PM EXCHANGE

featuring Michael C. Buchanan, Co-CIO

Webcast Summary

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Positioning for Potential Outcomes in the 2024 Post-Cash Era

Western Asset hosted a PM Exchange webcast led by Co-CIO Michael Buchanan, who was joined by the Interim Head of US-based Emerging Markets Team Kevin Ritter, Head of Non-US Credit Annabel Rudebeck and Global Head of ESG Investments Bonnie Wongtrakool. Together, the panelists discussed three potential economic scenarios for the year ahead, focusing on recent inflation data and expected Fed actions. They also reviewed why cash may not be advantageous in the current environment, marking the end of the cash era, and highlighted the investment opportunities they see in fixed-income today, particularly the compelling prospects in emerging market debt, especially Latin American debt.

Here are some key takeaways.

ON WESTERN ASSET's BASE CASE OUTLOOK FOR 2024

- Western Asset's base case outlook for the rest of 2024 sees growth slowing, but remaining resilient and not recessionary.
- On global inflation, we are well away from the double-digit annual increases experienced in the past, as disinflation continues, particularly in Europe.
- Given this backdrop, our view is that peak interest rates in European economies have most likely already been reached.
- The key question now arises around the timing and magnitude of potential rate cuts by central banks.

ON THE POTENTIAL FOR FEDERAL RESERVE RATE CUTS IN 2024

- While some recent economic data has been stronger than expected, the market is now pricing in less than 50 bps of rate cuts from the Fed this year, with the first cut now expected in the fall .
- The Fed's emphasis right now is more on the inflation side rather than the growth side.
- The Fed's view, similar to Western Asset's, is that inflation is moderating over time and moving in the right direction, based on forward indicators like rent price indices and used car prices.

ON THE POTENTIAL FOR EMERGING MARKET (EM) DEBT TO OUTPERFORM AS RATES ARE CUT

- Western Asset has a lot of conviction in EM, and despite recent underperformance of EM local currency bonds, they appear poised for outperformance as the easing cycle begins.

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- On the fundamental side, EM policymakers were proactive in hiking rates before developed markets (DM), allowing inflation to come down meaningfully in many EM countries. Additionally, growth across EM has been relatively resilient.
- EM valuations are attractive, as assets were punished severely during the Fed's 2022 hiking cycle but have not yet fully recovered.
- The general macro backdrop of some EM borrowers regaining access to capital markets after being shut out is an important development that should propel EM trades in 2024.

ON THE THREE POTENTIAL ECONOMIC OUTLOOKS

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- We have to prepare and build portfolios that can withstand and endure a whole range of different outcomes and perform to our expectations or exceed our expectations.
- While this may be complex, our process includes creating this range of potential scenarios then stressing and testing our portfolios.

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- In the optimistic scenario, growth really picks up not just in the US but also in China with improving domestic demand, and in Europe, aided by factors such as a calming of geopolitics and the rates environment topping out.
- A more negative potential scenario is one of a much harder economic landing or recession that would see credit tightening up across the board globally, and which would be positive for much of fixed-income but less good for credit products.
- The most negative scenario discussed is one in which inflation remains elevated or even rises further, coupled with a weaker growth backdrop; in such an environment, many asset classes would struggle.

ON THE "END-OF-CASH" ERA

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- It is very rare for cash to be the best performing asset class, which is what has been seen in recent years, but even rarer for it to be the best multiple years in a row.
- Historically, when the Fed has moved into an easing cycle, which is expected soon, fixed-income has outperformed and cash significantly lagged.
- Even if the Fed were to cut, then pause, historically in such a scenario, investors have been able to achieve healthy returns on diversified bond portfolios.
- Fixed-income can provide valuable diversification benefits in investor portfolios versus other asset classes when inflation is below key levels around 3%.

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- Looking at very long-run data for US credit, valuations on a spread basis are tight considering historical averages, but there have been periods when spreads were much tighter than today.
- Corporate fundamentals look good, with companies in a defensive mindset, focused on liquidity, terming out debt and maintaining higher credit ratings.
- Rating agencies have enacted far more upgrades than downgrades recently on the positive trajectory of corporate credits.
- While spreads may look rich over certain time frames, the yields available provide attractive income (currently 5.5% for investment-grade and 8% for high-yield Bloomberg).

REASONS NOT TO WAIT FOR A BETTER ENTRY POINT, CONSIDERING TIGHT SPREADS

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- Corporate treasurers and CFOs are still in a defensive mindset, focused on liquidity, terming out debt profiles and ensuring well-managed financing needs, which is a positive development.
- Companies recognize the value of maintaining higher credit ratings to access liquidity when needed, leading to a healthy, improved corporate market with more rating upgrades than downgrades recently.
- Fundamentals for corporates look good, with a positive rating trajectory and a desire for higher quality ratings.

THE MOST ATTRACTIVE OPPORTUNITES WE SEE TODAY IN FIXED-INCOME

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- Corporate credit, especially in the high-yield market with a bias toward higher quality credits and "rising-star" candidates (bonds currently rated BB but with potential to migrate to investment-grade).
- Investment-grade corporate credit, specifically in the 5- to 7-year maturity range.
- Structured credit, such as agency mortgage-backed securities (MBS), seasoned non-agency MBS, and non-office commercial real estate.
- EM debt, particularly in Latin America but also beyond.
- In high-yield, we favor higher quality for resiliency across different economic scenarios.
- EM debt in Latin America is particularly compelling, especially Mexico's attractive yields and improving fundamentals.

OPPORTUNITIES WE SEE SPECIFICALLY IN EMERGING MARKETS

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- Investment-grade rated EM debt looks attractive, currently offering 150-200 bps over US Treasuries compared to around 100 bps for US investment-grade.
- Value is being found in frontier markets, also known as "next generation" EM, which were punished during the 2022 Fed rate hikes but still look attractive versus US high-yield fundamentals.
- EM local currency supranationals are a niche opportunity, allowing for EM currency and rate exposure wrapped in a AAA rated security.
- Mexico is attractive due to its high level of yields (overnight rate at 11%, local Treasuries 9.5%-10.5%) combined with moderating inflation of below 4.5%.

THE REGIONS/COUNTRIES WE PARTICULARLY FAVOR

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- Latin America, especially Mexico, is a particularly favored region.
- The incoming administration in Mexico after the summer elections is viewed as likely being a net positive.
- Mexico is also likely to benefit from friend-shoring and supply-chain diversification tailwinds.
- India is a likely beneficiary from supply-chain diversification away from China.
- Other countries like the Dominican Republic and Costa Rica are also potential beneficiaries of friend-shoring trends.

HIGHLIGHTS FROM THE AUDIENCE Q&A

- Regarding the US elections, despite differences in personalities and stances on social issues, there are some consistencies in economic policies from both major candidates. These include a focus on deficit reduction and a tough stance on China. Markets may not react dramatically different to either outcome.
- The European Central Bank (ECB) has been defensive about taking cues from the Fed, stating that it is "data-dependent" not "Fed-dependent." Europe's inflation dynamics and need for stimulus are cited as reasons the ECB may cut rates before the Fed.
- If the ECB and Bank of England (BoE) cut rates while the Fed remains on hold, some of that is likely already priced in given the recent repricing of Fed rate-cut expectations.
- Regarding EM, either potential new US administration is expected to maintain a tough stance on China, benefiting friend-shoring to countries like Mexico, India, the Dominican Republic and Costa Rica.

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