



# 4Q23 Market & Strategy Update

September 28, 2023

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Chief Investment Officer

# 2023 Outlook

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**Disinflation ongoing but uneven**

**Fed tightening near end**

**Economy has remained resilient in part due to renewed fiscal stimulus**

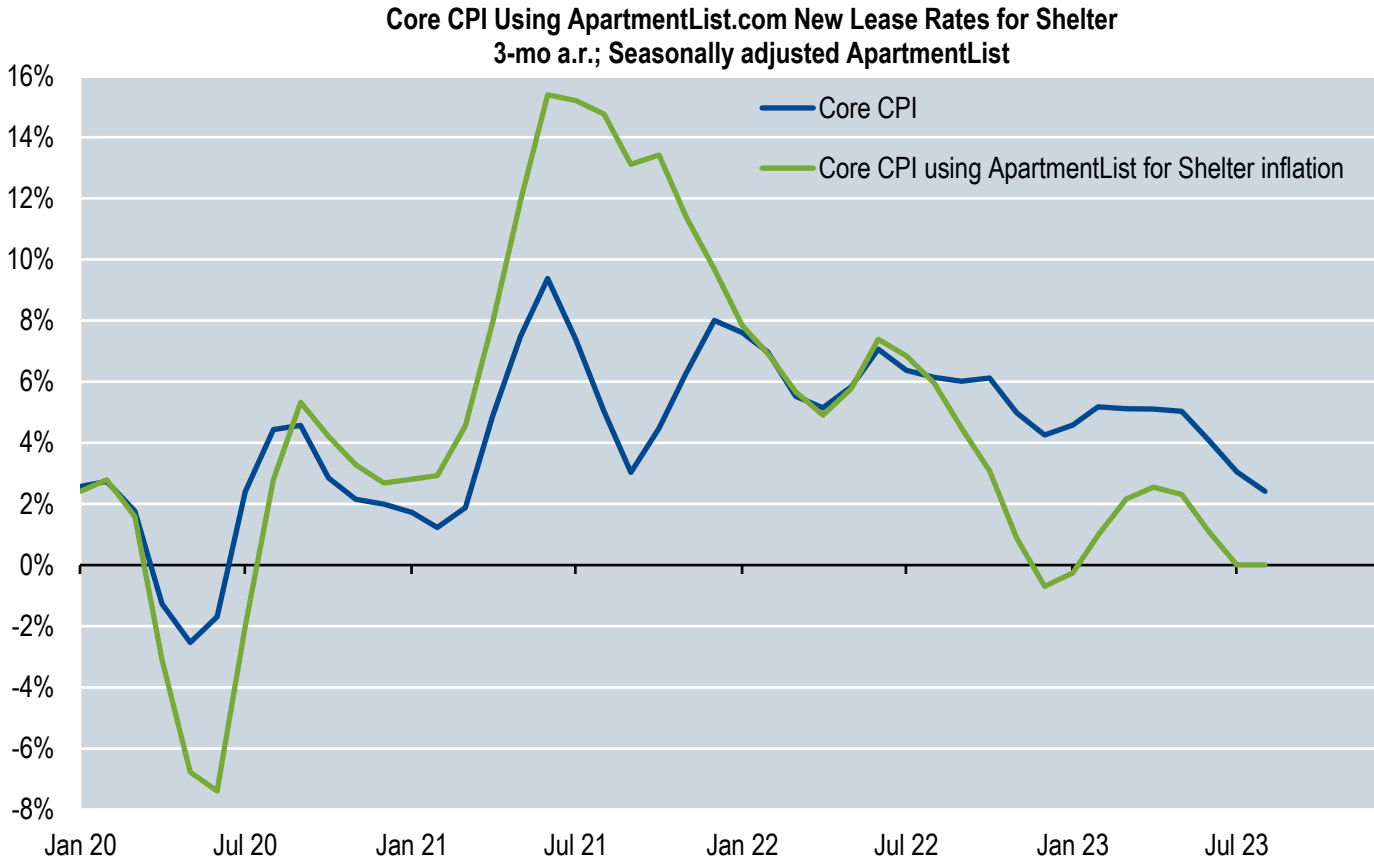
**Current banking stress extremely complex but not systemic**

## **Fixed-income outlook**

- US growth will slow but should avoid recession
- Global growth has downshifted and China is now a source of deflation
- Global inflation will continue to recede
- The dollar will weaken moderately
- Emerging markets—particularly in Latin America—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

*The above reflects current opinions of Western Asset and are subject to change with market conditions. As of 25 Aug 23*

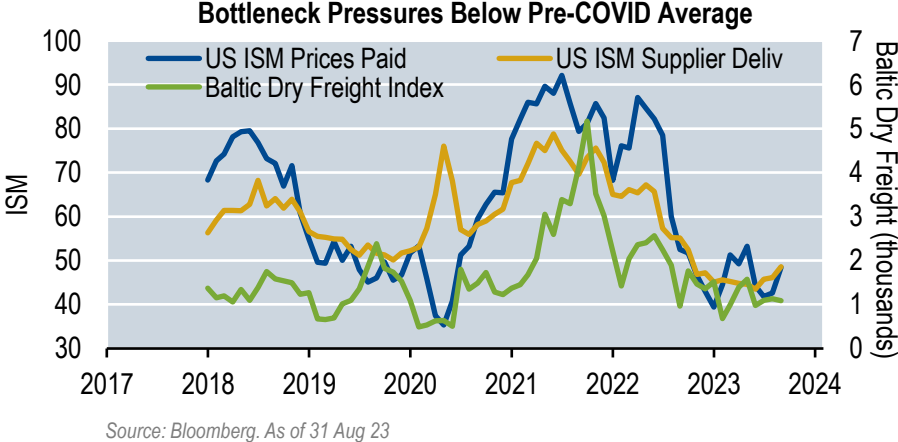
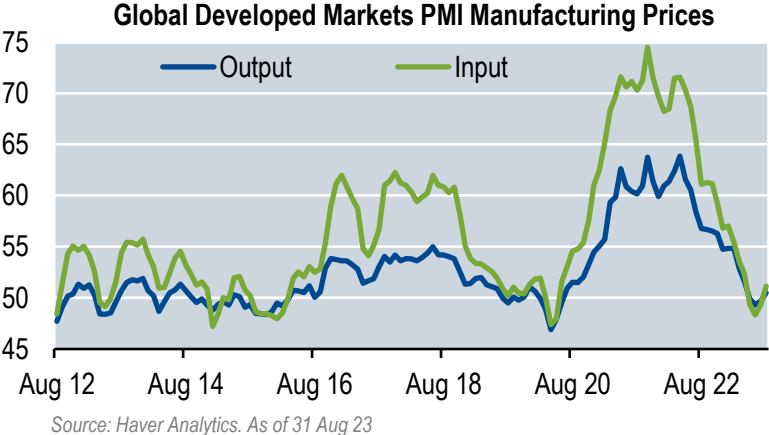
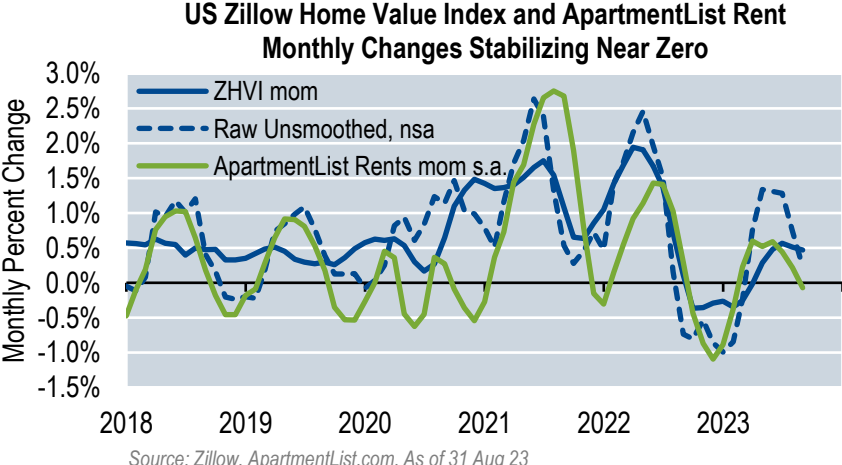
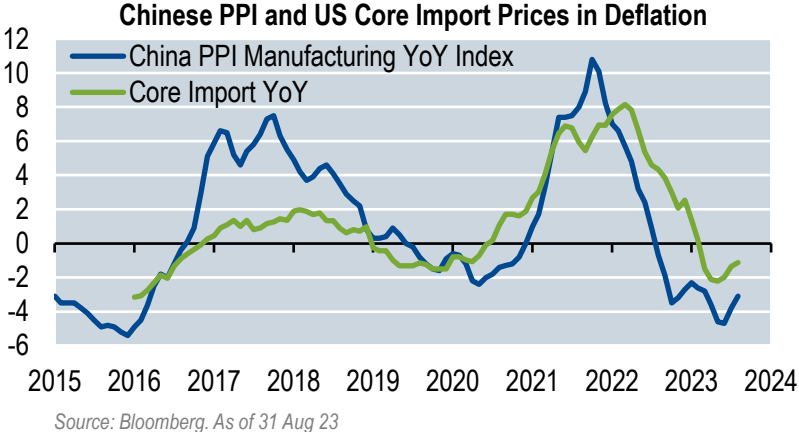
# Core Inflation Moving Toward Fed Target



Source: BLS, ApartmentList.com, Western Asset calculations. As of 31 Aug 23



# Global Inflation Is Broadly Declining



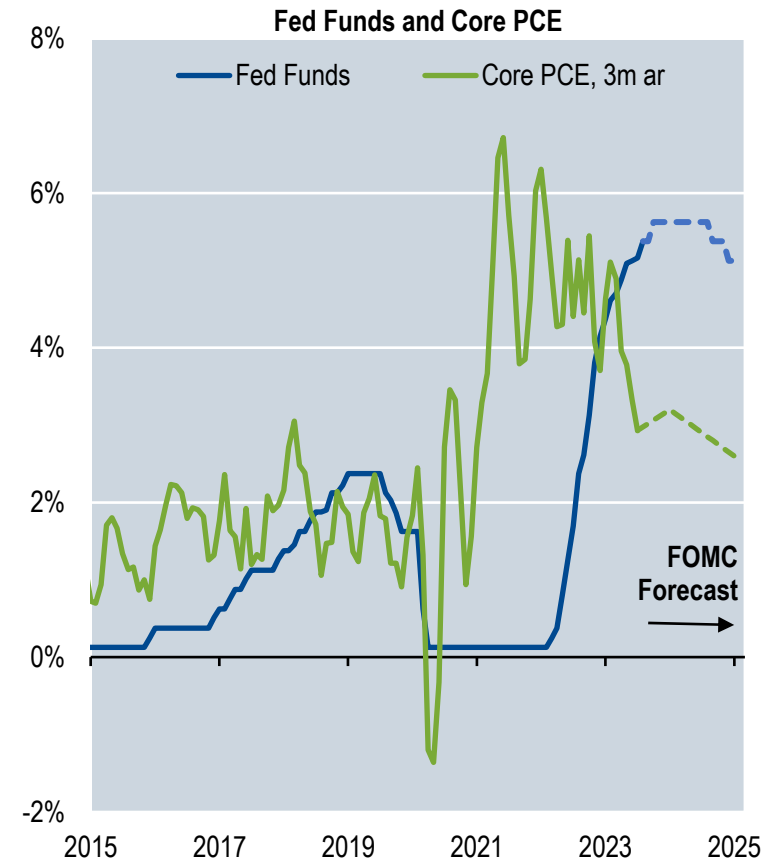
# FOMC Expects Restrictive Policy for an Extended Period

Projections are “Highly Uncertain”

“We see the current stance of monetary policy as restrictive, putting downward pressure on economic activity, hiring, and inflation.”

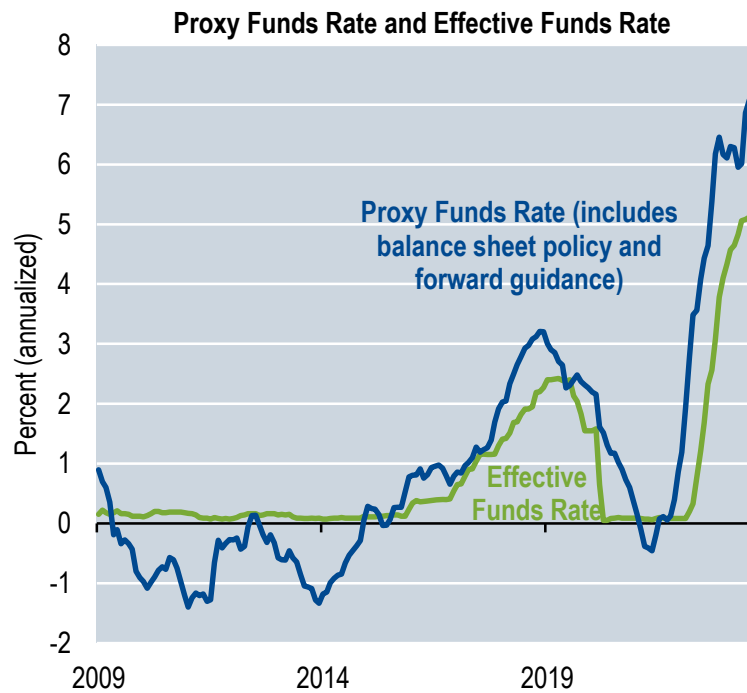
“These projections, of course, are not a Committee decision or plan...No one will look back at this and say, hey, we made a plan. It's not like that at all. **These are estimates made a year in advance that are highly uncertain, and that's how it is**”

– Chair Powell, Sep 20, 2023



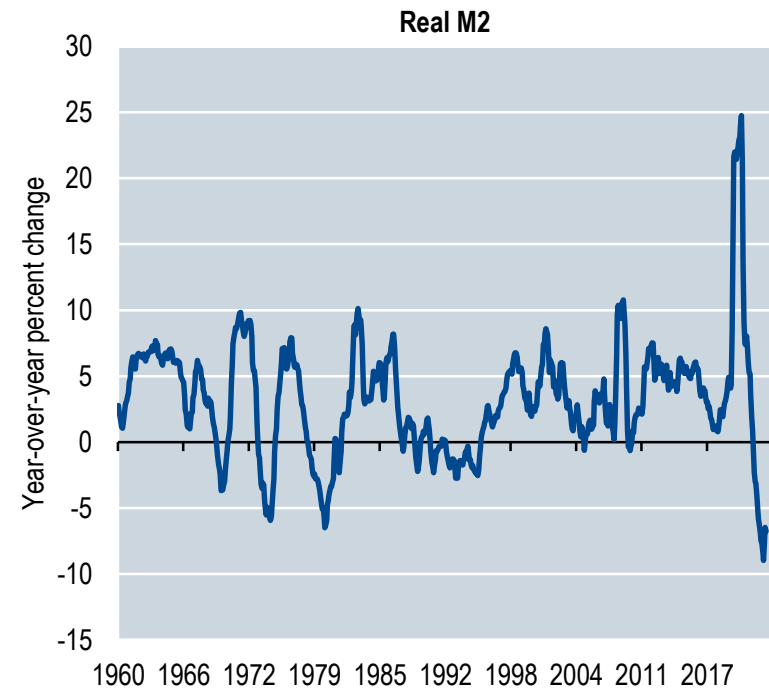
Source: Federal Reserve, U.S. Bureau of Economic Analysis, Haver Analytics.  
As of 31 Aug 23

# 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 Jul 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.

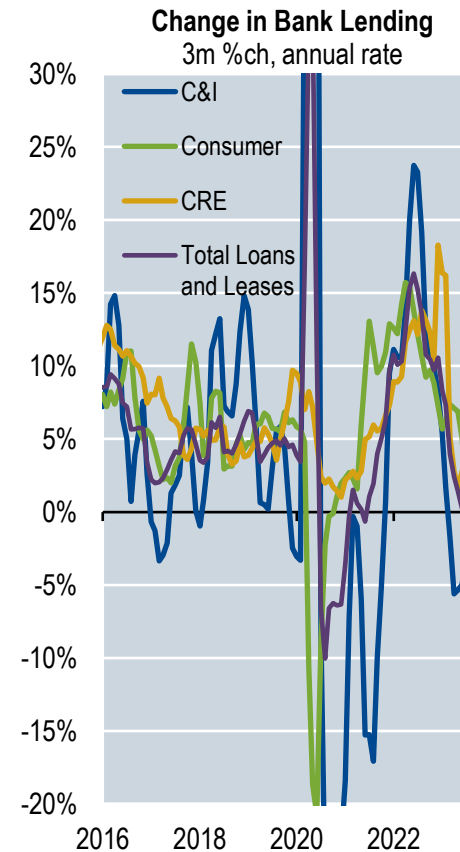
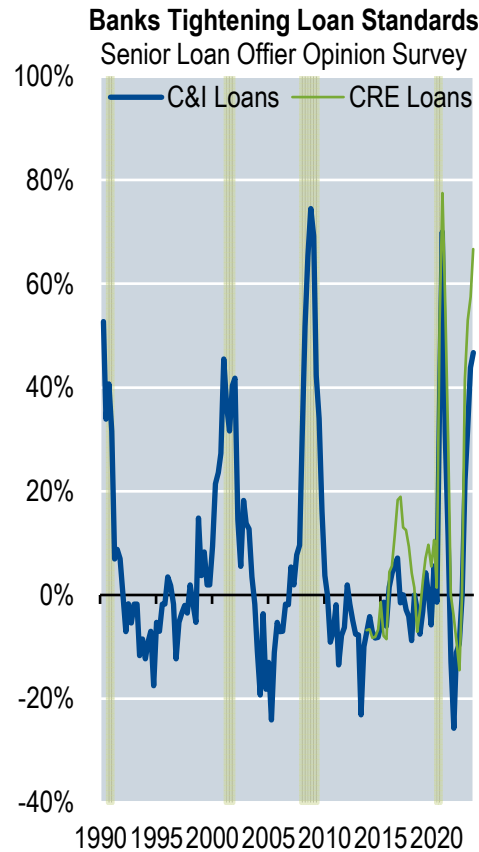


Source: Federal Reserve. As of 31 Jul 23

# Financial Conditions

“Beyond changes in interest rates, bank lending standards have tightened, and loan growth has slowed sharply.”

– Chair Powell, Aug 23, 2023

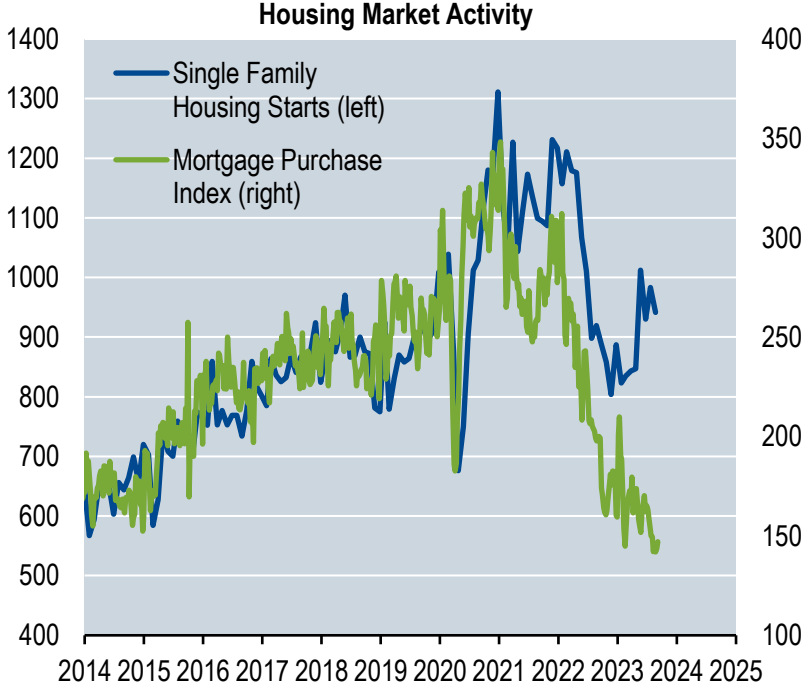


Source: Bloomberg, Federal Reserve, Haver Analytics. As of 25 Aug 23

# Higher Rates Are Slowing Activity



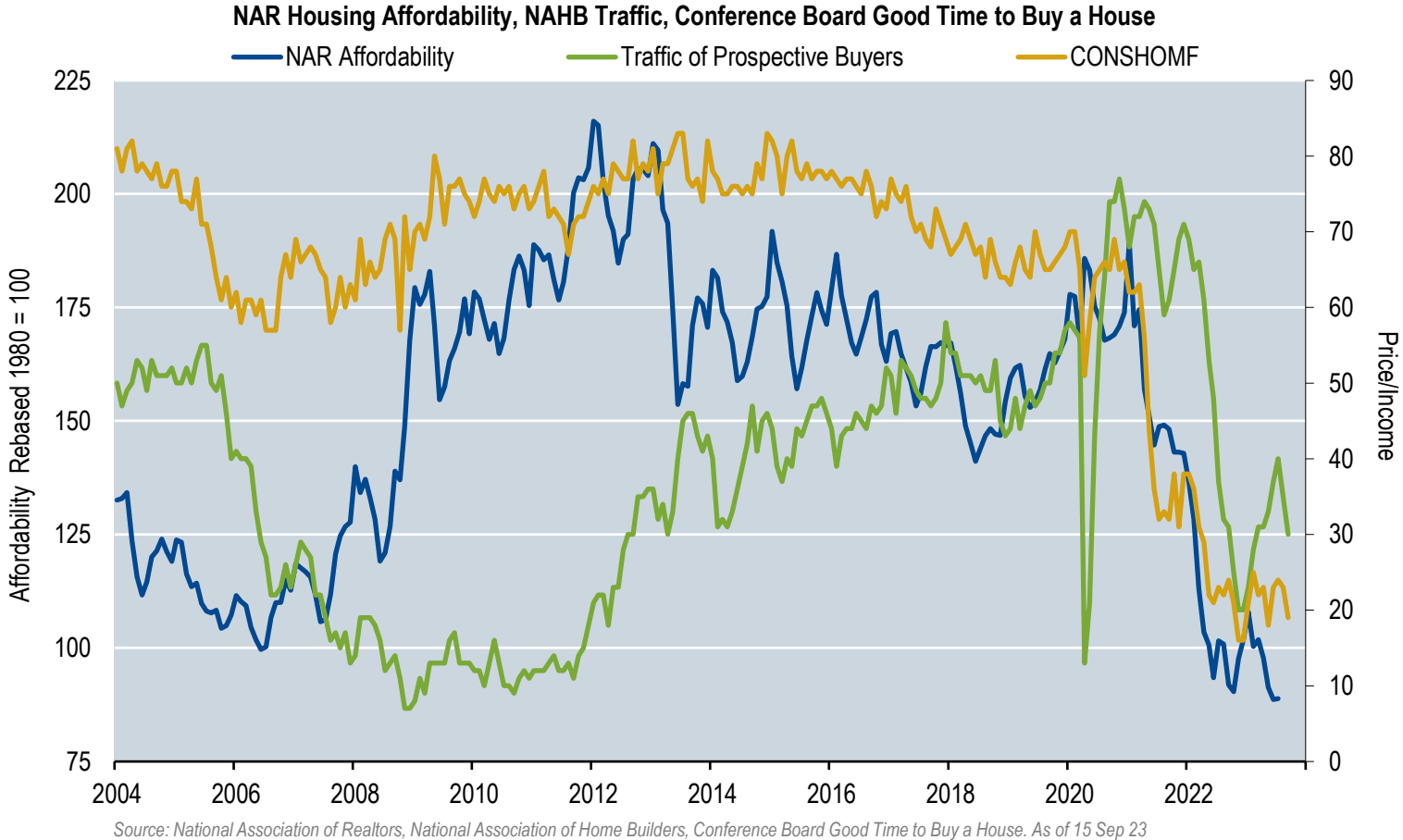
Source: Federal Reserve. Haver Analytics. As of 31 Aug 23



Source: Census, Mortgage Bankers Association of America, Haver Analytics. As of 31 Aug 23



# Home-Buying Traffic, Affordability and Confidence All Down

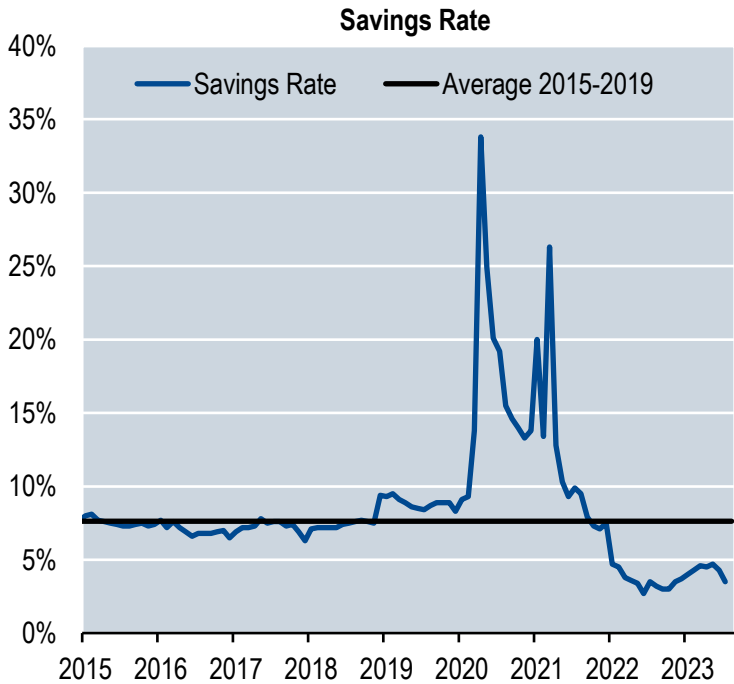


# Consumption Likely to Slow

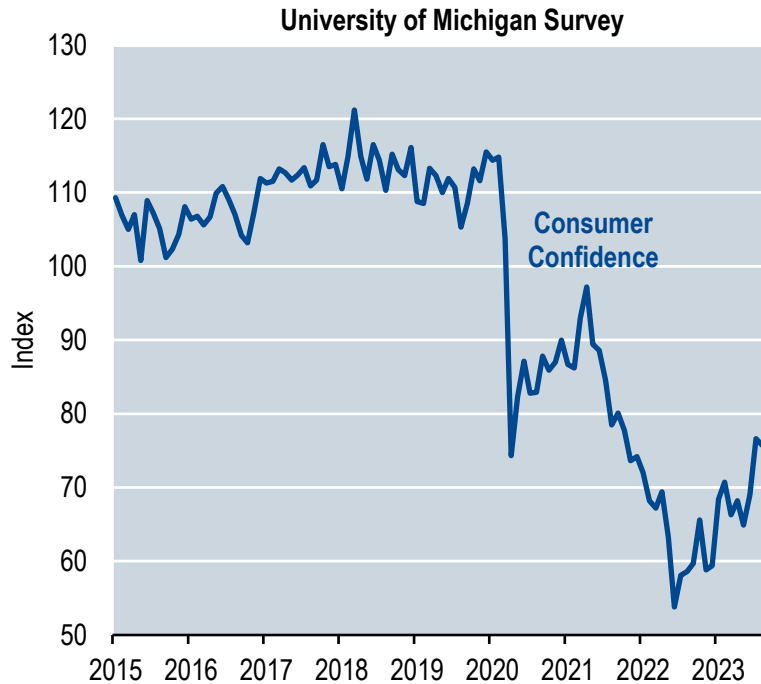
Recent consumption sustained by depleting savings

Consumer confidence remains low

Student loan reinstatement an additional headwind

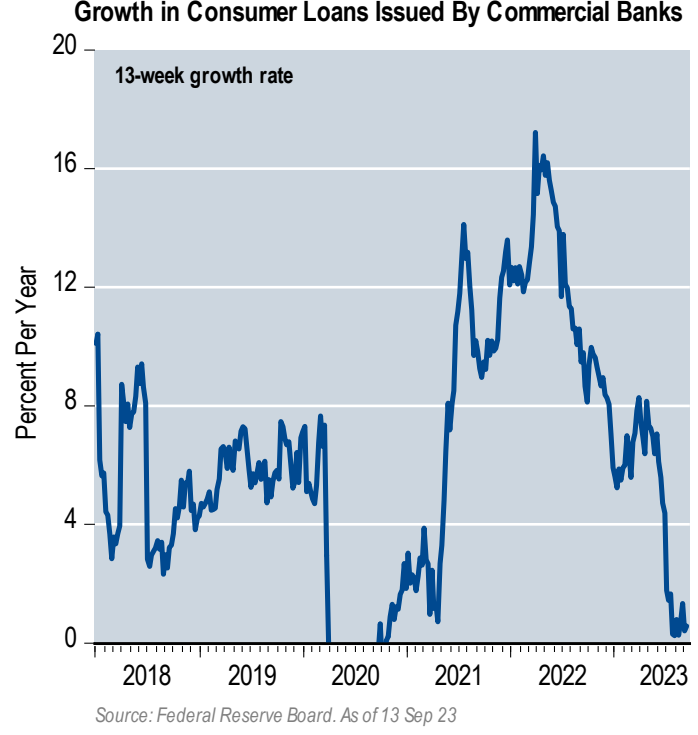
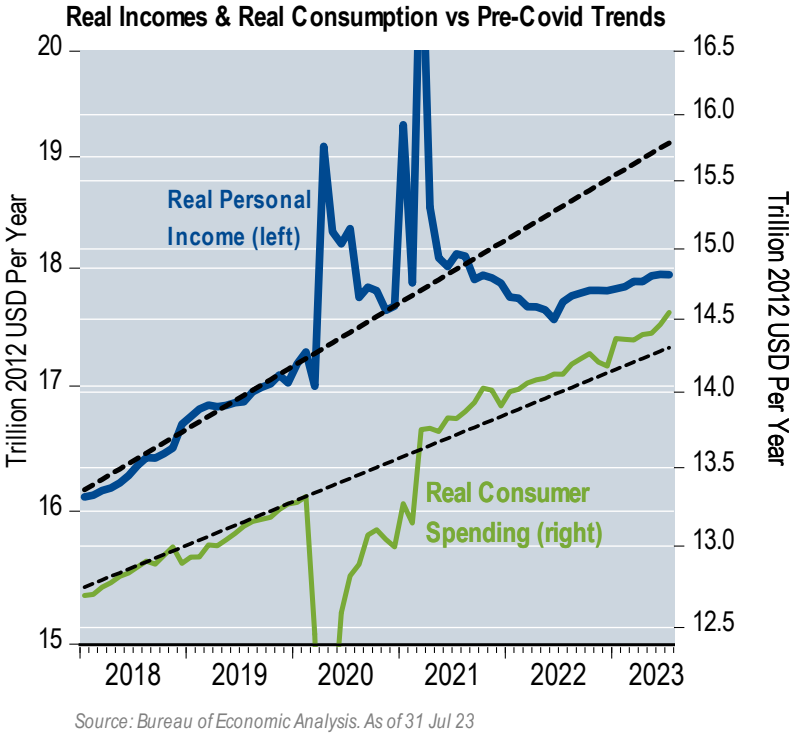


Source: U.S. Bureau of Economic Analysis, Haver Analytics. As of 31 Aug 23

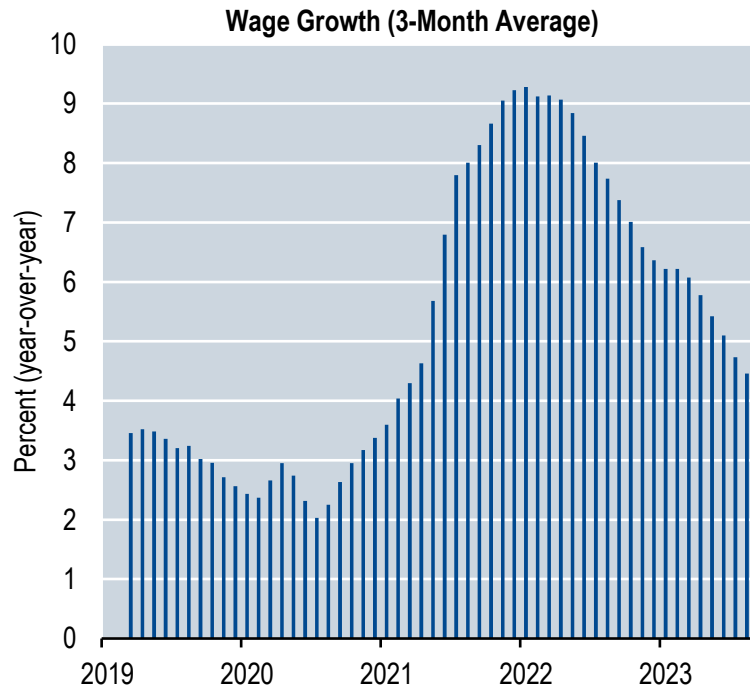


Source: University of Michigan, Haver Analytics. As of 31 Aug 23

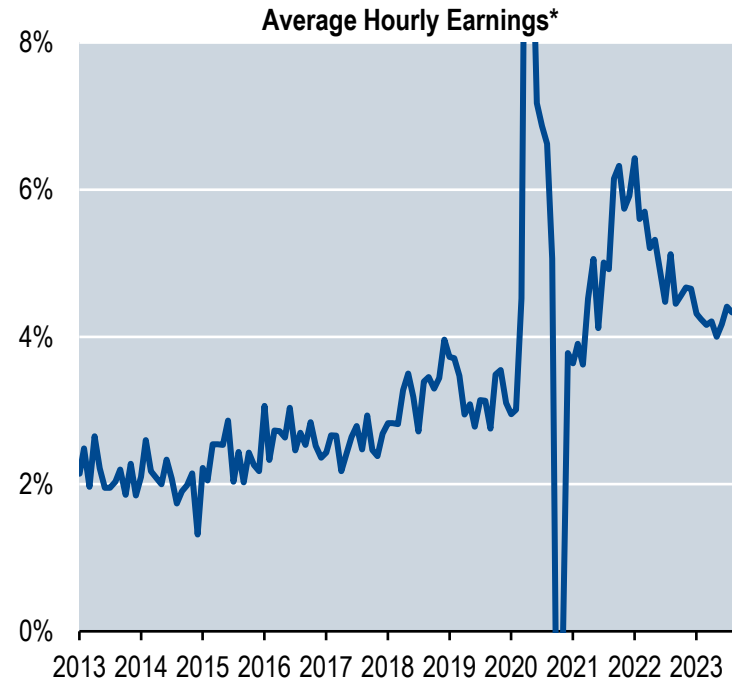
# Consumers Are Stretched and Starting to Pull Back



# Wage Growth Moderating



Source: Hiring Lab. As of 31 Aug 23

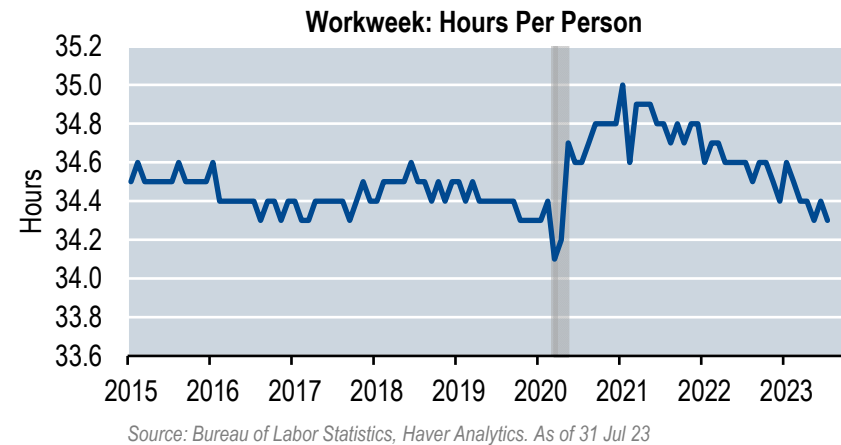
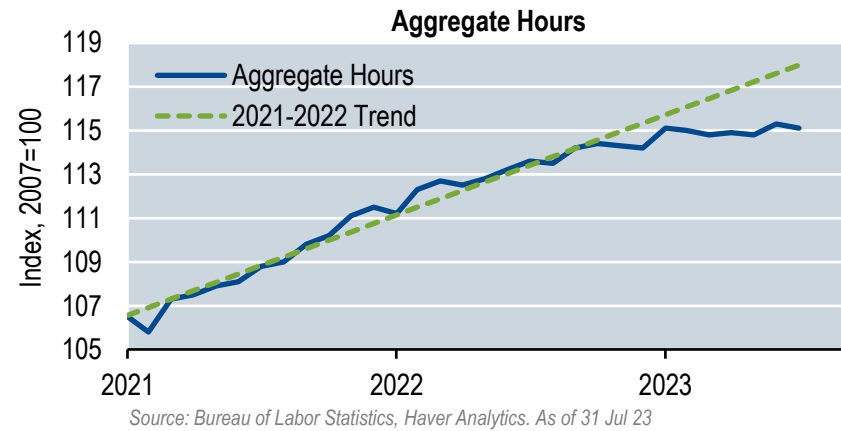
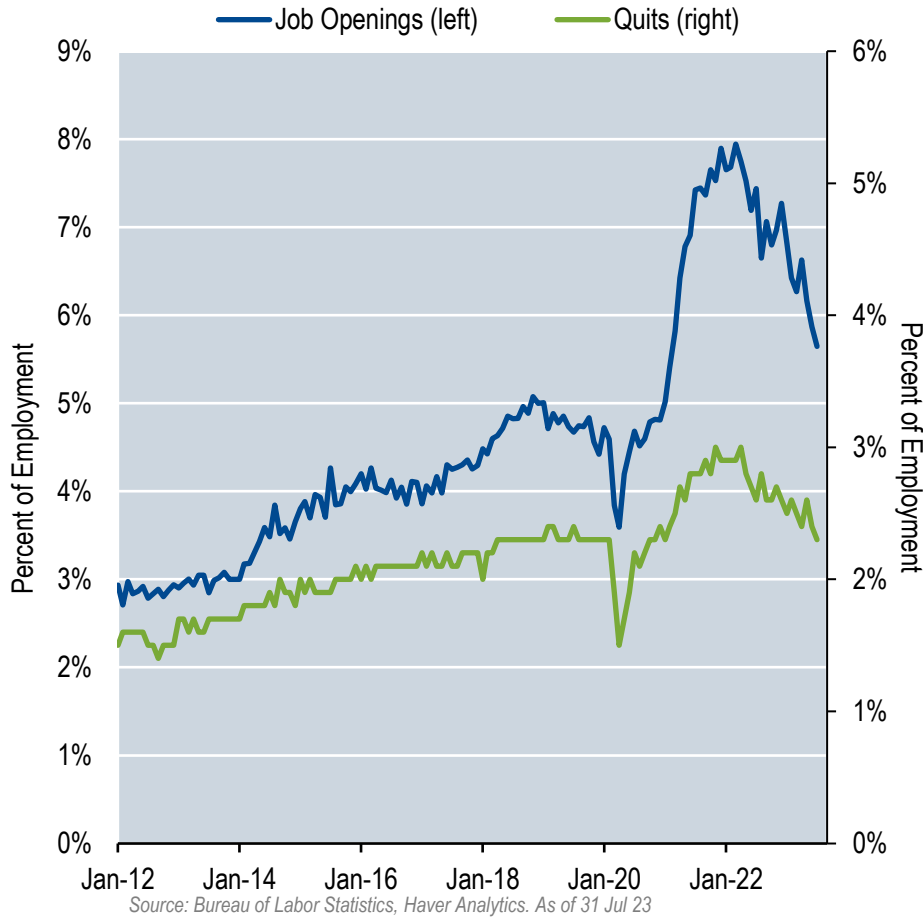


Source: Bureau of Labor Statistics. As of 31 Aug 23

\*6-Month percent change, annual rate

# Labor Demand Moderating

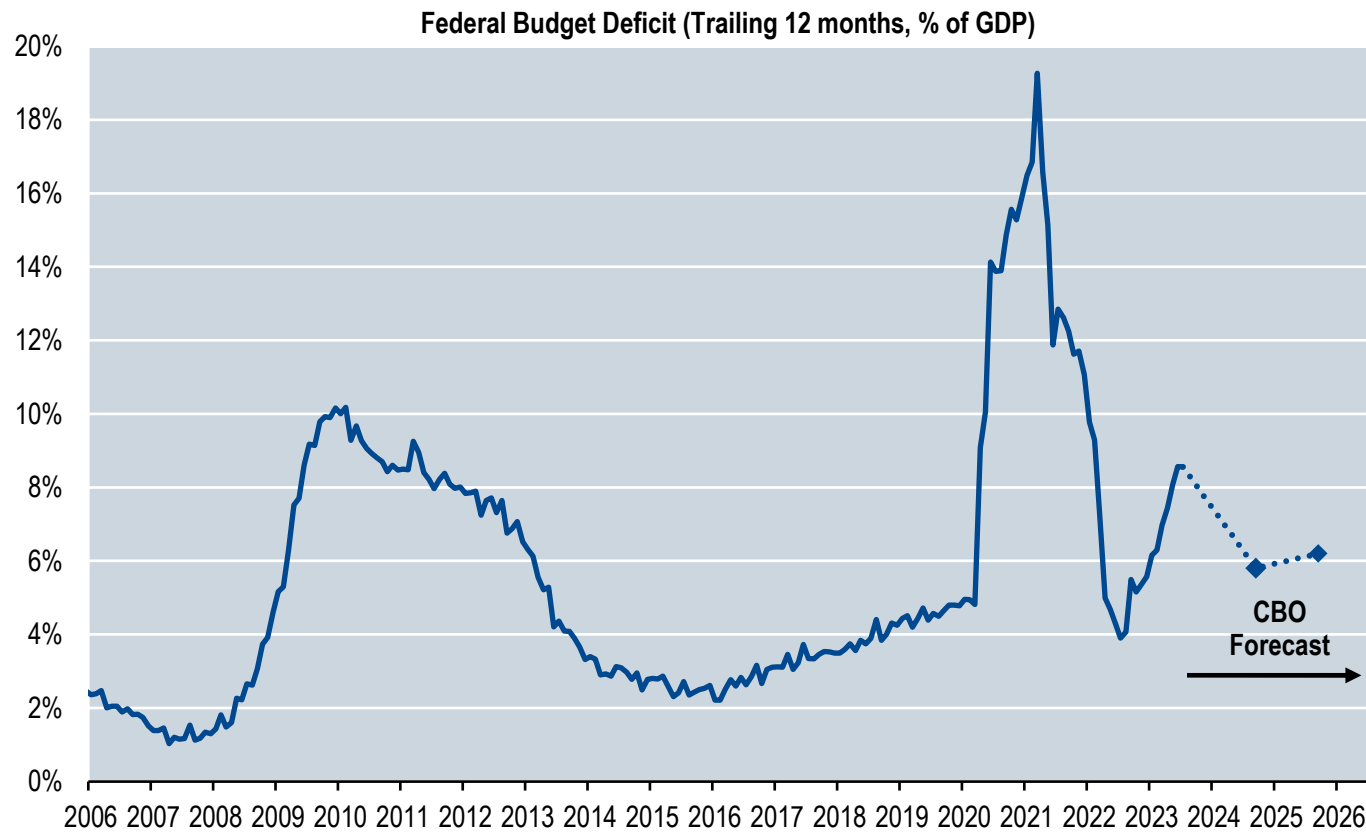
Job openings declining. Aggregate hours work normalizing.



# Fiscal Is a Concern

## 2023

- Inflation Reduction Act
- Student loan forgiveness
- Capital gains receipts



Source: S&P Global Market Intelligence, US Treasury, Haver Analytics. As of 31 Aug 23

# Long-Run Neutral Rates (R star)

“We are navigating by the stars under cloudy skies”

– Chair Powell, Aug 28, 2023

## Arguments for Lower Rates:

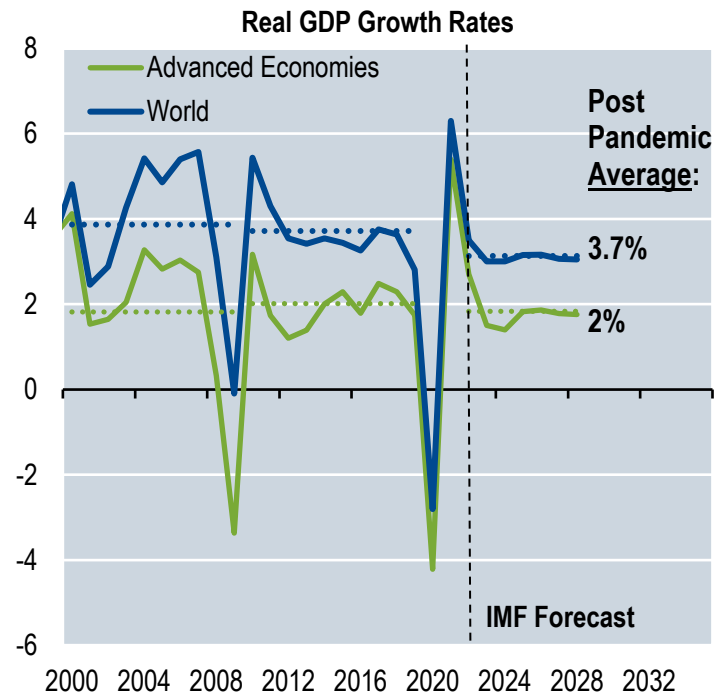
- Long-run growth to remain low
- Debt-levels are elevated
- Under-saving for retirement

## Arguments for Higher Rates:

- Carbon transition
- De-globalization
- Fiscal stance?

## Ambiguous:

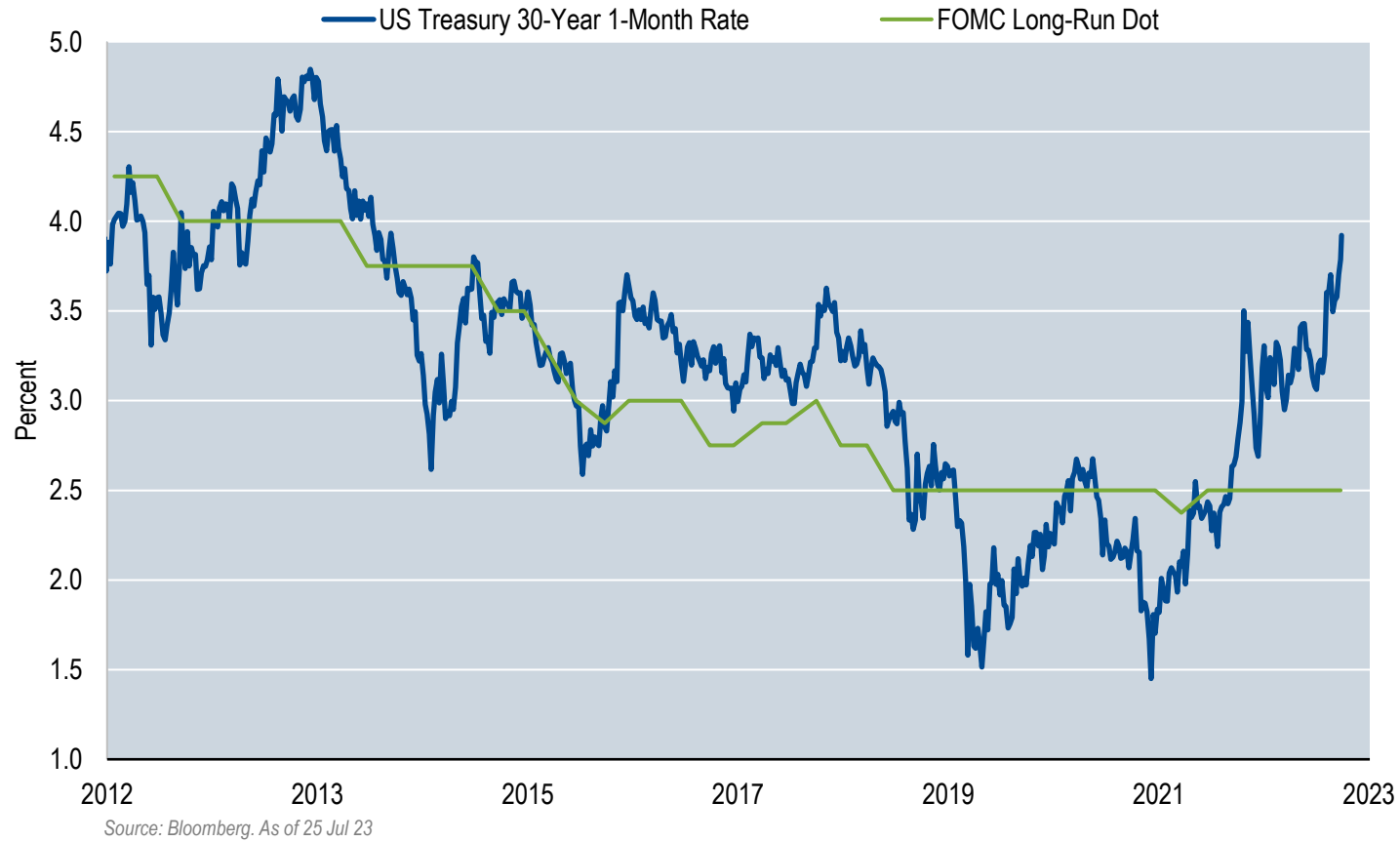
- Aging and demographics
- Artificial Intelligence



Source: International Monetary Fund, Haver Analytics. As of 31 Jul 23

# Forward Rates

Long-run market rates substantially above FOMC estimates





# China: Moderating Expectations for Post-Covid Economic Rebound

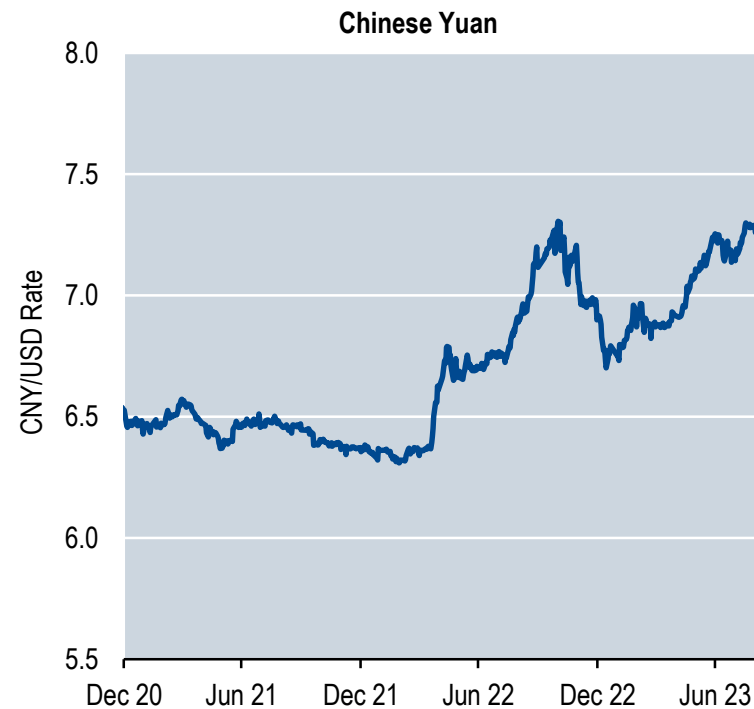
Government Focused on "Around 5%" GDP Growth Target

The post-Covid economic rebound appears to be disappointing exuberant forecasts, with external forecasters increasingly skeptical of China's 5% growth target despite ongoing policy adjustments.

In the face of continuing pressure on the property sector and the renminbi, policymakers have increased measures to stabilize financial markets, including rate cuts and FX intervention.



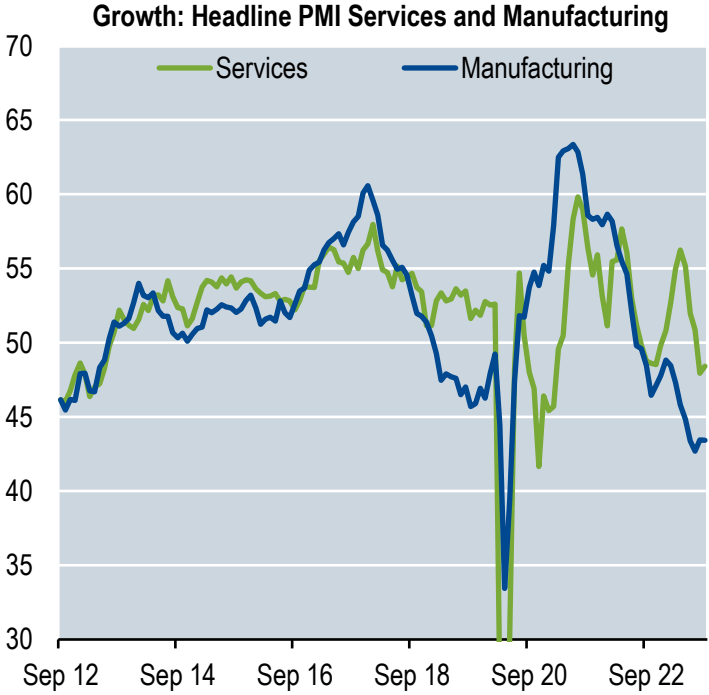
Source: Bloomberg, Citi. As of 15 Sep 23



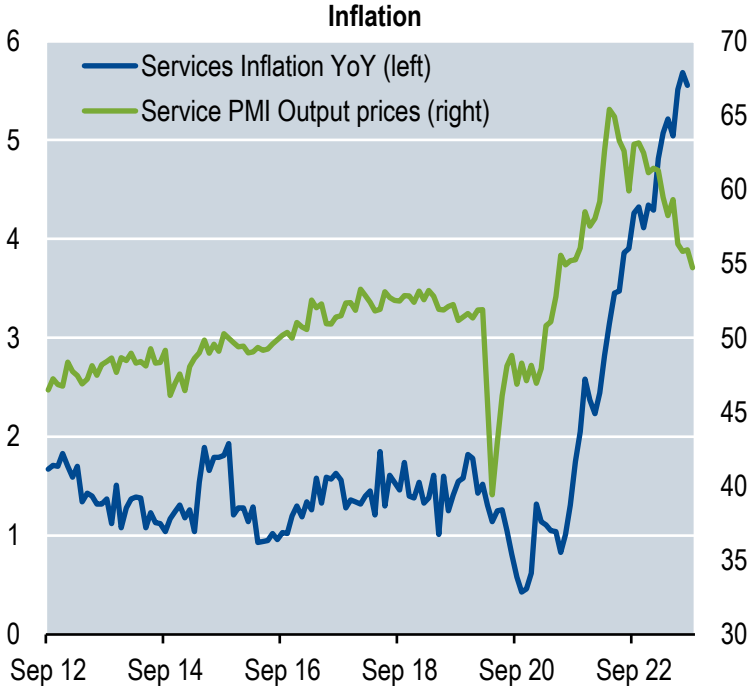
Source: Bloomberg. As of 15 Sep 23

# Europe's Growth Slowing and Core Inflation Will Follow

- Growth: Stagnation to mild contraction
- Inflation: Service disinflation will strengthen, pushing down core inflation
- ECB: No further hikes expected



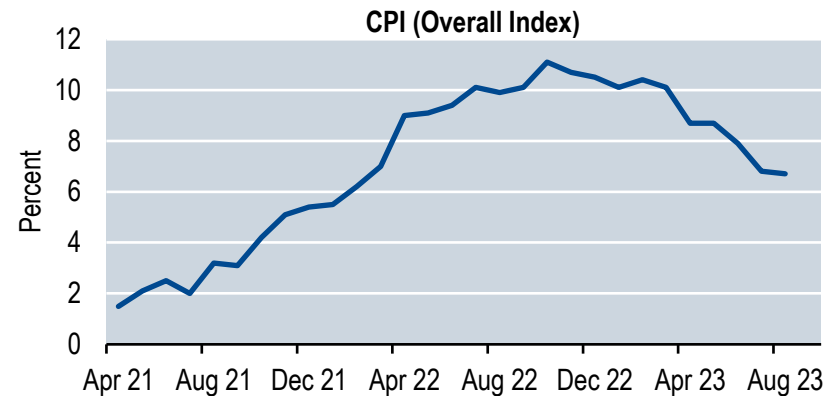
Source: S&P Global, Hamburg Commercial Bank, Haver Analytics. As of 31 Aug 23



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

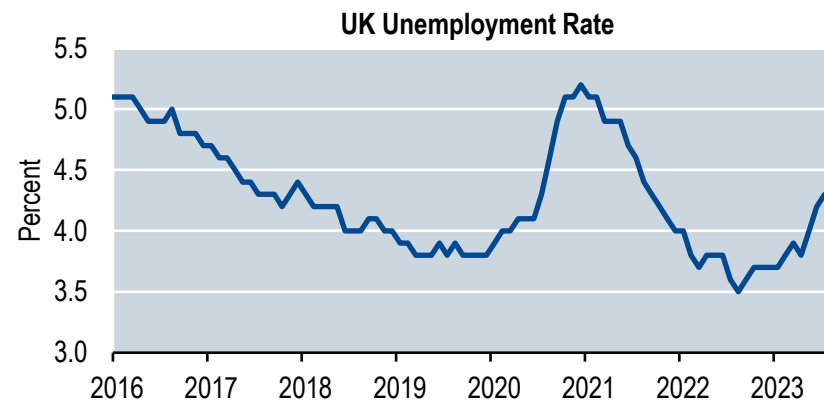
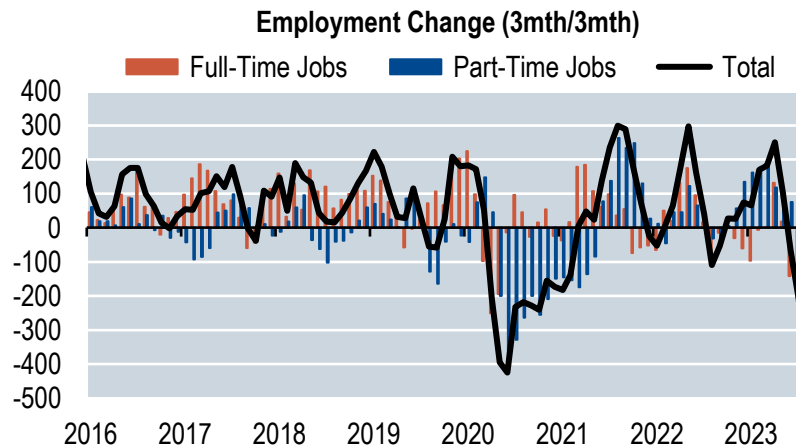
## United Kingdom: Inflation Is Falling, Belatedly

- Lower energy prices are allowing inflation to slow, which should continue
- Price inflation from food and services has begun to slow
- A large fall will be seen in October as lower regulated household energy prices become effective



## UK Labour Market Loosening

- Slack has returned rapidly with a large number of full-time job losses
- Hiring intentions have fallen sharply and the unemployment rate is now well above pre-pandemic level
- Along with lower inflation and sluggish growth, this should see wage growth pressures ease greatly

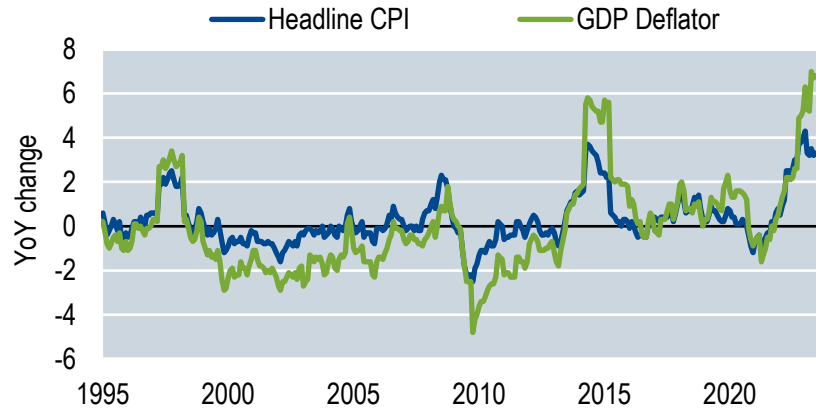


Source: Office for National Statistics. As of August 2023

The above reflects current opinions of Western Asset and are subject to change with market conditions.

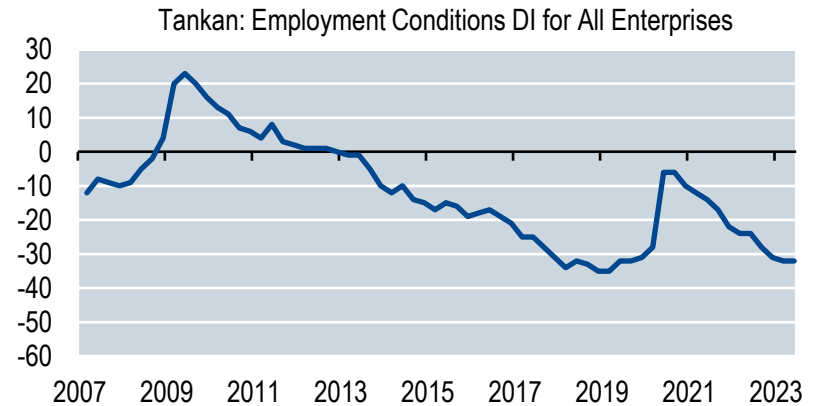
# Japan: Wage Pressure Slowly Building as Employment and Growth Outlook Brightens

Wages increased following the results of spring wage negotiation.



Source: Bloomberg. As of 31 Jul 23

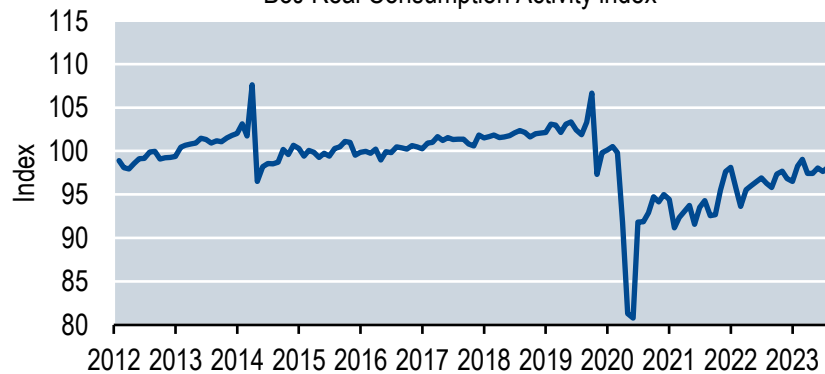
Employment Conditions Survey: BoJ Tankan survey: employment conditions DI suggests a deepening labor shortage.



Source: Bloomberg, Western Asset. As of 30 Jun 23  
Employment Conditions DI: "excessive employment" minus "insufficient employment"

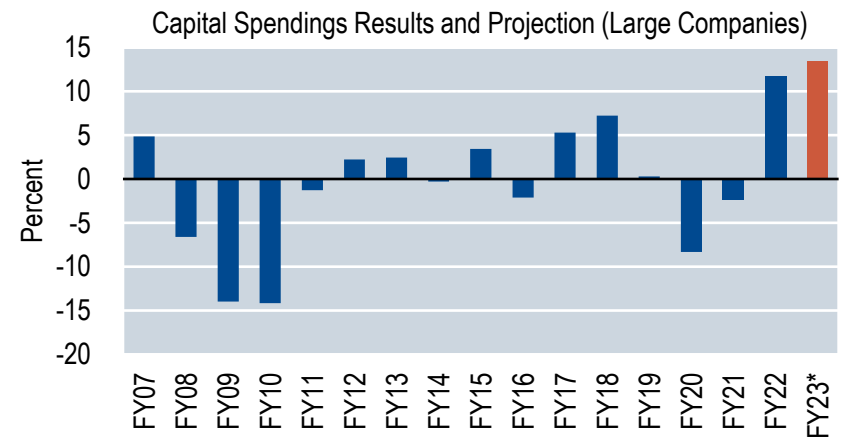
Consumer Activities

BoJ Real Consumption Activity index



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

Capital Spending: BoJ Tankan survey: Capital spending projections are strong.



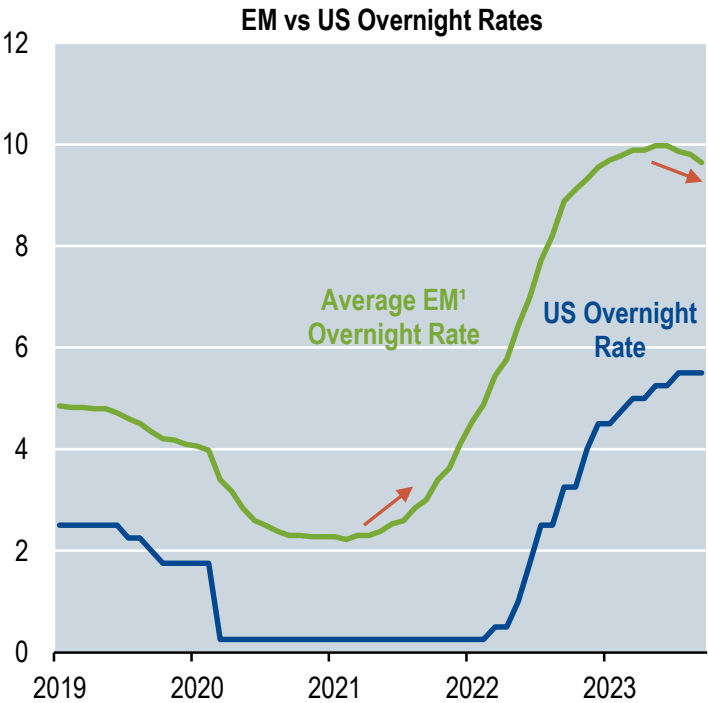
Source: Bank of Japan, Western Asset. As of 31 Mar 23  
\*FY2023 Projection

# EM Central Banks Are Ahead of the Curve

EM policymakers tightened policy aggressively, starting in early 2021 well in front of the Fed.

With both EM and DM inflation having peaked, EM central banks have already started to cut rates despite the Fed indicating no cuts in the US until late 2024.

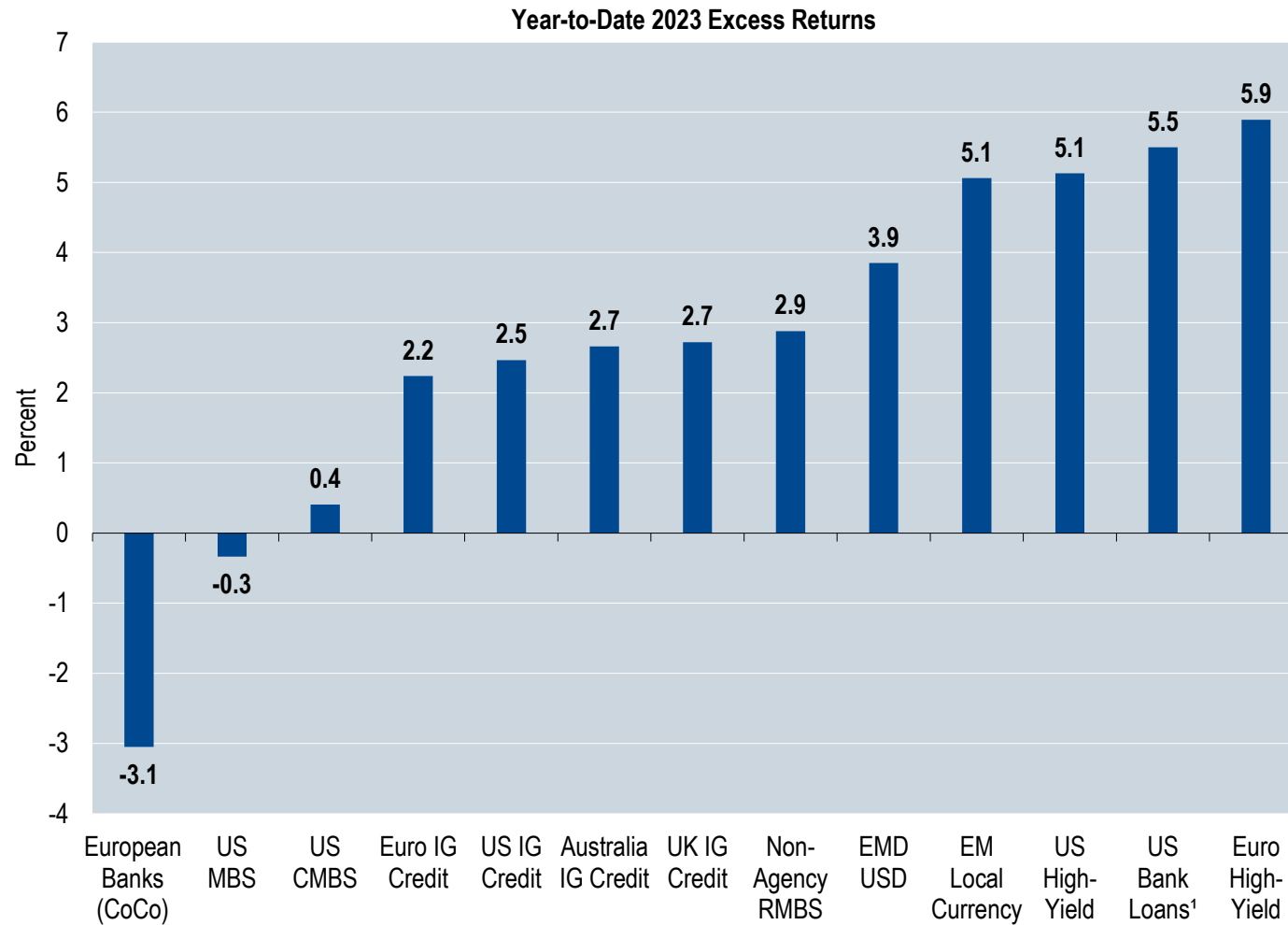
EM central banks' response to the recent inflation scenario has provided stability for EM FX and resiliency for growth



Source: Bloomberg, Western Asset. As of 15 Sep 23  
¹EM = Brazil, Mexico, Colombia, Hungary, Chile, South Africa, India, Indonesia and Poland



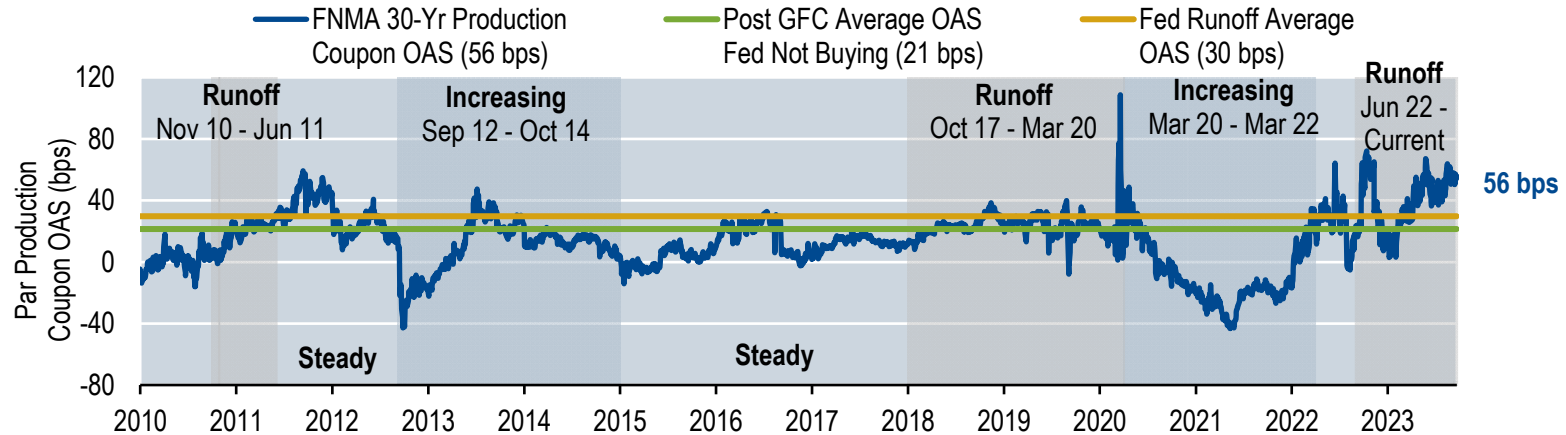
# Spread Sector Excess Returns



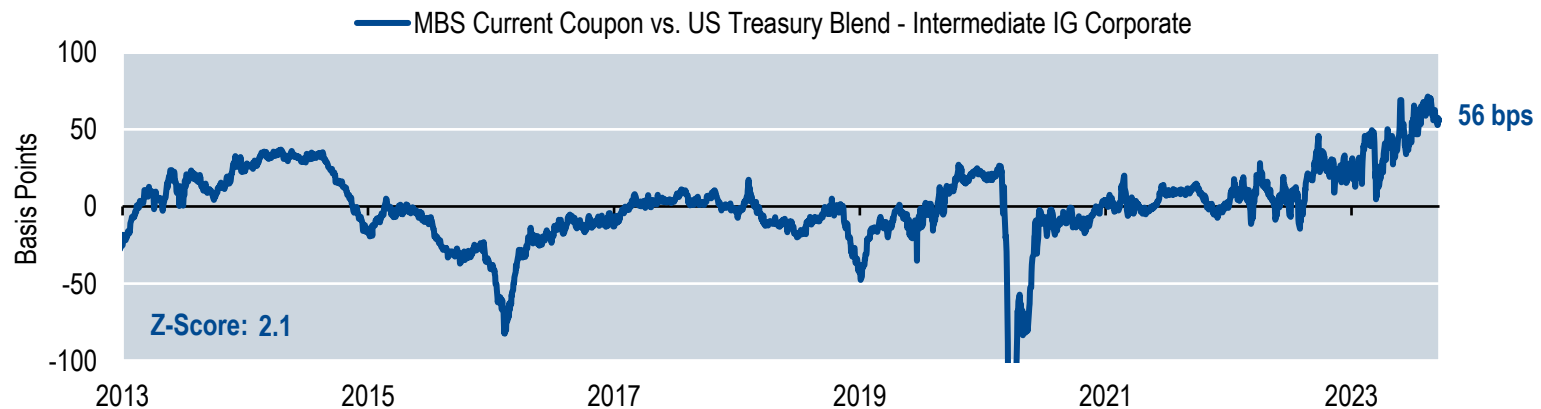
Source: Bloomberg, Citi, J.P. Morgan, S&P Global Market Intelligence, a division of S&P Global Inc, Western Asset. <sup>1</sup>S&P/LSTA Leveraged Loan Total Return Index excess return vs. 3-Month LIBOR. As of 26 Sep 23  
 Past performance is not a reliable indicator of future results.

# Agency Mortgages Are Historically Cheap

- Mortgage spreads have widened significantly as Fed and bank support diminished
- Agency MBS spreads have widened and are cheap compared to high grade corporate bonds, especially in production coupons
- Prepayment risk remains muted as mortgage borrowers have little refinancing incentive

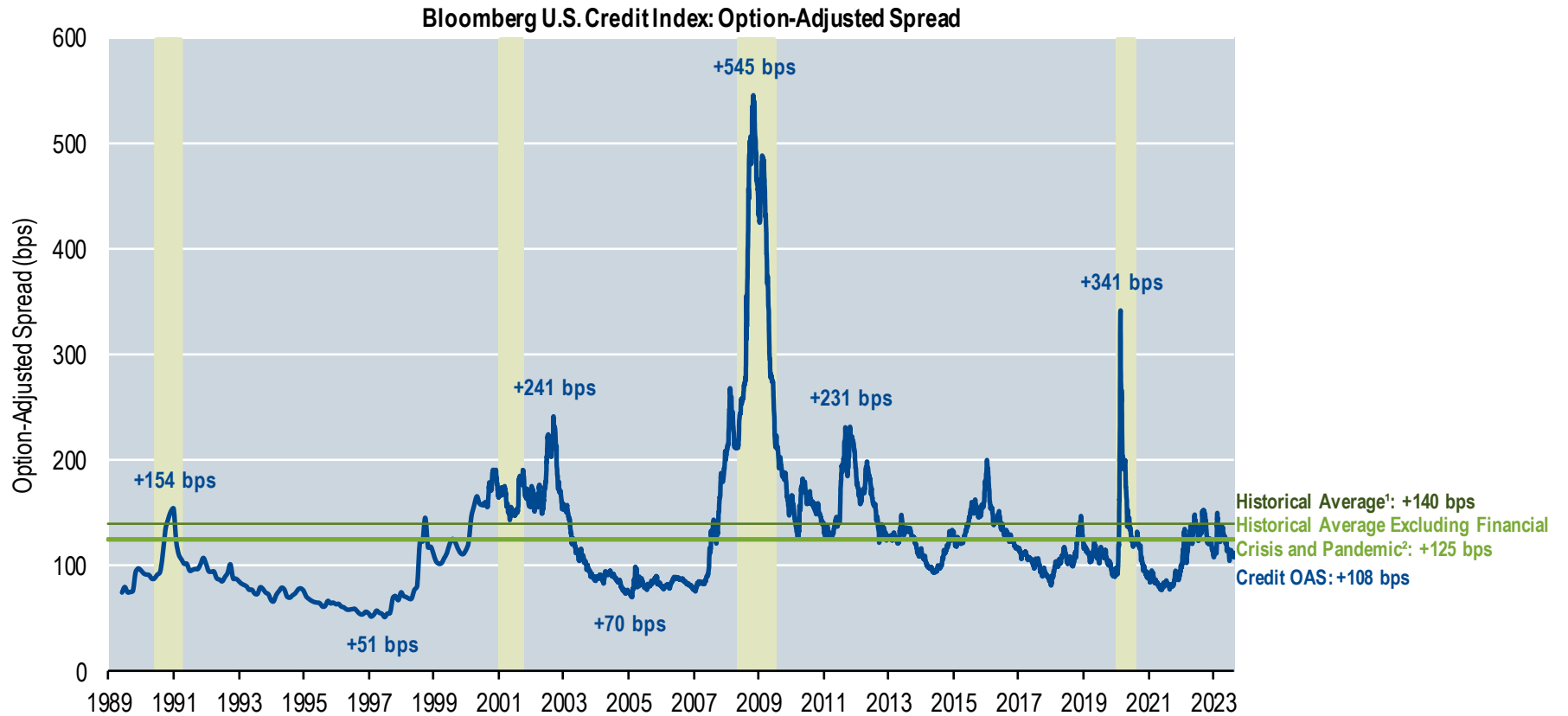


Source: Bloomberg, MS Research, Western Asset. As of 20 Sep 23



Source: Bloomberg. As of 20 Sep 23

# Valuation: US Credit “Fair” at +108 OAS



Source: Bloomberg. As of 22 Sep 23  
Periods of recession highlighted in yellow



## 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

## Energy Companies: 2022 About Deleveraging, 2023 Capital Discipline, Upgrades and Mergers

Issuer	2022 Debt (\$mm)	2022 Change in Index Debt (\$mm)	Upgraded in 2023/ Positive Outlook
<b>IG Energy Index Change in Debt Outstanding 2022</b>		<b>-42,408</b>	
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	Upgraded
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 2x
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	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	
<b>IG Bond Index Change in Debt Outstanding 2022</b>		<b>321,300</b>	

Source: J.P. Morgan, Bloomberg Finance L.P., Western Asset. As of 31 Aug 23

### 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, Western Asset. As of 31 Aug 23

The information provided is not a recommendation to purchase, sell, or hold any particular security and should not be construed as an endorsement of or affiliation with Franklin Templeton or Western Asset.

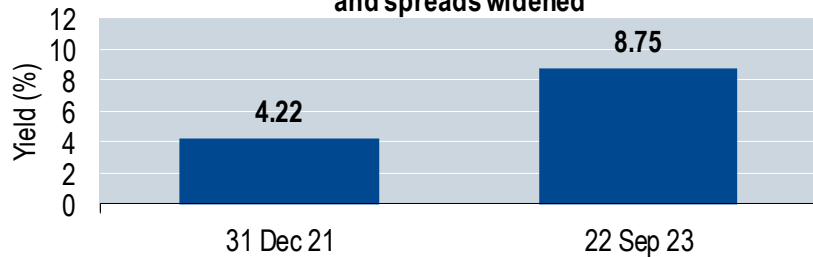
### Mergers in 2023

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. As of 15 Jun 23

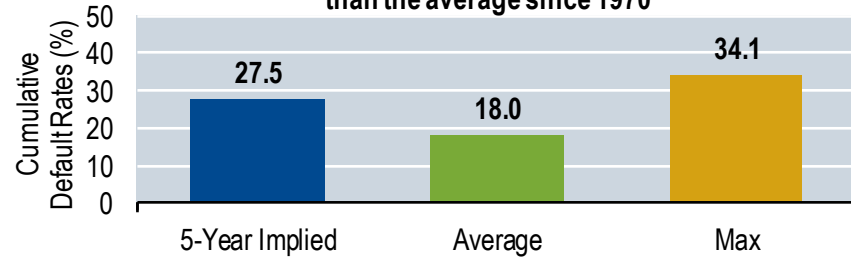
# High-Yield Credit: Valuations Are Compelling

**Yields rose by more than 4% since 2021 as rates rose and spreads widened**



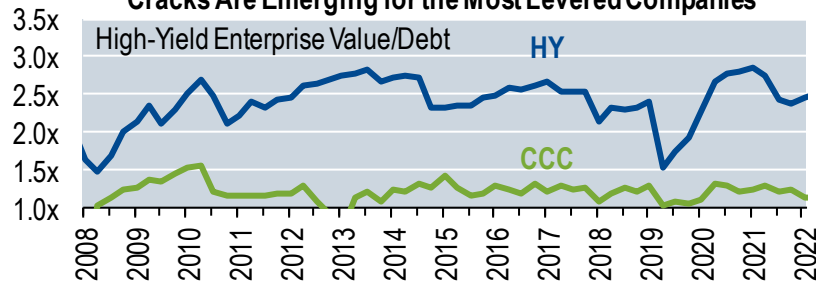
Bloomberg US High-Yield 2% Issuer Cap Index  
Source: Bloomberg. As of 22 Sep 23

**Spreads now imply much higher defaults than the average since 1970**



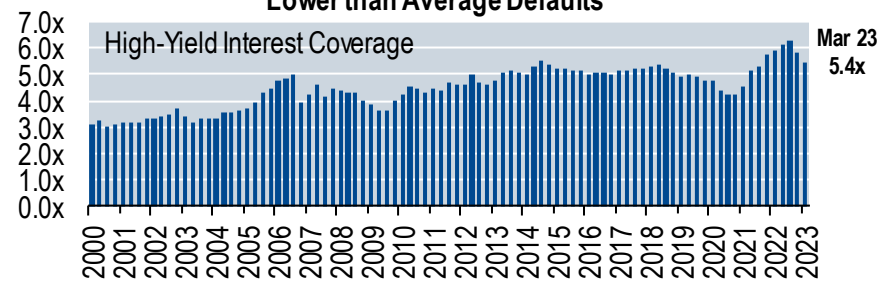
Source: Bloomberg, Moody's, Western Asset. As of 22 Sep 23  
40% recovery assumption was used and spread used to imply cumulative defaults over 5 years.  
Worst cumulative 5-year default period since 1970 was 1992

**Cracks Are Emerging for the Most Levered Companies**



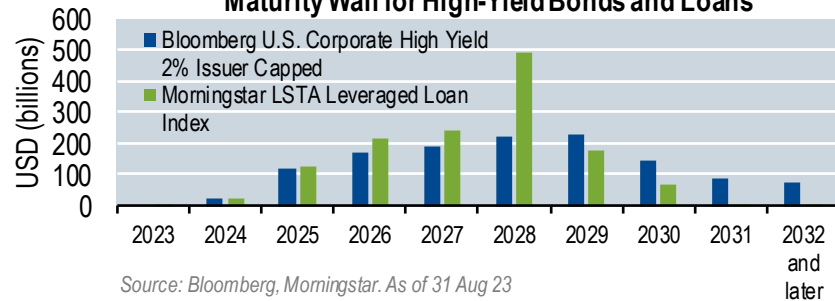
The sample is confined to public reporters for which we are able to retrieve four consecutive quarters of data from Bloomberg or S&P Capital IQ. New constituents are integrated quarterly based on additions to the Bloomberg US Corporate HY Bond Index).  
Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Mar 23

**Ability to Service Debt Also Supportive of Lower than Average Defaults**



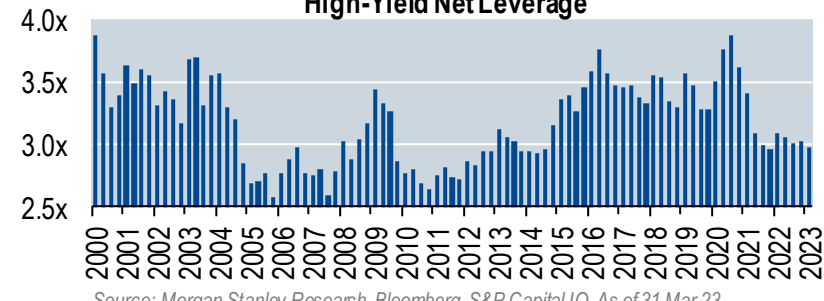
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Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Mar 23

**Maturity Wall for High-Yield Bonds and Loans**



Source: Bloomberg, Morningstar. As of 31 Aug 23

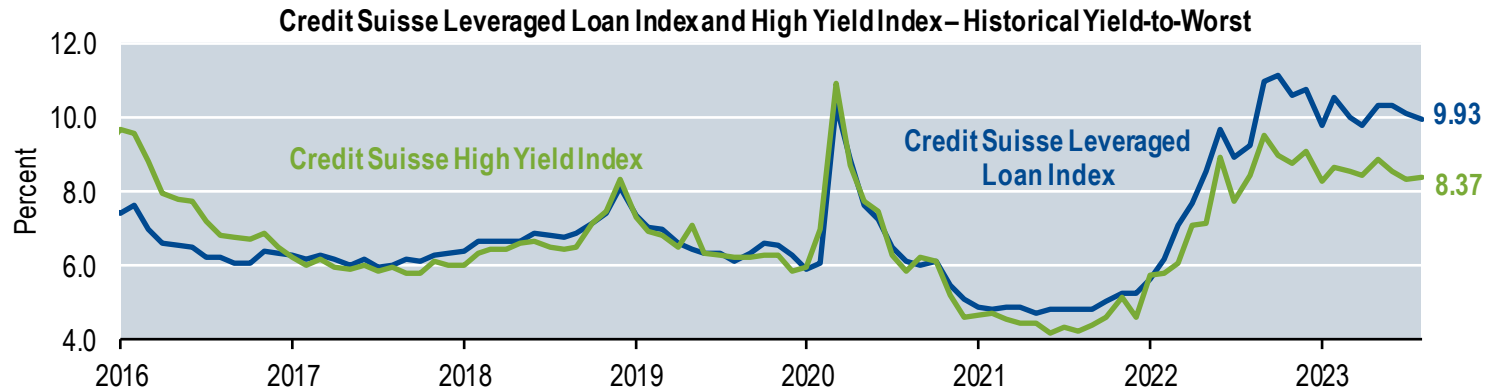
**High-Yield Net Leverage**



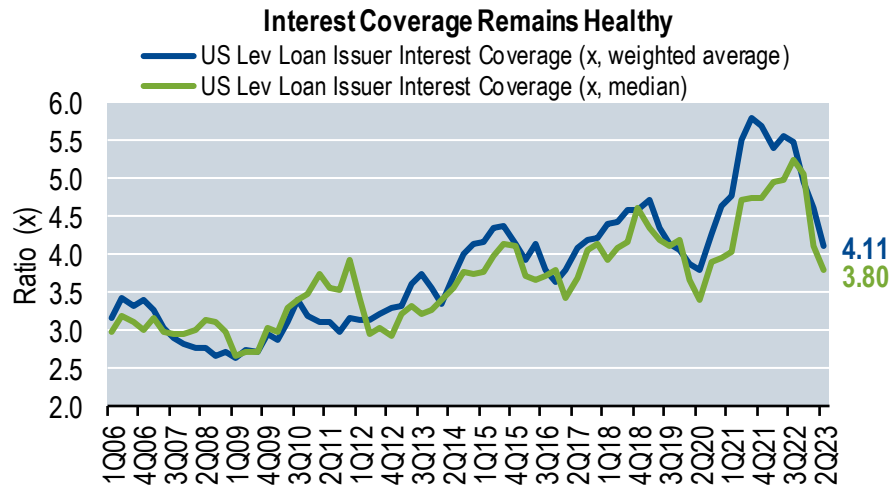
Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Mar 23

# Bank Loan Valuations Relative to High-Yield

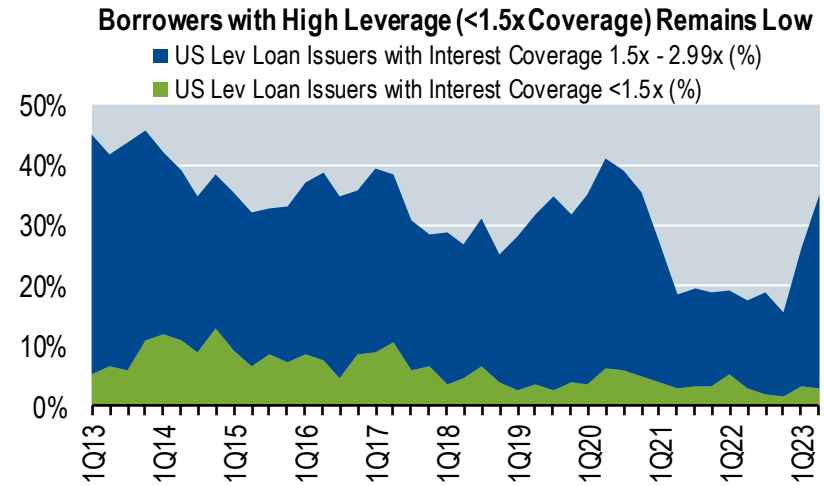
Since 1992, high-yield has historically had a YTW with 87 bps premium over leveraged loans and 82 bps spread over loans driven by higher risk profile due to unsecured, subordinated position in capital structure relative to loans



Source: Credit Suisse. As of 31 Aug 23  
Yield-to-Worst (YTW) is the lesser of yield-to-maturity or yield-to-call across all known call dates.



Source: Leveraged Commentary & Data (LCD). As of 30 Jun 23



Source: Leveraged Commentary & Data (LCD). As of 30 Jun 23

## 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
- 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
<b>20 Sep 23</b>	<b>328</b>	<b>223</b>	<b>1,069</b>	<b>116</b>	<b>371</b>
Difference Since 31 Jan 20	151	100	819	14	-19
31 Dec 18	246	127	371	153	526
<b>20 Sep 23</b>	<b>328</b>	<b>223</b>	<b>1,069</b>	<b>116</b>	<b>371</b>
Difference Since 31 Dec 18	83	97	698	-37	-155

Source: Bloomberg, Bank of America, Western Asset. As of 20 Sep 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.

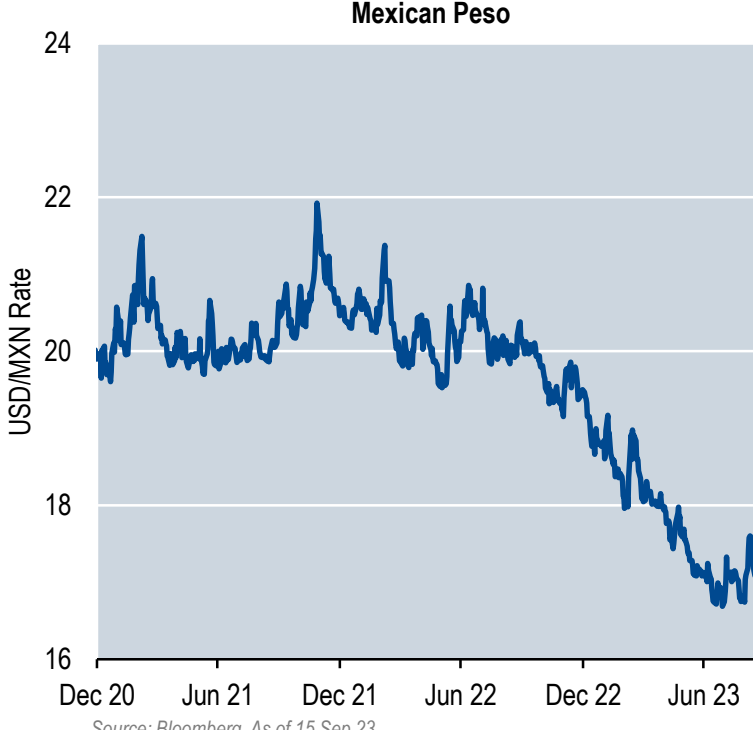
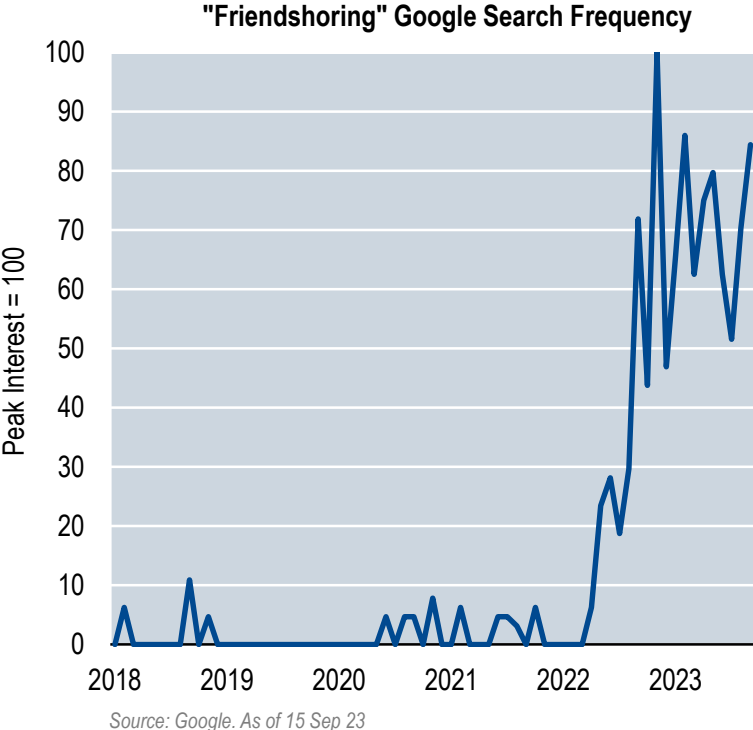
\*Representative RMBS CRT Below IG: On-the-run speed adjust spread for below investment-grade rated CRT cohort

Past performance is not a reliable indicator of future results.

# Globalization Transitions Toward Friendshoring

Some EM countries/regions are set to benefit from the evolution of global supply chains to reflect geopolitical considerations in addition to manufacturing costs.

We would highlight Mexico, Dominican Republic, Costa Rica, and India as potential beneficiaries of friendshoring.

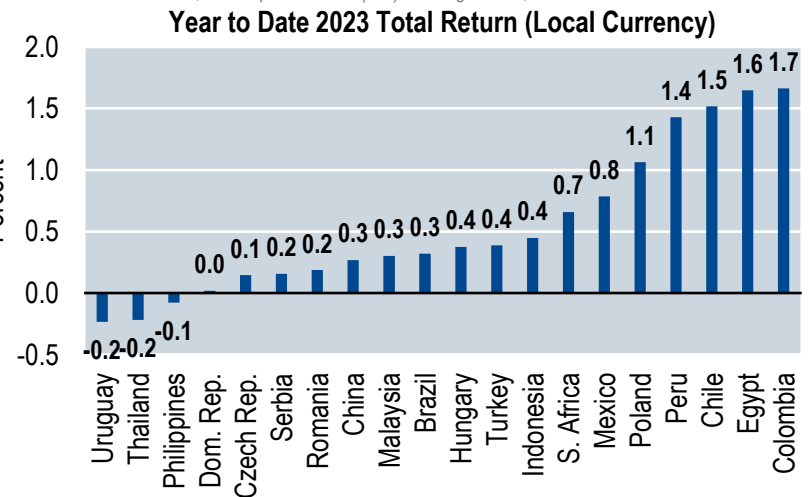
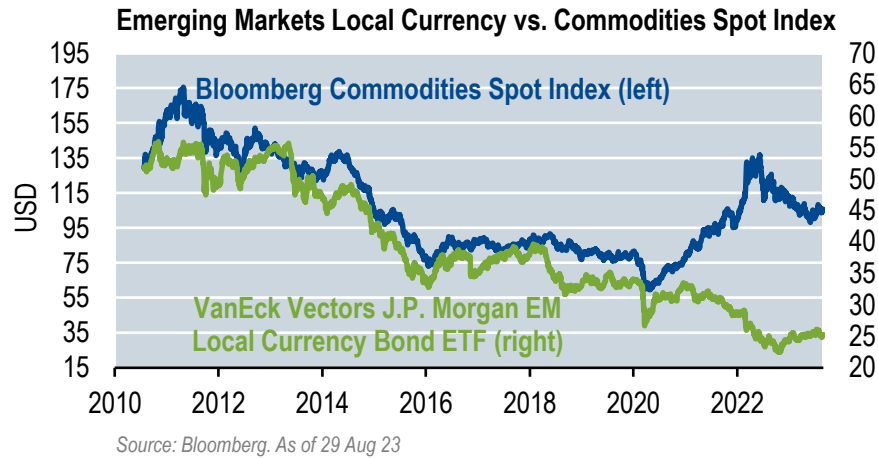
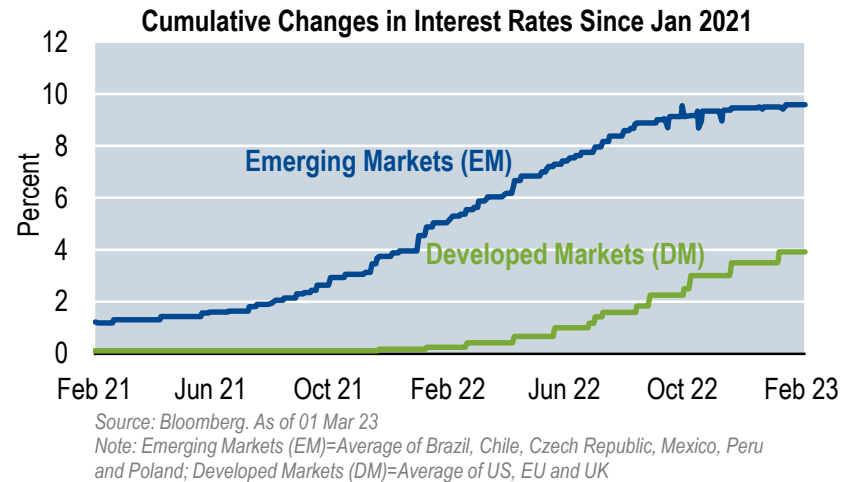


# The USD and Commodities: Key Emerging Market Drivers

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



# 2023 Outlook

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**Disinflation ongoing but uneven**

**Fed tightening near end**

**Economy has remained resilient in part due to renewed fiscal stimulus**

**Current banking stress extremely complex but not systemic**

## **Fixed-income outlook**

- US growth will slow but should avoid recession
- Global growth has downshifted and China is now a source of deflation
- Global inflation will continue to recede
- The dollar will weaken moderately
- Emerging markets—particularly in Latin America—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

*The above reflects current opinions of Western Asset and are subject to change with market conditions. As of 25 Aug 23*



## Questions & Answers

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**Thank you.**

## Risk Disclosure

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