Western Asset

Webcast Summary

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1Q24 Market & Strategy Update

The dramatic drop in inflation globally over the past year has allowed central banks to pivot from tightening monetary policy to preparing for easing. This shift has fueled powerful rallies across most areas of fixed-income. We expect further disinflation ahead, albeit unevenly, as global economic growth moderates. Downshifting global growth, falling inflation trends and central bank easing provide a favorable backdrop for fixed-income heading into 2024. Risks remain, due to geopolitical uncertainty, central banks potentially moving too slowly or a sharp slowdown in growth. We see particular value in some spread sectors such as BB high-yield bonds, and believe emerging markets, particularly in Latin America, are well positioned to outperform.

Market Review

- The global economy saw a downshift in inflation rates. Notably, China became a source of mild deflation.
- The US economy was resilient in the face of economic headwinds.
- The US yield curve has flattened significantly in the second half of 2023.
- Emerging markets (EM) have seen outperformance, likely due to a combination of factors including monetary policy responses and economic conditions.
- Central banks around the world have had to navigate complex economic landscapes and adjust their policies accordingly, with many pivoting their policies toward prospective easing to address the ongoing disinflation and to normalize real interest rates.

Inflation

- The disinflationary progress over the past six months has been substantial.
- Inflation data has retreated close to the Federal Reserve's (Fed) 2% target, reflecting more positive inflation developments.
- We expect the global disinflation trend to continue, albeit unevenly, as goods prices and rents ease.
- UK inflation surprised to the downside recently which, paired with soft growth and emerging labor market slack, suggests the Bank of England may pivot toward less restrictive policy soon.
- China has shifted from an inflation driver to a source of disinflation.
- Goods prices and shelter costs remain at elevated levels but should moderate as supply chains normalize.

Fed Policy

- The shift in Fed rhetoric has been dramatic—from warning markets to prepare for pain to now saying "so far, so good" in relation to decreasing inflation without a recession or an increase in unemployment.
- With inflation having fallen significantly, there is a high likelihood of interest rate cuts by the Fed in 2024 without a recession, particularly with inflation declining back toward the Fed's 2% target.
- There is a risk that the Fed waits too long into 2024 before starting to ease monetary policy.
- Markets have not fully priced in, nor reflected the scope and magnitude of rate cuts that could transpire.

US Economic Outlook

- GDP growth has moderated from the 5% annualized pace seen in 4Q23. We expect growth to slow yet avoid a recession, with a rate of around 2% in 2024.
- Various headwinds such as tighter bank lending, higher interest rates and lower consumption should prevent unusually rapid growth seen late last year.
- US corporate fundamentals should remain strong, aided by limited debt issuance.
- Balance sheets have actually improved across the median investment-grade company, and we expect rating agencies to eventually reflect these improvements.
- Profit margins remain strong on a historical basis and look promising over the near term, though they have retreated slightly from recent record highs.

Global Economic Outlook

- Geopolitical uncertainty continues to add volatility to the global outlook.
- Europe appears on the cusp of recession given very weak growth, yet inflation is declining faster than the dovish European Central Bank anticipated, likely requiring faster policy reassessment and possibly swifter easing.
- China's property market troubles continue to constrain its economy but modest official growth targets may be achievable given an ongoing policy pivot toward monetary and fiscal easing.
- Japan is experiencing some nascent wage cost pressures but the Bank of Japan (BoJ) remains highly accommodative. We think that ultimately Japan will exit from negative interest rates.
- Countries like Mexico stand to be prime beneficiaries of "friendshoring" production trends.
- We anticipate moderate global growth, currency stability and a favorable backdrop for EM assets.

Investment Themes

- **Overall risk assets:** Strong corporate fundamentals and central bank easing provide a favorable backdrop for risk assets, though parts of credit markets appear richly valued following sharp rallies. Selectivity is warranted given disparities in valuations across markets segments.
- **Investment-grade:** Current valuations appear somewhat expensive after substantially outperforming. Fundamentals remain supportive given improvement across median investment-grade companies' balance sheets.

- **High-yield:** Rising stars and BB high-yield offer particular value with additional room for price gains and upgrades yet to be fully reflected, while fundamentals are also strong with defaults expected to stay low. Energy and autos were notable contributors.

- **Bank loans:** Bank loans can provide floating-rate income buffers amid a rising-rate environment, but upside may be limited at this later stage of the cycle and the asset class remains sensitive to volatility from equity markets.

- **Structured product:** Agency mortgage-backed securities (MBS) provide relatively attractive yield profiles with the sector poised to benefit should the Fed slow its mortgage runoff pace, though negative convexity can be an issue; parts of non-agency residential and commercial MBS offer selective value but require in-depth credit analysis.

- **EM debt:** EM local debt stands out for its extremely cheap valuations and high real yields as EM central banks pivot to cutting rates. USD-denominated sovereign credit also merits consideration.

Q&A Highlights

- Risks of recession and hard landing in the US would rise if growth weakens more than expected, but policy stimulus would likely follow.

- Antecedents for a US recession are not currently apparent, but risks rise the longer monetary policy stays restrictive.

- The Fed is unlikely to formally change its 2% inflation target, but may tolerate modest deviations.

- EM election cycles introduce uncertainty, but the backdrop is still seen as positive.

- A rate hike from the BoJ is not seen as imminent given moderating global growth; we do expect an exit from negative rates in Japan may come by mid-2024.