For Immediate Release

Franklin Templeton's 2023 Fixed Income Market Outlook

December 19, 2022: Franklin Templeton and its specialist fixed income investment managers provide their annual outlooks for the global economy and key asset classes. They include insights from the following firms:

Brandywine Global Investment Management provides its global macro outlook along with its insights into currencies and structured credit. Headquartered in Philadelphia, Brandywine Global looks beyond short-term, conventional thinking to rigorously pursue long-term value. It has USD$52 billion in assets under management (AUM) as of September 30, 2022.

Western Asset Management provides its global fixed income outlook. Western Asset is a globally integrated fixed-income manager, sourcing ideas and investment solutions worldwide. Based in Pasadena, CA, it has USD$375.5 billion in assets under management as of September 30, 2022.

Brandywine Global: Macroeconomic outlook by Director of Global Macro Research Francis Scotland
Amid the crosscurrents, two themes have prevailed during the post-pandemic years: bipolar swings in macroeconomic policy and forces of economic normalization. The lockdowns knocked the world severely off the prevailing path of "normal." Since then, judgment—most of it bad—about what was needed to get back on that path has led to some wild swings in macro policy. The effect of each extreme policy pivot, plus the natural tendency to normalize, has flowed through into asset markets, real economic activity and inflation. In 2023, we expect it should be no different.

U.S. economic policy turbo-charged pandemic recovery with the most extreme combination of stimulus measures ever taken in peace-time history. Excessive spending and the flood of liquidity overflowed into commodities, asset markets and real estate prices, leading to booming economic and job growth and soaring price inflation. Dismissive of its scale, the U.S. Federal Reserve viewed the inflationary elements of this rebound as transitory, a perspective which only drove inflation higher.

The Fed capitulated this year by changing its inflation story from transitory to structural and turning liquidity from a flood to a drought. Inflation turned to deflation in crypto markets, commodities, stocks, bonds, and most recently, real estate prices. The scale and speed of the reversal in policy is unprecedented, and the failure of judgment at the Fed, both disappointing and disturbing, really muddles the outlook.

The yield curve says policy is restrictive enough with rates where they are. The most intense period of economic softness is likely to be in the first half of 2023. However, other factors could limit downside recessionary forces, including the recent plunge in energy prices, the rebound in the U.S. auto sector and a possible rapid decline in inflation. Recession odds increase significantly if Fed Chair Powell remains dogmatic on the need to create labor market slack. However, he has proven himself impressionable when it comes to the data. A pause in rate hikes seems very probable, especially if the data show a steep and deep decline in inflation.

Outside the U.S., the global economy is already in recession due to a strong U.S. dollar and a very weak China. China has started to back away, slowly, from the policies that have been depressing activity. If the dollar corrects lower as the U.S. economy decelerates and inflation retreats, and the U.S. avoids a bust, the world economy could be stabilizing by this time next year.

Brandywine Global: Structured credit outlook by Portfolio Manager Tracy Chen
As one of the most interest rate-sensitive sectors of the global economy, housing markets across most developed economies are going through various recessions because of interest rate hikes and poor housing affordability post-COVID. Unlike in other developed markets, the U.S. housing market is still supported by a tight labor market, the lock-in effect of low fixed mortgage rates for existing homeowners, tight mortgage underwriting, low leverage in the mortgage sector and low housing supply. Therefore, we believe we can avoid a severe housing downturn like the one in the Global Financial Crisis. U.S. consumers are still in spending mode with enough residual excess savings to last another one to two quarters, and their balance sheets remain healthy with decent home equity and low financial obligation ratios.

Given the above fundamentals, we see abundant attractive investment opportunities in the structured credit market, offering cheaper but safer alternatives in 2023. For example, valuations for agency mortgage-backed securities (MBS) are very attractive, and convexity is near the best levels due to the out-of-money status. Government-guaranteed agency commercial mortgage-backed securities (CMBS) with call protection are now cheaper than 7- to 10-year AA corporate bonds, a rare case in history. And currently, AAA rated conduit CMBS look cheaper than similar duration A rated corporate bonds.

There are also attractive opportunities in other AAA rated sectors, like AAA collateralized loan obligations (CLOs), AAA non-qualified mortgage securities, AAA commercial real estate (CRE) collateralized loan obligations (CLOs), AAA subprime auto asset-backed securities (ABS) and investment grade-rated credit risk transfers (CRT). The levels of subordination provide good credit support for AAA rated structured credits. Investors with larger risk appetites also can find opportunities in BBB or equivalent CLOs, CMBS or CRT, which offer double-digit yields that help compensate for the credit risks.

With high-quality structured credit having cheapened so much, investors do not need to take excessive credit risk to achieve decent returns. As recession risk looms in 2023, we believe these structured credit sectors should outperform during an economic downturn with minimal credit risks. Historically, wide spreads compensate for many risks. While these assets could cheapen further if the Fed overtightens and Treasury rates climb significantly higher, we think these structured credit investments should pay off over the medium to long term. We believe investors should consider taking advantage of these opportunities and the potential for attractive long-term returns.

Brandywine Global: Global currencies outlook by Portfolio Manager Anujeet Sareen
After experiencing an historically strong year of appreciation, the U.S. dollar now appears overvalued against a broad basket of currencies, and macroeconomic fundamentals are poised to deteriorate in 2023. The primary drivers of the dollar in 2022 were relative growth outperformance and relative monetary tightening. Although U.S. real growth decelerated in 2022, the substantial growth shocks in Europe, driven by the Ukraine war and energy shock, and in China, resulting from its restrictive zero-COVID policy and property market crisis, led to relative U.S. economic outperformance. In parallel, the Fed raised interest rates by 400 basis points (bps), more than nearly all other major central banks.

Relative monetary policy is also likely to move in parallel with the shift in relative growth. The Fed is likely approaching peak policy rates near 5%, but the European Central Bank, given that its policy tightening cycle began later, may still raise interest rates further in 2023. European inflation is likely to slow somewhat later, and fiscal policy is more supportive of growth in Europe than the U.S. This relative shift in monetary policy is constructive for the euro, all things equal.

In Japan, monetary policy also is poised to begin tightening in 2023. Governor Kuroda, one of the principal architects of Japan's aggressive reflationary monetary policies, is set to step down in early April. While his successor has not yet been determined, the recent acceleration in Japanese inflation, in contrast with the deceleration in U.S. inflation, has increased the probability of a shift tighter in Japanese monetary policy, which would be constructive for the yen.

Overall, the powerful rally in the dollar in 2022 was driven by an alignment of factors that will not persist in 2023. The greenback is expensive, and relative growth prospects point to a weaker dollar next year. Relative monetary policy will also tighten more outside the U.S., notably in Europe, and possibly in Japan as well. However, the Fed is unlikely to start easing monetary policy soon, and, hence, the positive carry offered by the U.S. dollar will offer some support to the greenback. Balance sheet contraction will further diminish the supply of dollars, also providing support to the currency. In conclusion, the dollar has likely started a peaking process. However, a sustained decline in the dollar will ultimately require the Fed lowering interest rates, the end of quantitative tightening and some expectation of improvement for the global economy, notably outside the U.S.

Western Asset: Global fixed income outlook by Ken Leech, Chief Investment Officer

Bond yields are attractive despite rapid inflation in 2022

Inflation has proceeded faster and for longer than we anticipated, and the damage to fixed-income investments has been commensurate. However, we believe a falling-inflation scenario is still at play — one that would provide some comfort and respite to bond investors. In our analysis, bond yields are also now at very attractive levels; the 10-year U.S. Treasury bond is at its highest rate since 2008. Given these factors and current market pricing, the priority for us over the next 12 months is to position portfolios to best maintain our current yield advantage relative to benchmarks. We see opportunities in specific places across fixed-income sectors.

Opportunities within fixed income in 2023

The combination of higher rates, wider spreads and de minimis defaults makes a good case for owning investment-grade credit, even despite macro concerns. Actual fundamentals at the corporate level are still very good given issuers' conservative approach to balance sheet management.

In the U.S., corporate fundamentals may have peaked, but they are coming off a strong starting point. Concerns abound that earnings will decelerate given tighter financial conditions, rising input costs and the currency impact of a surging U.S. dollar. We see opportunities in banking (where we expect further ratings upgrades), energy, select re-opening industries and rising-star candidates.

In Europe, utilities face higher funding needs, but with government support we see some opportunities in this space. Yields at multi-year highs look attractive to us. In particular, we like the 3- to 5-year part of the market. We find the most value in financials and real estate investment trusts (REITs) and are cautious on more cyclical consumer-facing sectors.

Additionally, we believe the quality of the high-yield market is the best it has been in decades. Fallen angels downgraded from investment-grade during COVID put a tremendous amount of BBs in the high-yield index. However, we continue to be extremely selective, choosing issues name by name. We also continue to favor investment-grade energy.

In the U.S., we believe high-yield credit spreads are relatively attractive. In our analysis, default rates are likely to rise from very low levels in the coming quarters, but yields are providing ample cushion for higher defaults. We continue to see opportunity in service-related sectors that are still recovering from the COVID-led recession (i.e., re-opening trades including airlines, cruise lines and lodging) and potential rising stars. In Europe, credit fundamentals face challenges including slowing regional growth, elevated energy prices and tightening financial conditions. We see value in BB and B rated issues, focusing on more defensive industries, including telecommunications/cable and health care.

Challenges and opportunities in mortgage-backed securities (MBS)
While we expect the homebuilding market is in for a major pullback, as well as substantial home price declines, we see selective opportunities.

For agency MBS, diminishing Fed and bank demand coupled with increased volatility remain headwinds, but we believe the fundamental picture has greatly improved as spreads widened significantly and look attractive historically, while prepayment risk has subsided.

For non-agency commercial MBS (CMBS), fundamentals vary by sector with continued strength in multi-family, industrial and lodging, but challenges remain in retail and office. Macro and rates pressures are depressing prices across the market; however, if volatility declines, we believe attractive yields are available across the capital stack for high-quality credits.

The future of inflation
Whether you focus on demand and supply as the driver of prices, on interest rates, or on the money stock as a measure of Fed policy, we believe all these indicators point to a substantial moderation of inflation in the near future. Furthermore, looking at economic conditions "on the ground" today, pricing in the goods and housing sectors is already moderating.

– Ends –

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About Franklin Templeton

Franklin Resources, Inc. [NYSE:BEN] is a global investment management organization with subsidiaries operating as Franklin Templeton and serving clients in over 155 countries. Franklin Templeton's mission is to help clients achieve better outcomes through investment management expertise, wealth management and technology solutions. Through its specialist investment managers, the company offers boutique specialization on a global scale, bringing extensive capabilities in equity, fixed income, multi-asset solutions and alternatives.

With offices in more than 30 countries and approximately 1,300 investment professionals, the California-based company has 75 years of investment experience and approximately AUD 2 trillion in assets under management as of July 31, 2022.

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