WESTERN ASSET

Webcast Summary

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4Q23 Market & Strategy Update

While inflation has been running high globally, primarily driven by the fiscal and monetary policy responses to Covid, there are now signs that the effects of the past year's monetary policy tightening are working their way through the economy and bringing inflation down, albeit unevenly. We believe that the inflation outlook has improved significantly and further restrictive policy through "higher for longer" rates may be unnecessary. Global economic growth remains positive overall and the risk of recession in major economies like the US has receded somewhat. Our key investment themes include favoring higher-quality bonds over lower-quality given lingering risks, and being highly selective around exposures to sectors like structured credit. Overall emerging markets appear well positioned to benefit from relative valuations, supportive policy and a still-growing global economy.

Market Review

- Treasury yields have risen on perceptions of higher terminal policy rates, as rate volatility has been extraordinarily high, especially in long-dated bonds.
- Investment-grade credit has performed well on solid fundamentals, with energy companies benefiting significantly from deleveraging.
- The US dollar strengthened notably through mid-year on growth differentials and policy divergence, but has weakened since.

Inflation

- Tailwinds for inflation, such as fiscal stimulus and supply-chain issues, have abated or become headwinds.
- Core CPI remains elevated but should decline further as policy tightening effects filter through the economy.
- Global inflation has peaked and is moving lower in most major economies.
- Chinese inflation is now in deflationary territory, a notable change from historical trends.
- Money supply growth has turned negative, removing fuel for future price increases.
- While the path is uneven, we expect US and global inflation to continue trending downward absent major shocks.

Fed Policy

- The aggressive tightening campaign by the Federal Reserve (Fed) over the past year has significantly restricted financial conditions.
- We view the Fed's rationale for keeping rates higher as being partly driven by a desire to curb resilient economic growth and avoid a wage-price spiral. However, we see evidence that wage growth and labor market tightness are already moderating.
- We believe there is a chance the Fed is overly hawkish given data showing inflation retreating, and should pause further rate hikes to avoid inadvertently overtightening, given lags in policy transmission.

US Economic Outlook

- Growth is slowing but recession risks have receded, making a soft landing possible.
- The consumer faces headwinds like declining savings and higher rates; as a result, spending is expected to moderate.
- Inflation should trend lower as fiscal stimulus fades, policy tightens, supply-chain issues ease and demand slows.

Global Economic Outlook

- Global growth is decelerating but remains positively oriented overall, aided by China's economic reopening providing a boost.
- Inflation rates have likely peaked in most major economies and a disinflationary environment appears to be taking hold.
- Consumption is likely to slow, as recent consumption has been sustained by depleting personal savings; consumer confidence remains low and the reinstatement of student loan payments will serve as an additional headwind.
- While on the surface housing looks to be healthy with resilient prices, optimism has plummeted due to a lack of affordability and the recent spike in mortgage rates making for a grim outlook.
- Emerging markets (EM) stand out as an attractive opportunity given low valuations, policy easing from central banks, and potential to benefit as global growth moderates.

Investment Themes

- **Overall risk assets:** We remain cautiously positioned on overall risk assets given lingering concerns around potential slowing growth or monetary policy overtightening. However, we believe current valuations and spreads across most spread sectors seem to adequately compensate investors for these risks. Selectivity and credit fundamentals are increasingly important in the current late-cycle environment.
- **Investment-grade:** Investment-grade credit offers opportunities, with fundamentals and technicals providing support. Spreads are reasonably attractive relative to historical averages, and underlying corporate cash flows remain healthy. The energy sector stands out given material deleveraging by companies, high commodity prices, and improved credit profiles.
- **High-yield:** High-yield valuations appear quite compelling considering current fundamental metrics and implied default risk is pricing in more pessimism than historical experience warrants. However, selectivity remains crucial given economic risks, and credit fundamentals bear monitoring amid higher interest costs.

- **Bank loans:** Bank loans currently offer very attractive risk premiums and valuations considering the economic growth concerns that have impacted the sector. Spreads have widened substantially relative to high-yield bonds, presenting unique opportunities. Leverage and debt coverage metrics remain in solid shape fundamentally.
- **Structured product:** Structured credit sectors like mortgage-backed securities (MBS) offer opportunities, but choice is key given rising rates and shifting real estate fundamentals. Elevated spreads and risk premiums provide cushion for solid investment-grade exposures.
- **EM debt:** EM debt stands out as an attractive opportunity today given depressed valuations, prospects of policy easing as EM central banks pivot, and potential to benefit from ongoing global economic growth. Both external and local currency EM bonds can offer value. After years of underperformance, fundamentals appear supportive for EM assets to potentially thrive.

Q&A Highlights

- We believe the uncertainty in markets is extremely high due to the pandemic, unprecedented monetary and fiscal policies, and now their reversal. Past experience is less relevant in this unique environment.
- Aggressive Fed tightening is damaging growth but should reduce inflation over time, though the economy may stay resilient for a while. This gives the Fed room to recalibrate if inflation falls.
- We think the front end of the yield curve is the best diversifier if growth weakens, as rates can fall again. But the back end has appeal too given the bear-steepening.
- Demographics, debt and technology trends have not changed—they remain disinflationary forces over the long run. Fiscal largesse lifting inflation also seems unlikely given political divides.
- Given the uncertainties, bonds can provide attractive income and potential capital gains to balance equity risk in a portfolio context. Their relative appeal versus equities is better than it's been in years.