WESTERN ASSET

Webcast Summary

Mark Lindbloom
Portfolio Manager

Travis M. Carr, CFA
Product Specialist

Strategy Update: US Core and Core Plus

While last year was challenging for most financial markets with negative returns across many asset classes, there has been meaningful recovery in 2023. We've seen US economic data be fairly resilient, and GDP growth is exceeding expectations. Inflation pressures appear to be easing and the Fed should be nearing the end of its rate hike cycle. This has reduced recession concerns and supported risk assets. Looking forward, we're optimistic and think this market backdrop makes a good case for active fixed-income. Currently, we see very attractive yields across fixed-income that haven't existed in years, but we prefer high-quality assets for our portfolios given economic uncertainties.

Here are some key takeaways.

Market Review

- Inflation is trending lower based on metrics such as the Consumer Price Index (CPI) core CPI and the Producer Price Index (PPI). We saw goods, services and shelter pricing all starting to moderate.
- Employment data is showing some signs of cooling, with job openings and wage growth coming off their peaks.
- Yields have been volatile as market narratives shifted across soft landing optimism, sticky inflation and recession worries.
- The diversification benefit of fixed-income has reemerged, with 60/40 strategies appearing attractive again.
- We are watching inflation data closely for any signs of embedded expectations that could prolong the disinflation process.

Fed Policy

- We believe the Federal Reserve (Fed) is nearing the end of its hiking cycle and will likely pause soon to assess impact. Market pricing expects the fed funds rate to top out around the current level of 5.25%-5.50%.
- The Fed continues to reaffirm its data-dependency and is monitoring inflation and labor data closely to inform future policy decisions.
- Financial conditions are impacted by the Fed and other economic factors. Recent regional banking challenges have contributed to tighter credit conditions and factor into the Fed's decisions.
- Real interest rates are now above pre-pandemic levels, indicating monetary policy is restrictive.

© Western Asset Management Company, LLC 2023. This publication is the property of Western Asset and is intended for the sole use of its clients, consultants, and other intended recipients. It should not be forwarded to any other person. Contents herein should be treated as confidential and proprietary information. This material may not be reproduced or used in any form or medium without express written permission.

Portfolio Positioning/Investment Outlook

- We believe yields and valuations are very attractive across the curve.
- Mortgage market pressures have cheapened valuations significantly and have allowed us to increase allocation to the agency mortgage-backed securities (MBS) sector from underweight to overweight.
- We have added exposure to non-agency mortgages and commercial MBS (CMBS), given significant spread widening.
- We have selectively trimmed investment-grade corporate bonds, generally in finance and industrials, after significant tightening of spreads.
- Emerging market (EM) debt has been positive for returns, mostly on currency and local bond performance. We continue to see attractive valuations in the sector.
- We have a preference to increase exposure to high-quality assets such as mortgages and higher-quality corporate bonds given economic uncertainty.
- Duration has been extended slightly to act as a portfolio diversifier amid growth risks and tight credit spreads. We shifted yield-curve positioning by reducing our overweight at the long end of the curve and increasing intermediate exposure.
- Performance has started to improve. While duration has not been additive, excess returns have been impressive coming from EM as well as high-yield, bank loans, investment-grade corporates and structured products.

Conclusion

- The outlook for fixed-income is very strong with attractive yields not seen in years.
- Overall, we're optimistic that the continued decline of inflation will be supportive for fixed-income markets.
- With correlations now back to their historical relationship, we believe "bonds are back."
- We're positioning the strategies for various scenarios—not just our base case; overall, we're moving up in quality and shifting our position on the yield curve to take advantage of a potential dis-inversion (less of an inversion), and perhaps even a steepening of the yield curve, by shifting around some of our key rate durations.

Q & A

- The Fitch downgrade of US debt likely had only a minor impact on the move higher in yields. In our view, other factors like US borrowing needs and Bank of Japan policy shifts were actually more impactful.
- In our US Core and Core Plus portfolios, we've moderately reduced our risk positioning since the end of the first quarter. We made this adjustment primarily by moving up in quality.
- We expect the US dollar to continue to weaken modestly versus EM currencies.
- Our preference now is to add exposure to CMBS selectively in higher quality multifamily, warehouse and hospitality and retail sectors.
- Regarding the inflation outlook, our greatest concern is the uncertainty around future fiscal policy and structural changes to the economy.

Past results are not indicative of future investment results. This publication is for informational purposes only and reflects the current opinions of Western Asset. Information contained herein is believed to be accurate, but cannot be guaranteed. Opinions represented are not intended as an offer or solicitation with respect to the purchase or sale of any security and are subject to change without notice. Statements in this material should not be considered investment advice. Employees and/or clients of Western Asset may have a position in the securities mentioned. This publication has been prepared without taking into account your objectives, financial situation or needs. Before acting on this information, you should consider its appropriateness having regard to your objectives, financial situation or needs. It is your responsibility to be aware of and observe the applicable laws and regulations of your country of residence.

Western Asset Management Company Distribuidora de Títulos e Valores Mobiliários Limitada is authorized and regulated by Comissão de Valores Mobiliários and Brazilian Central Bank. Western Asset Management Company Pty Ltd ABN 41 117 767 923 is the holder of the Australian Financial Services Licence 303160. Western Asset Management Company Pte. Ltd. Co. Reg. No. 200007692R is a holder of a Capital Markets Services Licence for fund management and regulated by the Monetary Authority of Singapore. Western Asset Management Company Ltd is a registered Financial Instruments Business Operator and regulated by the Financial Services Agency of Japan. Western Asset Management Company Limited is authorised and regulated by the Financial Conduct Authority ("FCA") (FRN 145930). This communication is intended for distribution to Professional Clients only if deemed to be a financial promotion in the UK as defined by the FCA. This communication may also be intended for certain EEA countries where Western Asset has been granted permission to do so. For the current list of the approved EEA countries please contact Western Asset at +44 (0)20 7422 3000.