MULTI-ASSET

A Selective Look at Corporate Credit

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Even in the face of rising US interest rates over the past year, corporate credit has been resilient, particularly in the high-yield category. Ed Perks, Franklin Income Fund portfolio manager and executive vice president and chief investment officer, Franklin Templeton Multi-Asset Solutions, takes a look at the corporate credit landscape and says fixed income investors still have plenty of reasons to be positive about the asset class.

US Economic Overview and Market Backdrop

Several US economic indicators have improved since the start of the year. We've seen robust job growth, an upgraded gross domestic product forecast, incremental improvement in consumer spending and rising consumer confidence. And, the last corporate earnings reporting cycle saw many upside surprises.

Against a backdrop of strong fundamentals in corporate America, the market has so far mostly shrugged off controversial US health care legislation, a dangerous and costly US hurricane season and tensions around North Korea's nuclear ambitions.

In terms of monetary policy, the US and global financial markets have returned to levels of stability that we believe no longer warrant the use of aggressive or unconventional monetary policy tools. These tools served their intended purpose during the depths of the 2007–2009 Global Financial Crisis.

That said, the Fed's move to unwind its balance sheet following years of atypical easing policies highlights a non-traditional framework. There is a lack of historic precedent for the market response to these actions.

Like many investors, we take the US Federal Reserve's (Fed's) policy actions in 2017 as a vote of confidence that the economy can now grow without persistent central bank support. We also think the Fed has signaled its policy intentions clearly enough that a disorderly debt-market decline similar to 2013's "taper tantrum" appears unlikely.

The political environment in Washington, DC, also remains a challenge. Several of the pro-growth economic policies US President Trump's administration has touted have been slow to develop.

Nonetheless, we are hopeful for potentially positive changes to come. Our focus remains on specific company fundamentals, the core economic backdrop and bigger-picture secular growth trends. Additionally, any meaningful US policy progress relating to major tax reform, financial system deregulation and/or infrastructure spending could give the US equity market—currently near all-time highs—a further boost.

Economic fundamentals still support a solid outlook for corporate profits, according to our analysis.

In line with a positive assessment of economic fundamentals, we view credit conditions as favorable. Interest rates remain low, corporate balance sheets generally remain strong and debt-service costs appear manageable. Markets still appear receptive to debt offerings. At the same time, we think investors should consider preparing for rising volatility following an unusually quiet period for global financial markets in general.

High-Yield Tailwinds

In the third quarter, economic data remained supportive of fixed income markets. The higher-yielding, below-investment-grade credits continued to rally on fundamental support. For example, high-yield bond defaults were in decline and appeared to be confirming the lower 2017 default forecasts major independent credit rating agencies had issued earlier in the year. Additionally, the asset class has continued to offer a standout average yield relative to investment-grade fixed income securities.

The recent rebound in a broad array of natural resource prices and a stronger global economy have helped improve commodity-linked companies' balance sheets. And, it's propelled a wave of corporate-bond upgrades for several energy and mining firms.

The latest upgrades have boosted bond prices and opened some companies to lower-cost borrowing. For example, the value of some high-yield oil and gas exploration and production (E&P) corporate bonds surged as oil prices moved further above their costs of production. In turn we saw lowered default risks and an enhanced ability to generate free cash flow and pay down debt.

Meanwhile, health care-related corporate bonds were an area of market weakness during the third quarter. Within the group, the key detractors were tied to hospital and health care-center operators.

Within the corporate bond market, the outperformance of the high-yield sector relative to high-quality (investment-grade) fixed income securities thus far in 2017 has led to tight credit spreads versus long-term averages. We think this thereby limits the potential for capital appreciation going forward.

Various issuers of high-yield, below-investment-grade debt appear to remain in good shape. Such companies generally possess balance sheets that have remained healthy by historic standards. A low interest-rate environment and reduced capital costs have been an aid. However, it is important to note that leverage levels have increased as the current cycle has aged.

In previous market cycles, we observed more selling of debt for acquisitions, buyouts and dividends. So far in 2017, issuance has been more focused around the refinancing of existing debt and extending maturities.

While high-yield valuations were somewhat elevated at the end of September, we have maintained our cautious expectation for stability within the asset class, absent an equity market selloff. With yields serving as the primary driver of returns, however, the performance of these debt securities may be more muted going forward than we saw in 2016 or year-to-date in 2017.

However, we have yet to see any early signs of broad credit deterioration, at least for the near-to-intermediate term. Default rates have remained low. We believe sustained improvement in the US and global economy should continue to support that trend. In sum, while we believe attractive value currently exists in certain pockets of the US high-yield universe, we remain selective and fully cognizant of the risks that inevitably come with such buoyant market conditions.

Actively Managing the Risks

The higher markets go, the greater the risks inevitably become, and the more we must monitor the risks every step of the way. Looking forward, key risks include a Fed mistake as it transitions to a more traditional and sustainable monetary policy framework, a too-rapid rise in inflation, or geopolitical tensions.

In recent months, our emphasis on selectivity has underpinned changes in the way we manage risk within our high-yield exposure. Essentially, our efforts in Franklin Income Fund are now focused on shedding asset class allocation risk for more idiosyncratic risk, with targeted and concentrated exposures to specific investment opportunities within high yield that we continue to find compelling.

Strong market fundamentals have compressed relative value within the high-yield asset class. So, we have been striving to reduce certain single-name exposures in Franklin Income Fund that we view as less attractive while focusing on what we view as high-conviction opportunities. We also favor bond-specific positioning in short- to intermediate-term maturities, which in our opinion offer better risk/reward potential at this point of the economic, business and credit cycles.

We continue to look across companies' individual capital structures in search of the most compelling investments among dividend-paying equities and many different types of fixed income securities for our portfolios. If and when US interest rates rise more substantially, we expect firms will continue to evaluate and modify their capital structures. This may in turn create new investment opportunities we can capitalize on through our flexible approach to uncovering relative value.

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What Are the Risks?

Franklin Income Fund

All investments involve risks, including possible loss of principal. The fund's share price and yield will be affected by interest rate movements. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in the fund adjust to a rise in interest rates, the fund's share price may decline. Changes in the financial strength of a bond issuer or in a bond's credit rating may affect its value. The fund's portfolio includes a substantial portion of higher-yielding, lower-rated corporate bonds because of the relatively higher yields they offer. Floating-rate loans are lower-rated, higher-yielding instruments, which are subject to increased risk of default and can potentially result in loss of principal. These securities carry a greater degree of credit risk relative to investment-grade securities. Stock prices fluctuate, sometimes rapidly and

dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. These and other risk considerations are discussed in the fund's prospectus.

For more information, contact your financial advisor or download a free prospectus. *Investors should carefully consider a fund's investment goals, risks, sales charges and expenses before investing. The prospectus contains this and other information. Please read the prospectus carefully before investing or sending money.*

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