Perspective from **Franklin Templeton Investment Solutions**

Making sense of different signals

January 2023

Key Points

- Valuations reset across most assets in 2022, leading to a rise in expectations for long-term returns for many risky assets, including high-yield bonds and equities.
- We view valuations as a better long-term asset allocation signal than a justification for short-term portfolio changes.
- Despite improved long-term return expectations, our cautious near-term macro-outlook—with significant recession risk—leads to a less favorable view of risky assets, such as high-yield bonds and equities, over the next several quarters.
- Putting it all together, the improvement in valuations currently leaves us moderately bearish on risky assets given our cautious cyclical outlook.

Introduction

Franklin Templeton Investment Solutions (FTIS) is optimistic about the performance potential for risky assets over the long term, which we consider to be a full business cycle, or about 10 years. However, our short-term preference (over the next 12 months) for risk assets is more cautious, based on our macro outlook. Some might notice these opposing viewpoints and wonder what signals would make an investment manager bearish in the short-term and bullish over the long-term, and how they balance this tension in a portfolio. Here, we attempt to provide the rationale behind these opposing views. While generally applicable to all risky assets, we will focus specifically on high-yield bonds and equities.

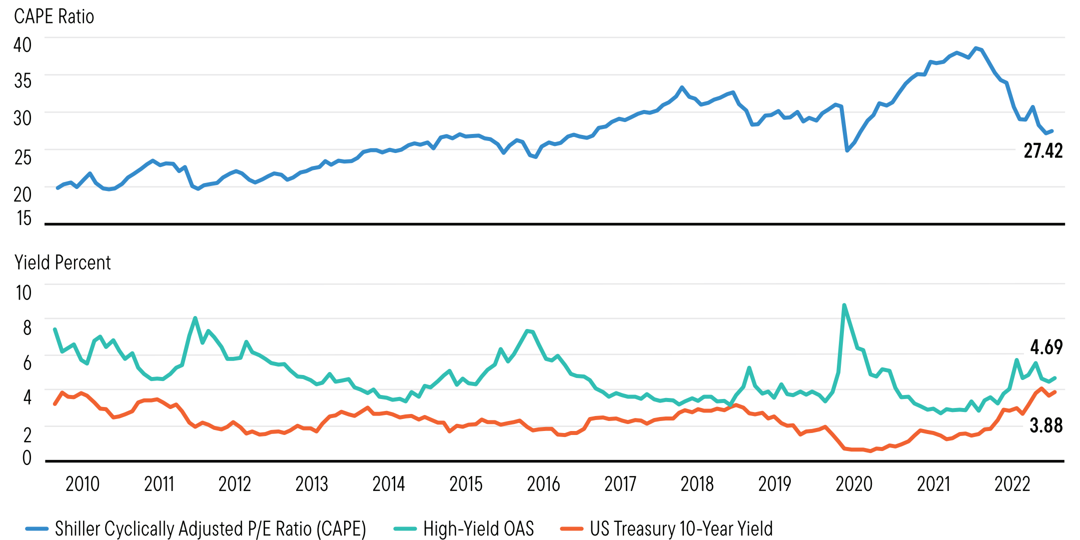
Long-term return expectations have improved

Our long-term return expectations have risen across every asset class, due largely to the market declines in 2022, which have reset valuations (Exhibit 1 on the next page). In equities, lower price-to-earnings (P/E) multiples (and thus higher earnings yield) now mean that valuations are a tailwind over the foreseeable future, rather than a headwind. In fixed income, interest rates have risen across the yield curve. Higher rates and wider credit spreads make high-yield bonds look more appealing to us over the long term.

Historically, valuations have been helpful indicators of long-term returns. As an asset class gets cheaper (i.e., yields increase), generally the long-term return expectations increase. However, valuations are much less effective at predicting shorter, one-year returns (Exhibit 2 on the next page).

Exhibit 1: Stocks and Bonds Became Cheaper in 2022

Data begin on October 31, 2009. Treasury Yield and High Yield Option-Adjusted Spread (OAS) as of December 31, 2022; Cyclically Adjusted Price-to-Earnings Ratio (CAPE) as of November 30, 2022



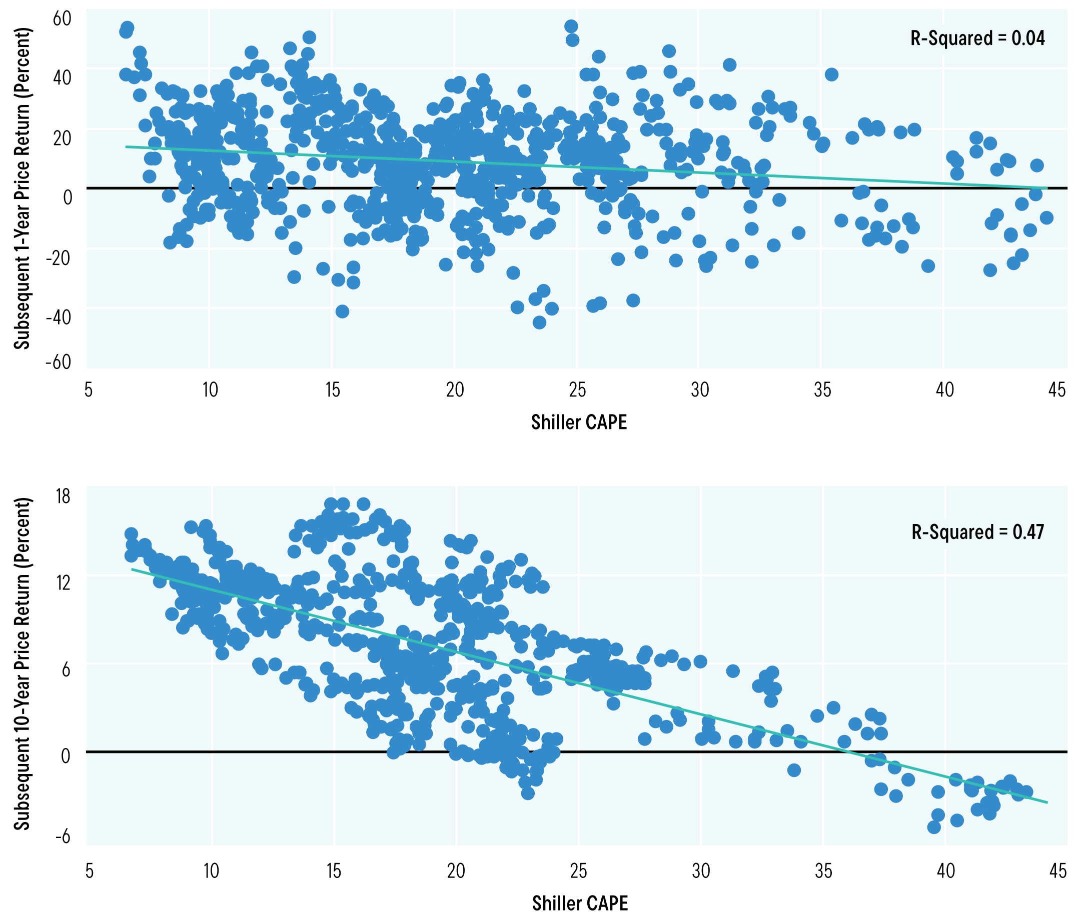
Sources: S&P/Robert Shiller, US Department of the Treasury, Bloomberg, Macrobond. High yield is represented by the Bloomberg US Corporate High Yield Total Return Index (Unhedged). Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is no guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

Exhibit 2: Valuations Have Predicted Long-Term Returns Better than Short-Term Returns

Top: Equity Valuations (CAPE) vs. Subsequent 1-Year Price Return

Bottom: Equity Valuations (CAPE) vs. Subsequent 10-Year Price Return

Data from 1948, monthly frequency, as of December 31, 2022



Sources: S&P Dow Jones Indices, S&P/Robert Shiller, US Department of the Treasury, Macrobond. The Y-axis plots the price return of the S&P 500 Index. The first chart plots P/E data through December 31, 2021, against each month-end's subsequent 1-year price return (return data through December 31, 2022). The second chart plots P/E data through December 31, 2012, against each month-end's subsequent 10-year price return (return data through December 31, 2022). Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is no guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

Focusing on the long term

We believe it's hard to argue against the long-term case of high-yield bonds and equities, assuming they fit an investor's risk parameters and investment horizon. Historically, high-yield bonds have produced a total return somewhere in between US stocks and investment-grade corporate bonds. And they have achieved these returns with less volatility than equities, resulting in what we believe to be strong risk-adjusted returns (see Exhibit 3).

Exhibit 3: Historical Asset Class Returns and Risk

July 1983–December 31, 2022

	Total Return	Volatility	Sharpe Ratio
US Stocks	10.6%	15.5%	0.47
US High-Yield Bonds	8.18%	8.4%	0.57

Sources: Bloomberg, Russell. Volatility is calculated as standard deviation. Total return and standard deviation use monthly returns, annualized. To determine the Sharpe ratio, we measure the average annualized excess return of the asset class over US Treasury bills (risk-free rate, calculated as an average of the daily values over the time period) divided by its annualized standard deviation. A greater Sharpe ratio indicates a higher return per unit of risk. US stocks are represented by the Russell 3000. US high yield is represented by the Bloomberg US Corporate High Yield Total Return Index (Unhedged). Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is no guarantee of future results.**

Careful selection

Higher default rates in high-yield bonds make careful selection vital. While equities can constantly fluctuate into perpetuity, bonds (including high yield) need to prove one thing to mature at par—that they won't default. Investors who pick the "right" high-yield bonds (or pick managers to do it for them) will realize profits if bought below par and held to maturity.

High-yield issuers usually have less equity and/or more leverage on their balance sheets, which raises their default risk and leads to a higher credit spread when compared with their investment-grade counterparts. The higher credit spread leads high-yield bond returns to move more in lockstep with the perceived financial strength of their issuers. Thus, they usually respond to the strength of the economy (similar to stocks) more so than changes in interest rates, which tend to impact investment-grade corporate bonds to a greater degree. Put simply, high-yield bonds have more exposure to the economic growth factor, while investment-grade bonds have more exposure to the interest-rate factor. Investors are compensated for this extra credit risk with excess returns—at least when times are good, and the default rates are low.

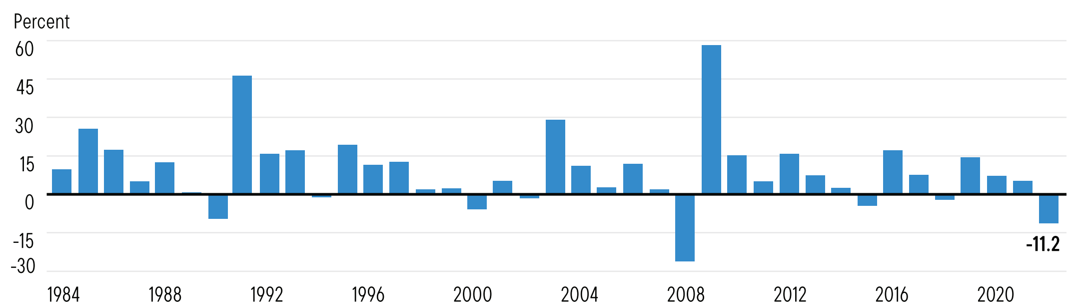
What about when times are bad? Of course, like equities, high-yield bonds are not impervious to downturns. **But so far, we have never observed two straight calendar years of negative returns in the high-yield asset class**[1] (see Exhibit 4). With a streak like that, should investors consider high yield?

Our view (short-term vs. long-term)

Our near-term macro outlook for 2023 remains cautious. While inflation may have peaked, we believe it will remain above the US Federal Reserve's (Fed's) target levels of 2% for some time. The Fed has repeated that it is unconditional in its fight against inflation, with the hope that it can lower job openings (weaken wage inflation) without materially affecting

Exhibit 4: US Corporate High-Yield Total Return by Calendar Year

1984–2022



Sources: Bloomberg, Macrobond. High yield is represented by the Bloomberg US Corporate High Yield Total Return Index (Unhedged). Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is no guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

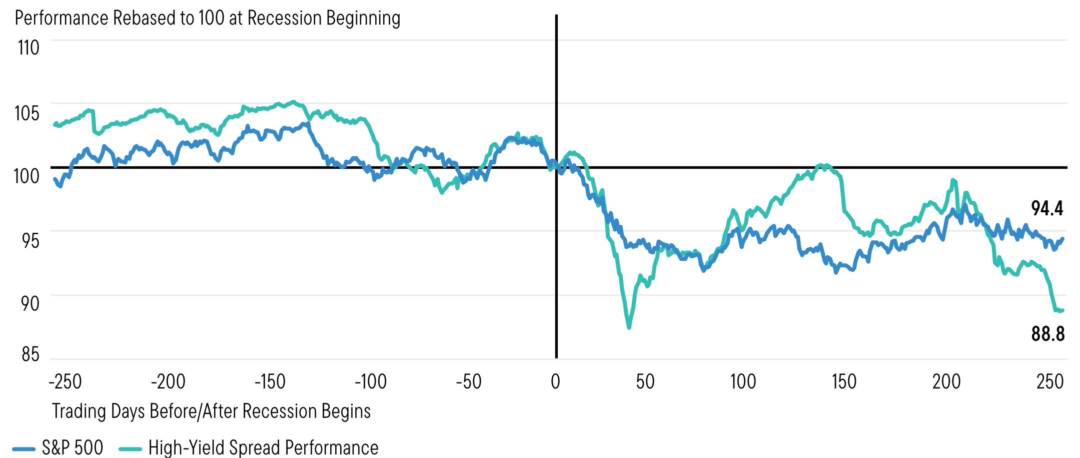
employment. We think this will be difficult to achieve. We also believe that growth and employment need to weaken to fully normalize inflation. FTIS' odds for a US recession over the upcoming year remain high at 65%.

The implications of this viewpoint for asset allocation are straightforward. Risky assets, such as equities and high yield, have performed poorly heading into recessions (see Exhibit 5).

During recessions, the high-yield risk premium, or spread over Treasuries, typically spikes up to compensate for anticipated higher defaults. At its peak, the default rate has reached more than 10% in a recession and spreads often widened past 7%. We do not think high-yield bonds are currently pricing in a recession from a spread valuation perspective (see Exhibit 6). In other words, the market, in our view, is not pricing in the much tighter financial conditions and weaker financial performance for issuers that often comes with a market downturn and can lead to an increase in defaults.

Exhibit 5: Multi-Asset Performance Heading into Recessions

As of December 31, 2022.
S&P 500 Index from April 1959.
High Yield from March 2000

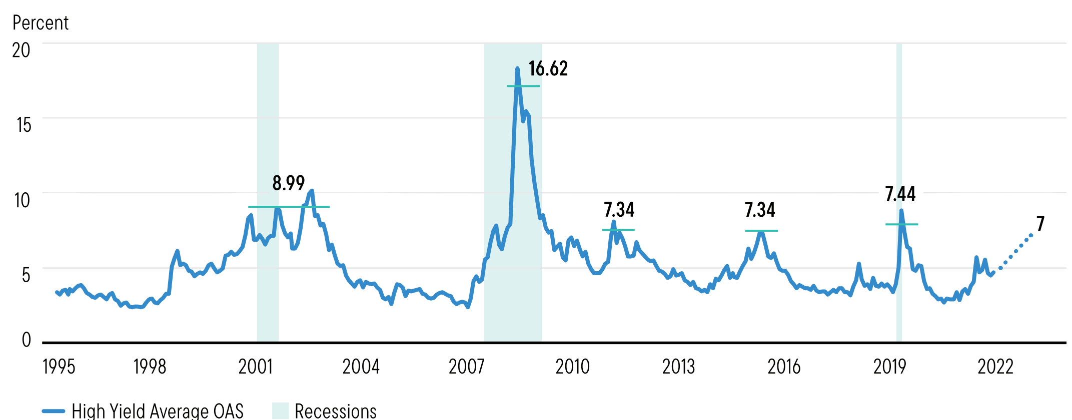


Sources: S&P Dow Jones Indices, Federal Reserve, Macrobond. High-yield spread performance reflects the performance of the option adjusted spread of the high-yield index (over the Treasury), assuming a five-year constant duration. High yield is represented by the Bloomberg US Corporate High Yield Total Return Index (Unhedged). Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is no guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

Exhibit 6: Spreads Have Not Yet Hit Levels Typically Seen in a Recession

Bloomberg US Corporate High Yield Index (Unhedged) Average OAS

February 29, 1995–
December 31, 2022



Sources: Bloomberg, Macrobond. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is no guarantee of future results.** There is no assurance that any projection, estimate or forecast will be realized. Important data provider notices and terms available at www.franklintempletondatasources.com.

A volatile year ahead

At the opening of 2022, we believed the Fed was walking a tightrope heading into the year.[2] Unfortunately, it is still on the same tightrope, in our view, as the central bank tries to engineer a soft landing in 2023. The Fed will likely try to pause its interest-rate hikes at some point in 2023, fearful of driving the US economy into recession. The market is pricing in Fed rate cuts in 2023 due to growth worries. We find this scenario unlikely, and think the Fed is likely to keep rates restrictive throughout 2023. As always, what ultimately happens will depend on a number of variables, many outside the Fed's control, including the US economy's sensitivity to higher interest rates, and how geopolitical developments evolve.

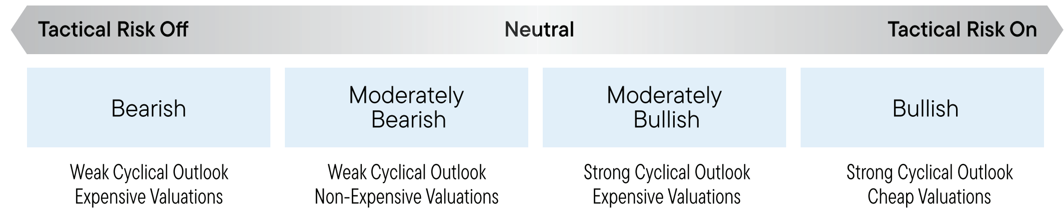
The performance of risky assets will depend on these variables, among others. Returns at year end don't reflect the volatility experienced along the way. Prices will likely be volatile until the market has an unobstructed view of clear skies ahead—and that will likely begin with the Fed's policy actions.

This is why we believe that nimble, active management is important, especially in times like these. Our own viewpoint will change as our cyclical outlook changes.

Conclusion

Improved valuations have increased the long-term expected return outlook for multi-asset portfolios in general. However, in the near term, we weigh our cyclical outlook more heavily, which leaves us defensively positioned given our view of significant US recession risk. This combination of improved valuations and an uncertain near-term view leaves us moderately bearish toward risky assets, such as high yield and equities.

Exhibit 7: Dynamic Views Scale/Rationale



Source: Franklin Templeton Investment Solutions. For illustrative purposes only.

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Endnotes

1. We use the Bloomberg US Corporate High Yield Index (Unhedged) as a proxy, which has an inception date of July 1983. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**
2. Podkaminer, G., Mayorga, M. et. al. 2022. "The Fed: Walking a Tightrope in 2022."

Definitions:

The **Russell 3000 Index** is an unmanaged index of the 3,000 largest US companies.

The **Bloomberg US Corporate High Yield Total Return Index** measures the total return of the US dollar-denominated, high-yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and Standard & Poor's is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets (EM) country of risk, based on Bloomberg EM country definition, are excluded.

The **cyclically adjusted price-to-earnings ratio (CAPE)** is defined as price divided by the average of ten years of earnings, adjusted for inflation.

Option-Adjusted Spread (OAS) refers to the difference in yield between a security or index and the yield of a benchmark, other security or index, adjusted for options within the index. These options give rights to bond issuers and holders. One example is a call option, which allows a bond issuer to redeem a bond before maturity, affecting its yield output. A higher OAS denotes more risk as assigned by the market.

R-squared measures the degree to which performance can be explained by another variable; a higher r-squared denotes a higher correlation.

A **Sharpe ratio** is a risk-adjusted measure of investment return. The higher the Sharpe ratio, the better the index or fund's historical risk-adjusted performance.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in lower-rated bonds include higher risk of default and loss of principal. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. Floating-rate loans and debt securities tend to be rated below investment grade. Investing in higher-yielding, lower-rated, floating-rate loans and debt securities involves greater risk of default, which could result in loss of principal—a risk that may be heightened in a slowing economy. Interest earned on floating-rate loans varies with changes in prevailing interest rates. Therefore, while floating-rate loans offer higher interest income when interest rates rise, they will also generate less income when interest rates decline. Actively managed strategies could experience losses if the investment manager's judgment about markets, interest rates or the attractiveness, relative values, liquidity or potential appreciation of particular investments made for a portfolio, proves to be incorrect. There can be no guarantee that an investment manager's investment techniques or decisions will produce the desired results.

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