



3Q23 Market & Strategy Update

June 20, 2023

Ken Leech

Chief Investment Officer

Disinflation ongoing but uneven

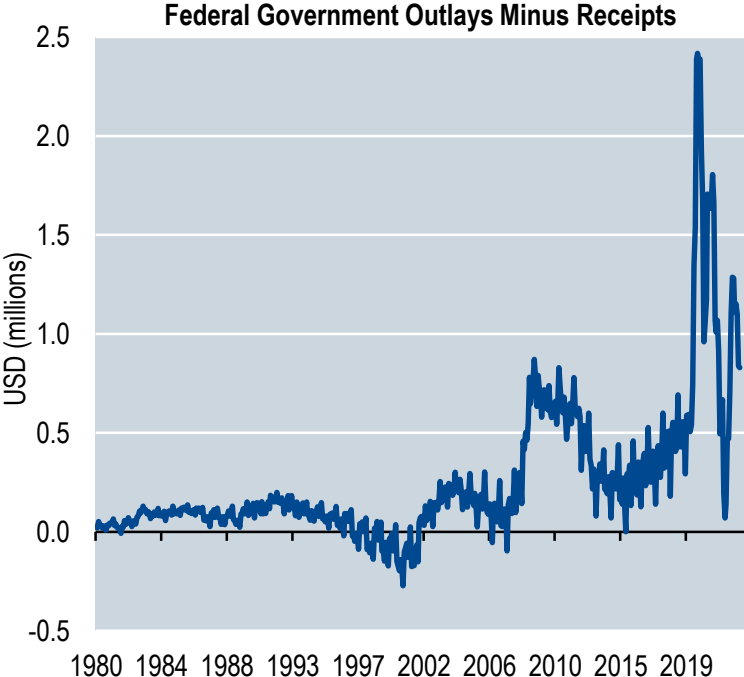
Fed tightening near end

Current banking stress extremely complex but not systemic

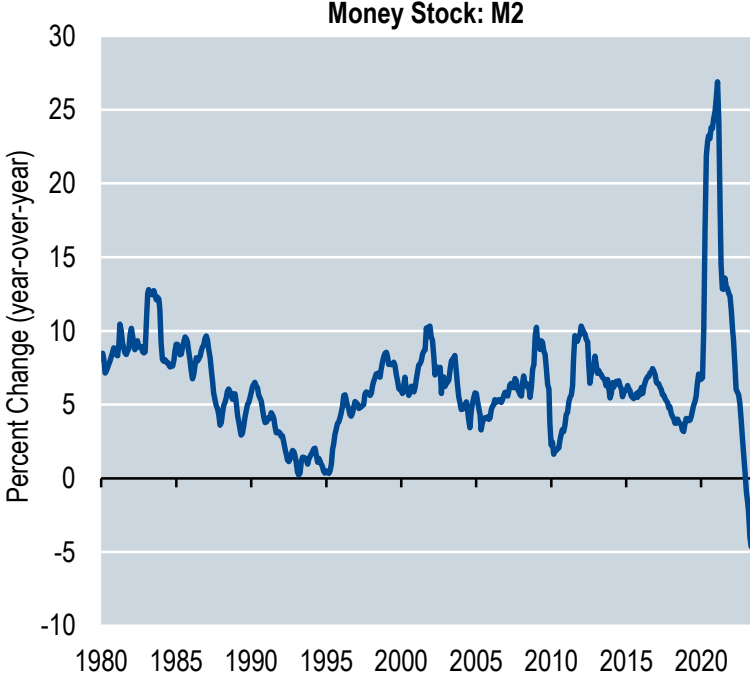
Fixed-income outlook

- US growth will slow but should avoid recession
- Global growth has downshifted, but with China's reopening will remain resilient
- Global inflation will continue to recede
- The dollar will weaken moderately
- Emerging markets should outperform
- Central bank overtightening is a meaningful risk
- Spread sectors are still attractive but the outlook is clouded by macro risk
- Geopolitical uncertainty continues to add to volatility

Inflation Tailwinds Have Turned Into Headwinds

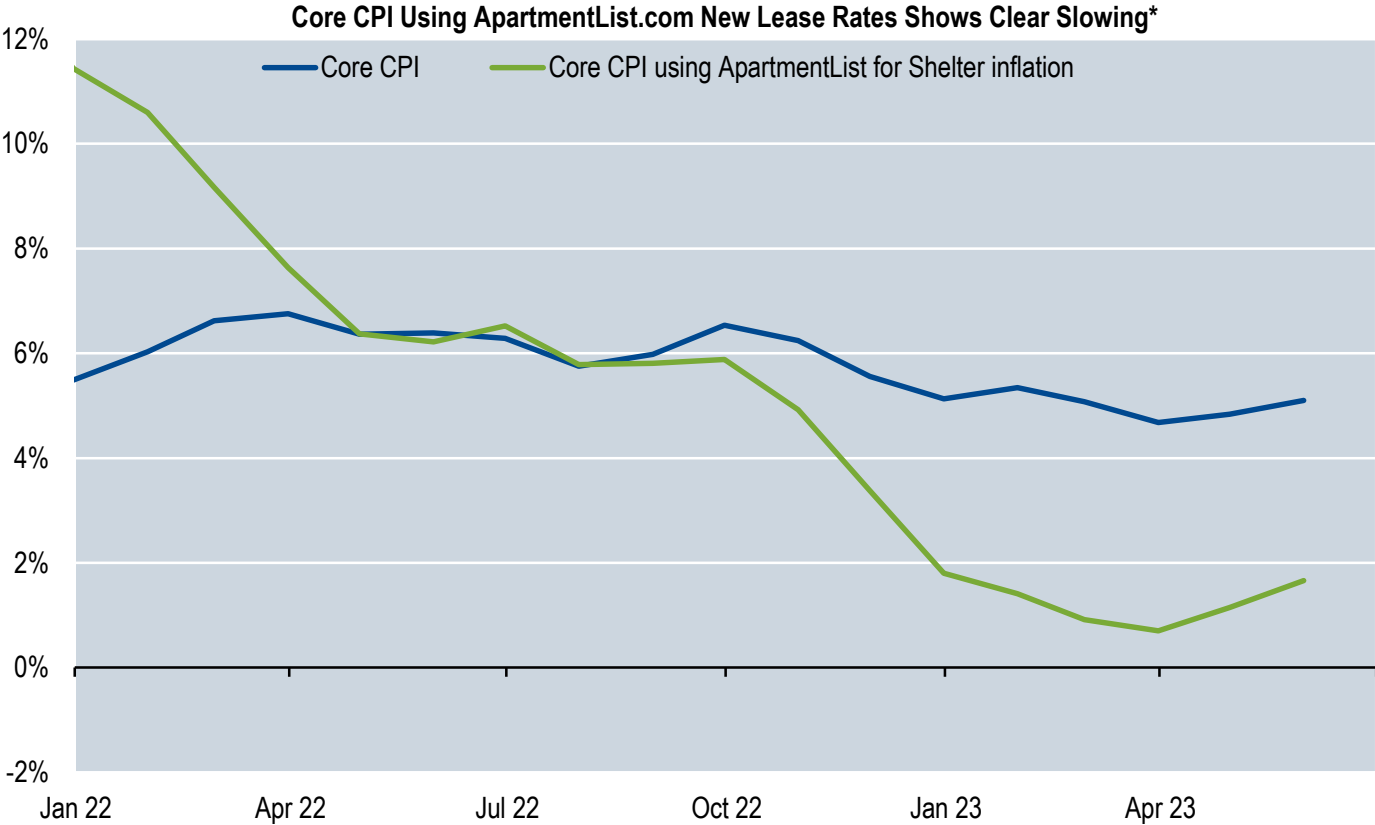


Source: Federal Reserve, Haver Analytics. As of 31 May 23
6-month trailing sum



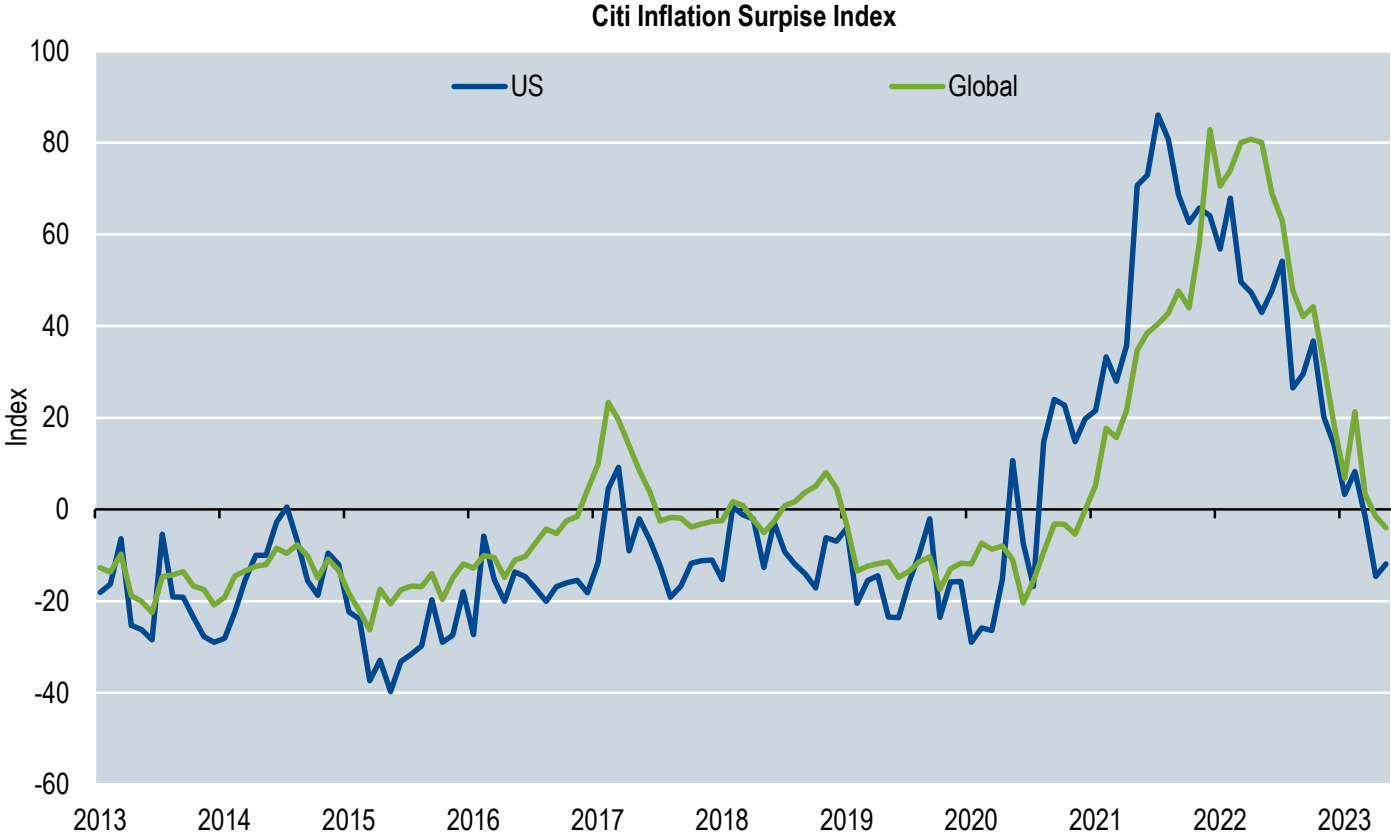
Source: US Treasury, Haver Analytics. As of 30 Apr 23
Seasonally adjusted

Inflation Trending Lower—Persistent but Uneven



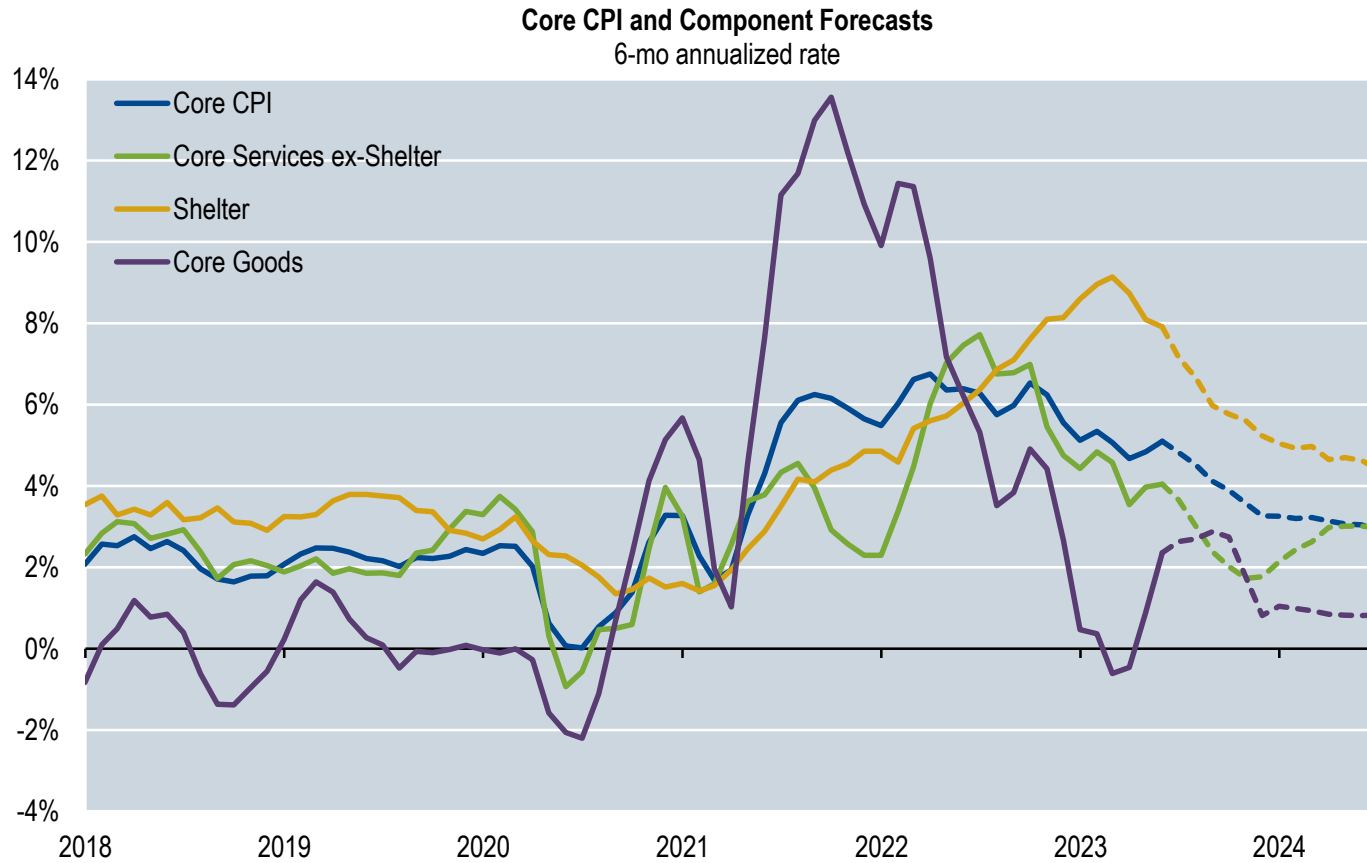
Source: BLS, ApartmentList.com, Western Asset calculations. As of 31 May 23
*6-month annualized rate

Inflation Surprises to the Downside



Source: Bloomberg. As of 31 May 23

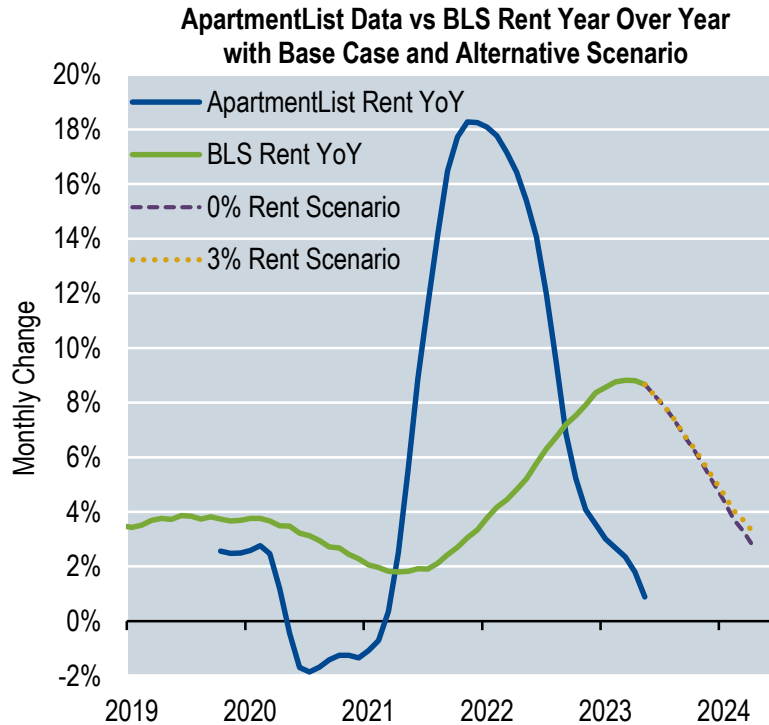
Disinflation Ongoing but Uneven



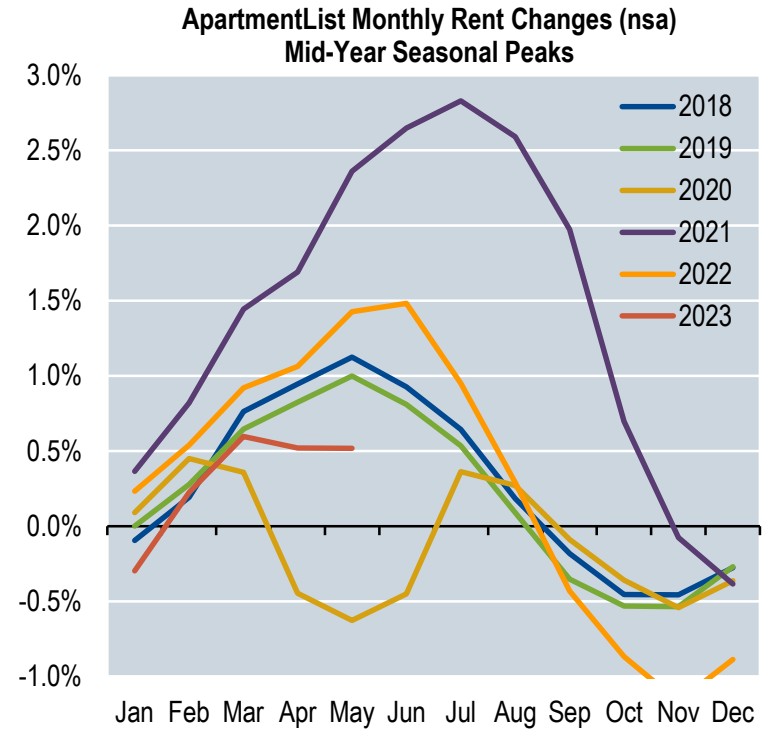
Source: Bureau of Labor Statistics, Western Asset. As of 30 Apr 23

Shelter Disinflation to Continue Throughout 2023

Rent growth has returned to normal

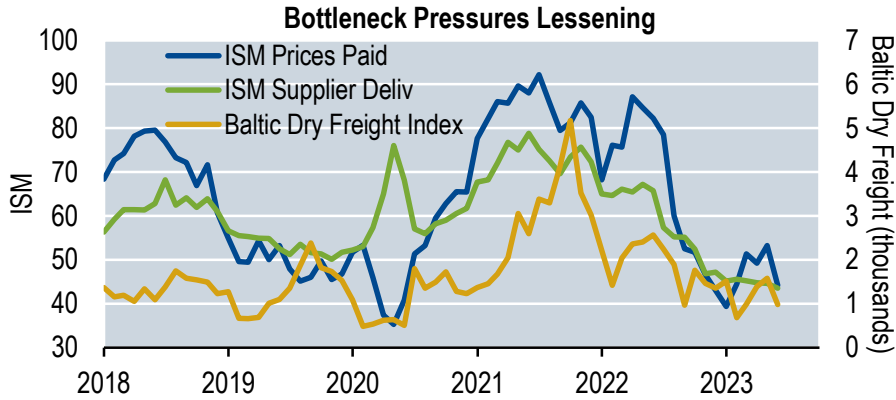


Source: Apartmentlist.com, Western Asset. As of 31 May 23

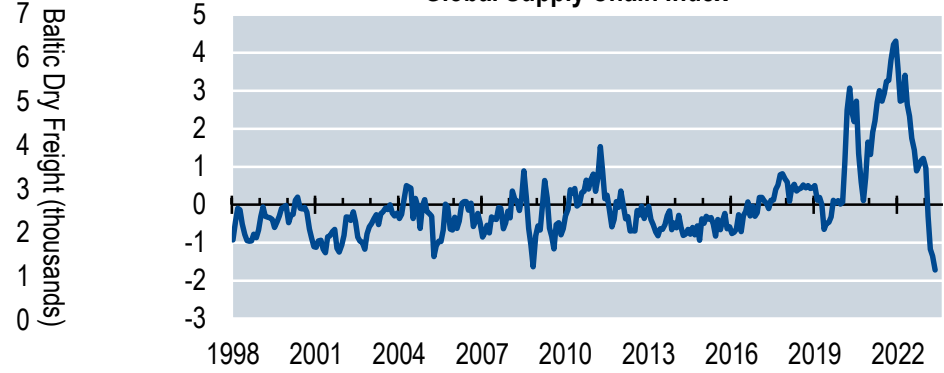


Source: Apartmentlist.com, Western Asset. As of 31 May 23

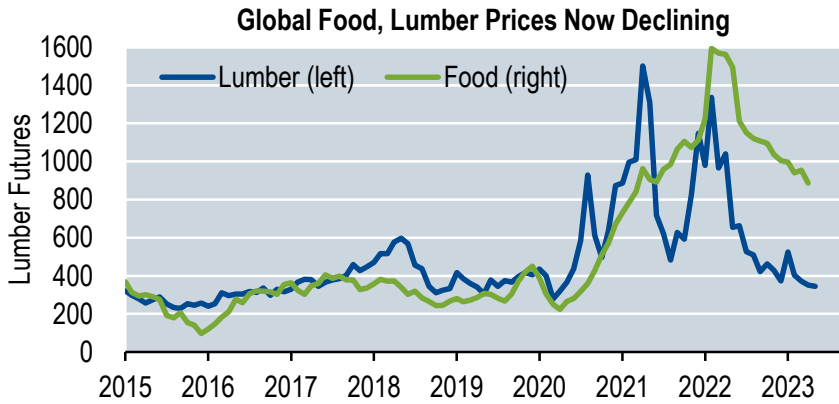
Core Goods Deflation to Resume



Source: Bloomberg. As of 31 May 23



Source: Federal Reserve Bank of New York. As of 31 May 23

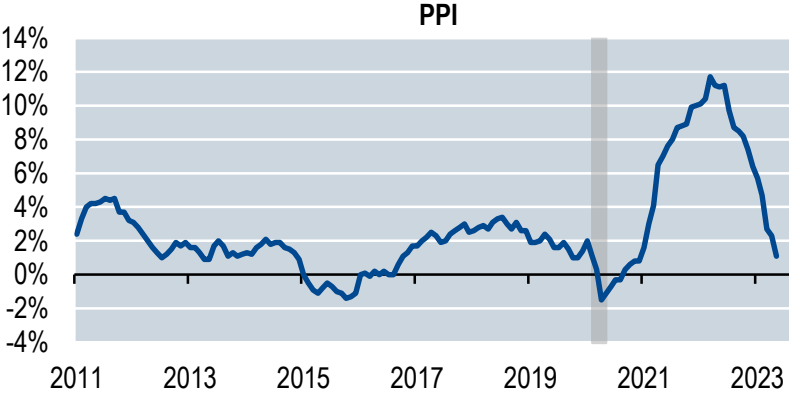


Source: Bloomberg. As of 31 May 23



Source: Bloomberg. As of 31 May 23

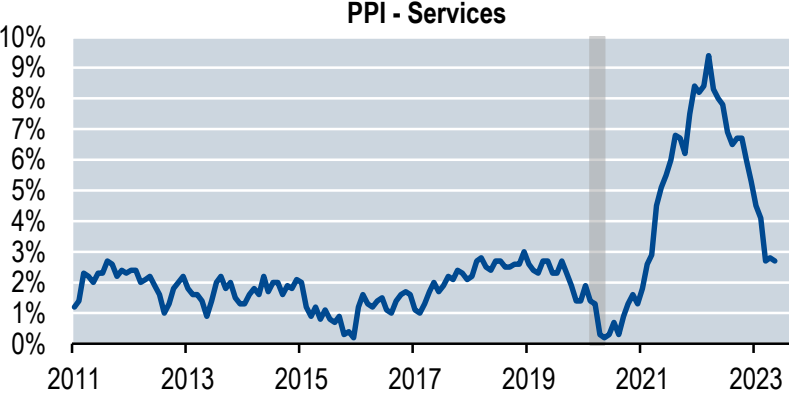
PPI – Pipeline for Future Inflation Is Very Weak



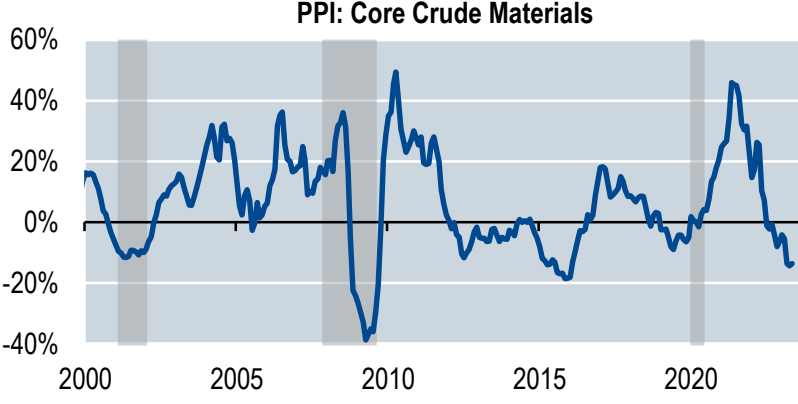
Source: Bureau of Labor Statistics, Haver Analytics. As of 31 May 23
Year-over-year percent change. Shading indicates recession.



Source: Bureau of Labor Statistics, Haver Analytics. As of 31 May 23
Year-over-year percent change. Shading indicates recession.

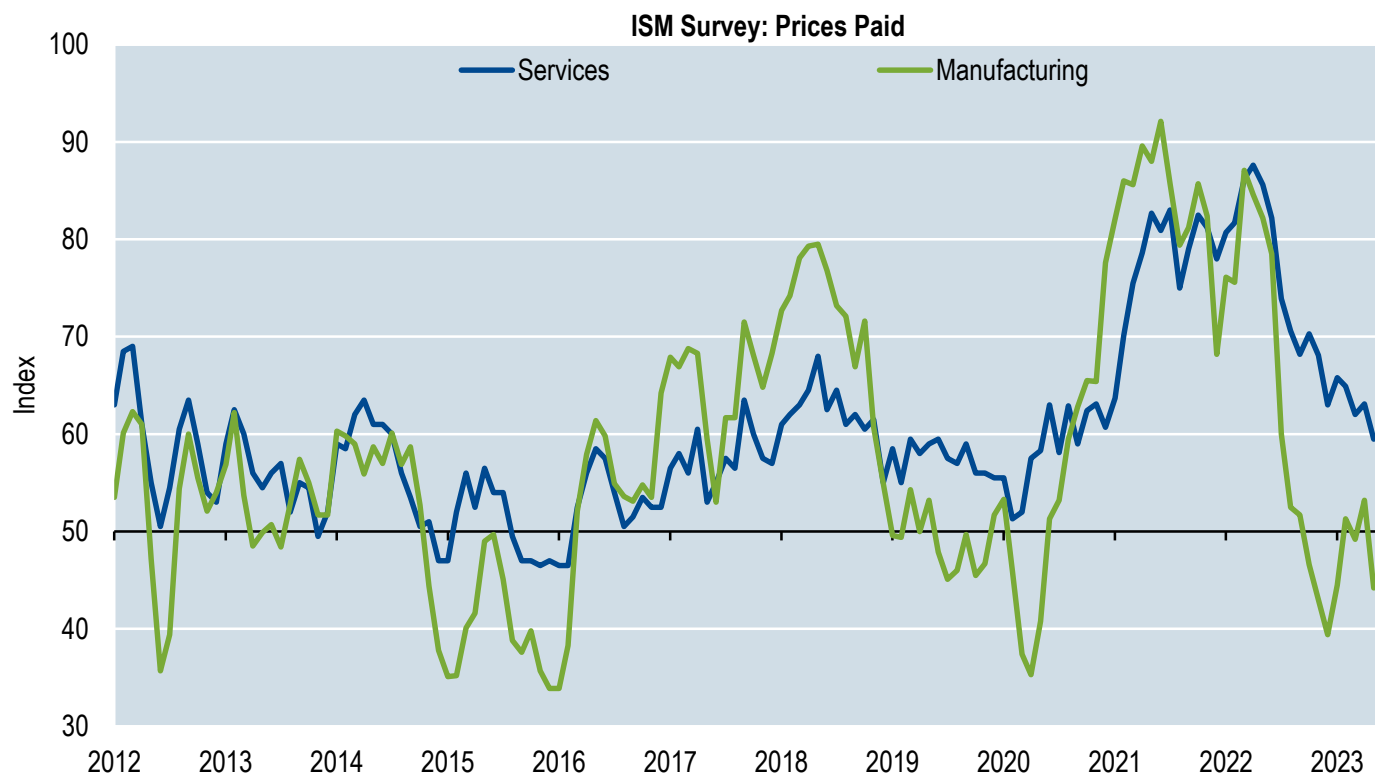


Source: Bureau of Labor Statistics, Haver Analytics. As of 31 May 23
Year-over-year percent change. Shading indicates recession.



Source: Bureau of Labor Statistics, Haver Analytics. As of 31 May 23
Year-over-year percent change. Shading indicates recession.

Service Sector Inflation Is Also Turning Down



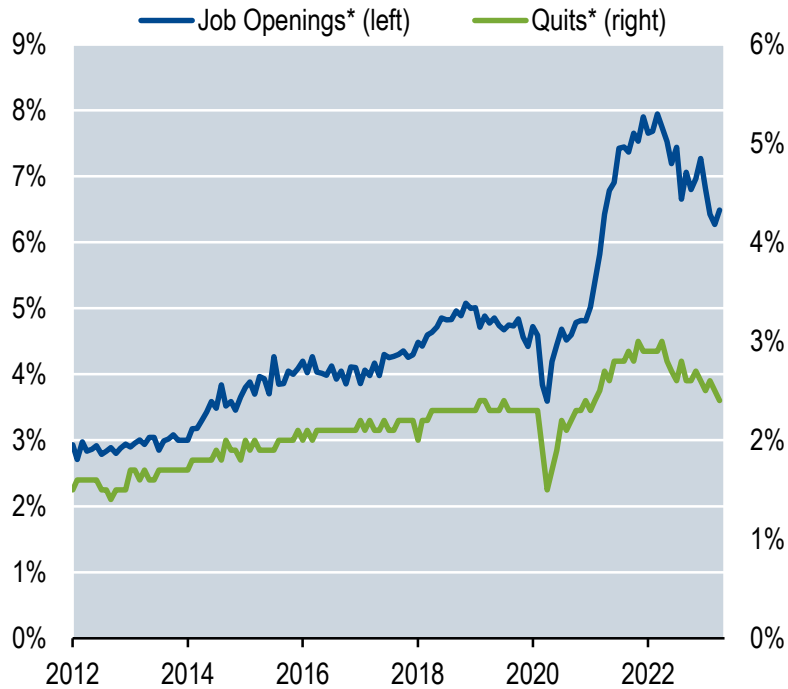
Source: Haver Analytics. As of 31 May 23
>50 Indicates Expansion

“What really was different this time was the series of unexpected and persistent supply shocks that featured in the inflation process.”

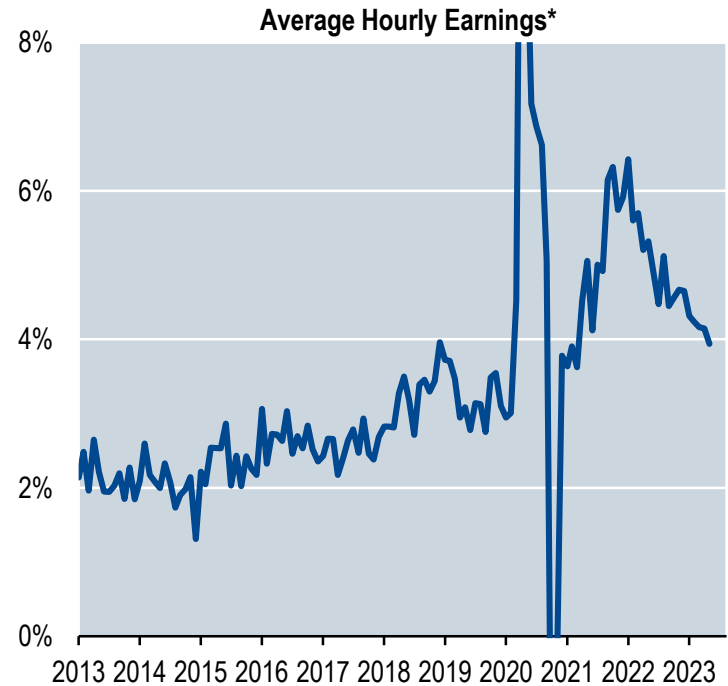
– Chair Powell, 19 May 23

Labor Market Loosening and Wage Growth Moderating

Quits rate close to pre-Covid level. Job openings declining.



Source: Bureau of Labor Statistics. As of 31 May 23
*Percentage of employment

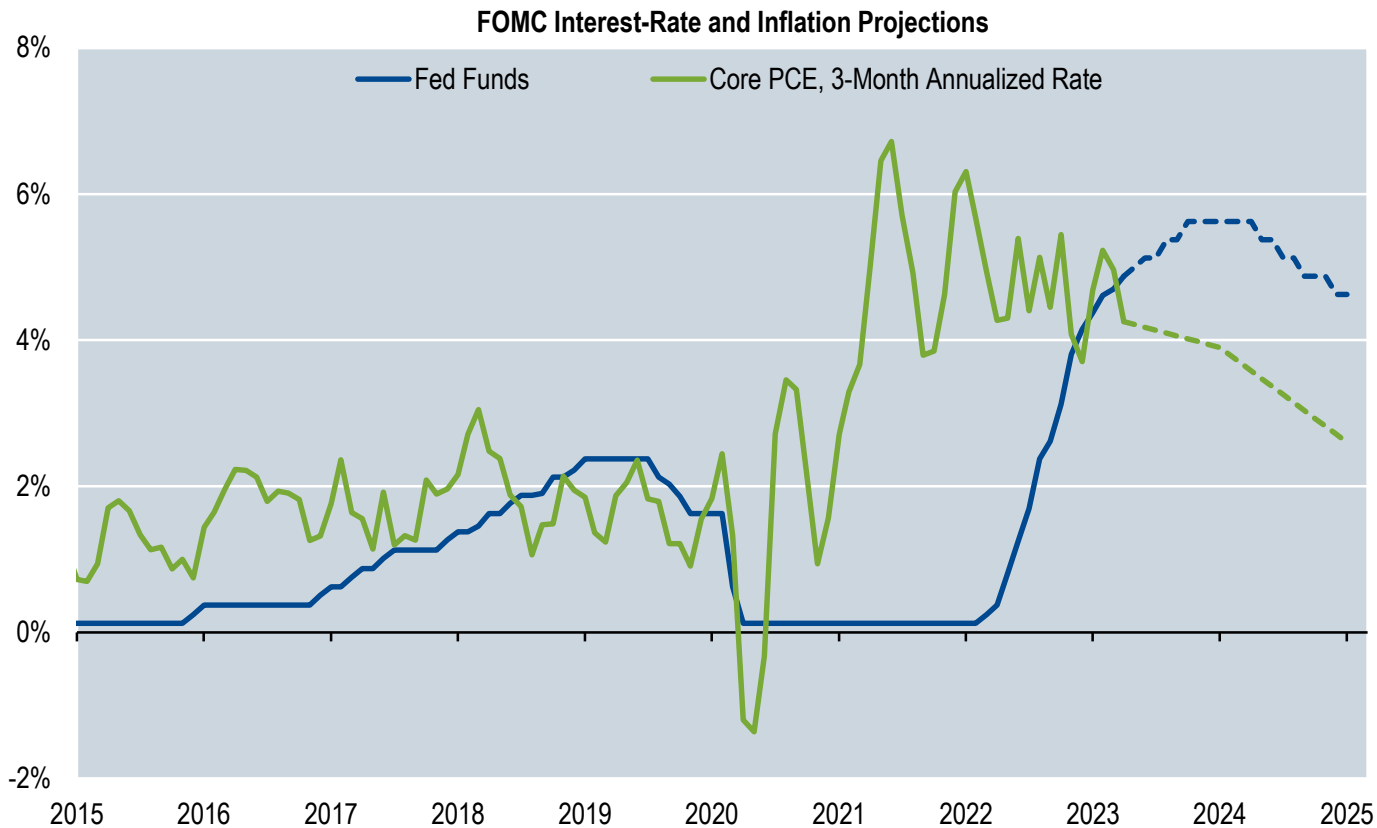


Source: Bureau of Labor Statistics. As of 31 May 23
*6-Month percent change, annual rate

Monetary Policy: Restrictive for an Extended Period

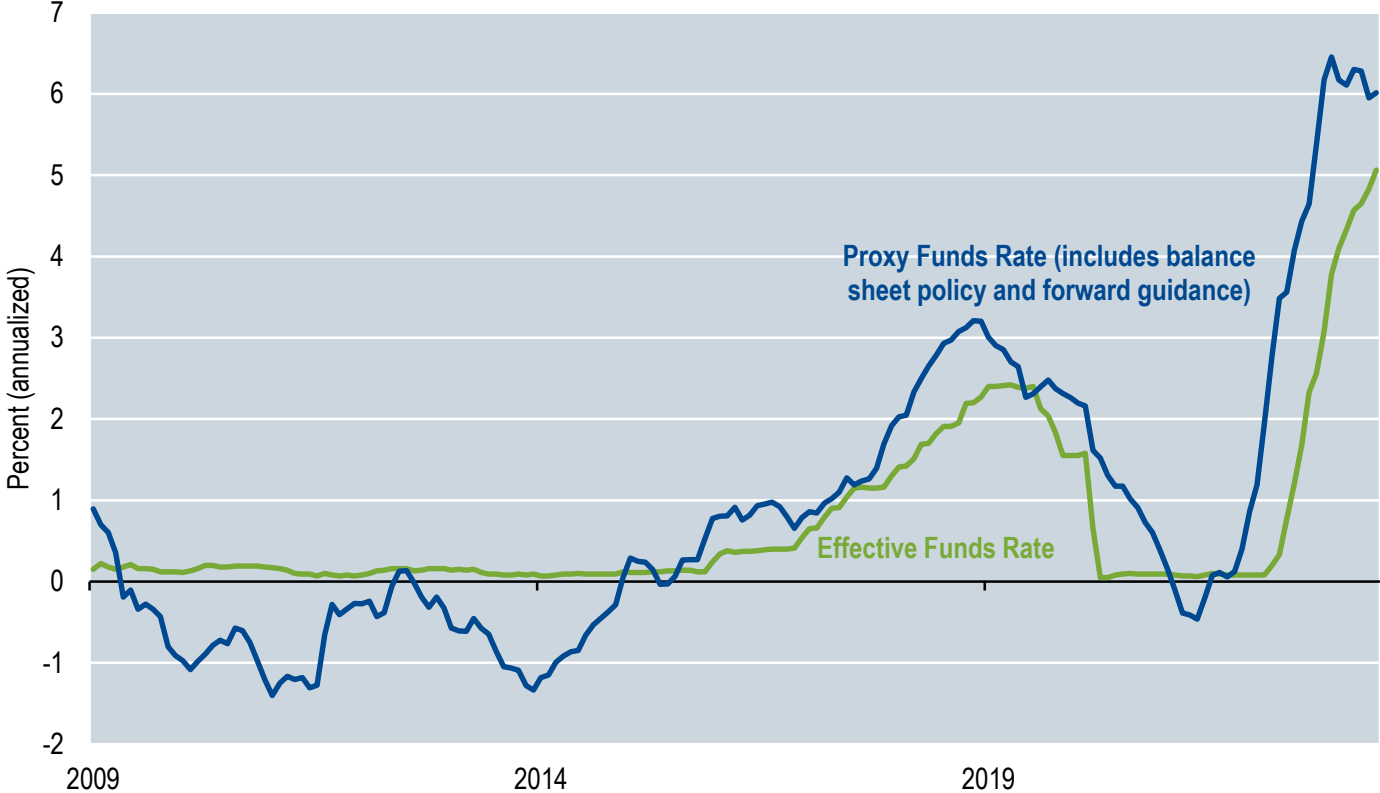
“We have come a long way in policy tightening, and the stance of policy is restrictive ... Having come this far, we can afford to look at the data and the evolving outlook and make careful assessments.”

– Chair Powell, May 19, 2023



Source: Federal Reserve. As of 30 Apr 23

Monetary Policy Is Already Tighter Than It Looks



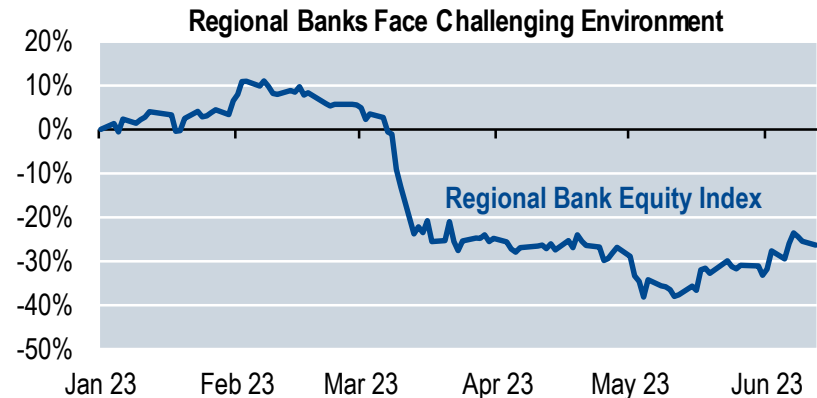
Source: Federal Reserve, Freddie Mac, The Bond Buyer, Moody's, Choi et al. (2022). As of 31 May 23
Proxy Funds Rates uses public and private borrowing rates and spreads to infer the broader stance of monetary policy. When the Federal Open Market Committee uses additional tools, such as forward guidance or changes in the balance sheet, these policy actions affect financial conditions, which the proxy rate translates into an analogous level of the federal funds rate.

Financial Stability and Credit Conditions

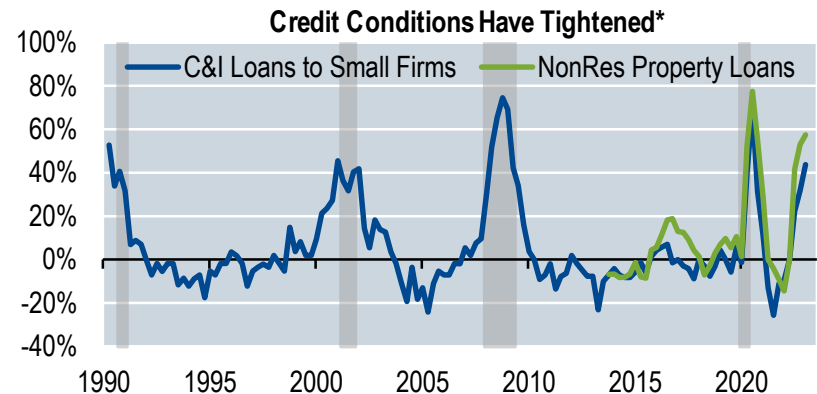
“Developments in the financial sector are contributing to tighter credit conditions and are likely to weigh on economic growth, hiring and inflation. So as a result, our policy rate may not need to rise as much as it otherwise would have to achieve our goals.”

“Our tools can have separate objectives, but their effects are often not entirely independent ... Financial stability affects macroeconomic stability and vice versa.”

– Chair Powell, May 19, 2023



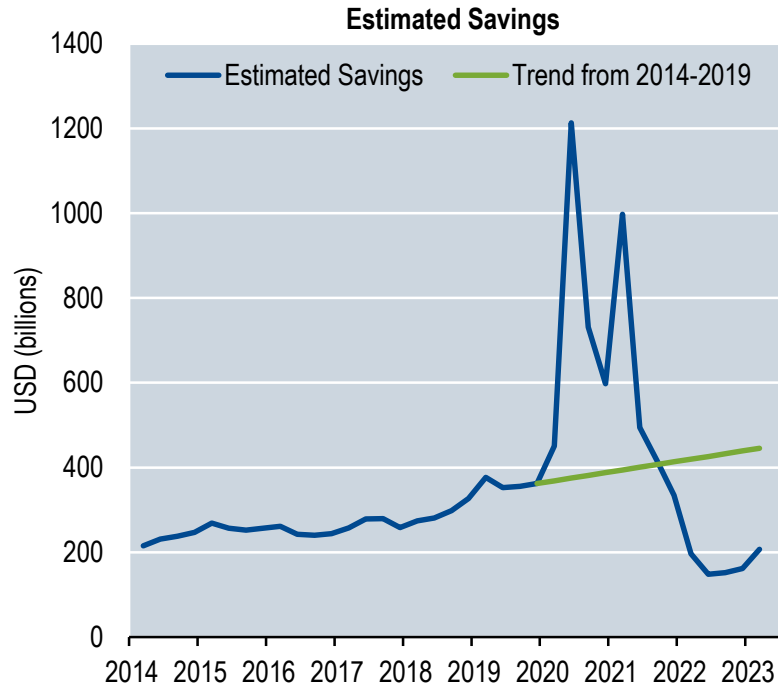
Source: Bloomberg. As of 12 Jun 23



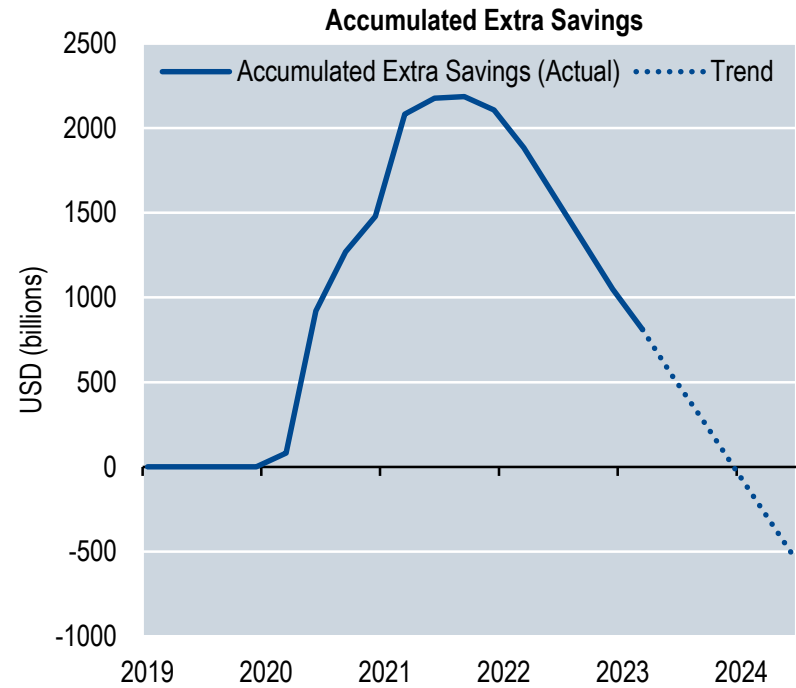
Source: Federal Reserve. As of 31 Mar 23
*Percent of Banks Tightening Standards

Consumers Under Pressure

Extra savings accumulated due to Covid policies are being depleted

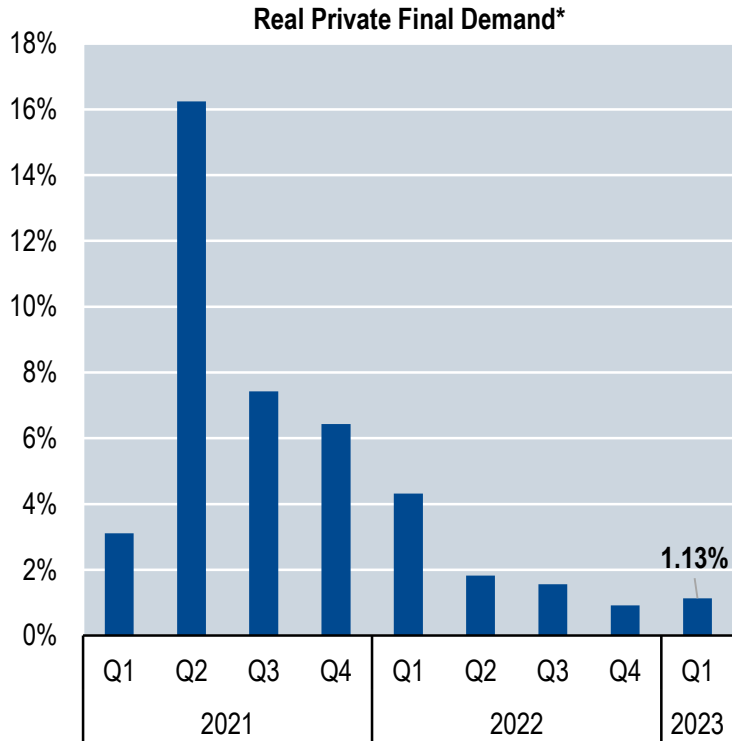


Source: Bloomberg, Western Asset. As of 20 Mar 23

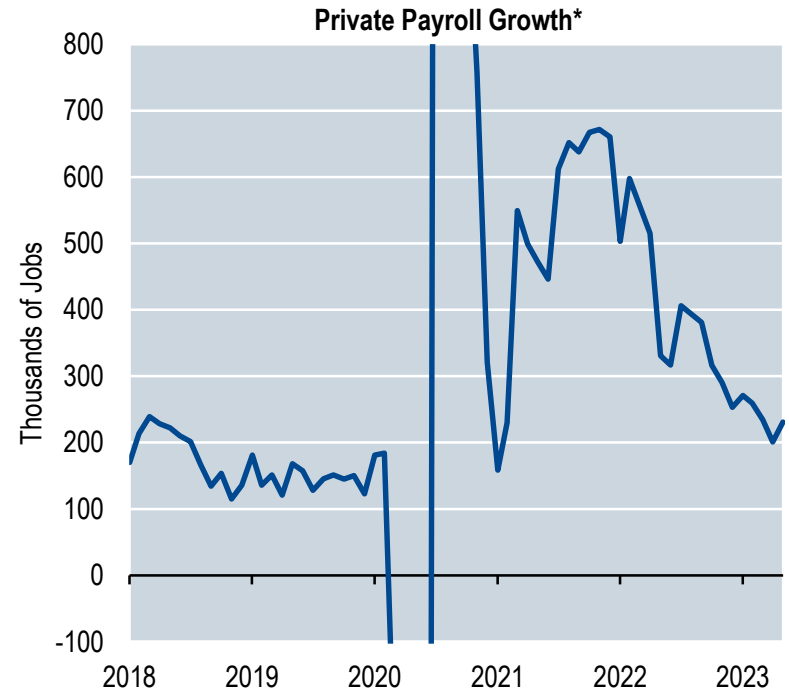


Source: Bloomberg, Western Asset. As of 20 Mar 23

Slowing Demand



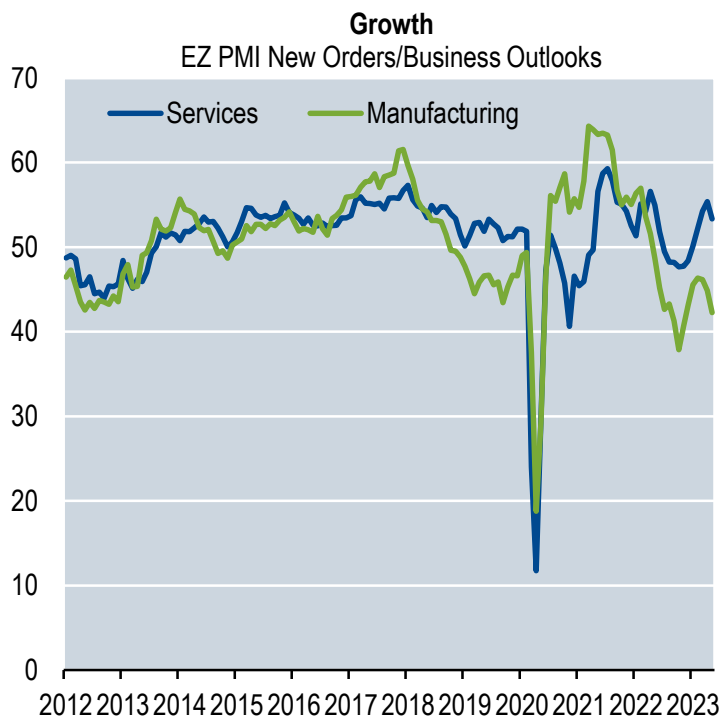
Source: Haver Analytics. As of 31 May 23
 *4-quarter percent change



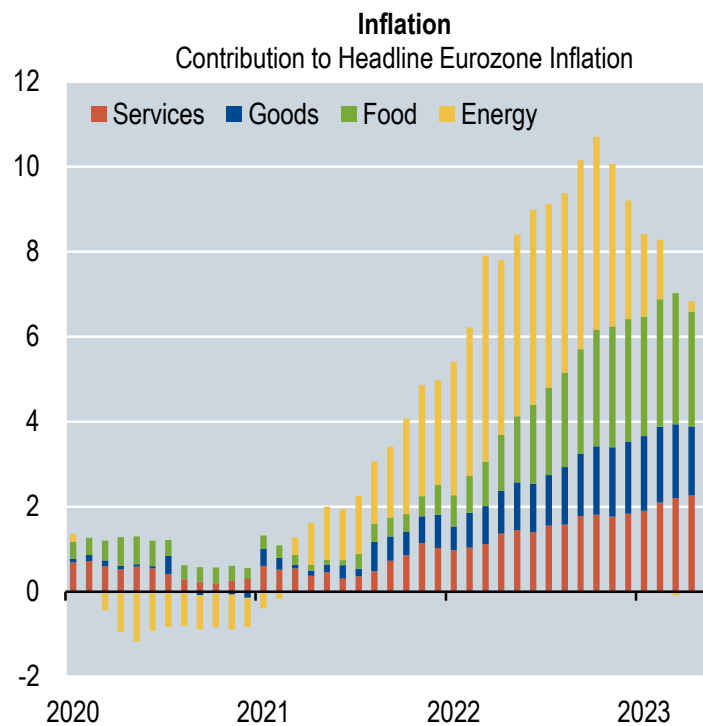
Source: Haver Analytics. As of 31 May 23
 *3-month average

Europe's Growth Slowing and ECB Tightening Gaining Traction

- Manufacturing demand soft, services demand turning lower
- Inflation peaked in October 2022, core beginning to turn lower, inflation expectations moderate
- Need for further rate increase questionable



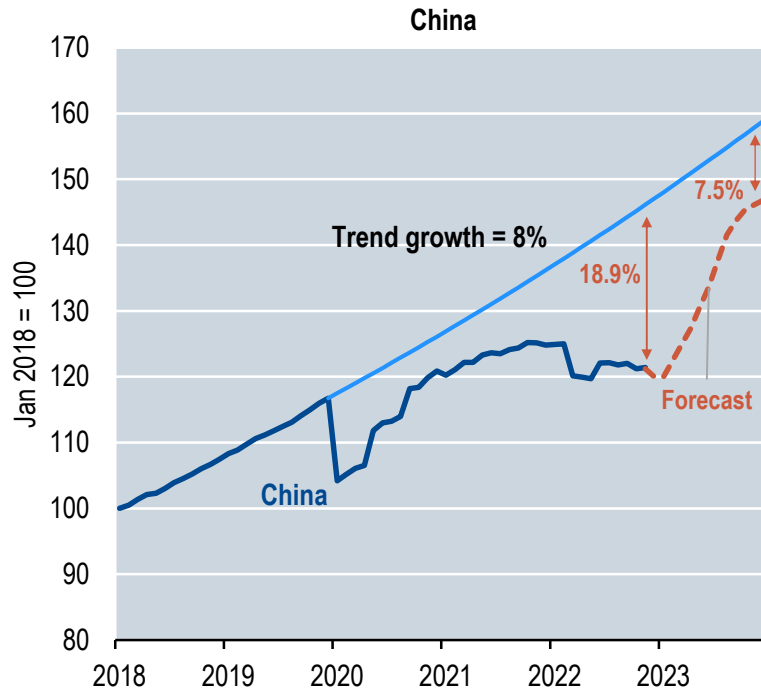
Source: S&P Global, Hamburg Commercial Bank, Haver Analytics. As of 31 May 23



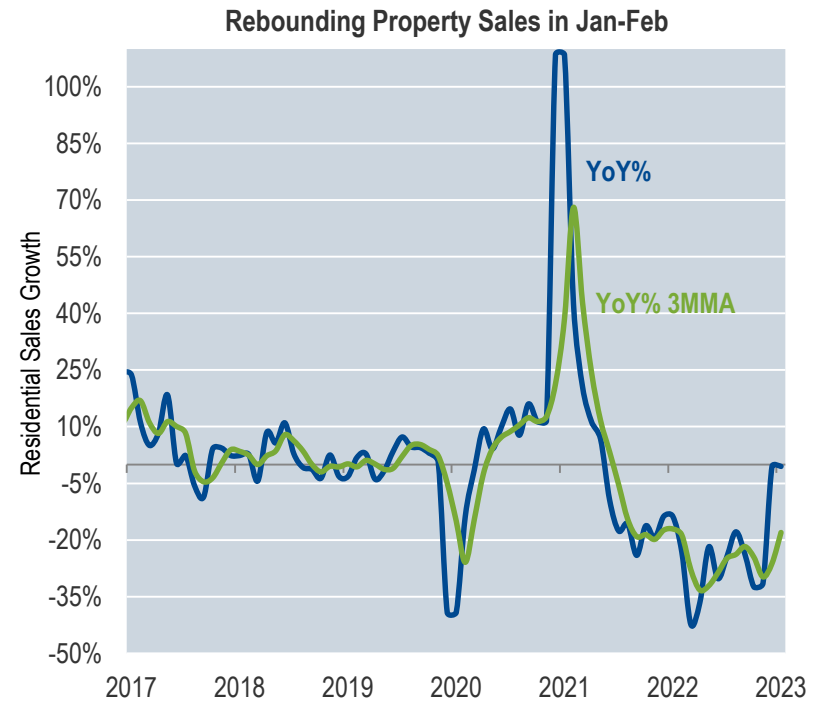
Source: Eurostat, Haver Analytics. As of 31 May 23

China Outlook: Cyclical Rebound, Secular Concerns

- Consumption will be a key growth driver, although the trend in China remains unimpressive
- Broad policy accommodation should nonetheless remain intact until the economy is on strong footing
- Support for property market should help contain further fallout from current market doldrums



Source: Citibank. As of 31 Dec 22



Source: CEIC, NBS, Morgan Stanley Research. As of 28 Feb 23

Japan Outlook

- We expect that the Japanese economy will continue to grow at 1.0%-1.5% because of the broader reopening, pent-up and inbound demands, supply chain improvements and policy support.
- Inflation is expected to continue to rise, but then moderate in the second half of 2023. Inflation will remain lower than in other advanced economies. However, underlying inflationary pressures are proving stronger than initially expected, as suggested by a more sustained rise in core inflation than expected.

Wage Are Expected to Increase in Coming Months After the Results of Spring Wage Negotiation



Source: Bloomberg. As of 30 Apr 23
*Year-over-year percent change

Positive Developments in Wages Are Confirmed



Source: Keidanren, Western Asset. As of 16 Mar 23

BoJ Tankan Survey: Employment Conditions DI Suggests a Deepening Labor Shortage



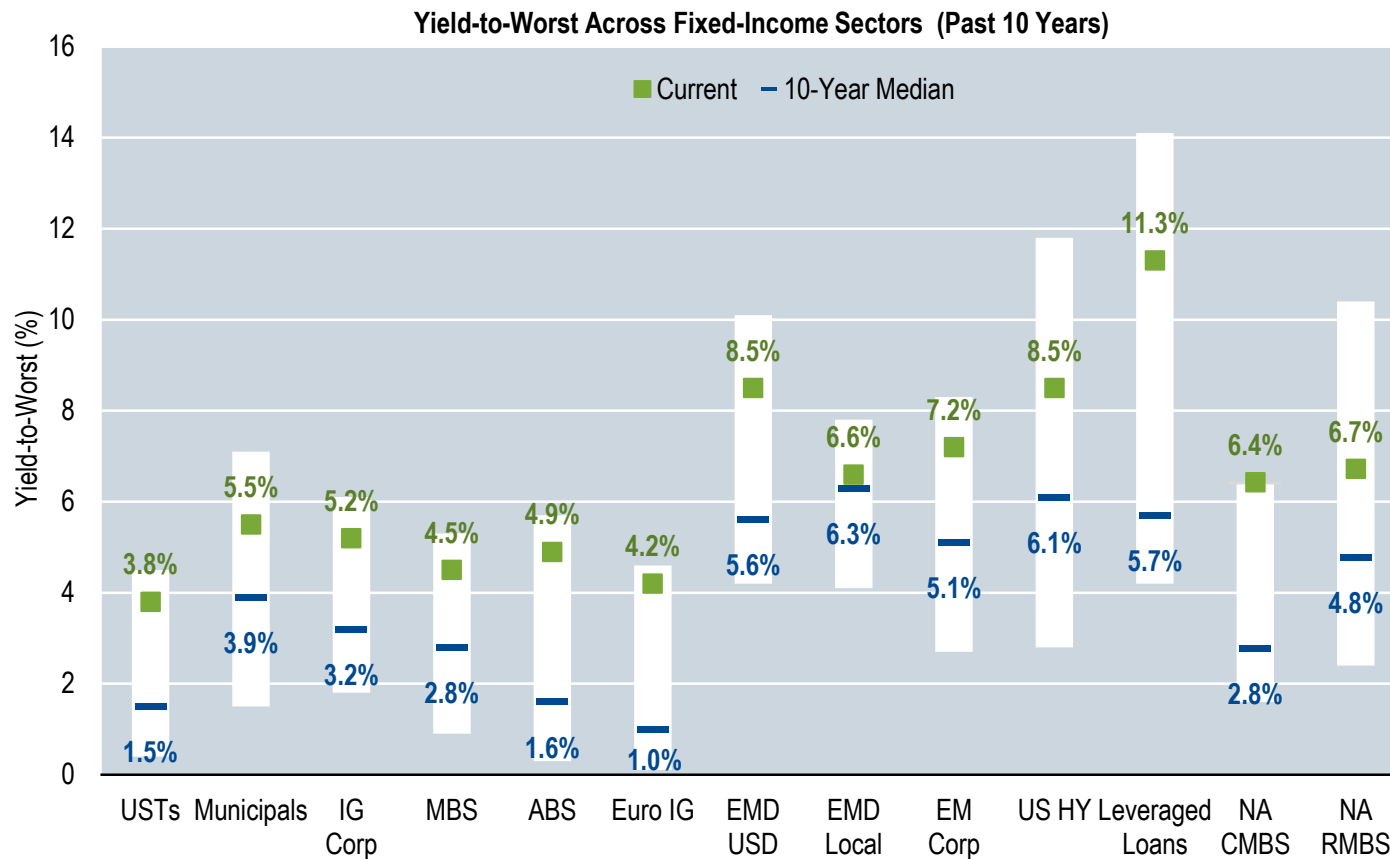
Source: Bloomberg, Western Asset. As of 31 Mar 23

Business Confidence Survey



Source: Bloomberg, Western Asset. As of 31 May 23

Fixed-Income Valuations

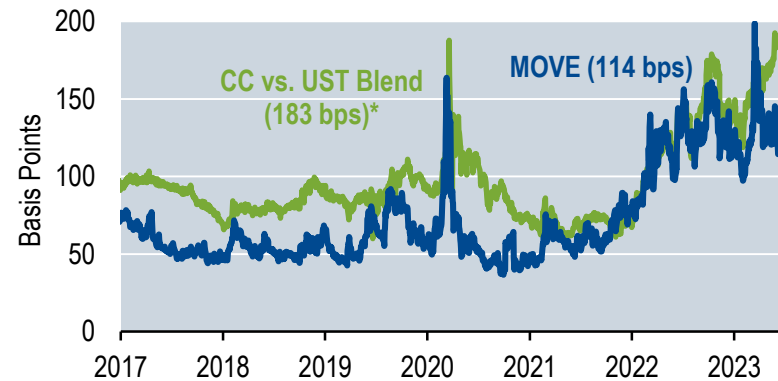
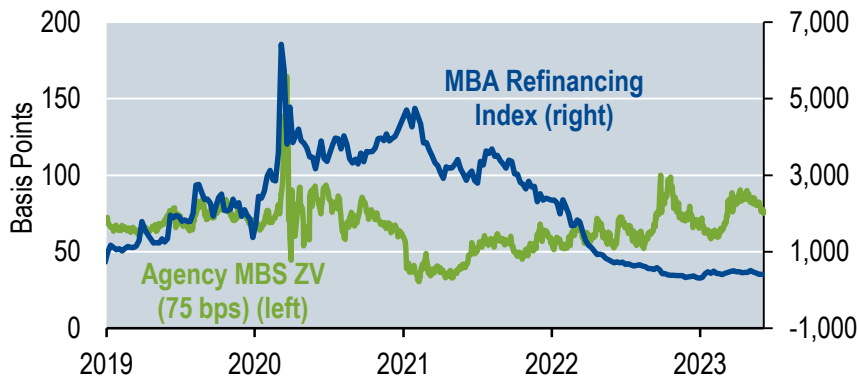
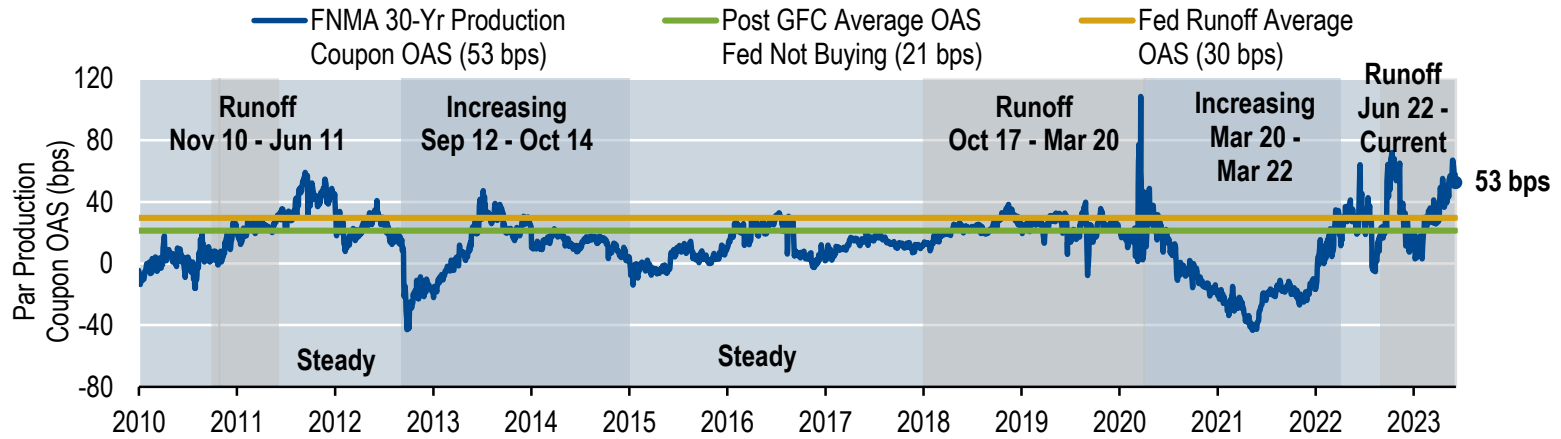


Source: JP Morgan. As of 31 Mar 23

Source: Bloomberg, FactSet, J.P. Morgan Credit Research, J.P. Morgan Asset Management. Indices used are Bloomberg except for emerging market debt and leveraged loans: EMD (USD): J.P. Morgan EMIGLOBAL Diversified Index; EMD (LCL): J.P. Morgan GBI-EM Global Diversified Index; EM Corp.: J.P. Morgan CEMBI Broad Diversified; Leveraged loans: JPM Leveraged Loan Index; Euro IG: Bloomberg Euro Aggregate Corporate Index; Euro HY: Bloomberg Pan-European High Yield Index. Yield-to-worst is the lowest possible yield that can be received on a bond apart from the company defaulting. All sectors shown are yield-to-worst except for Municipals, which is based on the tax-equivalent yield-to-worst assuming a top-income tax bracket rate of 37% plus a Medicare tax rate of 3.8%. Guide to the Markets—US Data are as of 31 Mar 23.

Agency Mortgage-Backed Securities: Fundamentals and Valuations have Improved

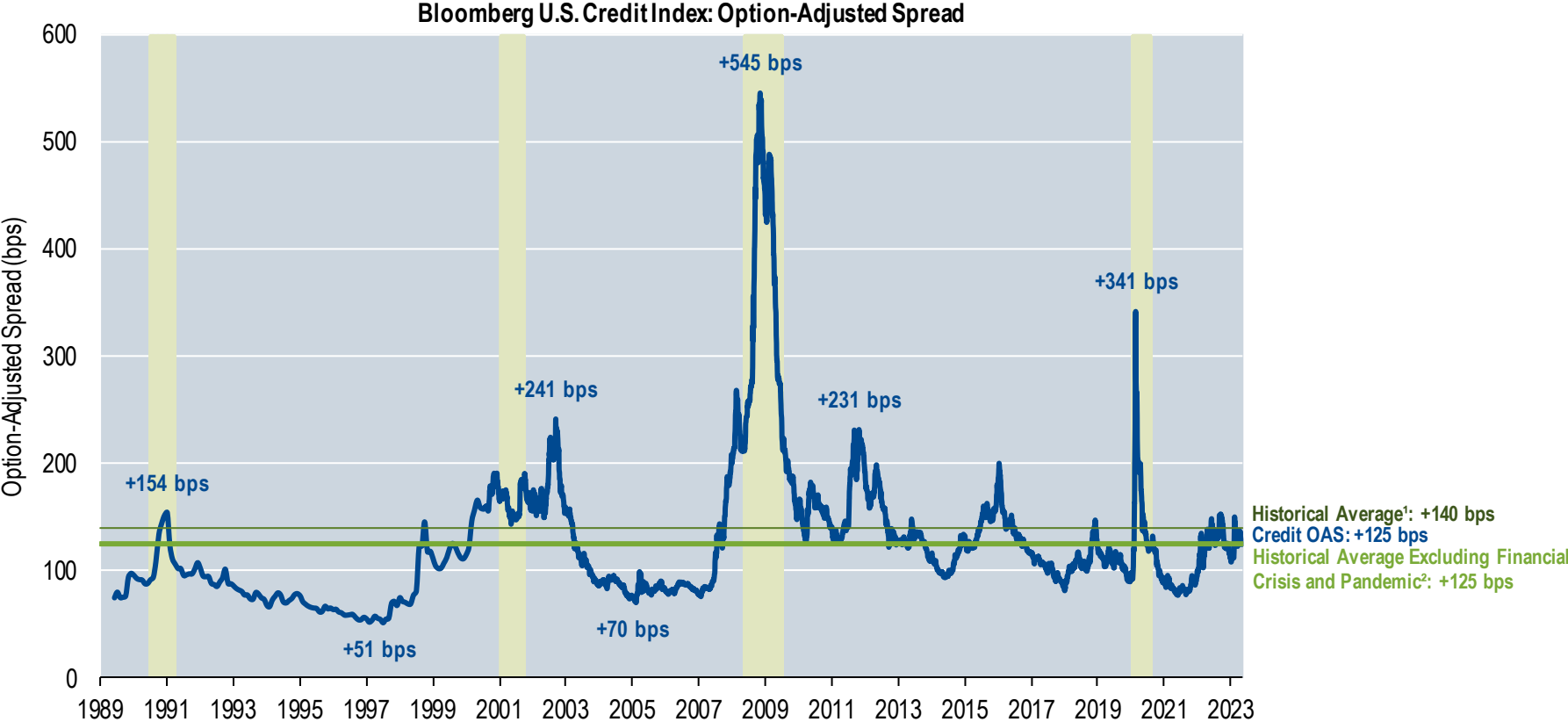
- Mortgage spreads have widened significantly as Fed and bank support diminished
- Agency MBS spreads have widened with elevated volatility and yield curve inversion
- Prepayment risk remains muted as mortgage borrowers have little refinancing incentive



Source: Bloomberg, MS Research, Western Asset. As of 06 Jun 23

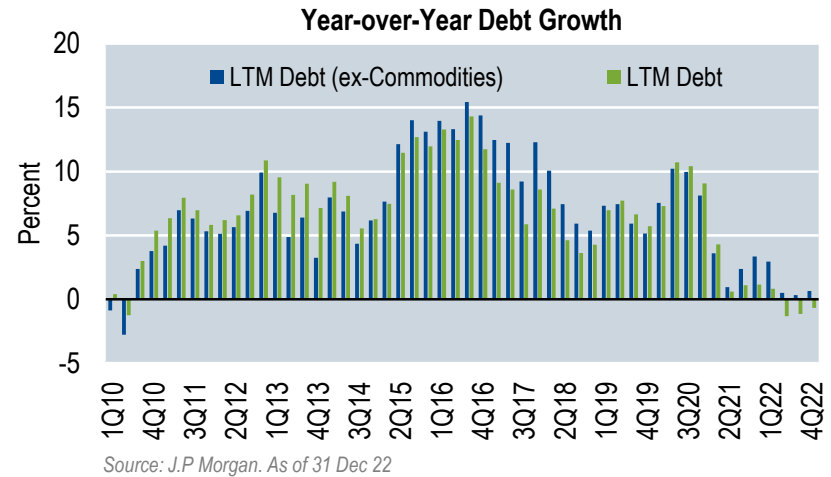
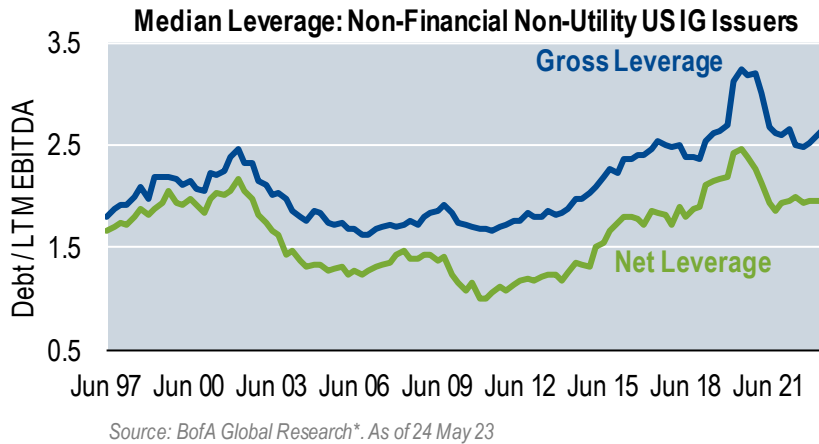
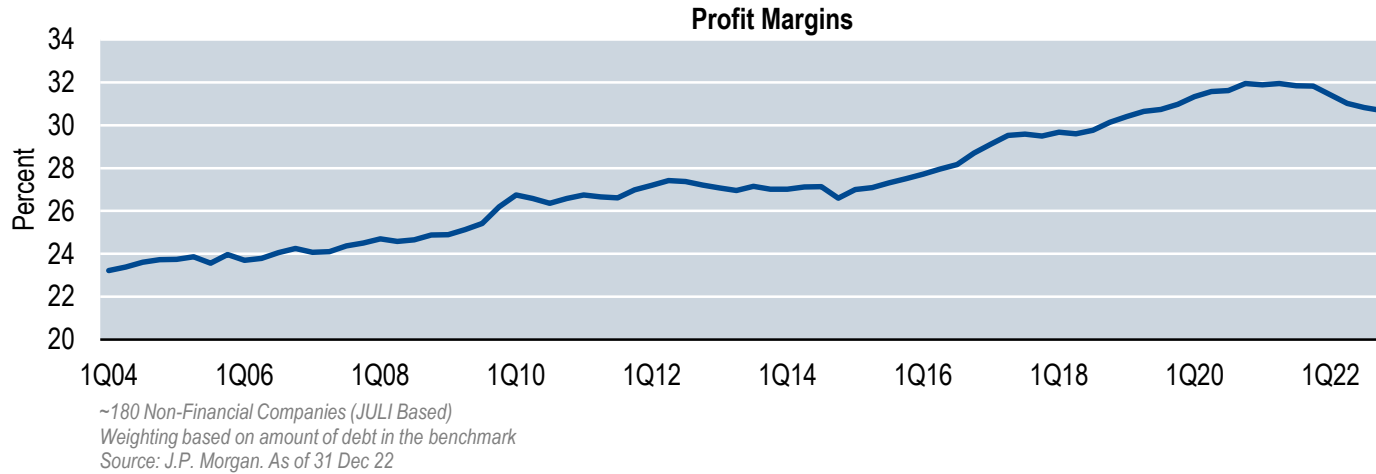
*As of 30 May 23

Valuation: US Credit “Fair” at +125 OAS



Source: Bloomberg. As of 14 Jun 23
 Periods of recession highlighted in yellow

Cash Flow and Debt Metrics Support Investment-Grade Credit



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Investment-Grade Energy – Strong Relative Performance in 2022

Since 2016, IG Managements Have

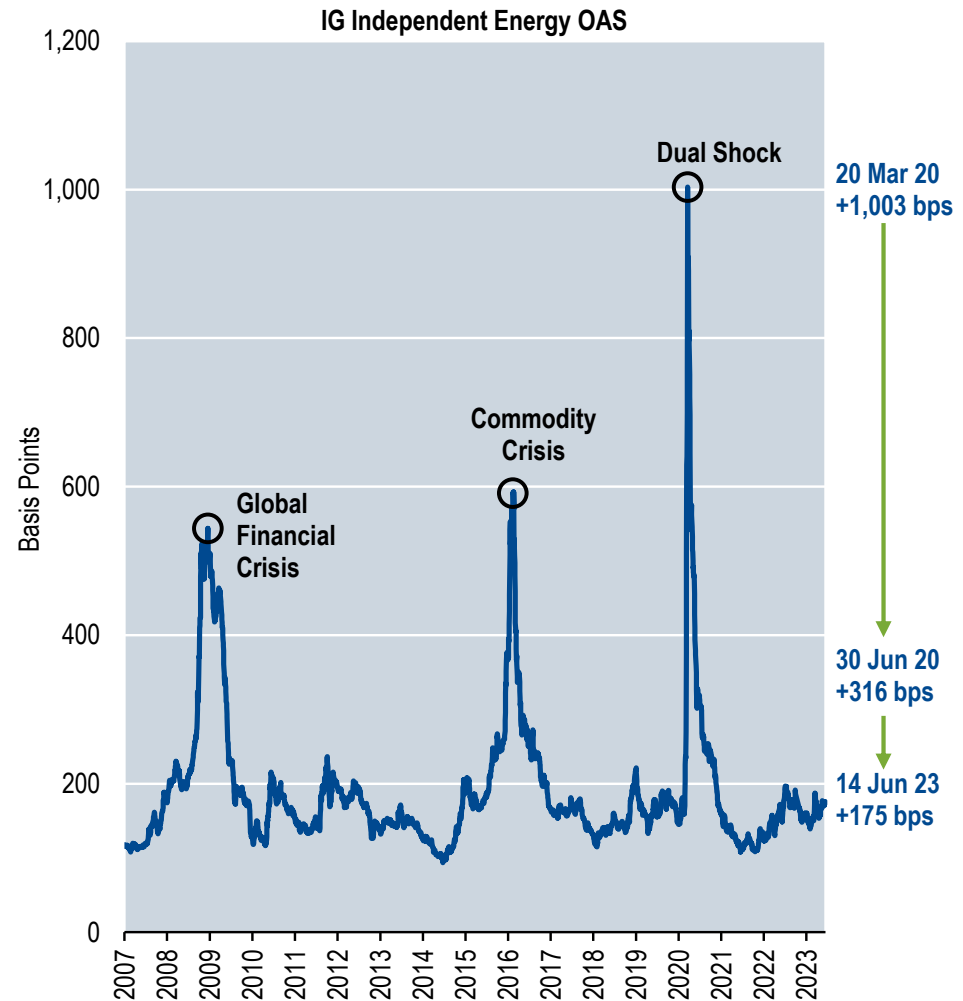
- Acted conservatively
- Lowered cost structures
- Improved cash flow
- De-levered balance sheets
- Extended maturity runways
- Improved liquidity

Conservatism Prevails

- Capital budgets remain conservative
- Shareholder returns are from excess free cash flow

Conclusion

- Focus continues to be on cost reduction and greater capital discipline even in the face of higher commodity prices
- Seeing bottlenecks in the energy space also
- Under-owned sector
- Continue to hold our overweight



Source: Bloomberg. As of 14 Jun 23

Energy Companies: 2022 About Deleveraging, 2023 About Upgrades and Mergers

Issuer	2022 Debt (\$mm)	2022 Change in Index Debt (\$mm)	Upgraded in 2023/ Positive Outlook
IG Energy Index Change in Debt Outstanding 2022		-42,408	
BP PLC	25,539	-5,000	Positive Outlook
Chevron Corp	14,687	-4,700	
Exxon Mobil Corp	29,500	-4,000	
Energy Transfer Partners LP	32,611	-2,643	Positive Outlook
Valero Energy Corp	7,598	-2,602	
TotalEnergies SE	11,850	-2,000	
Conoco Inc	12,860	-1,768	
Sabine Pass Liquefaction LLC	10,350	-1,468	Upgraded
Enterprise Products Operating LLC	25,975	-1,250	Upgraded
Halliburton Company	7,600	-1,200	
Plains All American Pipeline LP	7,033	-1,100	Positive Outlook
Phillips 66	11,741	-1,032	
Canadian Natural Resources	7,250	-1,000	
Shell PLC	30,750	-1,000	
ONEOK Inc	11,885	-925	Upgraded
Kinder Morgan Inc	24,168	-725	
TC Energy Corp	14,625	-625	
Williams Cos Inc	21,058	900	
Enbridge Inc	15,150	900	
MPLX LP	19,057	1,011	
IG Bond Index Change in Debt Outstanding YTD		321,300	

Source: J.P. Morgan, Bloomberg Finance L.P. As of 07 Oct 22

BB Energy Issuers and Change in Index Debt Outstanding 2022

Issuer	2022 Debt (\$mm)	2022 Change in Index Debt (\$mm)	Upgraded in 2023/ Positive Outlook
Occidental Petroleum	19,937	-8126	Upgraded
Apache	5,037	-1310	Upgraded
Petrofac Ltd	600	-600	Positive Outlook
Antero Resources	1,120	-979	Positive Outlook
Southwestern Energy	4,161	-573	Positive Outlook
Western Midstream Operating	6,256	-502	Upgraded
TechnipFMC plc	203	-430	
MEG Energy Corp.	1,971	-225	Upgraded
DCP Midstream Operating	4,275	-350	Upgraded
Murphy Oil Corp	2,044	-442	Upgraded

Source: J.P. Morgan. As of 11 Oct 22

Mergers in 2023

Acquiring Company	Target	Size (\$bn)	Date Announced
Phillips 66	DCP	3.8	Jan 2023
Targa Resources	Grand Prix	1.1	Jan 2023
Energy Transfer	Lotus Midstream	1.5	Mar 2023
Ovintiv	Multiple Targets	4.3	Apr 2023
Chevron	PDC Energy	7.9	May 2023
Conoco	Total-Surmont	3.0	May 2023
OneOK	Magellan	18.9	May 2023
Patterson-UTI	NexTier	2.1	Jun 2023

Source: Bloomberg

The Two Tiers of the US Banking System

We prefer large US banks over regionals

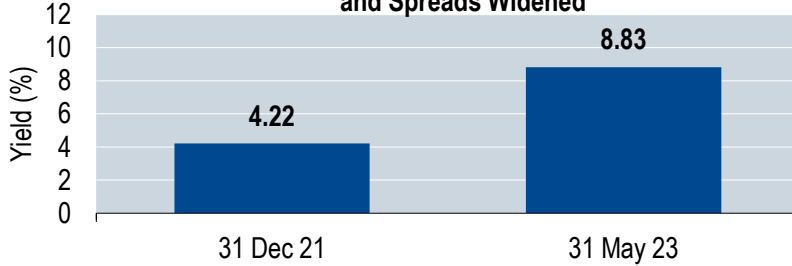
	Regulatory Scrutiny	Balance Sheet Strength	Deposit Mix	Interest Rate Risk	Current Market Confidence
Large US Banks	High	Very High	Diversified, Low Risk	Low	High
Regional US Banks	Moderate	Moderate	Narrow, Medium Risk	Medium	Low

Expectations

- Large banks will get stronger while weaker regionals will consolidate
- Regulation (and issuance) will increase for regional banks
- Regional bank ratings will come under pressure

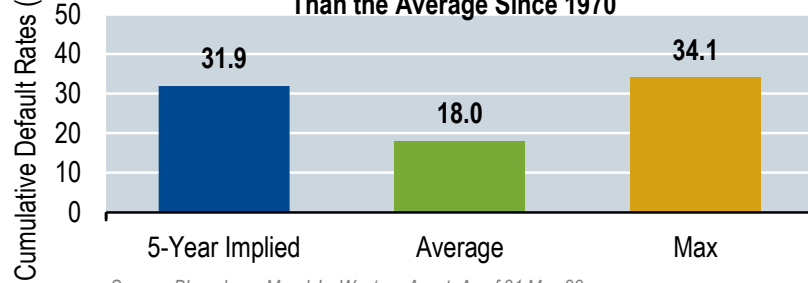
High-Yield Credit: Valuations Are Compelling

Yields Rose by More Than 4% Since 2021 as Rates Rose and Spreads Widened



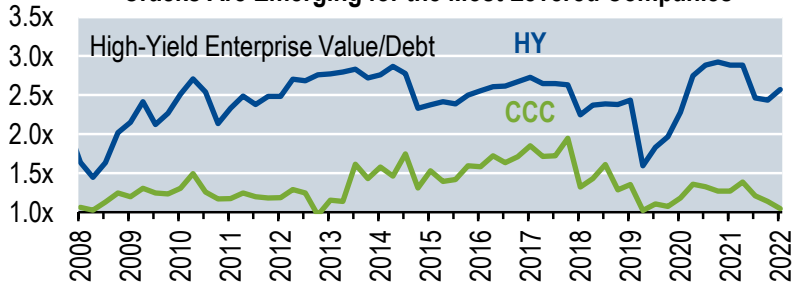
Bloomberg US High-Yield 2% Issuer Cap Index
Source: Bloomberg. As of 31 May 23

Spreads Now Imply Much Higher Defaults Than the Average Since 1970



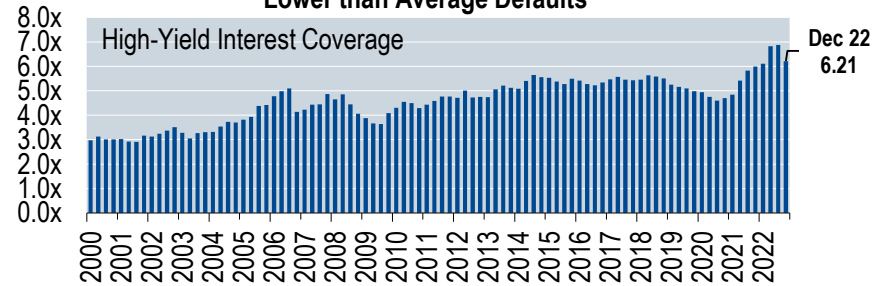
Source: Bloomberg, Moody's, Western Asset. As of 31 May 23
40% recovery assumption was used and spread used to imply cumulative defaults over 5 years.
Worst cumulative 5-year default period since 1970 was 1992

Cracks Are Emerging for the Most Levered Companies



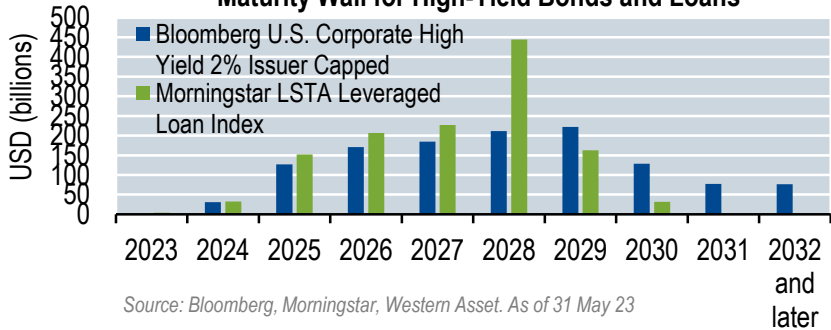
The sample is confined to public reporters for which we are able to retrieve four consecutive quarters of data from Bloomberg or S&P Capital IQ. New constituents are integrated quarterly based on additions to the Bloomberg US Corporate HY Bond Index).

Ability to Service Debt Also Supportive of Lower than Average Defaults



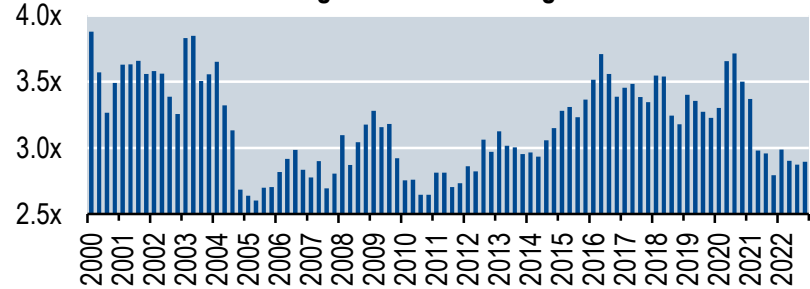
The sample is confined to public reporters for which we are able to retrieve four consecutive quarters of data from Bloomberg or S&P Capital IQ. New constituents are integrated quarterly based on additions to the Bloomberg US Corporate HY Bond Index).

Maturity Wall for High-Yield Bonds and Loans



Source: Bloomberg, Morningstar, Western Asset. As of 31 May 23

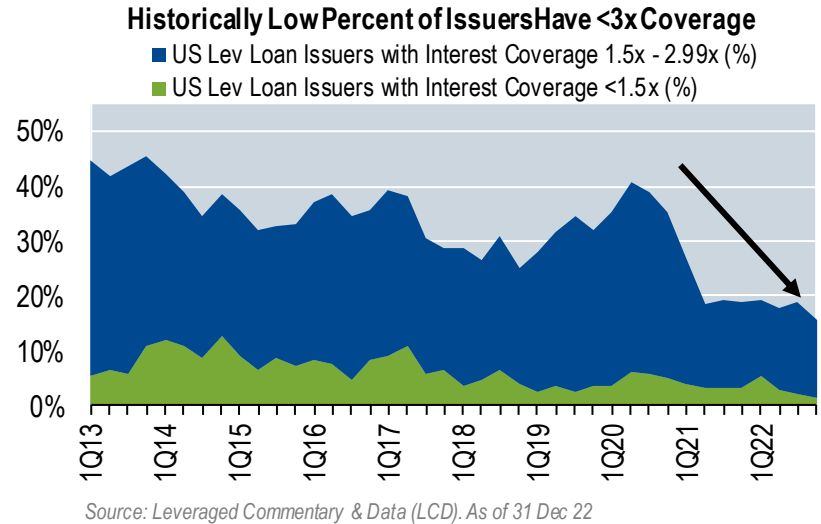
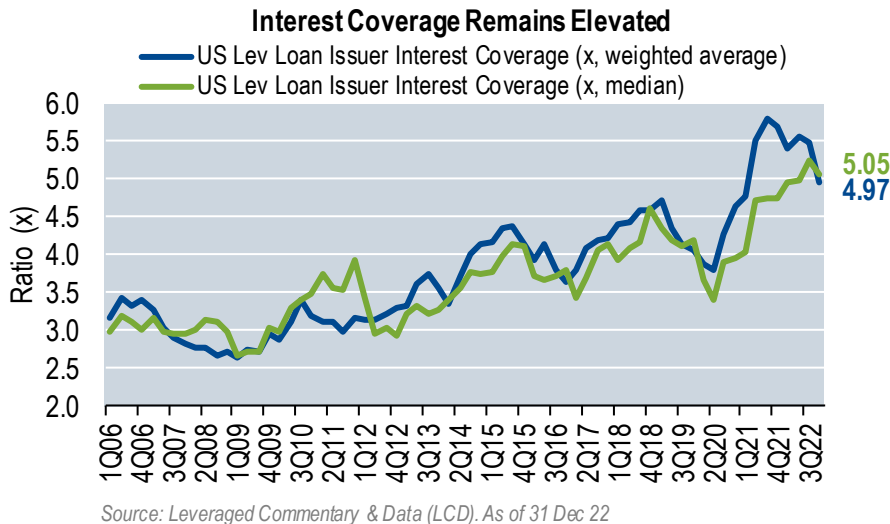
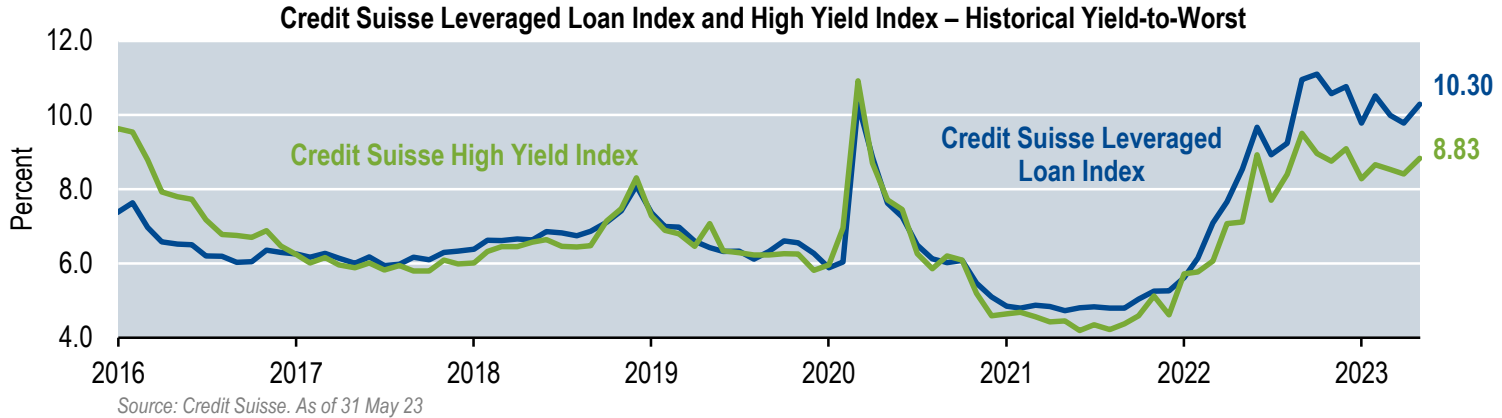
High-Yield Net Leverage



Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Dec 22

Bank Loan Valuations Relative to High-Yield

Since 1992, high-yield has historically had a YTW with 89 bps premium over leveraged loans and 84 bps spread over loans driven by higher risk profile due to unsecured, subordinated position in capital structure relative to loans



Mortgage Credit Offers Attractive Relative Value

- While real estate prices are expected to cool from the record increases, market spreads are elevated with increased risk premiums
- During the housing boom of Covid, lending stayed conservative and single family markets remain well supported by long-term fundamentals
- The commercial real estate sector has largely been able to pass on the cost of higher interest rates in rents at hotels, apartments, and industrial properties, while the office sector faces continued headwinds from Covid

Spreads	Representative RMBS CRT Below IG*	BAML RMBS Legacy Below IG	Bloomberg Non-Agency CMBS BBB	Bloomberg US IG Corporate	Bloomberg US High Yield
31 Jan 20	178	123	250	102	390
31 May 23	421	247	996	138	461
Difference Since 31 Jan 20	243	123	746	36	71
31 Dec 18	246	127	371	153	526
31 May 23	421	247	996	138	461
Difference Since 31 Dec 18	175	120	625	-15	-65

Source: Bloomberg, Bank of America, JP Morgan, Western Asset. As of 31 May 23

Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situations or needs of investors.

*Representative RMBS CRT Below IG: On-the-run speed adjusted spread for below investment-grade rated CRT cohort

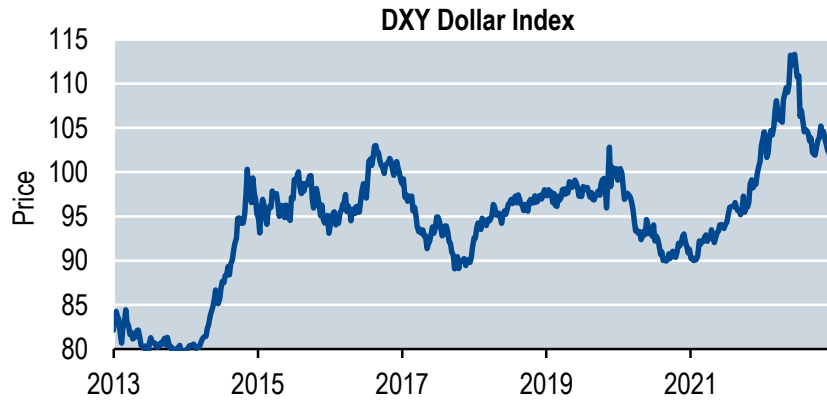
Past performance is not a reliable indicator of future results.

The USD and Commodities: Key Emerging Market Drivers

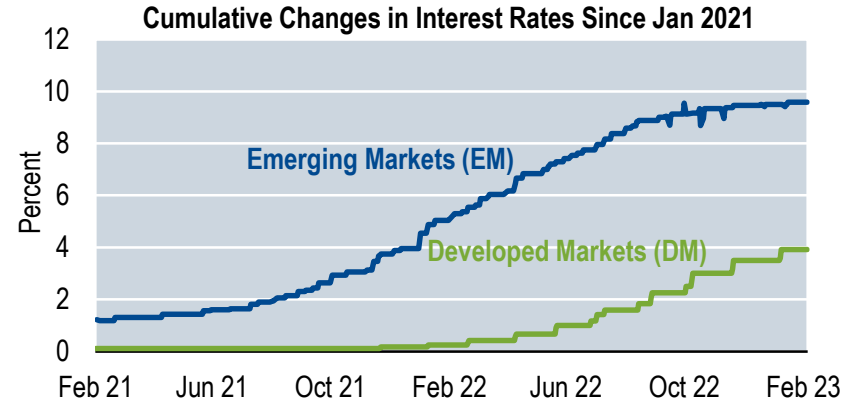
EM central banks are closer to the end of the tightening cycle relative to the developed world

USD relative strength and commodity prices are both inputs into EM economic conditions and returns.

A Fed pause combined with China reopening bodes well for EM

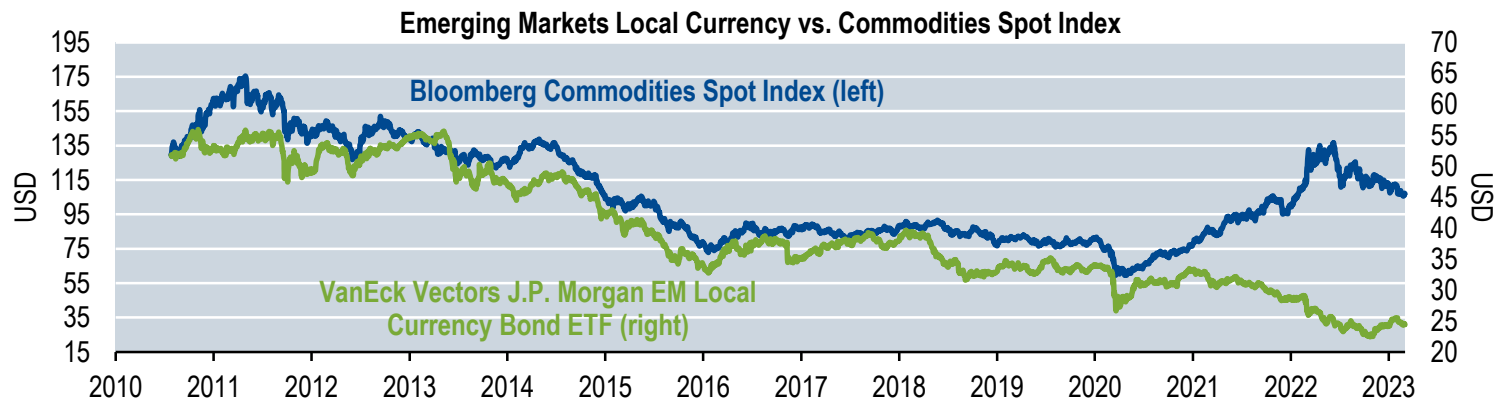


Source: Bloomberg. As of 24 Feb 23



Source: Bloomberg. As of 01 Mar 23

Note: Emerging Markets (EM)=Average of Brazil, Chile, Czech Republic, Mexico, Peru and Poland; Developed Markets (DM)=Average of US, EU and UK



Source: Bloomberg. As of 02 Mar 23

Disinflation ongoing but uneven

Fed tightening near end

Current banking stress extremely complex but not systemic

Fixed-income outlook

- US growth will slow but should avoid recession
- Global growth has downshifted, but with China's reopening will remain resilient
- Global inflation will continue to recede
- The dollar will weaken moderately
- Emerging markets should outperform
- Central bank overtightening is a meaningful risk
- Spread sectors are still attractive but the outlook is clouded by macro risk
- Geopolitical uncertainty continues to add to volatility



Thank you.

Risk Disclosure

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