, the US economy grew at a surprisingly modest 6.6% Q/Q seasonally-adjusted annualized rate in the second quarter—well below the median consensus forecast of 8.4% and our previous downside scenario forecast of 8.3%. However, despite the quarterly miss, the 12.2% year-over-year (Y/Y) GDP growth rate represented the fastest pace of expansion in 70 years and leaves the economy 1 percentage point above the pre-COVID peak, while nominal GDP is 5 percentage points higher.[7]

Underlying domestic growth momentum is stronger than the headline number suggests. While government consumption, residential investment, net exports, and inventories were a drag on growth, consumer spending surged by a stronger-than-anticipated annualized 11.8% rate, the second largest advance since 1952. Services became the dominant contributor (5.1 percentage points) to overall Personal Consumption Expenditure (PCE), suggesting that the much-anticipated rotation from goods to services is well underway. On the capital expenditure (capex) side, business equipment investment made a solid contribution to overall growth.[8]

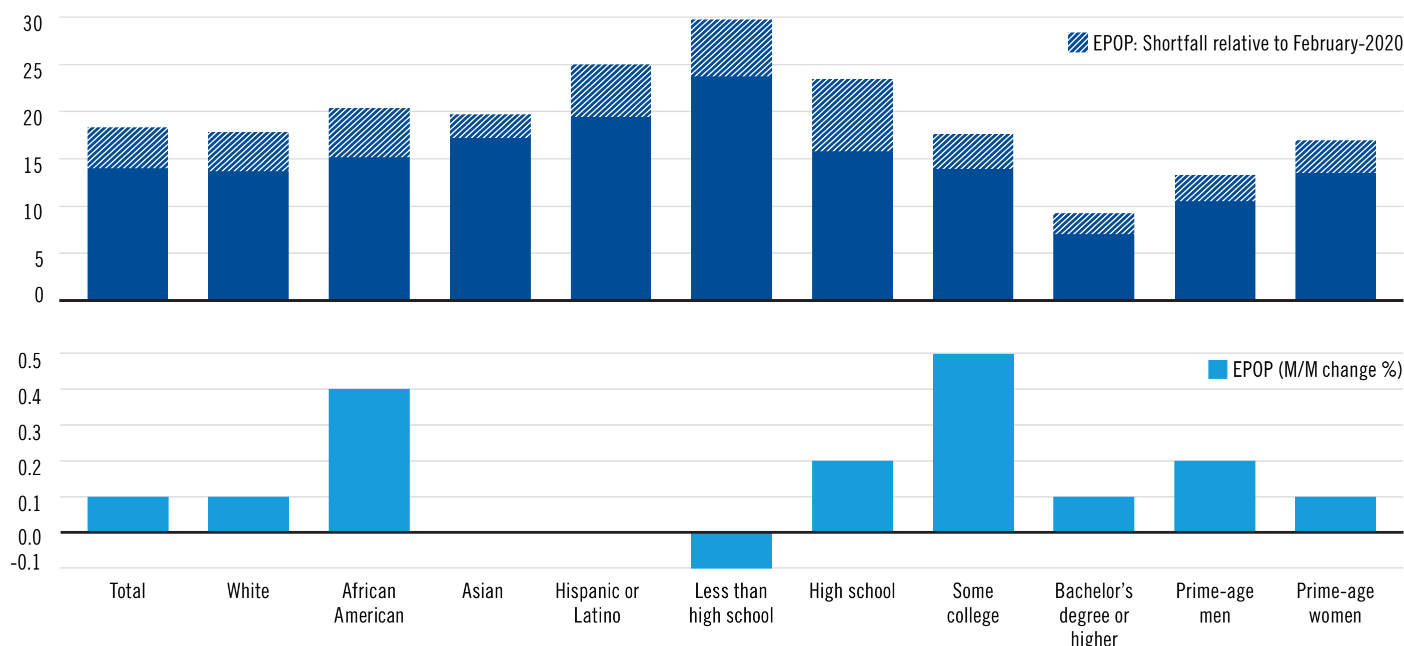
Given a still high savings rate, excess savings of nearly US$3 trillion and consumer spending exceeding expectations, we expect firms to continue with robust capex in anticipation of rising demand. Moreover, we expect inventory restocking to be a significant tailwind for third quarter growth (and possibly the entire second half of 2021).

The labor market: Job openings remain at record levels, yet transition to employment remains weak

Nonfarm payrolls beat consensus estimates in July but unexpectedly downshifted in August to only 235,000 jobs—the weakest pace since January. The leisure and hospitality and retail trade sectors suffered from the rapidly spreading Delta variant, and in August the number of people unable to work because of COVID-19 stood at 5.6 million—up 400,000 from a month earlier. On a positive note, payrolls excluding leisure and hospitality still showed a robust 243,000 gain in August. The three-month trailing

EPOP DISPARITIES NARROWING ACROSS DIFFERENT DEMOGRAPHICS

Exhibit 1: Employment-to-population ratio (EPOP)
August 2021



Sources: Franklin Templeton Fixed Income Research, BLS, Macrobond.

average for payroll gains now stands at 750,000 and the payrolls shortfall relative to February 2020 levels (pre-COVID) now stands at 5.3 million, with the leisure and hospitality sector constituting 1.7 million of the total.[9]

The unemployment rate fell to 5.2% (from 5.4% in July) with a steady labor force participation rate (LFPR). Underemployment (U-6) declined from 9.2% to 8.8%, while those unemployed for 27+ weeks continued to trend lower. While the employment-to-population ratio (EPOP), a broader measure of labor market conditions, ticked up by 0.1 percentage points to 58.5, employment disparities across different demographics are narrowing. Note that some FOMC participants have put increased emphasis on EPOP as an important input for when to begin tapering. Encouragingly, the EPOP for prime age (25–54) workers rose 0.2 percentage points to 78%. Prime age EPOP will likely become an important indicator over the coming months as it is less affected by the aging population, which adds downward pressure on the headline LFPR and EPOP.[10]

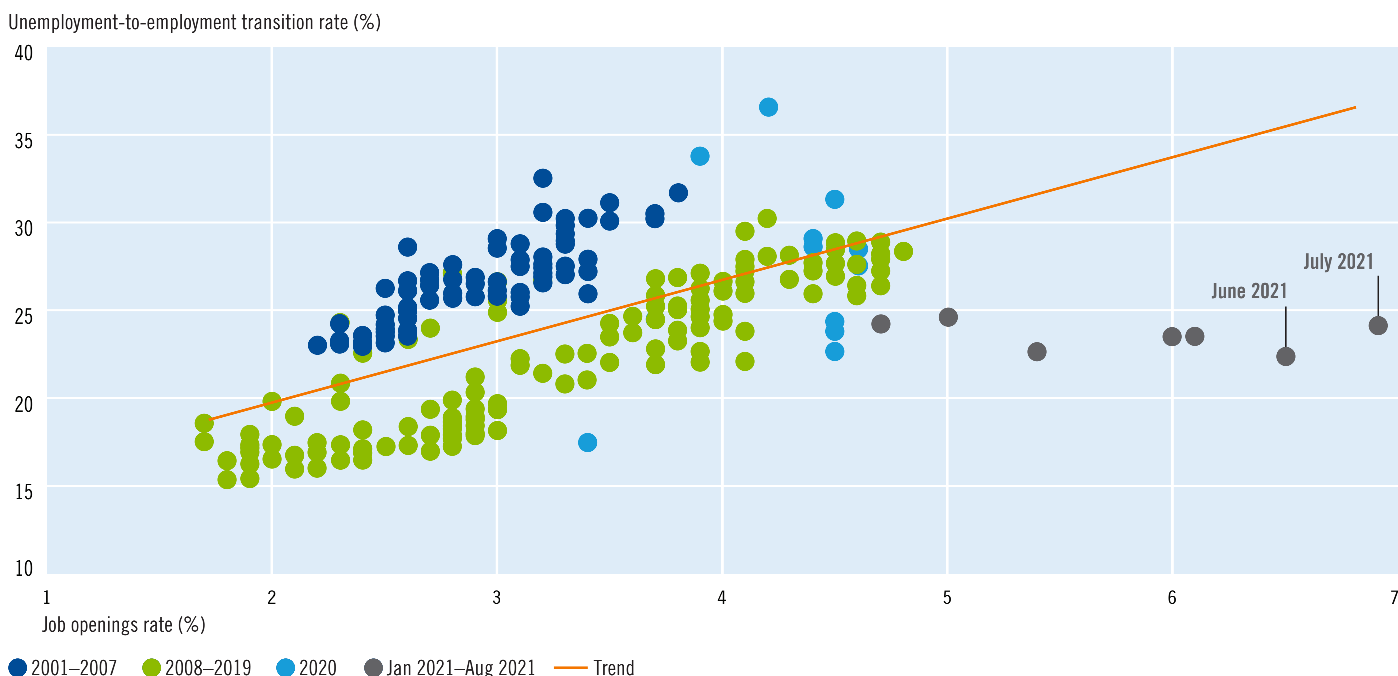
Despite the record high 10.9 million job openings in July, the transition from unemployment to employment (U–E) has consistently fallen below trend since the start of the year. In contrast, the elevated levels of job openings and quit rates point to a very tight labor market. Leisure and hospitality, retail trade, transportation and warehousing, and manufacturing have particularly high quit rates—also the four sectors where Y/Y wage growth (average hourly earnings or AHE) has been particularly strong.[11]

Average hourly earnings rose 0.6% M/M in August, beating consensus estimates of a 0.3% increase. Wages in the leisure and hospitality sector accelerated by 1.3% M/M—the strongest across all sectors.[12] Employers are offering incentives to attract workers, such as one-time bonuses and higher starting wages, but jobs continue to be difficult to fill.

Labor composition-adjusted wages such as the Employment Cost Index (ECI) and the Atlanta Fed's wage tracker show that wage growth has held up at its pre-pandemic pace, due in large part to the acceleration in wages for the lowest income quartile of workers and low-skilled workers.[13] A closer look at the NY Fed's labor market survey shows that as of the first quarter, more respondents with less than a college degree were receiving non-wage benefits than was the case in 2019. Similarly, the reservation wage—the lowest wage rate at which a worker would be willing to accept a job—has risen by 26% (or US$13,000) for those with less than a college degree. Overall, if wages were the one singular indicator for the health of labor market and the economy, one would be hard-pressed to believe that employment was still 5.3 million below the pre-COVID peak.[14]

TRANSITION FROM UNEMPLOYMENT TO EMPLOYMENT REMAINS BELOW TREND

Exhibit 2: US unemployment-to-employment rate (%) vs. job openings rate (%)
January 2001–July 2021

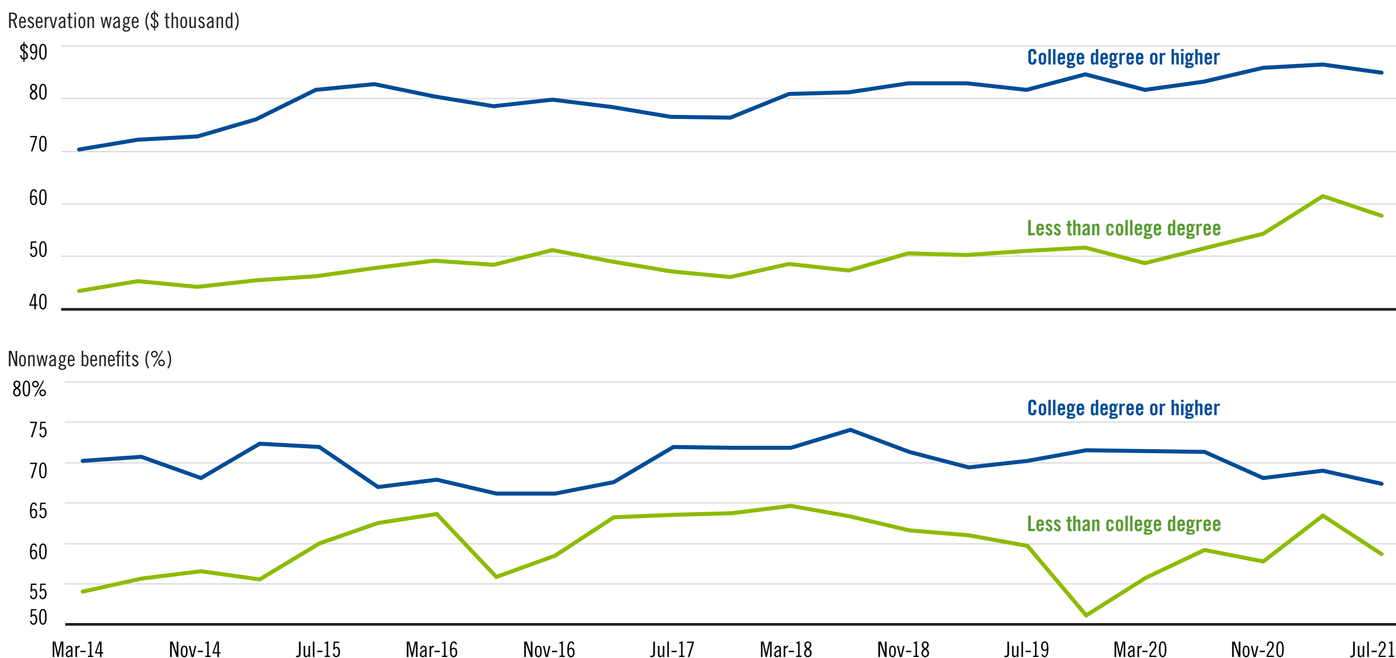


Sources: Franklin Templeton Fixed Income Research, BLS, TCB, Macrobond.

US WORKERS WITH LESS THAN A COLLEGE DEGREE DEMANDING HIGHER PAY

Exhibit 3: Reservation wage (US$) and non-wage benefits (%)

March 2014–July 2021



Sources: Federal Reserve Bank of New York, SCE Labor Market Survey.

The consumer: Spending and financial health look solid, but inflation to weigh on purchasing power

Disposable income and spending held up well through the pandemic on the back of the swift government/fiscal response. In real terms, July expenditure was up 2.7% since February 2020, while income was up 3.4%. Despite the continued reduction in fiscal aid to households, real personal spending and real retail sales have largely returned to normal M/M trend growth rates.[15]

Rising inflation, however, is beginning to pose a risk to consumer spending. Though nominal and real wages and salaries staged an initial strong V-shaped recovery, the inflationary “surge has meant that real wages and salaries have remained stagnant since December 2020. Similarly, while nominal hourly earnings for production and non-supervisory workers have risen by 3.4% since January 2021, inflation adjusted AHE actually declined by 1.1% over the same time.[16]

Consumers fear this erosion of purchasing power will continue. The University of Michigan survey shows consumers expect a decline in purchasing power, and other recent surveys (for example by the New York Fed) unambiguously point to consumer expectations for higher inflation and interest rates in the year ahead and beyond.

Inflation: Reopening effects starting to wane

The Fed has continued to downplay inflationary concerns, insisting that the surge in prices is transitory and can be attributed to a handful of outliers. That was true for earlier inflation prints between April and June, with over 50% of the M/M surges driven by used and new vehicles, vehicle insurance, hotels, food away from home, and airfare. By July and August, however, reopening-sensitive categories moderated in importance, and price pressures are starting to appear broader.

Even though M/M readings have moderated, to 0.3% in August, Y/Y basis headline CPI inflation remains above 5%. Meanwhile, the PCE series, which is more representative of what goods producers and service providers are selling, shows that services inflation has continued to gain share over goods over the past several months.

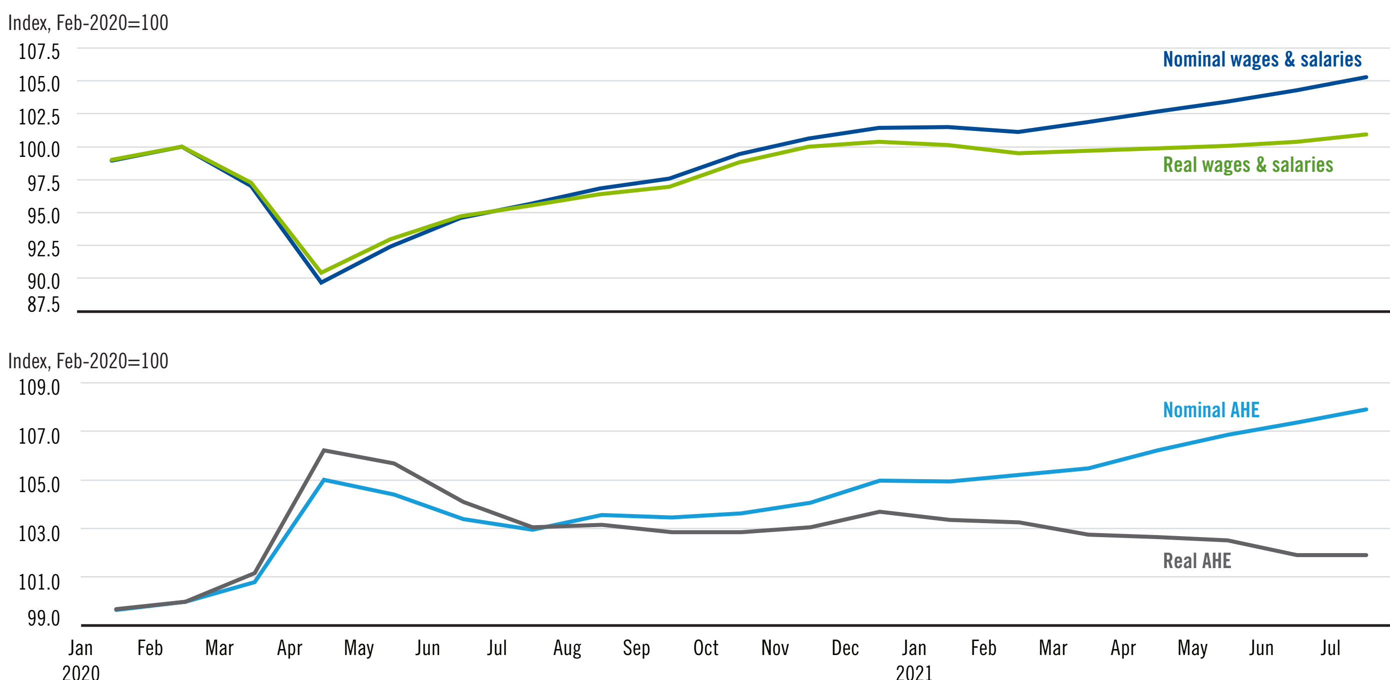
While Core PCE also accelerated at a pace not seen since 1991, the Dallas Fed's Trimmed Mean PCE measure suggests that inflationary pressures are not yet pervasive. A trimmed mean reading of 2% contrasts with a headline PCE of 4.2% and Core-PCE of 3.6%. The divergence arises because the trimmed mean focuses specifically on the middle distribution of the PCE basket, which has not shifted substantially in terms of pricing.[17]

However, the trimmed mean PCE generally tends to follow headline PCE with a 12-month lag, which represents the “bleed-through” effects of the large supply-demand imbalances that initially

INFLATION IS EATING INTO NOMINAL WAGE GAINS

Exhibit 4: US nominal wages & salaries vs. real wages & salaries; nominal AHE vs. real AHE

January 2020–July 2021



Sources: BEA, BLS, Macrobond.

affect a small set of PCE items, but eventually spill over into a broader range of goods that represent a larger share of consumer expenditure.

Semiconductor shortages, for instance, have attracted a lot of attention primarily due to their effect on prices of used cars (+38% Y/Y), but a continuation of these shortages would lead to price increases for a broader range of consumer electronics. Similarly, a supply-demand imbalance for materials such as lumber have impacted headline PCE inflation through components such as furniture and have contributed to rapidly rising house prices. While house price appreciation may not show up directly in PCE, the coming months could lead to a more durable pickup in rents.

We are keeping a close eye on rental inflation since it accounts for 31.4% and 15.8%, respectively, of the CPI and PCE baskets and would therefore qualify as the more "sticky" component of overall inflation. Meanwhile, data from the US Census Bureau suggests that asking rents have climbed higher, in line with higher home prices. Historically, there appears to be a 12–16-month lag between house prices and CPI/PCE rental inflation.

Fed gets ready to taper

With inflation remaining higher for longer than the Fed initially expected, the FOMC September meeting has opened the door to a November taper announcement so long as economic progress continues broadly as expected. Chair Powell further reinforced this timeline by noting that, in his view, the test for substantial further progress is "all but met" and that he only needed to see a "reasonably good" (not a "knockout") September jobs report. With the test for progress on inflation already met, a September jobs gain that is somewhere in the range of August's 235K and 750K (current 3-month trailing average) will likely suffice for the Fed to move ahead with a November announcement.[18]

Moreover, there is unanimous support within the Committee to conclude tapering by mid-2022. Although the pace of tapering remains undecided, for asset purchases to end by mid-2022 (June 2022), the Fed may well start with a monthly reduction of US$15 billion/month (UST: US$10 billion; MBS: US$5 billion) in November itself. However, a November start to tapering might require not only sufficiently strong economic data, but also a resolution to the ongoing debt limit standoff. A delay in tapering, therefore, could result in a faster pace of monthly reductions given the mid-2022 deadline. Moreover, Powell also stressed that the pace of tapering will likely not follow a preset course, as the Fed will maintain the flexibility to either speed up or slow down the pace of purchases as the economic situation evolves.

As for liftoff, the FOMC remains evenly divided between hiking and holding in 2022. The September dot plot shows that the median dot remains divided between three to four hikes by

end-2023, followed by another three hikes by end-2024. However, the wide dispersion of policy rate forecasts over 2023 and 2024 suggests that there is much less consensus on the quantum of rate hikes per year. Note that in the prior rate hike cycle, the FOMC was overly ambitious regarding the pace of interest rate normalization, both in terms of the pace of hikes and the eventual longer-run rate. Moreover, the composition of the FOMC is also likely to be very different over the next couple of years. We expect Powell to be reappointed, while dovish members such as Lael Brainard and John Williams are likely to gain increased influence (all three likely favor a 2023 liftoff). Therefore, the median policy rate could very easily move lower in the future.

US fiscal policy: A fractious dual-track strategy in progress

Democrats have pursued a two-track strategy, seeking to approve both the US$1.2 trillion bipartisan infrastructure plan supported by moderates and a bigger package sought by progressives that focuses on social safety net programs and climate change mitigation. The Senate passed the Infrastructure Investment and Jobs Act (IIJA) on August 10. Over a five-year period, the legislation allocates US$550 billion in new financing for roads, bridges, ports, internet, and water infrastructure. It also reauthorizes a number of current programs, increasing the total notional cost to over US$1.2 trillion.

Meanwhile Senate Democrats approved the FY22 budget resolution (BR) amounting to US$3.5 trillion on August 11, which sets the stage for the reconciliation process, i.e., allowing the Biden Administration to pass far-reaching spending and taxation legislation without the need for Republican support. The BR needs to be approved by both chambers before Democrats can press ahead with the reconciliation plan, which will likely be brought up for consideration in the fall.

Both pieces of legislation—the IIJA (US$1.2 trillion) and BR (US$3.5 trillion)—now sit in the House, where Progressive Democrats want to push ahead with a vote on the BR while holding off on the bipartisan IIJA as leverage, while centrist Democrats want to prioritize the IIJA; and some of them have also pushed back on the BR bill's price tag of US$3.5 trillion as excessive.

Negotiations are ongoing to clarify just how large the final spending package will be, and which tax increases are likely to be included. We expect an increase in corporate taxes to 25%, changes to taxation of international corporations, an increase in taxes for individuals earning more than US$400,000 and greater funding for the IRS to enforce tax compliance, are likely to find strong support. However, other changes such as the boost to capital gains tax rates and a change in the levy on inheritance are likely to prove tougher to implement. Meanwhile, 11 Democrats on the House Ways and Means Committee have specifically highlighted the need to expand the US$10,000 cap on the state and local tax (SALT) deduction. Since unanimous Democratic support for raising US$1.8 trillion in new taxes may be hard to come by in the Senate, Democrats could scale back the spending target of US$3.5 trillion.

US economic outlook

We continue to anticipate exceptionally strong real GDP growth for the remainder of 2021, with third-quarter GDP revised upwards in anticipation of the inventory build-up that had originally been expected in the second quarter. Growth forecasts for the fourth quarter have been revised lower, but GDP growth is still expected to be higher than the first two quarters of the year given the possibility of a strong holiday spending surge. The table (Exhibit 5 on the next page) shows our updated outlook.

Euro area economy: Out of the recession, the rebound is here

The euro area economy expanded faster than expected in the second quarter as consumers responded strongly to the gradual easing of social distancing restrictions, with second quarter real GDP of 2.2% Q/Q. This time, peripheral countries outperformed core countries: Spain and Italy expanded by 2.8% and 2.7% Q/Q, respectively, Greece surged to 3.4% Q/Q, while France (1.1% Q/Q) and Germany (1.6% Q/Q) grew more moderately. The main growth driver remained private consumption, rebounding by 3.7% Q/Q. COVID-sensitive sectors, such as recreation and hospitality, outperformed and drove the momentum in the periphery. Industrial bottlenecks, in particular in the auto industry, led to manufacturing weakness (especially in Germany), while net trade likely subtracted from headline growth in most countries as consumption's resurgence steered imports momentum over exports. Overall, the euro area economy remains about 2.5% below pre-COVID levels, with a narrower dispersion of GDP trajectories which should further shrink over the second half of the year.[19]

The vaccination campaign in the "big4" countries has reached an advanced phase, with more than 70% of the population receiving at least one dose and around 65% fully vaccinated, well ahead of the United States.[20] Although the pace of inoculations has slowed, the introduction in an increasing number of countries of active policies requiring a health ("green") pass to access indoor activities and public spaces/transportation, notably in France and Italy, will likely give vaccination rates a further boost.

FRANKLIN TEMPLETON FIXED INCOME—US GROWTH OUTLOOK

Exhibit 5: Real US GDP growth, unemployment rate, and inflation rate forecasts
As of September 2021

	Baseline scenario		
	Real GDP (% Q/Q AR)	Unemployment rate (%)	CPI inflation (% Y/Y)
2021-Q1	6.3%	6.0%	1.9%
2021-Q2	6.6%	5.9%	4.8%
2021-Q3	*7.2%*	*5.0%*	*5.2%*
2021-Q4	*6.8%*	*4.6%*	*4.8%*
2022-Q1	*5.5%*	*4.4%*	*4.3%*
2022-Q2	*3.4%*	*4.2%*	*3.2%*
2022-Q3	*2.7%*	*4.1%*	*2.8%*
2022-Q4	*2.3%*	*4.1%*	*2.5%*

	Baseline scenario	
	Real GDP (annual)	Real GDP (Q4/Q4)
2020	–3.4%	–2.3%
2021	*6.3%*	*6.7%*
2022	*5.1%*	*3.5%*

Italics indicates forecast.

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

OUT OF RECESSION, BUT STILL RUNNING BELOW PRE-COVID LEVELS

Exhibit 6: Real GDP (% Q/Q)
Q2 2020–Q2 2021

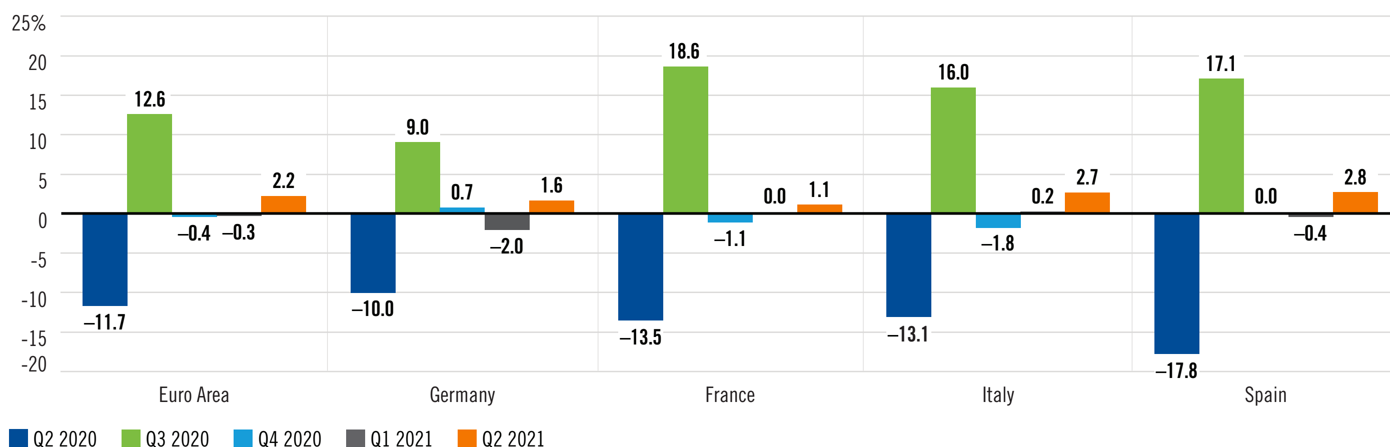
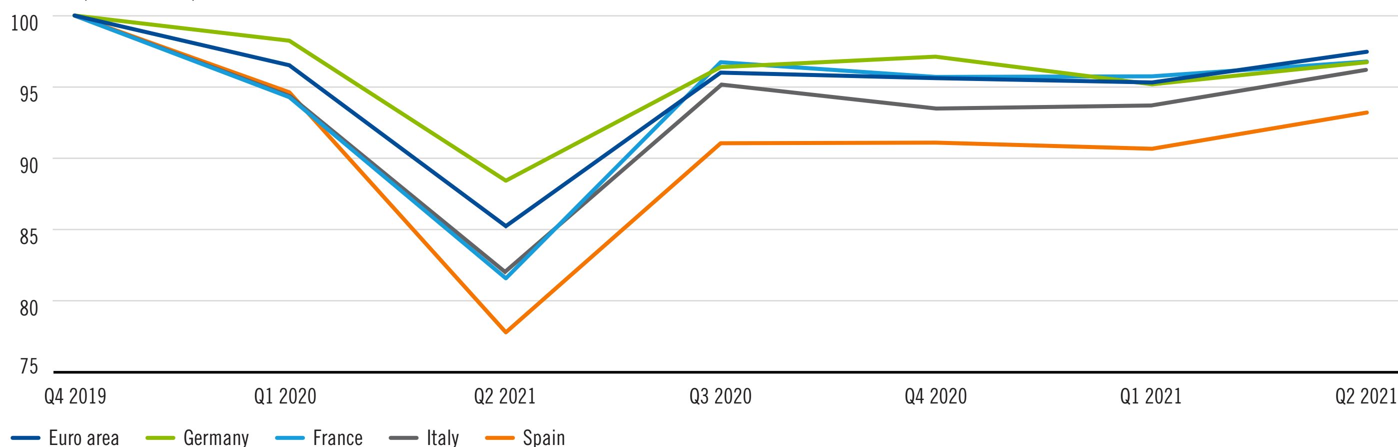


Exhibit 7: Real GDP (relative to Q4 2019)
Q4 2019–Q2 2021



Sources: Eurostat, Macrobond.

Variant resurgence poses downside risks

The spread of the Delta variant led to a generalized increase of cases. However, thanks to high vaccination rates—especially among the older age cohorts—mortality rates have remained relatively stable and hospitalization admissions and ICU occupancy are not causing concerns over pressure on the healthcare systems.

Governments have thus far refrained from reimposing far-reaching restrictions, adopting only targeted limitations on the hospitality and entertainment sector (for example, restricting large gatherings and events and reducing indoor capacity), which are relatively less costly economically.

The fear of COVID-19 is again having some impact on confidence: Germany's Ifo Business Climate indicator, for example, unexpectedly fell to a three-month low of 99.4 in August, from 100.7 and 101.8 the previous two months, driven by a sharp drop in the expectations component to 97.5 from 101. The EC Economic Sentiment survey's consumer confidence component declined for the past two months, driven by weakening expectations of demand prospects in the next three months for all sectors.

Overall, given the advanced vaccination rollout, we believe the risk of strict lockdowns at this point seem manageable and the economic outlook remains constructive.

Euro area economic outlook

The better-than-expected Q2 GDP print, closer to our prior upside scenario than baseline, pushes our euro area real GDP forecast to 5.1% in 2021 (versus our last quarter estimate of 4.4%) and 4.5% in 2022 (unchanged). We believe growth will continue to be healthy in the third quarter. We expect peripheral Europe to continue to outperform on the back of the summer touristic season and recover part of the lost ground versus pre-COVID levels. The outlook for 2022 remains virtually unchanged, with the fiscal boost from Next Generation EU (NGEU) funds kicking in.

Euro area headline inflation climbed to 3% in August, from 2.2% in June, surpassing consensus expectations and reaching the highest level since November 2011. The rise was once again driven by energy prices—which reached historical highs—and supply bottlenecks. Core inflation also rose to 1.6% in August.

The official ECB message remains solidly dovish, arguing inflation will be transitory, but tensions within the Governing Council will likely intensify with the higher inflation prints. Tensions will be exacerbated by the especially notable rise of inflation in Germany, where headline inflation reached a 13-year high of 3.4% in August (partly on base effects) and will likely climb north of 4% in the fourth quarter—a record high.[21]

New strategy, old messages

The ECB's Strategy Review, presented ahead of time in mid-July, was underwhelming. It focused on interest rates and lacked clarity on the reaction function, leaving more thorny topics such as the use of other monetary policy tools unresolved. The shift to a new "symmetric" inflation target of 2% over the medium term was widely expected, as was the focus on a "green tilt" which monetary policy could adopt in the upcoming years—still unspecified. The Harmonized Index of Consumer Prices (HICP) will be complemented with owner-occupied housing (OOH) costs in a multi-year project given a lack of timely data in the EU. In an attempt to re-anchor inflation closer to 2%, the ECB added that "forceful or persistent" use of monetary tools will be justified when operating close to the interest rate lower bound, which may also imply a transitory period of moderate overshoot of the inflation target. Overall, the Strategy Review confirms the internal divisions within the ECB, in our opinion.

In its first policy meeting after the Strategy Review on July 22nd, the ECB articulated a three-leg condition for hiking rates:

- Headline inflation should reach 2% "well ahead" of the end of the forecast horizon; that is, by the mid-point.
- Inflation should remain durably at such level for the remaining part of the projections.

FRANKLIN TEMPLETON FIXED INCOME—EURO AREA GROWTH OUTLOOK

Exhibit 8: Real euro area GDP growth scenarios

As of September 2021

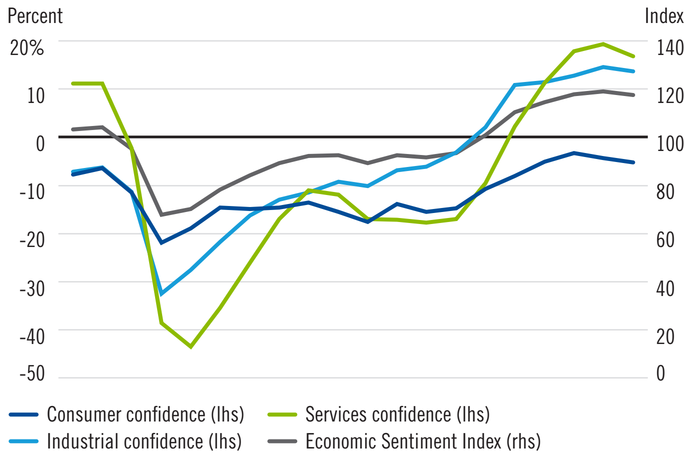
		% Q/Q					% Q/Q				
	2020 (% Y/Y)	2021-Q1	2021-Q2	*2021-Q3*	*2021-Q4*	*2021 (% Y/Y)*	*2022-Q1*	*2022-Q2*	*2022-Q3*	*2022-Q4*	*2022 (% Y/Y)*
Upside scenario				*3.1%*	*1.4%*	***5.5%***	*0.9%*	*0.8%*	*0.6%*	*0.6%*	***5.1%***
Baseline scenario	-6.5%	-0.3%	2.0%	*2.4%*	*1.3%*	***5.1%***	*0.8%*	*0.7%*	*0.6%*	*0.6%*	***4.5%***
Downside scenario				*1.5%*	*1.2%*	***4.6%***	*0.7%*	*0.6%*	*0.5%*	*0.5%*	***3.7%***

Italics indicates forecast.

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

FEARS OF THE DELTA VARIANT IMPACTING CONFIDENCE, WHILE INFLATION RISES

Exhibit 9: Euro-area economic sentiment indicators
January 2020–August 2021



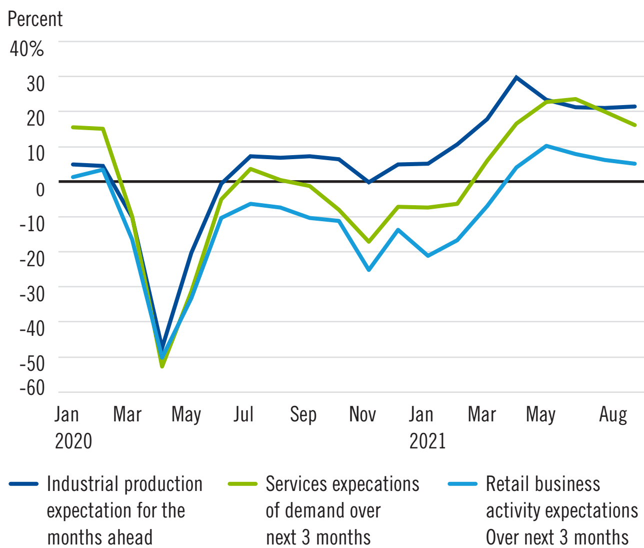
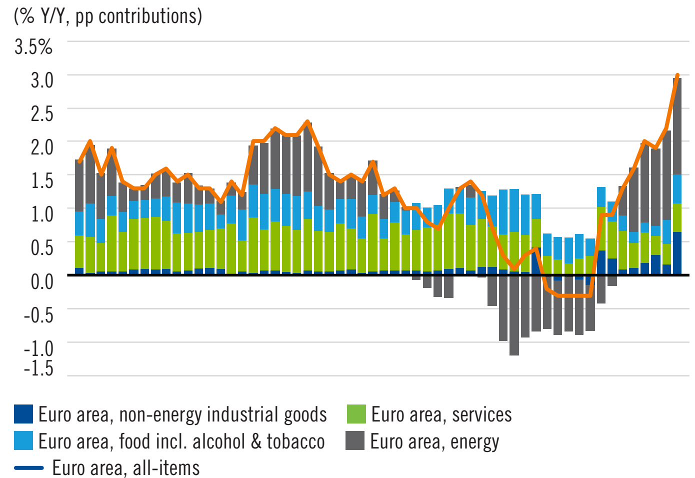
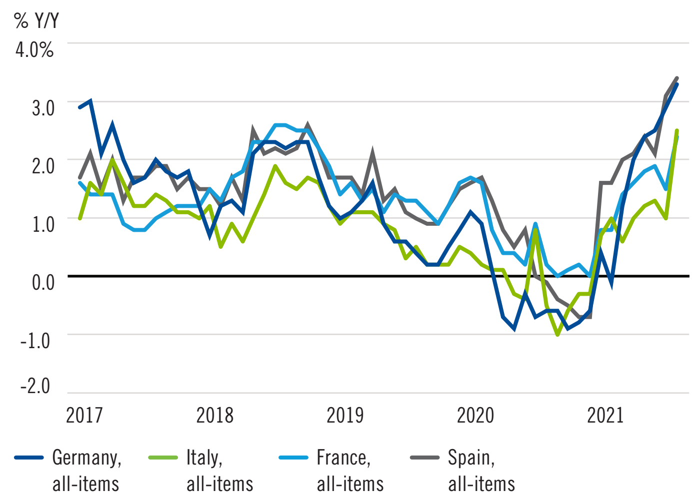


Exhibit 10: Inflation rates (% Y/Y)
January 2017–August 2021





Sources: European Commission, Eurostat.

- Progress in underlying inflation should be consistent with headline stabilizing at target over the medium term.

This sets a very high bar for interest rate hikes. The latest inflation projections from the ECB's September meeting see average headline inflation at 2.2% in 2021, peaking at 3.1% in the fourth quarter, declining to an average 1.7% in 2022 and 1.5% in 2023. This would likely imply interest rates would remain unchanged for the next 4–5 years.[22]

What really matters for markets is quantitative easing (QE). The Asset Purchase Programme (APP), which runs at €20 billion per month, will continue at the current pace for longer as its end is set for "shortly before the first rate hike." But that is a relatively small amount compared to the Pandemic Emergency Purchase Programme (PEPP), which has been purchasing around €80 billion per month since March 2021. During its September meeting, the ECB agreed to reduce the current pace of the PEPP to between €60–€70 billion per month, which the Governing Council (GovC) believes can still maintain favorable financing conditions. While hawkish voices within the GovC will likely demand a faster reduction of the current pace, the risks associated with the spread of the Delta variant tilt the decision in favor of the status quo until the December meeting.

The PEPP is pandemic-contingent and the GovC will need to decide what kind and how much QE stimulus will be needed in the post-pandemic phase, possibly ramping up the current APP by an additional €20–30 billion per month and transferring some of the PEPP's flexibility features. Even though tapering will likely be measured and deliberate, the reduction in purchases will be significant as it will remove a price-insensitive bond buyer from the market and put upward pressure on yields.

Sector settings

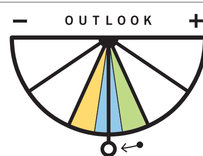
Overall Risk Outlook

We continue to believe a sustainable global economic recovery has taken hold, but momentum is likely to slow as we approach the end of the year. While we remain constructive on the fundamental backdrop and the health of the underlying economy, rich valuations are increasingly a concern and remaining upside potential has become more limited in several areas of the fixed income universe. With the best macro scenario already priced in, asset prices are becoming even more sensitive to changes in policy regime or potential disruptions to the market. Investors should be prepared for increased volatility as markets try to interpret and anticipate these changes.

With the recognition that spread sectors are trading at valuations reflecting a close to best-case recovery scenario, we are retaining our risk posture but cautiously monitoring the market and stand ready to reduce our exposure should we see further spread tightening. We are also closely monitoring inflation dynamics, which have now been running higher and for longer than many market participants had anticipated, as well as any signals that tapering will proceed at a faster rate than market expectations—factors that would put upward pressure on rates. At a time when the case for tightening policy is strong, financial markets have never been more dependent on the Federal Reserve (Fed) and the stakes are high for a smooth transition away from quantitative easing.

Given our concern with valuations, we have slightly reduced our overall risk outlook to neutral. We continue to expect an above-consensus rise in bond yields, and limiting duration remains one of our main underlying strategy themes. Selectivity and active management are of the utmost importance, in our view. With valuations a growing concern and the risk of rising interest rates and steepening of the yield curve, we believe the only way to navigate through this challenging market environment is to focus on in-depth, fundamental research to uncover attractive opportunities.

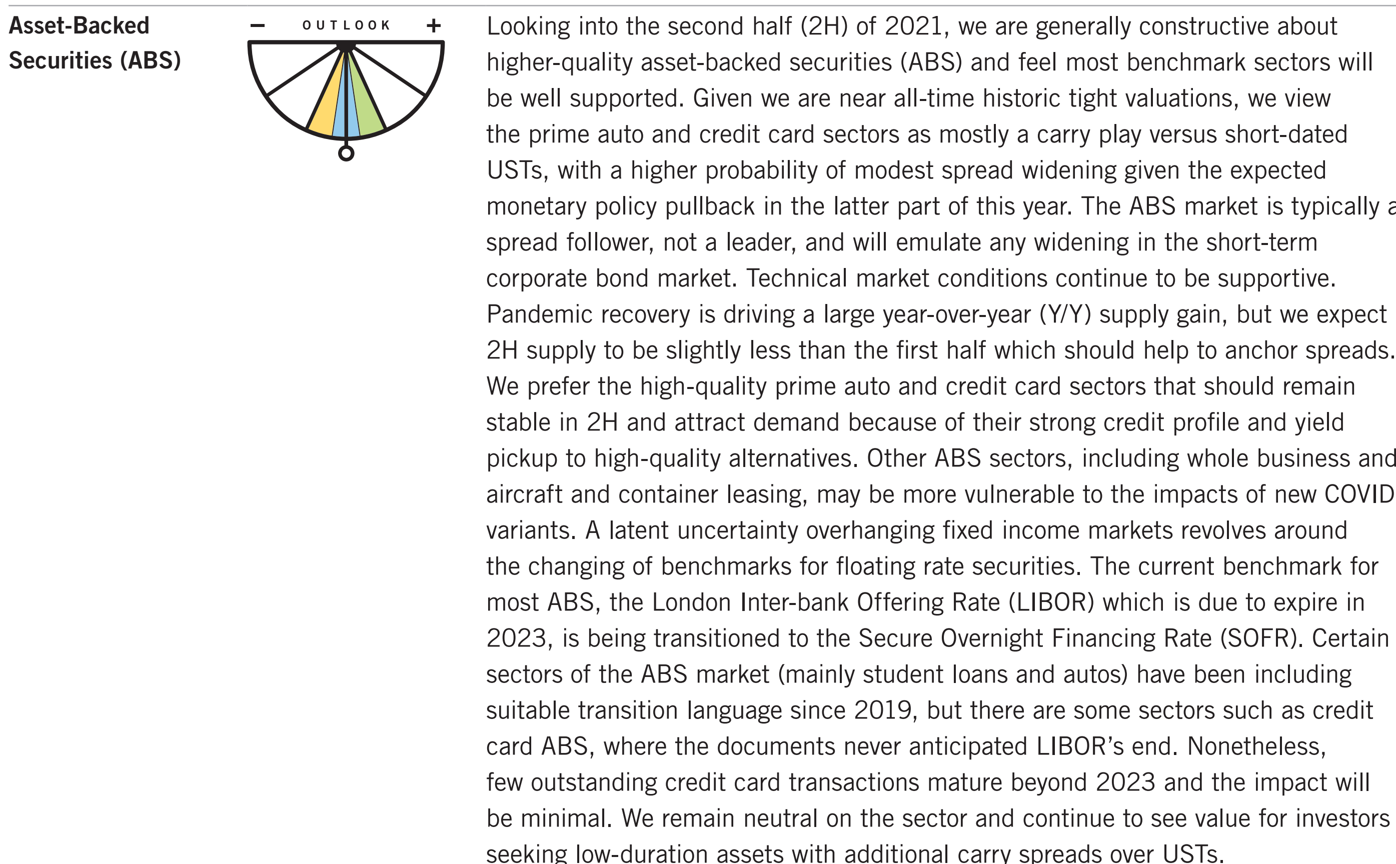
The sector settings on the following pages reflect our six- to 12-month outlook on each asset class.

Sector	Outlook	Our viewpoint
US Treasuries		After reaching their 2021 highs in March, we have seen intermediate- and long-term US Treasury (UST) yields trend lower. This is somewhat difficult to justify when looking at the US economy's solid rebound. Second-quarter (Q2) real US gross domestic product (GDP) surpassed its fourth-quarter 2019 level (pre-COVID) and continues to push higher. Consumer spending, bolstered by very strong fiscal and monetary support and an improving job market, remains a strong and resilient growth driver. The Fed continues to purchase USTs and holds a staggering US$5.4 trillion, keeping yields suppressed and supporting the market as a relatively non-price-sensitive purchaser.[23] However, rhetoric from the Fed has turned somewhat more hawkish as it began the process of signaling to the market that it will, in the near-term, taper UST and MBS purchases. This, in and of itself, should be enough to push UST yields higher, but inflation also remains a concern for the market, which could put upward pressure on rates. Strong intervention by the Fed was needed during the pandemic, but we feel that given the robust economic rebound, the Fed's loose monetary stance is no longer needed to support growth and is boosting inflation risks. In our view, UST yields are too low, and the curve is too flat. Our expectation is that the yield curve will steepen over the remainder of the year. This is also based on the previous Fed tapering experience, in 2013. In an improving economy, the Fed began to lower its rate of purchases of USTs. Ten-year UST yields rose 100 basis points (bps) and the curve steepened over 80 bps.[24] As the Fed begins to lessen its current footprint in the UST markets, we hold a strong conviction that we will see higher intermediate- and long-maturity UST rates over the remainder of the year. Although we have faith in the US economy, we retain our moderately bearish outlook on intermediate- and longer-term UST rates and believe active duration management will be increasingly important over the coming quarters.
US Treasury Inflation-Protected Securities (TIPS)		Treasury Inflation-Protected Securities (TIPS) have strongly outperformed nominal US Treasuries (USTs) year-to-date (YTD) as break-even (BE) inflation rates have risen across the curve.[25] We have seen moderate retracement of BE rates since the middle of May, but unusually strong inflation accruals have allowed TIPS to continue to perform well versus nominal USTs. TIPS principal accruals follow the consumer price index (CPI), which has seen elevated month-over-month gains averaging 0.7% over the past six months ending in August, well above their 10-year average of 0.2%.[26] Businesses report severe supply chain disruptions and difficulty attracting workers which has, in turn, caused them to pass on price increases to the consumer. The Fed has repeatedly stated they feel that current elevated inflation is transitory in nature and will abate over the remainder of the year. However, we have seen key inflation components (such as energy and shelter) expand, leading to higher consumer inflation expectations. We continue to believe that US inflation will be persistent and more difficult for the Fed to rein in than had been widely accepted earlier in this year. Opinions vary substantially on how long "transitory" inflation might last. Over the past several Fed meetings, some members have turned hawkish, leading to questions regarding the timing, pace, and composition of the tapering of their asset purchase program. Tapering may have a strong effect on the TIPS market as the Fed currently holds well over 20% of outstanding TIPS.[27] With a smaller buyer base than nominal USTs, the TIPS market may be challenged in absorbing added supply once the Fed cuts back its purchases. While we feel inflation may remain pervasive, TIPS markets are now pricing in a fair amount of that, with five-year inflation BEs exceeding 2.5% at the end of August, up from 0.5% at the end of March of last year. Due to very strong recent performance and some concerns about the effect of tapering on this asset class, we have reduced our outlook to neutral for TIPS.

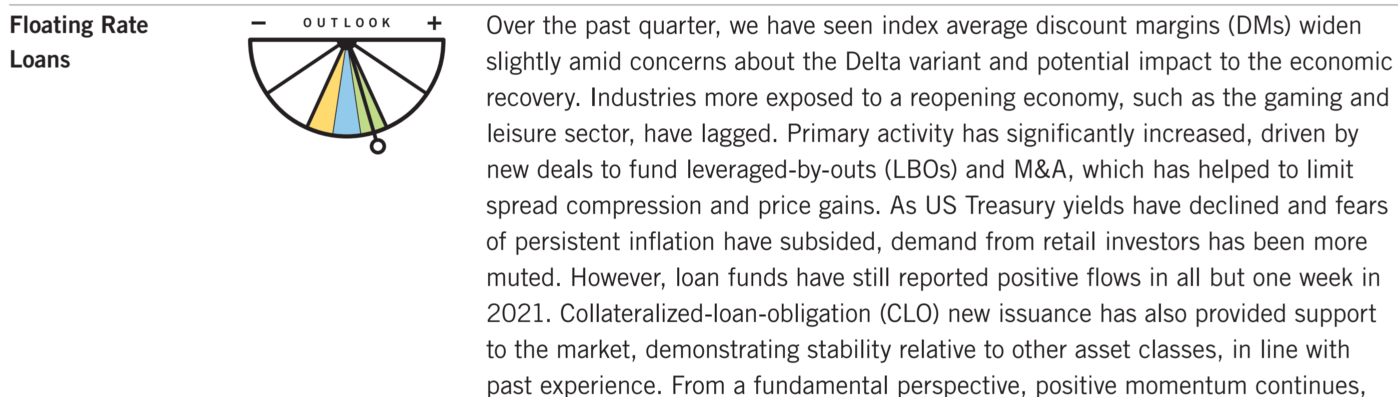
Sector	Outlook	Our viewpoint
Eurozone Government Bonds		Despite the resurgence of COVID infections, European economic data have been mostly upbeat and show that household consumption is leading the charge toward economic recovery. In August, we saw a small drop in European Union (EU) consumer sentiment, but this was off an all-time high in July.[28] Much as we would expect with the economic reopenings, spending on services increased throughout the summer months. The EU continues to provide important fiscal support by moving to deliver the first portion of the €750 billion COVID-19 economic recovery funds by the end of September. In contrast, eurozone manufacturing fell to a six-month low in August as supply-chain bottlenecks prevented any meaningful progress toward long-term average manufacturing capacity levels. These supply constraints and increasing energy and commodity prices have put upward pressure on inflation rates. Eurozone inflation increased to 3.0% in August, the highest level in over a decade. The ECB updated its inflation forecast for 2021 to 2.2%, which would then decline to 1.7% in 2022. With these projections, the ECB is signaling that it will not be inclined to respond to near-term price increases with changes to monetary policy. The ECB also raised its 2021 GDP growth projection from 4.6% to 5.0%, showing the belief that the economic recovery is on a strong footing. More recently, the ECB announced that it is reducing asset purchases under the PEPP as there has been significant progress toward the program's goal of financial markets stability. Even though the ECB will likely move slowly in terms of tapering, the reduction in purchases is significant, with a large price-insensitive bond buyer removed from the market. As such, we think this will likely push bond yields higher. In Europe, we think the peripheral bonds will probably come under more pressure as the ECB has been a big buyer there—Italy in particular has been a big beneficiary. Core European bonds are probably better anchored. That said, we do not think yields will move dramatically higher; we think we'll see a mild move up and then probably see bonds stabilize at new, still very low levels. In our view, bonds in Europe are not in for a dramatic selloff, but we could see some volatility over the next couple of months as people digest the tapering on both sides of the Atlantic.
Japanese Government Bonds		On the back of robust private consumption, improving capex, and government spending, Q2 Japanese GDP growth came in a bit higher than expectations at +0.5% quarter over quarter.[29] This was despite the extension in the state of emergency across the main prefectures of Tokyo just ahead of the Olympics. The Japanese consumer has remained confident despite record high COVID cases and extended periods of emergency. Most high frequency indicators underline this trend, including retail sales in July (which rebounded following the drop in June) and consumer confidence which moderated less than expected. Exports remain formidable due to improving global growth, and notwithstanding the economic slowdown in China, which is Japan's biggest export market, and supply chain disruptions. The most recent COVID-19 wave, following the Tokyo Olympic Games, has peaked as the state of emergency was extended to almost 80% of the economy—which resulted in a hit to mobility. Despite rapid progress on vaccinations, Japan still lags some developed countries with only close to 52% of the population fully vaccinated.[30] With case counts now seemingly under control and vaccinations progressing, we look for a rebound in household spending in the fourth quarter after the lull in the third quarter. Japan's Prime Minister Yoshihide Suga announced that he will not be in contention for the LDP (Liberal Democratic Party) leadership election to be held at the end of September, marking an exit after only a year in office. This move comes amid widespread criticism for his leadership in containing Japan's virus spread.

Sector	Outlook	Our viewpoint
Japanese Government Bonds *continued*		The chance of the LDP losing control of the government is all but ruled out, likely meaning a broad extension of current economic policies including a supplementary round of fiscal stimulus which could be in the range of 3–4.5% of GDP. In its bid to achieve a 2% inflation target, which is unlikely to be achieved unless a clear GDP growth impulse is underway, the Bank of Japan (BoJ) is expected to maintain its ultra-loose monetary policy including and not restricted to, negative policy rates, Quantitative and Qualitative Easing (QQE) and yield curve control. BoJ Governor Kuroda has said easing will continue well after the pandemic until the 2% inflation target is achieved. In our view, the BoJ's policies, including interest rate targets, will stabilize the yield curve for the foreseeable future. We expect another round of fiscal stimulus to be delivered after the elections, but previous rounds have had little impact on JGB rates. Furthermore, we feel JGBs are no longer an effective hedge against a risk-off shift in market sentiment. We remain neutral on JGB's as we feel there is no impetus for yields to substantially change over the near and intermediate terms.
Agency Mortgage-Backed Securities (MBS)		The agency mortgage-backed securities (MBS) market continues to be well supported by Fed purchases, keeping spreads below their long-term historical averages. Since March 15, 2020, the Fed has purchased US$2.41 trillion in agency MBS and as of August 2021, owns 31.6% (US$2.43 trillion) of the agency MBS market.[31] For perspective, the Fed purchased US$2.15 trillion during the 2007–2010 quantitative easing programs. Over the past several months, the Fed has begun internal talks regarding the appropriate timeline for tapering their monthly purchases of UST and agency MBS. Many participants, including Fed Chair Powell, have stated that if the economy continues upon its current path, then tapering would likely be announced and would begin by the end of this year. Additionally, the Fed will not reduce MBS purchases at a rate higher than USTs. A macro environment that would allow Fed tapering would be fundamentally strong and supportive of higher interest rates. A rate selloff should lead to lower mortgage origination and a decline in paydowns on the Fed's MBS portfolio, which would result in lower asset purchases. We project that Fed holdings of agency MBS will ultimately reach US$2.75 trillion, and we do not expect the Fed to sell MBS in the near-term. With an additional US$1.25 trillion of MBS held in banks' hold-to-maturity portfolios, it essentially locks away 45% of all agency MBS, supporting market valuations. Overall prepayment activity has remained elevated relative to past prepayment waves despite wider primary and secondary market spreads. These spreads have begun to normalize, which will lead to additional prepayments. After increasing steadily for the first few months of the year, mortgage rates were range-bound in the second quarter before declining into July's rate rally. The current Primary Mortgage Market Survey (PMMS) remains historically low but has increased since the beginning of this year.[32] At that time, we believe approximately 70% of the universe was in-the-money (ITM) to refinance versus 43% of the universe currently.[33] If 10-year UST rates were to increase to 1.7%, as per our internal forecasts, we estimate only 30% of the universe would be ITM to refinance and index prepayments would drop. Elevated prepayment risk, combined with yield spreads tighter than long-term averages, and the possibility of spread widening due to Fed taper-related discussions leads us to retain our "neutral with reason for concern" outlook. We believe, however, over the near term that continued Fed support should keep valuations stable. There will be buying opportunities on market dips, and agency MBS should continue to provide a high-quality allocation and a modestly attractive carry profile, in our view.

Sector	Outlook	Our viewpoint
Non-Agency Residential Mortgage-Backed Securities (RMBS)		The fundamental backdrop for mortgage credit remains positive and should bode well for the residential MBS (RMBS) sector over the near to intermediate terms. Overall spreads in various RMBS sectors have recovered at least 85%, and in some cases surpassed, their March 2020 wides. Demand for housing remains robust and transactions have been limited by historically low supply, although we have seen inventories begin to tick up. Home price appreciation (HPA) remains strong, up 18.6% over the past 12 months.[34] In our view, HPA will continue, albeit at a slower pace. The Franklin Templeton proprietary HPA model forecasts a price increase of 5.6% nationally over the next year. Although the Primary Mortgage Market Survey rate (PMMS) has risen off its all-time lows seen in January, rates are still historically very low supporting home prices.[35] Increasing overall interest rates would have many implications for the RMBS sector which would be modestly credit negative. Primarily, higher rates may further hinder already stretched housing affordability, negatively impact HPA, and result in slower prepayment speeds, and, in turn, slow RMBS structure deleveraging. As of August, Mortgage Banker Association (MBA) pandemic-related forbearance levels have declined to approximately 1.63% in conventional collateral, after peaking in May 2020 at 6.4%.[36] In our view, using conservative estimates, about 600,000 homes out of the aforementioned forborne borrowers are likely to result in defaults. This net supply would be less than half of what was experienced at peak supply during the 2007-2008 global financial crisis (GFC), when home prices depreciated by about 30%. However, with the relaxation in flex modifications for below 80% loan-to-value (LTV) mortgages, more borrowers are now eligible for modifications and eventual defaults could be lower than our forecast. Our RMBS positioning is heavily weighted to seasoned Credit Risk Transfer Securities (CRTs). Liquidity in the CRT market is improving as new issuance is expected to increase under new Biden administration policies. We maintain our neutral outlook with reason for optimism and continue to monitor the CRT market and our positions, looking to scale back as prepayment lockout expire and premium compression presents itself.
Commercial Mortgage-Backed Securities (CMBS)		We retain our bearish view on the commercial MBS (CMBS) sector as valuations remain on the tighter end of their long-term range. CMBS spreads have widened modestly after reaching cycle lows in mid-July. Fundamentals in the commercial real estate (CRE) sector are improving marginally but remain challenged as they have yet to recover to pre-COVID levels. CMBS conduit delinquencies (30+ days), at 6.1%, remain elevated.[37] The recovery of fundamentals has not been even across property types. Industrial properties weathered the pandemic well as higher e-commerce sales resulted in increased demand, as one- and two-day delivery options required additional fulfilment centers. This trend is expected to continue as evidenced in an all-time high pre-lease rate, which accounts for signed leases before construction is complete. In contrast, we have seen less improvement in both the office and multi-family sectors. Remote work capabilities have led corporations to question the utility of office space, which may ultimately lead to unfilled office space in many metro centers. Although hotel occupancy has rebounded to more normal levels, revenue per available room has lagged causing net operating income levels to remain challenged. CRE valuation is, and always has been, a property-by-property analysis of cashflow determined by underlying leases, tenant quality, interest rates, taxes, demographics, and a myriad of other factors. CMBS conduit transactions present the largest investment opportunity within CMBS but typically have 50–80% exposure in the office, retail, and hotel sectors. As conduit cash

Sector	Outlook	Our viewpoint
Commercial Mortgage-Backed Securities (CMBS) *continued*		tranches are predominantly longer-duration bonds, we do not find current risk-adjusted returns attractive. We do, however, find pockets of value in some single asset, single borrower (SASB) deals, where we are credit positive on the collateral type, geographic location, and expected cashflows. Significant capital has been raised for CRE investment, yet investors have not been able to put it all to work, resulting in a sizable amount of dry powder which should provide a backstop to any significant spread widening. Given current valuations, we would not add significant exposure down the CMBS capital structure. In AAA last cash flows (LCFs) we prefer deals with higher exposure to industrial and multifamily.
Asset-Backed Securities (ABS)		Looking into the second half (2H) of 2021, we are generally constructive about higher-quality asset-backed securities (ABS) and feel most benchmark sectors will be well supported. Given we are near all-time historic tight valuations, we view the prime auto and credit card sectors as mostly a carry play versus short-dated USTs, with a higher probability of modest spread widening given the expected monetary policy pullback in the latter part of this year. The ABS market is typically a spread follower, not a leader, and will emulate any widening in the short-term corporate bond market. Technical market conditions continue to be supportive. Pandemic recovery is driving a large year-over-year (Y/Y) supply gain, but we expect 2H supply to be slightly less than the first half which should help to anchor spreads. We prefer the high-quality prime auto and credit card sectors that should remain stable in 2H and attract demand because of their strong credit profile and yield pickup to high-quality alternatives. Other ABS sectors, including whole business and aircraft and container leasing, may be more vulnerable to the impacts of new COVID variants. A latent uncertainty overhanging fixed income markets revolves around the changing of benchmarks for floating rate securities. The current benchmark for most ABS, the London Inter-bank Offering Rate (LIBOR) which is due to expire in 2023, is being transitioned to the Secure Overnight Financing Rate (SOFR). Certain sectors of the ABS market (mainly student loans and autos) have been including suitable transition language since 2019, but there are some sectors such as credit card ABS, where the documents never anticipated LIBOR's end. Nonetheless, few outstanding credit card transactions mature beyond 2023 and the impact will be minimal. We remain neutral on the sector and continue to see value for investors seeking low-duration assets with additional carry spreads over USTs.
US Investment-Grade Corporates		US investment grade (IG) corporate bonds continue to benefit from strong demand as investors look to the asset class as a relatively safe source of yield. The prevalence of low or negative yields around the globe should remain a supportive technical going forward. The Fed has also now divested itself from all IG corporate bond and ETF holdings, removing a potential market overhang. Corporate fundamentals have shown further signs of recovery as the effect of the pandemic fades. Earnings have improved for most companies, even compared to pre-COVID levels, while leverage remains manageable. There is continuing incremental concern about the impact of inflation and supply chain disruptions on profit margins, as well as the potential for corporate tax increases in the United States. We believe IG corporate bonds should still benefit from above trend growth, even if GDP and earnings growth have peaked. However, the investment opportunity has become less compelling given full valuations, even as credit spreads have come off from recent tight levels. The market has largely embraced a best-case recovery scenario, which creates some possibility of disappointment and a risk-reward balance that is

Sector	Outlook	Our viewpoint
US Investment-Grade Corporates *continued*		more skewed to the downside. We also note the possibility of negative total returns if US Treasury yields move higher. We are neutral with reason for concern on the sector due to tighter valuations, but we remain generally comfortable with fundamentals and market technicals. We prefer select intermediate bonds, including BBB rated issuers, and believe investors can take advantage of new issues or any market dislocations to add exposure.
European Investment-Grade Corporates	− OUTLOOK +	European investment-grade (Euro IG) bond spreads have traded in a tight range over the last three months. Euro IG yields reached an all-time low in August as the result of falling European government bond rates and have gradually moved back to their three-month average. On the macroeconomic front, European economies have re-opened and travel restrictions have eased, making the important summer season as strong as possible despite the spreading of the Delta variant. Second-quarter earnings have been solid, although cost inflation is slightly squeezing operating margins for some industries. In our view, this remains manageable at this stage and corporate management teams do not sound particularly concerned for the second half of the year. We believe that earnings recovery is coming to an end, and we do not see fundamental tailwinds for Euro IG in the second half of the year. A pickup in mergers and acquisitions (M&A) and shareholder rewards is likely, due to significant cash on balance sheets, but we do not expect Euro IG companies to re-leverage significantly in the short term. We have, therefore, slightly reduced our outlook to neutral. Still supportive technicals and rather stable fundamentals should offset expensive valuations but risks to the sector continue—including the potential of a sharp increase in M&A and shareholder distributions, economic stress from future COVID variants, and policy errors by the ECB leading to reduced support for Euro IG bond purchases. We believe that with spreads at their current low levels and trading in a tight range, this is likely indicative that spreads have probably touched the lows for this cycle. Low yields are posing a challenge to further spread tightening. We still see the prospect of higher rates as healthy. If rates rise steadily and gradually, this should be positive as it will remove the spread limit created by negative yields. If rates stay at current low levels due to lower-for-longer rates and consistent central bank quantitative easing, the search for yield should continue, which would not be beneficial for the sector.
US High-Yield Corporates	− OUTLOOK +	The mostly steady march lower of US high-yield (HY) corporate bond spreads was interrupted mid-summer for about a month by concern around the spread of the Delta variant that caused a modest amount of widening but spreads once again tightened as the new issue pipeline shut down in the second half of August and was relatively slow to restart post-Labor Day. The reach for yield remains strong, and investors are focusing on the positives. Credit fundamentals have meaningfully improved the last two quarters, and the last twelve-month (LTM) default rate is near 1%, down from a peak of 6%+ last October. Input cost inflation pressures and shortages could present some headwinds to the fundamental picture, but based on an assessment by our analysts, the vast majority of US HY sectors are not likely to be negatively impacted to a significant degree. The near-term spread outlook will likely be driven by the amount of new issue supply and the duration and severity of the current COVID wave. To the extent the latter is relatively short-lived, we would expect spreads to continue grinding tighter, in part as US Treasury (UST) yields are likely to climb higher on continued inflationary pressures stemming from the re-opening economy and supply chain problems, with spreads likely to compress to

Sector	Outlook	Our viewpoint
US High-Yield Corporates *continued*		absorb that rise in UST yields. If, on the other hand, the current COVID wave lasts longer or becomes still more problematic, then we would expect COVID-sensitive sectors to reprice—though we do not foresee a meaningful increase in defaults unless the wave lasts well into next year. Given that we expect robust economic growth over the intermediate term and beyond, along with concerns about potentially rising rates, we remain comfortable with single-B credits and are less favorable on the higher-duration BB space. We retain our moderately bullish outlook but continue to be of the view that careful credit selection will be an important driver of outperformance.
Euro High-Yield Corporates	– OUTLOOK +	European high-yield (EHY) spreads have been moving in a very narrow range over the past quarter. During the period, the EHY market has performed roughly in line with the US high yield market, albeit weekly correlation was low. The EHY market underperformed until the end of June only to recover during the second half of the quarter, as concerns around the Delta variant eased in Europe. There were worries that a quick spread could lead to new mobility restrictions moving into the European summer season which is critical for the most COVID-exposed sectors. With this risk now behind us, we have decreased our 12-month default expectations as we see the risk of those issuers going into restructuring strongly lower compared to last quarter. BB-rated spreads slightly tightened during the period as we saw a larger number of euro investment-grade (Euro IG) assets put to work in the EHY market, looking for alternatives to historically low (if not negative) euro sovereign and euro IG corporate yields. BB spreads are still trading somewhat wider than the historic lows reached at the end of 2017. Flat fund flows into dedicated EHY funds and increasing single B supply led lower rated securities' spreads slightly wider. Despite relentless primary market issuance, the size of the EHY market (approximately €480 billion) did not grow as much as in previous quarters as we saw more companies using record cash balances to redeem existing bonds. Average EHY corporate cash balances/available liquidity remain, however, at very high levels despite such bond buybacks and both incremental shareholder remuneration and M&A activity in Europe being at a multi-year high. We have upgraded our outlook on the sector from neutral to moderately bullish as improving economic conditions/earnings have not been reflected in any meaningful spread movement during the period. In addition, with the ECB rhetoric of lower-for-longer rates still very much in place, we expect demand for positive-yielding euro fixed income assets to remain solid for the foreseeable future. Within sectors, we continue to favor select financial subordinated bonds due to their higher average spread (versus market average) and improving capital ratios within the banking sector.
Floating Rate Loans		Over the past quarter, we have seen index average discount margins (DMs) widen slightly amid concerns about the Delta variant and potential impact to the economic recovery. Industries more exposed to a reopening economy, such as the gaming and leisure sector, have lagged. Primary activity has significantly increased, driven by new deals to fund leveraged-by-outs (LBOs) and M&A, which has helped to limit spread compression and price gains. As US Treasury yields have declined and fears of persistent inflation have subsided, demand from retail investors has been more muted. However, loan funds have still reported positive flows in all but one week in 2021. Collateralized-loan-obligation (CLO) new issuance has also provided support to the market, demonstrating stability relative to other asset classes, in line with past experience. From a fundamental perspective, positive momentum continues,

Sector	Outlook	Our viewpoint
Floating Rate Loans *continued*		with improving performance from loan issuers. Q2 earnings among loan issuers remain healthy though inflationary pressures on labor and raw material costs remain. We continue to believe supply chain disruptions and inflation could delay, but not derail, full recovery. Defaults have seemingly disappeared of late as default risk continues to decline from a peak of 4.9% in September 2020.[38] Rating upgrades continued to outpace downgrades at a rate of 3.5 to 1 in July, extending the streak we have seen since December 2020.[39] We believe that in the near term the loan market could see some volatility if the Delta variant takes hold or causes material delays in the ongoing improvement in fundamentals. However, we believe that the underlying trends on fundamentals among loan issuers remain intact over the medium term, even if there may be short-term hiccups. Technical conditions also remain healthy. Retail fund flows may continue to moderate if the expectations around Fed tapering get materially pushed out, but by far the largest investor in the market, CLOs, remains an attractive option for investors. This in turn should support valuations in the loan market. We have maintained our moderately bullish outlook but stress that current market conditions in no way suggest an indiscriminate buying of the broader loan index; security selection remains of paramount importance to performance. We favor B-rated loans and selectively adding exposure to COVID-impacted sectors that have lagged in recent months and would see any spread widening in loans as a buying opportunity.
Collateralized Loan Obligations (CLOs)		Despite record issuance YTD in both euro and US collateralized loan obligations (CLOs), higher-rated spreads have been largely range-bound over the past quarter and remain inside their long-term averages primarily due to strong demand. The CLO credit curve has steepened over the past year but remains flat compared to historical spreads. Credit fundamentals in the loan market are improving with the trailing 12-month default rates, 0.5% in the United States and 1.1% in the eurozone respectively, reaching their pre-COVID levels.[40] Upgrades, while slowing from their pace earlier in the year, have remained directionally positive. US market value over collateralization (MVOC) percentages have returned to pre-COVID levels, and euro CLOs have also shown improvement, although they are not quite back to pre-COVID marks. Median junior over-collateralization (OC) cushions and median CCC-rated exposures have also improved but not returned to their pre-COVID levels. In our view, these metrics should advance further as corporate fundamentals strengthen and additional loans are upgraded. In the near term, we expect CLO collateral metrics will continue to improve, leading to a potential decline in credit tail risk. We are constructive on leveraged loan fundamentals, which should continue to benefit CLO collateral quality, but concerns over the Delta variant and excess supply from refi and reset transactions may result in spread volatility in the coming quarters. We remain positive on the overall CLO asset class and retain our neutral with reasons for optimism outlook on US CLOs. We expect spreads to remain range-bound with a bias toward marginal tightening. In euro CLOs, we have a neutral outlook and expect spreads to widen modestly due the heavy refi and reset activity and a smaller investor base. We prefer a rotation from CLO tranches that are priced above par with a higher call probability into CLOs with sufficient call protection and strong fundamentals. We also prefer mezzanine bonds that are trading at a discount, backed by fundamentally strong collateral, and flagged by our proprietary models as likely to refi or reset.

Sector	Outlook	Our viewpoint
Municipal Bonds		We continue to see strong technical conditions and improving fundamentals in both the tax-exempt and taxable US municipal (muni) bond markets supporting, albeit historically lofty, valuations. Both supply and demand dynamics in the tax-exempt market continue to provide a substantial base. Investor expectations for higher personal income tax rates and persistent need for tax-exempt income by an ageing investor cohort has underpinned strong demand for the asset class with over US$87 billion in fund inflows year-to-date (YTD).[41] In the first quarter of 2021, personal income grew at the fastest Y/Y pace since 1948, accruing savings that will need to be invested.[42] In our view, increasing household wealth, relative credit quality, and lower rate volatility will continue to attract investors into the tax-exempt muni bond market. We have seen no net issuance growth in the first eight months of 2021 when compared to the prior year.[43] Although off their lows in June, ratios of muni bond yields versus US Treasuries still remain well below longer-term averages. Even at these rich levels, we retain a neutral outlook with reasons for optimism for the tax-exempt muni bond market for those investors that can benefit from their income tax advantages. In tax-free munis, we are seeing opportunities in lower-rated investment-grade bonds. Additionally, we believe select high-yield muni bonds also remain attractive, providing additional yield and income. In the taxable muni bond market, we continue to see a growing global audience desirable for high-quality US-domiciled fixed income assets. Primary market taxable muni bond issuance, while still a significant percentage of overall muni supply, is lower by 11.8% YTD adding to strong market technicals.[44] Issuers continue to look to the taxable muni market as a stable source of funds, for both new issuance and refunding activities. While we believe that taxable muni bond spreads will continue to tighten over the remainder of the year, there are risks that rising investment-grade corporate bond spreads could limit cross-over taxable muni bond investors. Credit fundamentals across muni issuers continue to improve due largely to federal stimulus and the reopening of economies nationwide. The rapidly recovering economy, a strong stock market, and growing personal income are also boosting tax revenue collections for states. Indicators of the improving credit environment include state and local governments' reduced need for short-term cash borrowing and rating agency activity. Q2 2021 rating upgrades outnumbered downgrades for the first time since before the COVID pandemic.[45] New infections from variants of the COVID virus, including breakthrough cases, have the ability to stall the strong economic recovery we are experiencing. Therefore, in the taxable muni market, we continue to favor a highly-rated, high-quality, and structurally liquid portfolio. We continue to prefer opportunities in sectors more challenged by COVID, such as transportation, health care, and lower-rated state general obligation bonds.
Emerging Market (EM) Debt		Emerging market debt (EMD) spread levels have widened over the last several months, which can partially be attributed to a broader deterioration in risk sentiment associated with the Delta variant, although a significant portion of the widening has also come from idiosyncratic country level developments in a handful of the highest-yielding sovereigns: El Salvador, Tunisia, Lebanon, Sri Lanka, and Suriname. With respect to fundamentals, economic growth rates across EM countries have lagged those in advanced economies this year, for a multitude of reasons. A slower vaccine rollout across EMs is one driver, with administered vaccine rates around 10% in EM countries relative to ~37% across advanced economies.[46] EM economies have also lacked the fiscal impetus that we've seen in the United States and other developed market (DM) countries. This is in addition to monetary policy tightening, which for many EMs has been a relative headwind to growth.

Sector	Outlook	Our viewpoint
Emerging Market (EM) Debt *continued*		Looking ahead, we do see a synchronized global growth recovery as benefitting EMs, with the International Monetary Fund (IMF) expecting growth in EMs to improve relative to DMs in 2022. Sustained higher commodity prices are also leading to an improved terms of trade outlook for EMs, as a net commodity exporting asset class. Debt rollover risks have also improved for many of the lower-credit quality countries, on the back of the recent approval of a $650 billion IMF Special Drawing Rights (SDR) allocation in August, which we believe has potential to be followed by a favorable SDR re-allocation to developing countries. In light of these factors, we remain bullish on EMD and anticipate spreads will tighten over the next quarter. Still loose global financial conditions and relative valuations continue to be supportive for flows into the sector, in our view. Hard currency EMD remains attractive in the context of still low/negative developed market fixed income yields. Following the second quarter real-yield compression in DMs, and a repricing of policy tightening in EMs, we also now see local market yields as more attractive. We acknowledge that downside risks remain, including any deterioration in COVID-19 conditions that might further delay or compromise the global growth rebound.
Emerging Market (EM) Corporates		Emerging market corporate bond (EM corp) performance has been unexceptional in recent months. As expected, the sector shrugged off anticipated threats from volatile US Treasuries and the burden of ongoing COVID-19 containment measures; however, the unexpected underperformance of China's high-yield market has eroded returns at the index level. The abrupt change in sentiment in China's offshore high yield market can be attributed to a combination of regulatory pressure on the private sector in general and the specific travails of the real estate development sector in particular. We believe that bond market risk premiums will be sensitive to the nature of the resolution of specific distressed developers. We are seeing some value emerge in what has been an expensive market. The outlook for the fundamentals of the asset class is improving. We expect earnings growth to reflect the recovery in EM economic activity through to 2022, with the commodity-heavy countries in Latin America leading the way, while some parts of Asia lag as COVID-related restrictions bite. Market technicals are supportive of a constructive stance in EM corporates. On a YTD basis, gross supply is tracking at record levels; however, net supply has been easily absorbed, as seen in the strong orderbooks for the majority of the new issues in the market. Despite the country-specific volatility in China, our view of the EM corporate asset class remains unchanged—we retain our moderately bullish outlook and expect gradual spread tightening over the next three, six and 12 months. Our base-case scenario anticipates that spreads will remain wide of the pre-COVID 2020 tights, with spread projections calibrated to be lower beta than our expectations for EMD sovereigns. We think that the additional carry versus developed-market (DM) corporates provides attractive compensation for the risk of default and any liquidity considerations.
Global Sukuk		The global Sukuk index remains high quality with an average A– rating and modest duration at 4.8 years. The US$650 billion market should remain a defensive allocation with volatility in line with government bonds rather than emerging market debt. Corporate Sukuk stood out for their financial discipline post-COVID and though upgrades are unlikely, positive medium-term structural reform trends and a reduction in geopolitical risks support many sovereign-related Sukuk issuers. The Gulf Cooperation Council (GCC) has executed a very successful vaccine strategy, with the United Arab Emirates, for instance, leading vaccinations on a

Sector	Outlook	Our viewpoint
Global Sukuk *continued*		global level.[47] A gradual opening up of global travel should benefit these countries as events like the Expo in Dubai and the World Cup in Qatar take place over the next 18 months. In Southeast Asia, the pace of vaccinations has recently picked up and we are optimistic for a positive impact over the next few quarters, though the current weakness in manufacturing purchasing managers index (PMI) figures in some countries highlights the challenge. The reopening, coupled with higher oil prices and increasing demand for Sukuk, should keep Sukuk spreads relatively stable and support our neutral with reasons for optimism outlook. While we continue to believe that the global economy is in cyclical recovery mode, which should persist for the remainder of 2021 and into 2022, the momentum is likely to slow from here as most of the growth improvements have been registered and leading indicators appear to have peaked. New waves and new variants of the virus are a risk to the global growth recovery, and falling yields, that were initially linked to receding inflation expectations, may have developed into a signal of investor concern about the ongoing strength of the cyclical recovery. Further declines in yields that result from here may not prove as beneficial to fixed-income returns, due to the potential widening of spreads in such a "risk-off" scenario, a scenario the Sukuk market is relatively better positioned for, in our view. Issuance is on pace to reach US$70 billion, with a noticeable increase in high-yield issuers relative to investment grade, and more international issues out of the Gulf Cooperation Council (GCC) and Africa relative to Asia. Sovereign issuance should contribute about a third of new deals, compared to almost 50% the last two years, with energy issuance picking up to finance ambitious projects related to the transition to low carbon.

Endnotes

1. Sources: Franklin Templeton Fixed Income Research, Bureau of Economic Analysis (BEA).
2. Source: Eurostat.
3. Source: Our World in Data. CC BY 4.0. As of September 27, 2021.
4. Source: Bureau of Labor Statistics (BLS).
5. Source: BEA.
6. Source: Eurostat.
7. Source: BEA.
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9. Source: BLS.
10. Source: BLS.
11. Sources: Franklin Templeton Fixed Income Research, BLS.
12. Source: BLS.
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14. Sources: Federal Reserve Bank of New York, BLS.
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25. Sources: Bloomberg US Treasury Inflation-Linked Bond Index, Bloomberg US Treasury Index. As of September 17, 2021.
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27. Source: Federal Reserve. As of August 31, 2021.
28. Source: European Commission.
29. Sources: Cabinet Office of Japan.
30. Source: Johns Hopkins. As of September 16, 2021.
31. Source: Federal Reserve.
32. Source: Freddie Mac.
33. Source: Franklin Templeton Fixed Income Research estimate.
34. Source: S&P/Case-Shiller. As of June 2021.
35. Source: Freddie Mac.
36. Source: Mortgage Bankers Association.
37. Source: JP Morgan.
38. Source: Credit Suisse.
39. Source: JP Morgan.
40. Source: S&P. As of August 31, 2021.
41. Source: Investment Company Institute (ICI). As of August 25, 2021.
42. Source: Pew Charitable Trusts.
43. Source: Barclays.
44. Source: Barclays
45. Source: S&P.
46. Source: IMF, World Economic Outlook. As of July 2021.
47. Sources: Our World in Data, CC BY 4.0. As of September 17, 2021. GCC = Consists of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

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