WESTERN ASSET

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Market Commentary

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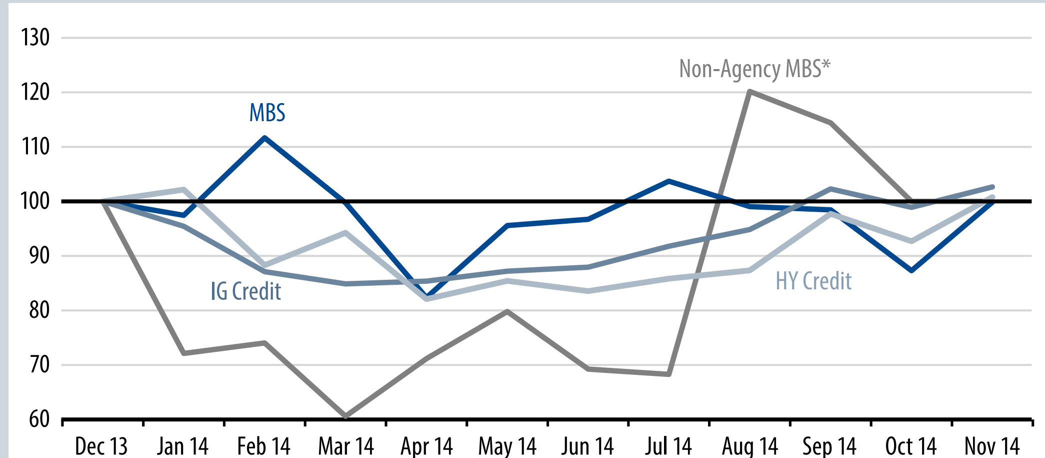
Little by little does the trick. ~Aesop

Our diversified strategies have performed well in 2014 and we believe they are likely to be appropriate in 2015. Global crosscurrents have cut into spread products even as the economic storylines remain favorable. Global inflation is shifting downward and the US dollar is gaining, which is producing a favorable backdrop for US Treasuries (USTs). So, as the US economy continues to improve, even as the Federal Reserve (Fed) inches off its zero-rate policy, we believe combining spread products with the opportunistic use of duration remains compelling.

The US economy continues to grow solidly if unspectacularly, while global growth and inflation have downshifted. In the US, the debate centers on the timing and pace for rate increases by the Fed, while in Europe and Japan, monetary policy is slated to become much more expansionary. The sharp decline in commodity prices, particularly oil, presents meaningful challenges for many emerging markets. But for the developed world, the decline in energy prices should provide a boost to growth.

The global crosscurrents complicate what appears to be a pretty sunny US environment. Indeed, the S&P 500 has hit all-time highs. For fixed-income investors, US spread products have not followed suit. Yield spreads have widened moderately since late June, and are now roughly back to where they started the year.

Exhibit 1
Sector Spreads: Normalized



Beginning of the Year Levels	
Non-Agency MBS*	104.0
MBS	55.4
IG Credit	112.3
HY Credit	428.4

Source: Barclays, Bank of America Merrill Lynch. As of 13 Nov 14
**NAMBS uses the (BAML R0FH Index) YTW over government yield at a point on the fair value curve equal to the workout date. For the other indicies we use the Zero Volatility Spread on the Barclay's MBS, IG Credit, and HY Credit 2% Issuer Capped indicies.*

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For investors in spread products, the benefits for higher yields must be weighed against the challenges of adverse economic events. A constructive investment environment needs elements of attractive valuations, economic growth and supportive liquidity conditions. Liquidity conditions rely on supportive Fed policy, which in turn, relies on benign inflation trends. Our view is that the US now enjoys all three elements. Valuations are attractive as spreads remain somewhat elevated. The US economy should continue to grow at a moderate pace. The Fed, while moving away from the emergency policy engendered by the crisis, intends only to inch the funds rate slowly above zero, a process not expected to begin until the middle of next year. The combination of all these factors strongly suggests spread sectors should outperform USTs.

The risk to this outlook can come from one of two directions, and one important reason for today's elevated spreads is that both are at play. Stronger economic growth, which is traditionally beneficial for spreads sectors, may accelerate the path of Fed interest rate increases. Weaker economic growth, perhaps caused by a more pronounced global downturn, might undermine the recovery picture and cause spread sectors to widen sharply.

The risk from stronger growth was seen in the summer of 2013 as investors learned how challenging a market of both higher interest rates and wider spreads can be. If the pace of the US economy were to accelerate alongside a labor market that shows definitive signs of healing (as it has already), the Fed might move to normalize rates more quickly. This has been the risk investors have focused on for most of this year, keeping durations short to avoid such adverse consequences. Our view is that this is a risk worth running for two reasons. The first and most important is that better growth, while it might bring a Fed-induced widening in the short run, is ultimately not bad for the fundamentals of spread products. Better growth brings declining default rates and higher real asset prices, particularly in housing. A short-term mark-to-market risk should give way to improving fundamentals. Indeed we saw this in the late summer of 2013—after the initial widening of spreads, the market stabilized and subsequently improved.

The second reason is tied to our expectation that the economy and inflation are unlikely to accelerate meaningfully. We have been steadfast in our contention that the path of the US and global recovery would be a long one. We continue to expect the US economy to maintain a roughly 2%–2.5% growth pace. More important, in our view, is the substantial change in the projected path of inflation. Considering how subdued inflation has already been during the post-crisis recovery, the downshift in global growth and the sharp decline in commodity prices suggest an even weaker global inflation picture. (Exhibit 2)

Exhibit 2

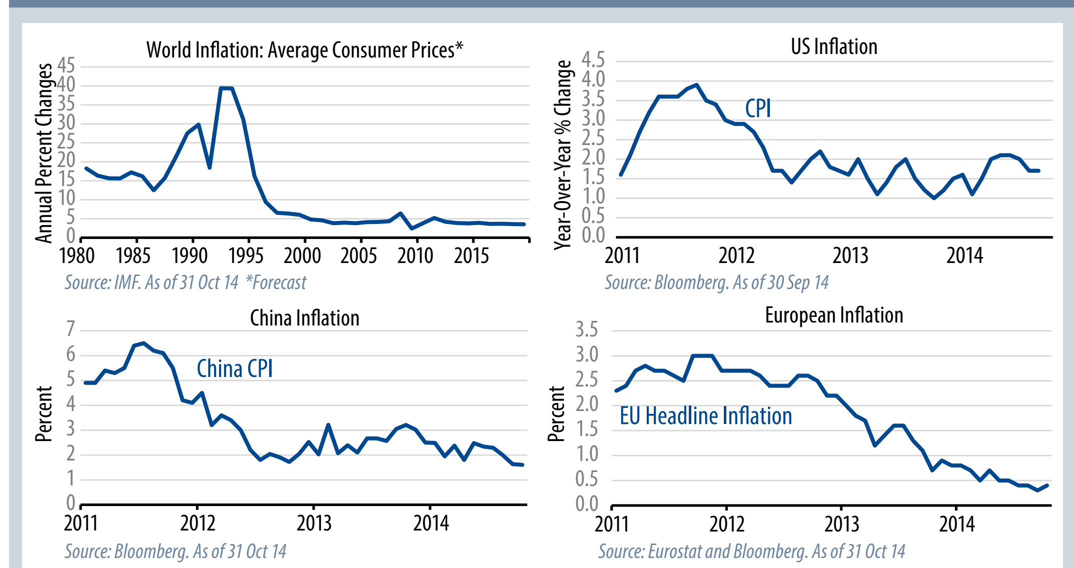

Exhibit 2 shows the trend in global inflation, as well as a breakout of trends in the US, Europe and China. The recent declines in energy and other commodity prices should feed through with a lag, further accentuating the declining trends. In Europe, the European Central Bank (ECB) is wrestling with inflation dropping toward zero. Chinese inflation declined from over 6.5% to under 2%. The US is not immune. A stronger dollar also acts as a strong disinflationary force. Early estimates for 2015 CPI are in the 1% zone.

Over long periods of time, the story of interest rates is simply the story of inflation. We have felt inflation would be slow to return to normal levels in this subpar recovery. Recent developments suggest this timeframe may be even longer, keeping global sovereign bond rates, including USTs, near recent lows. In the absence of inflationary pressure, our view is that a dovish Fed will be very restrained. We still expect them to move the fed funds rate above zero, ending this "emergency" policy rate. But we think it is unlikely they will move faster than the path embedded in the forward UST yield curve.

The bigger risk, in terms of its consequences, would be a downturn in growth. The global recovery continues to be fragile. In early October, investors got a whiff of how quickly the risk-off scenario can return. Fears of slowing growth in both Europe and China led to a rout in risk assets. For spread sector investors, this is the risk that must be examined most acutely. Presently, the greatest source of concern emanates from Europe where much weaker growth has been combined with a swift deterioration in the Russia/Ukraine conflict. Additionally, the softness in commodity prices suggests the meaningful prospect that global demand may be weakening. The previously noted downward inflation trends are a serious concern. As Alan Greenspan once famously said, "the US cannot continue to be an island of prosperity." If the global growth backdrop becomes sufficiently challenging, US risk assets will suffer.

We think investors must be exceptionally attentive to monitoring global risks. But we also think there are meaningful reasons for optimism, and that the tail risks embodied in a global downturn are unlikely to be realized. The global economy has moved a long way since the crisis. While the recovery has only been one of moderate growth, it is still nearly six years old, and the systemic risks have been severely reduced. In addition, monetary policy continues to be very accommodative. The Fed, while moving away from emergency stimulus and eventually raising rates above zero, will still retain an accommodative posture. The ECB, the Bank of Japan, and to a lesser extent, the People's Bank of China will be moving toward greater monetary accommodation. Lower oil prices also act to stimulate global growth. Some estimates suggest an improvement of as much as 0.5%. The low interest rate backdrop is also favorable. Interest rates have declined meaningfully around the globe. These factors could form the base for a more positive growth backdrop next year. But at a minimum, they should support the modest pace of global growth we have seen over the last several years. If this view proves correct, the fears of tail risk scenarios brought about by a steeper decline in global growth should go unrealized.

Our base case is that the US recovery will retain its moderate pace though 2015. We believe the Fed will inch the policy rate above zero but remain in a very accommodative mode. With the extensive monetary accommodation and low international interest rate backdrop, US yields are unlikely to rise substantially. More importantly, the risk case of a shortfall in global growth in such a low inflation context could lead to further rallies in the sovereign bond markets of the US and other developed countries. We continue to lean on the benefits of opportunistically using additional US duration in conjunction with spread assets to provide crucial portfolio ballast.

Diversified strategies are important because forecast errors abound, particularly given the global crosscurrents we currently face. When the base case falls short, strategies that can provide returns and bolster the downside risk are crucial. This year was another constructive example as spread sectors, against a backdrop of favorable valuation, growth, inflation and monetary policy, still widened. The heavy lifting for portfolio

returns had to come from the macro contributions of duration and yield-curve management, in conjunction with the bottom-up contributions of security selection and subsector positioning.

We expect the same approach to be beneficial in 2015. Spread sector valuations are attractive, US growth is solid, inflation is subdued and monetary policy is accommodative. Although the global backdrop will need to be constantly monitored for further weakness, the seeds for better growth—given a favorable policy backdrop and lower energy prices—are being sown. Importantly, low if not falling inflation provides for the continuation of broad-based global accommodative monetary policy.

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