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BEYOND BULLS & BEARS

A Selective Approach to Fixed Income in 2014

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Fixed income faced some ups and downs in 2013, and as the year progressed, some questioned whether the asset class still held value. One theme that did seem to emerge was that a broad-brush approach to the sector was likely not a preferred strategy. Christopher Molumphy, chief investment officer, Franklin Templeton Fixed Income Group®, believes that investors may need to be more selective in 2014, but he sees a number of fixed income sectors that hold appeal—and potential value.

As we look ahead into 2014, we are optimistic that we could finally see better economic growth in the US. Since 2009, when the US emerged from the Great Recession, we have seen a fairly consistent pattern of subpar growth up to and including 2013. During 2013, however, the US economy faced significant headwinds from a variety of sources, such as higher taxes and diminished government spending levels. In evaluating the prospects for the US economy in 2014, we think that the diminished impact from fiscal drag leads us to a modestly more constructive outlook than last year.

Internationally, we think prospects for developed markets relative to their emerging-market counterparts are looking better for the first time in a long time. In particular, we think several countries in the core eurozone have the potential for modestly improved growth. In addition, we are reasonably constructive on the Japanese economy based on the supportive aggregate impact of the country’s monetary and fiscal policy regimes.

In contrast, while we believe there are still a number of emerging economies with decent opportunities, we think it will be critical to discriminate from country to country. While certain nations, such as South Korea, Poland and Malaysia, have maintained fiscal discipline, face positive growth prospects and appear poised to potentially do well in 2014, in our view, others are facing weaker growth amid limited policy options.

In this environment, we think a number of fixed income sectors hold appeal. For example, the corporate credit sector may continue to benefit from solid underlying fundamentals, such as healthy balance sheets, ample liquidity and reasonable earnings prospects. Consequently, we are constructive on market sectors such as investment-grade securities, high-yield bonds and floating-rate bank loans.

In our view, the global fixed income market also holds opportunities for investors, although we do not think it will be as easy as investing in the broad emerging-market category. However, we think it could prove beneficial to have selective exposure to countries where, despite better fundamental fiscal conditions and growth prospects, yields are higher than in the United States. As a result of the supportive fiscal situations in those countries, investors may also be exposed to the potential for currency appreciation.

Overall, we think the US municipal bond sector has sold off indiscriminately in recent months, driven by a few high-profile situations, notably those in Puerto Rico and Detroit. In contrast, we believe that many state and local governments have made solid progress in achieving fiscal sustainability and that the situation overall has continued to improve. As a result, we believe there are attractive opportunities in that sector.

Fundamentally, we are constructive on the broad fixed income asset class. Given year-end market valuations following some of the negative media coverage and the subsequent indiscriminate selloffs in the asset class, we think the fixed income sector may represent some value potential in 2014.

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What Are the Risks?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. When interest rates rise, bond prices fall, and the converse is true. Floating-rate loans and high-yield corporate bonds are rated below investment grade and are subject to greater risk of default, which could result in loss of principal—a risk that may be heightened in a slowing economy. Special risks are associated with foreign securities, including currency fluctuations, economic instability and political developments.

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