



Thank you for joining Western Asset's *4Q18 Market and Strategy Update* webcast featuring CIO Ken Leech. The presentation will begin shortly.



Ryan Brist



James So

New Q&A: An Update on BBBs

Our new piece examines the recent build-up of BBB rated bonds as it relates to current market anxieties, the decline of the domestic credit market, risk and more.

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4Q Market and Strategy Update

October 25, 2018

Ken Leech
Chief Investment Officer

2019 Outlook

Global growth and inflation will moderate

US growth and inflation will moderate

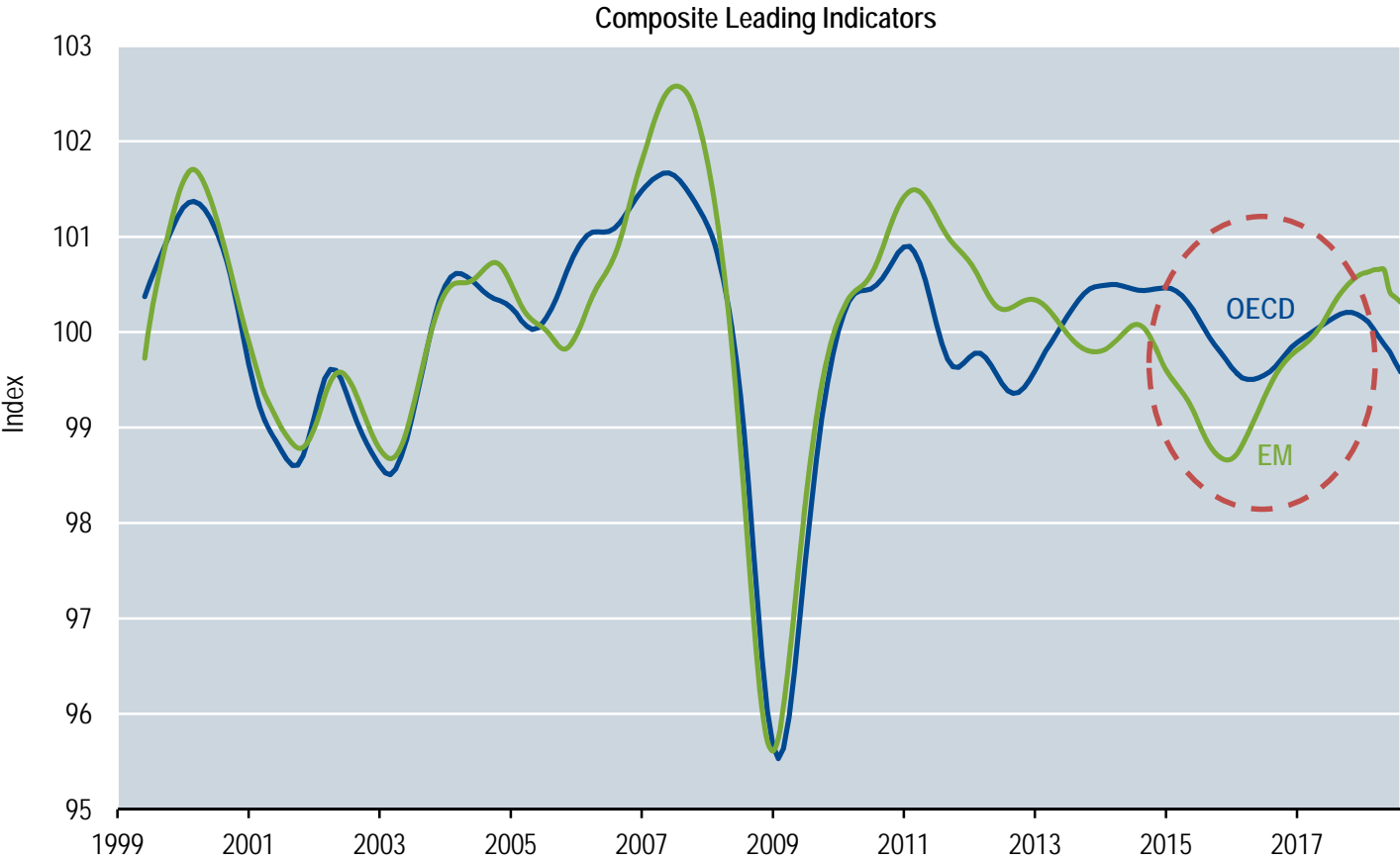
Central bank normalization and communications will increase uncertainty

Trade policy poses substantial risks

Emerging markets, though volatile, should outperform

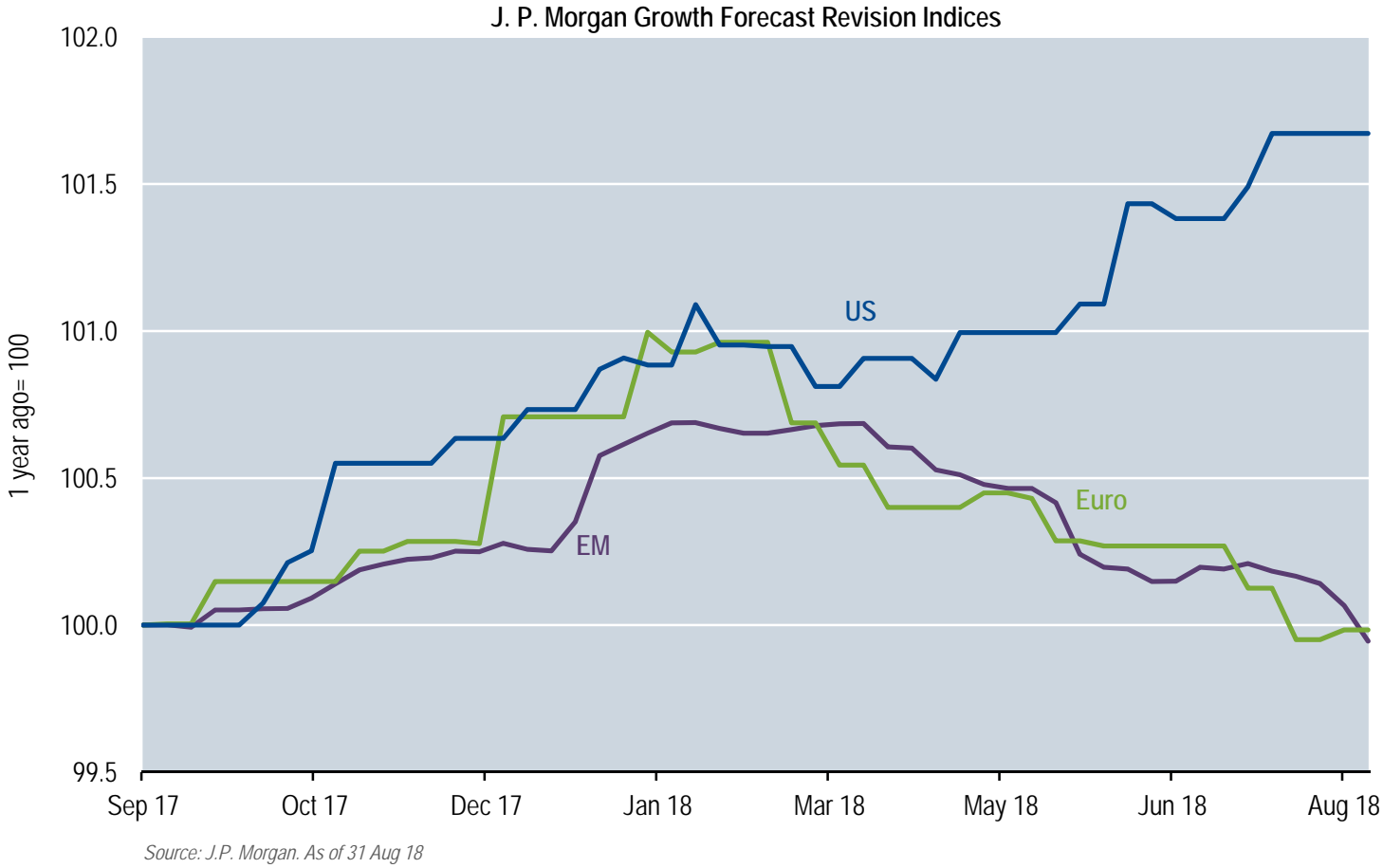
Global Growth

Emerging markets and developed markets growth synchronized?

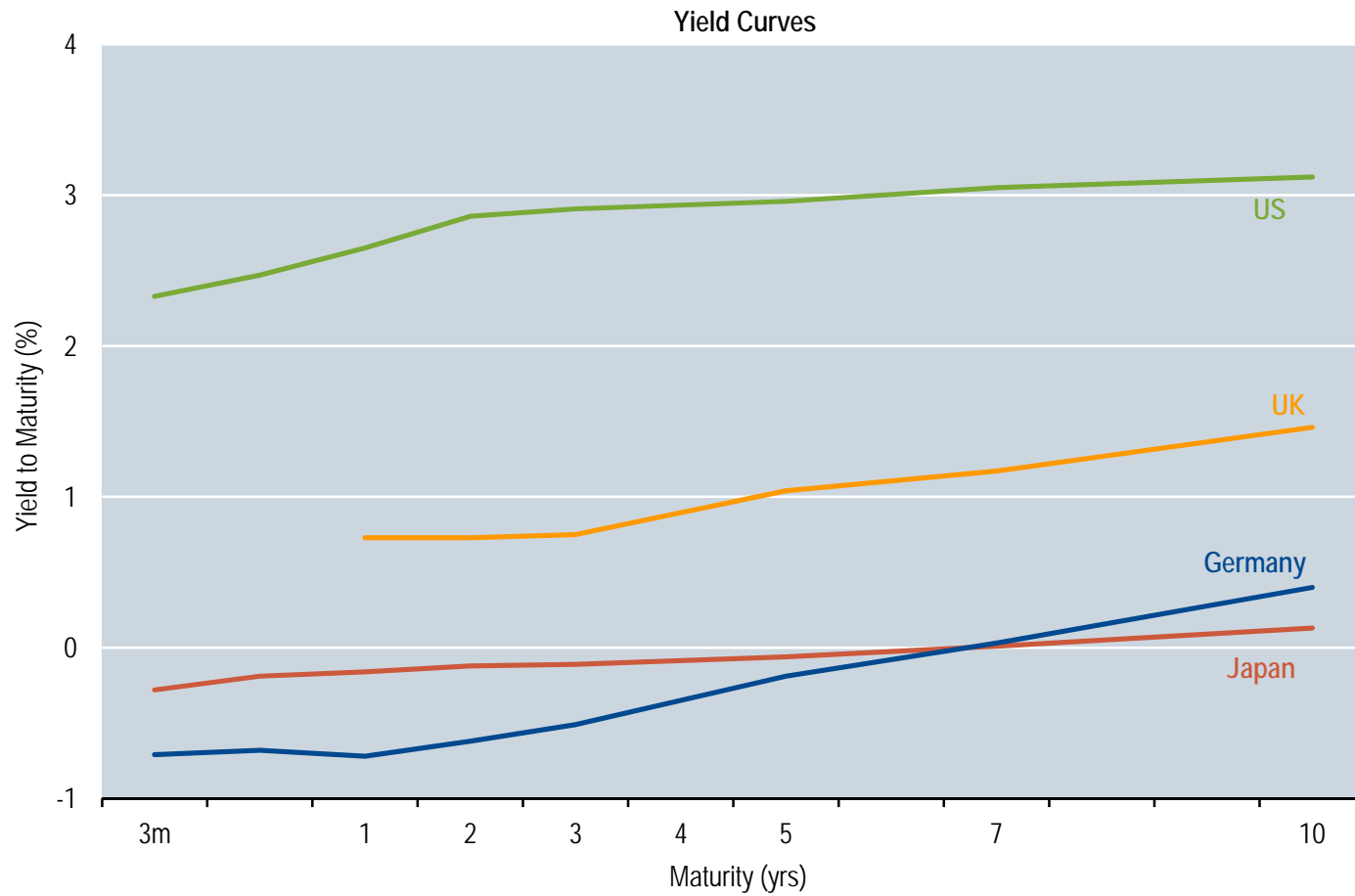


Source: Organisation for Economic Co-operation and Development. As of 31 Aug 18

Growth – Divergence vs. Expectations



US Interest Rates Remain Attractive Relative to Most of the Developed World



Source: Factset. As of 24 Oct 18

“Reflation Trade” vs. “Secular Stagnation”

Global growth moderated and inflation should remain at subdued levels.

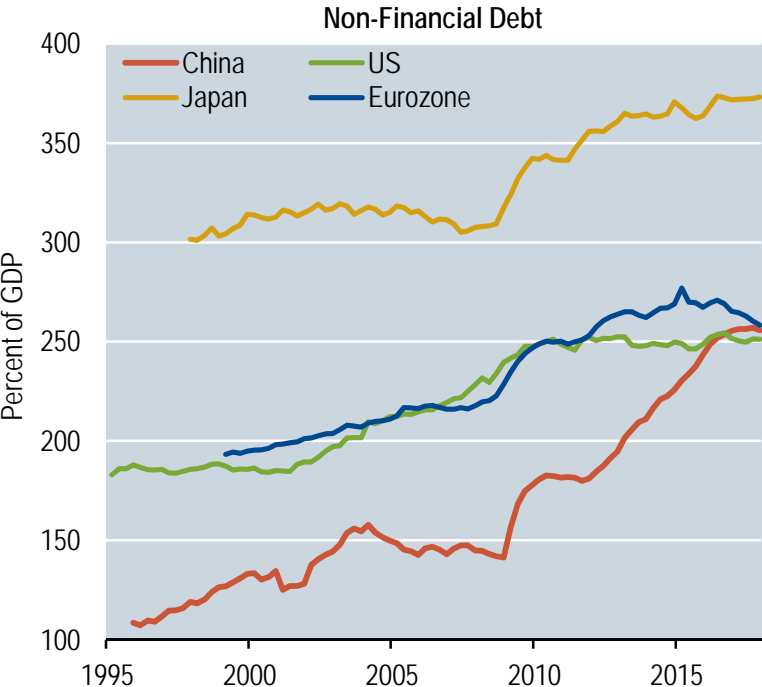


Source: International Monetary Fund. As of 30 Apr 18

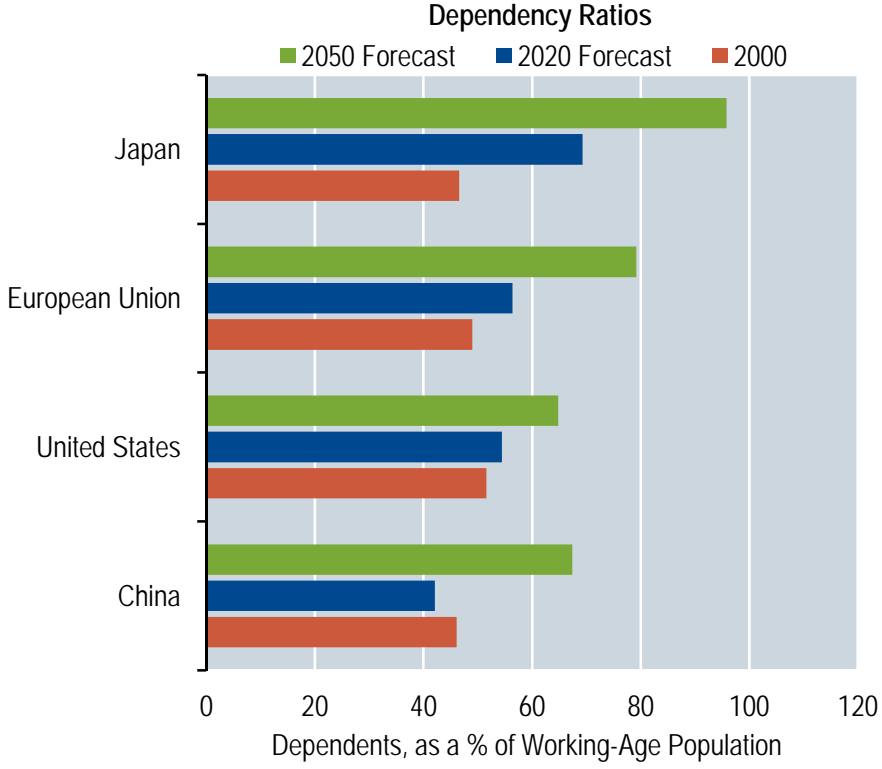


Source: Bloomberg. As of 30 Sep 18

Global Headwinds: Debt and Demographics

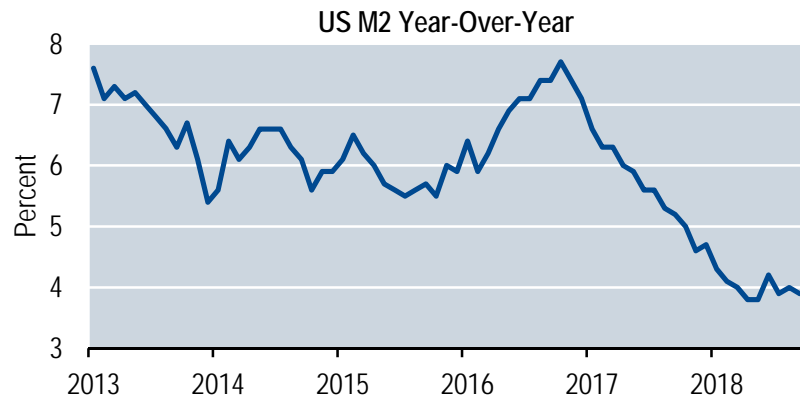


Source: Bank for International Settlements. As of 31 Dec 17



Source: World Bank. As of 30 Jun 17

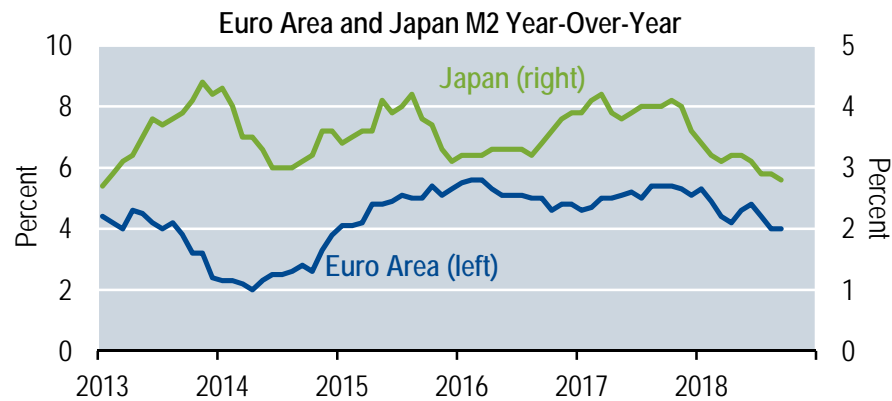
Slowing Money Growth Suggests Low Global Inflation



Source: Bloomberg. As of 30 Sep 18

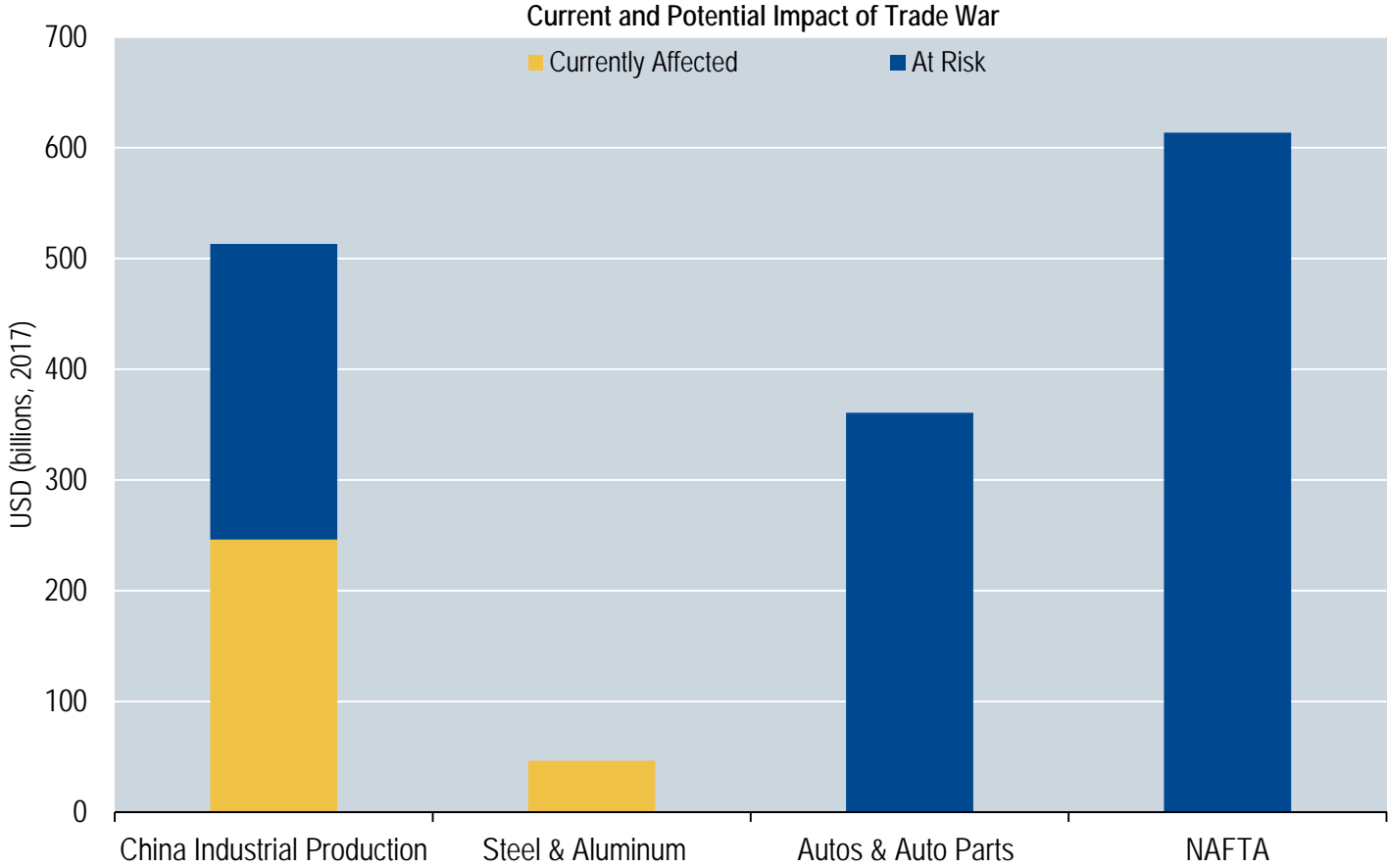


Source: Bloomberg. As of 30 Sep 18



Source: Bloomberg. As of 30 Sep 18

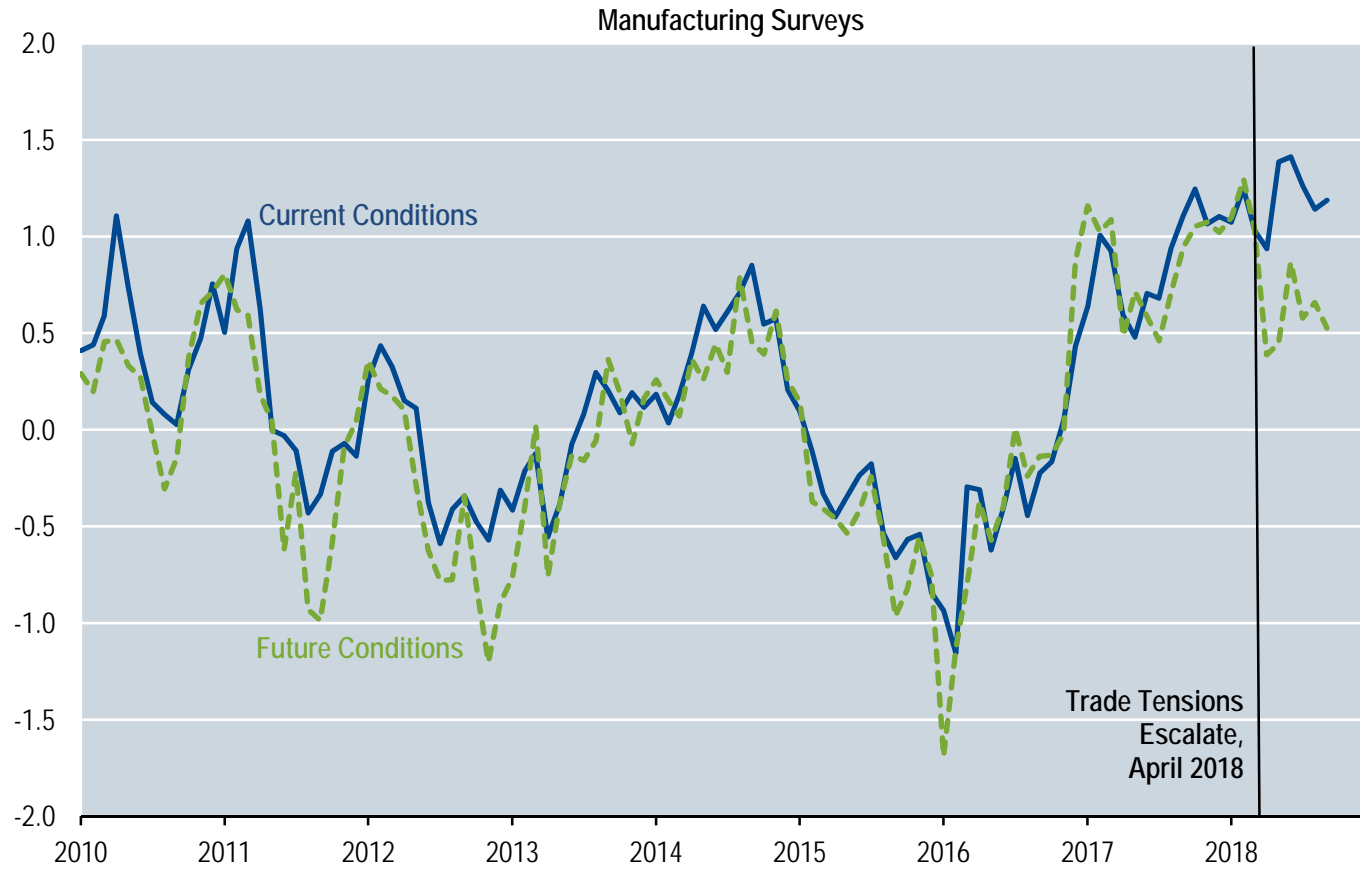
Where Next on Trade?



Source: Nomura. As of 18 Sep 18

Trade Tensions to Weigh on Future Conditions?

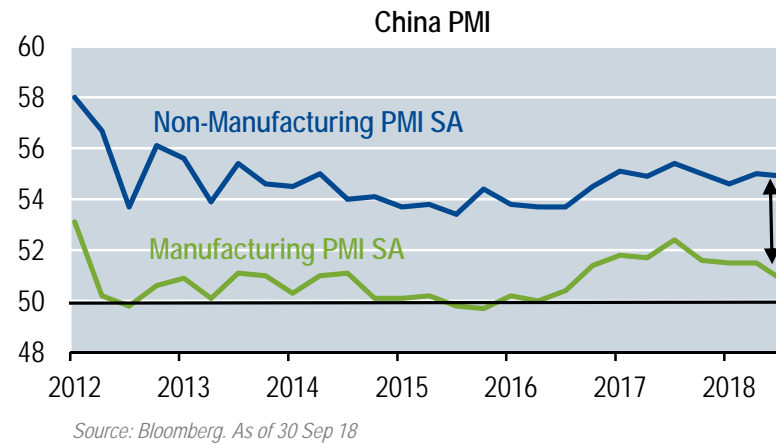
Surveys suggest a divergence in perceptions of current and future conditions, starting in April of this year.



Source: Goldman Sachs. As of 30 Sep 18

Note: Average of ISM, Markit and Empire, Philly, Richmond, Kansas City and Dallas Fed manufacturing surveys, standardized over 2000-present

China: Decelerating Growth and Trade Fears Prompt Policy Easing



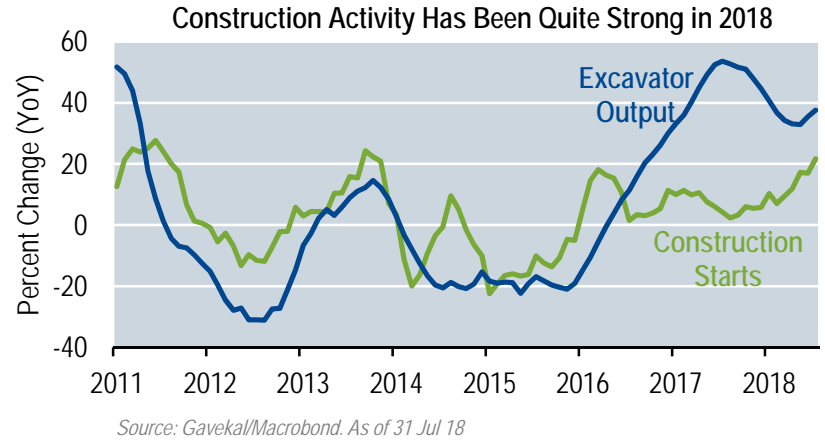
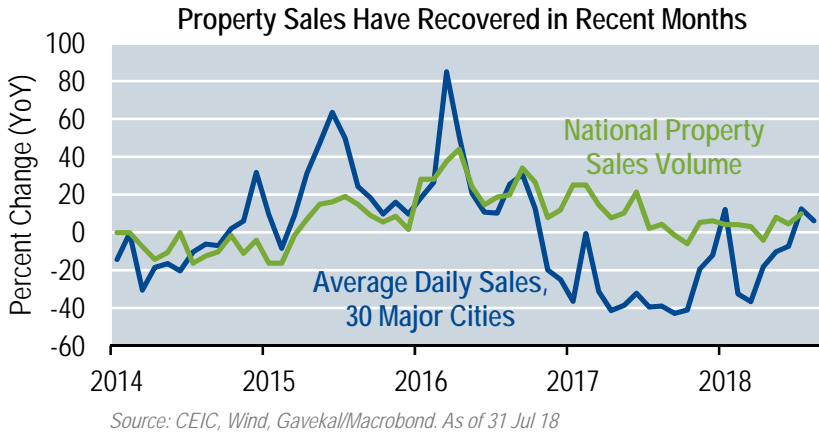
China Stimulus

Girding for potential trade war

Measures include:

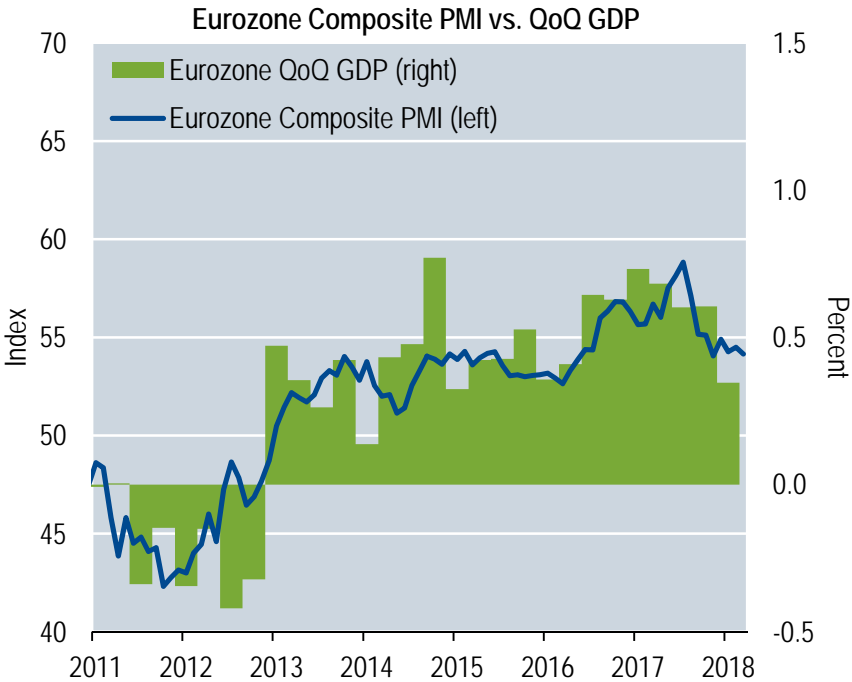
- Interest rate cuts
- Reserve requirement reductions
- Greater lending to private enterprises
- Targeted fiscal spending
- Individual tax cuts

China Easing

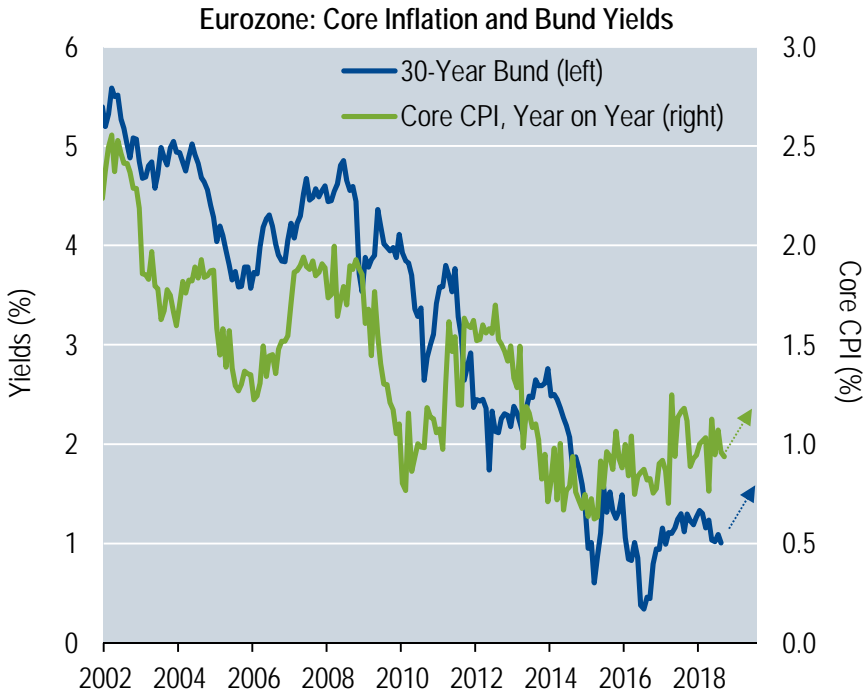


Eurozone Growth & Inflation

European growth remains sturdy; inflation to rise gradually as economic slack diminishes.



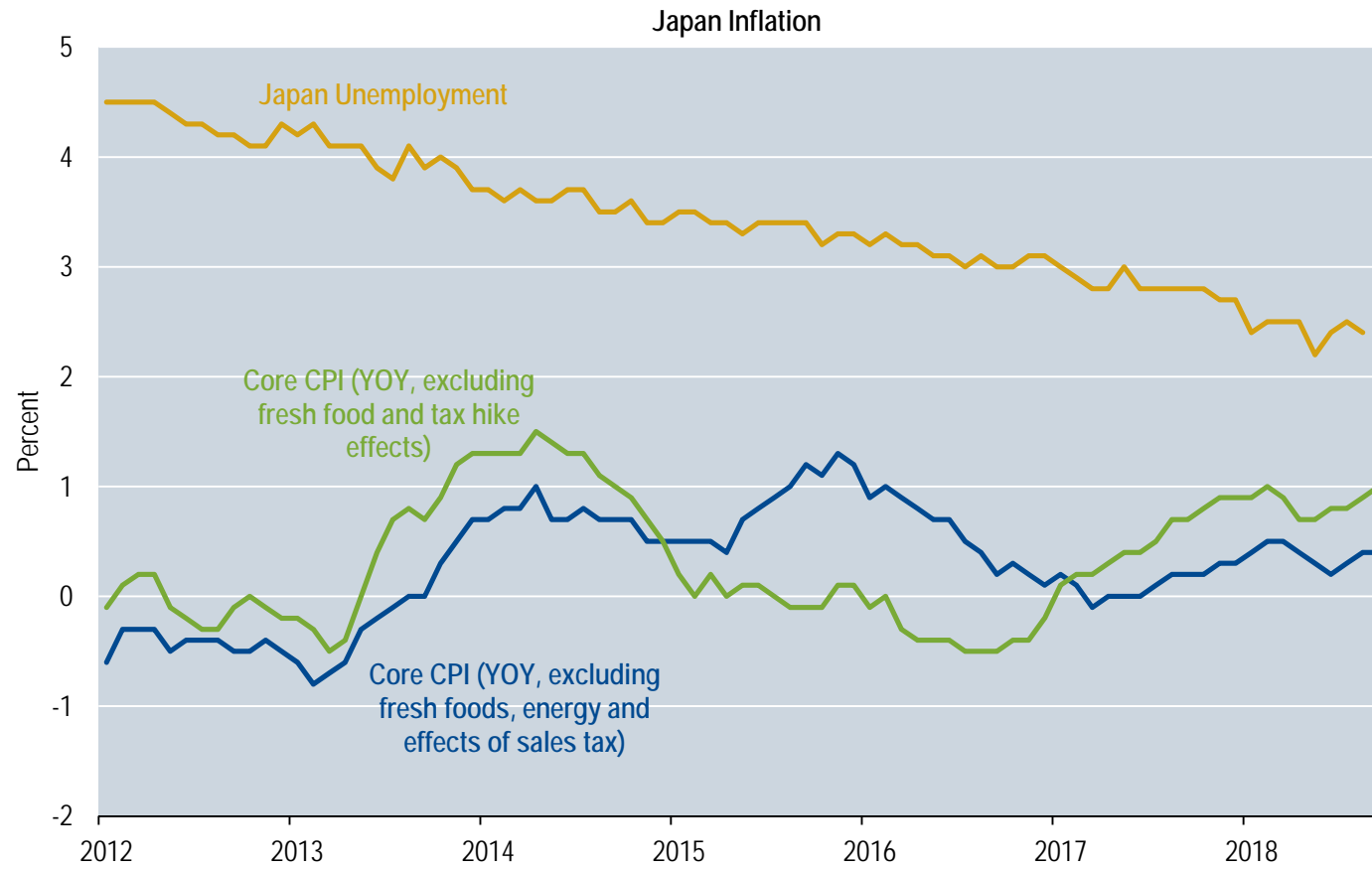
Source: IHS Markit, Haver, Western Asset. As of 30 Sep 18



Source: Bloomberg, Western Asset. As of 30 Sep 18

Japan

The current fiscal and monetary policy mix supports moderate growth.



Source: Datastream, Western Asset. As of 30 Sep 18
*Unemployment rate as of 31 Aug 18

Fed Speak

“But there's — there's really no reason to think that this cycle can't continue for quite some time, effectively indefinitely.”

– Jerome Powell, October 3, 2018

On Neutral Rates

- “Guiding policy by the stars in practice, however, has been quite challenging of late because our best assessments of the location of the stars have been changing significantly.”
– Jerome Powell, August 24, 2018 (Jackson Hole)
- “At times r-star has actually gotten too much attention in commentary about Fed policy...At some point in the future, it will no longer be clear whether interest rates need to go up or down, and explicit forward guidance about the future path of policy will no longer be appropriate,”
– John Williams, President of New York Fed, September 28, 2018

On Inflation

- “The baseline forecasts of most FOMC participants...show unemployment remaining below 4 percent for an extended period, with inflation steady near 2 percent. I have made the case that this forecast is not too good to be true.... Instead, the outlook is consistent with evidence of a very flat Phillips curve and inflation expectations anchored near 2 percent.”
– Jerome Powell, October 2, 2018

On Growth

- “I am pleased to say that, by these measures, the economy looks very good...From the standpoint of our dual mandate, this is a remarkably positive outlook”
– Jerome Powell, October 2, 2018

On Neutral Rates

- “We may go past neutral. But we’re a long way from neutral at this point, probably,”
– Jerome Powell, October 3, 2018
- “My view is our path today is getting us back to normal interest rates or neutral interest rates relatively quickly, over the next year or so”
– John Williams, October 10, 2018

On Inflation

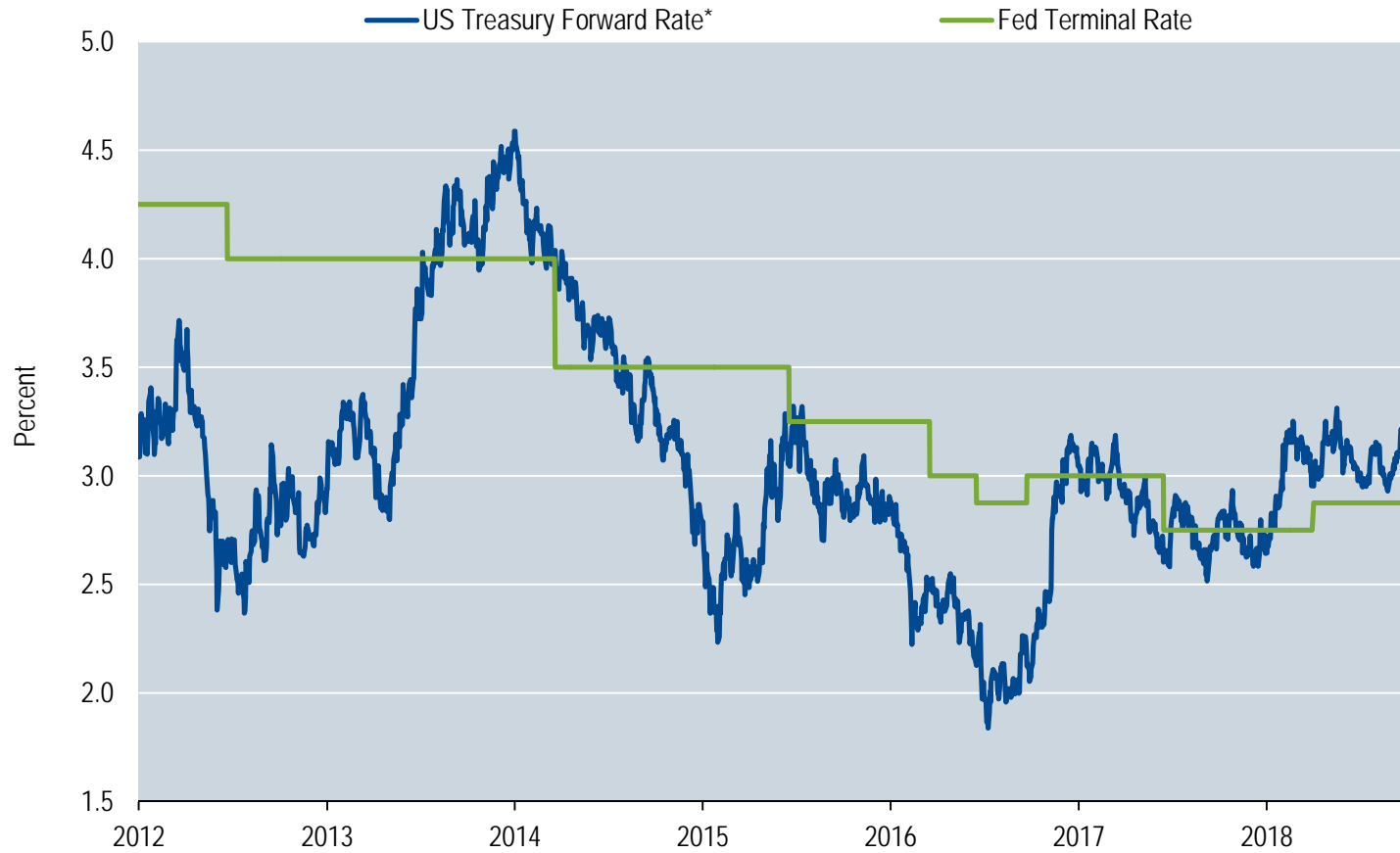
- “That’s why we are gradually raising interest rates. So that we can [address] the possibility that inflation will move up faster than we think and not always be at 2%,”
– Jerome Powell, October 3, 2018

On Growth

- “My take on the economy is well summarized by the most recent FOMC statement, in which we used variations on the word “strong” five times in only four short paragraphs.”
– John Williams, September 28, 2018

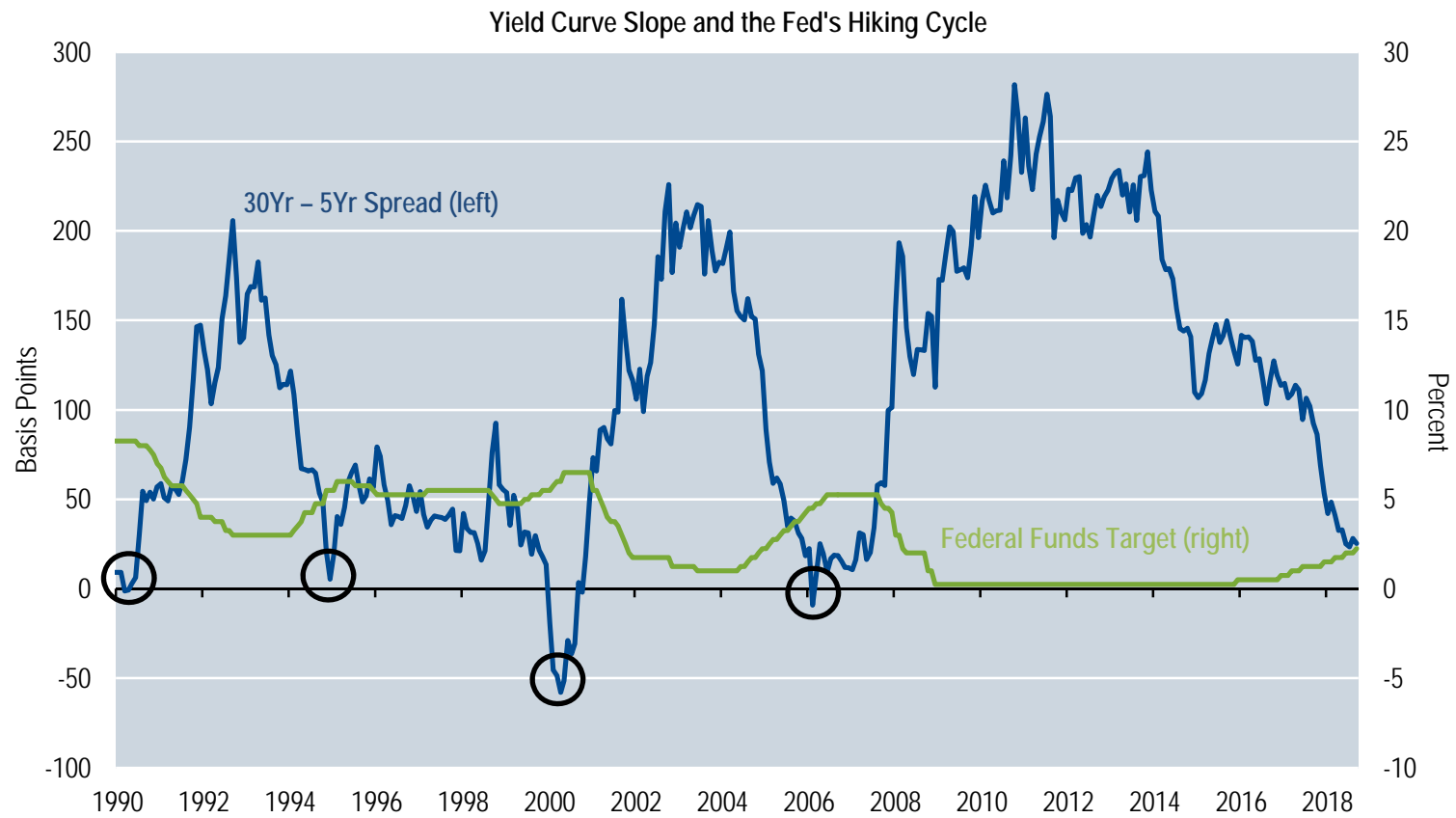
US Interest Rates

Market Priced Above the Federal Reserve Terminal Rate



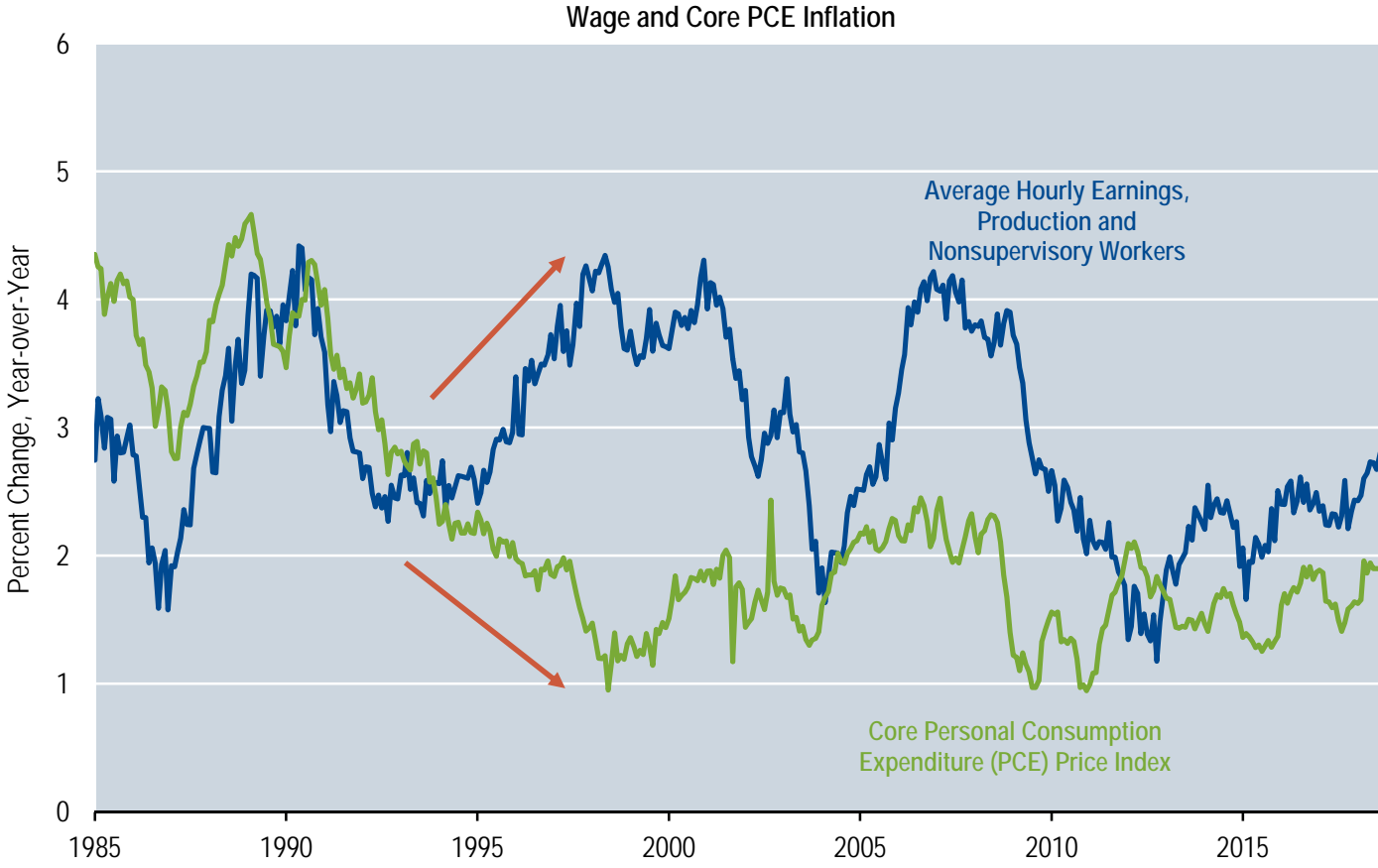
Source: Bloomberg. As of 15 Oct 18
*5 Year/5 Year Forward Rate

US Yield Curve



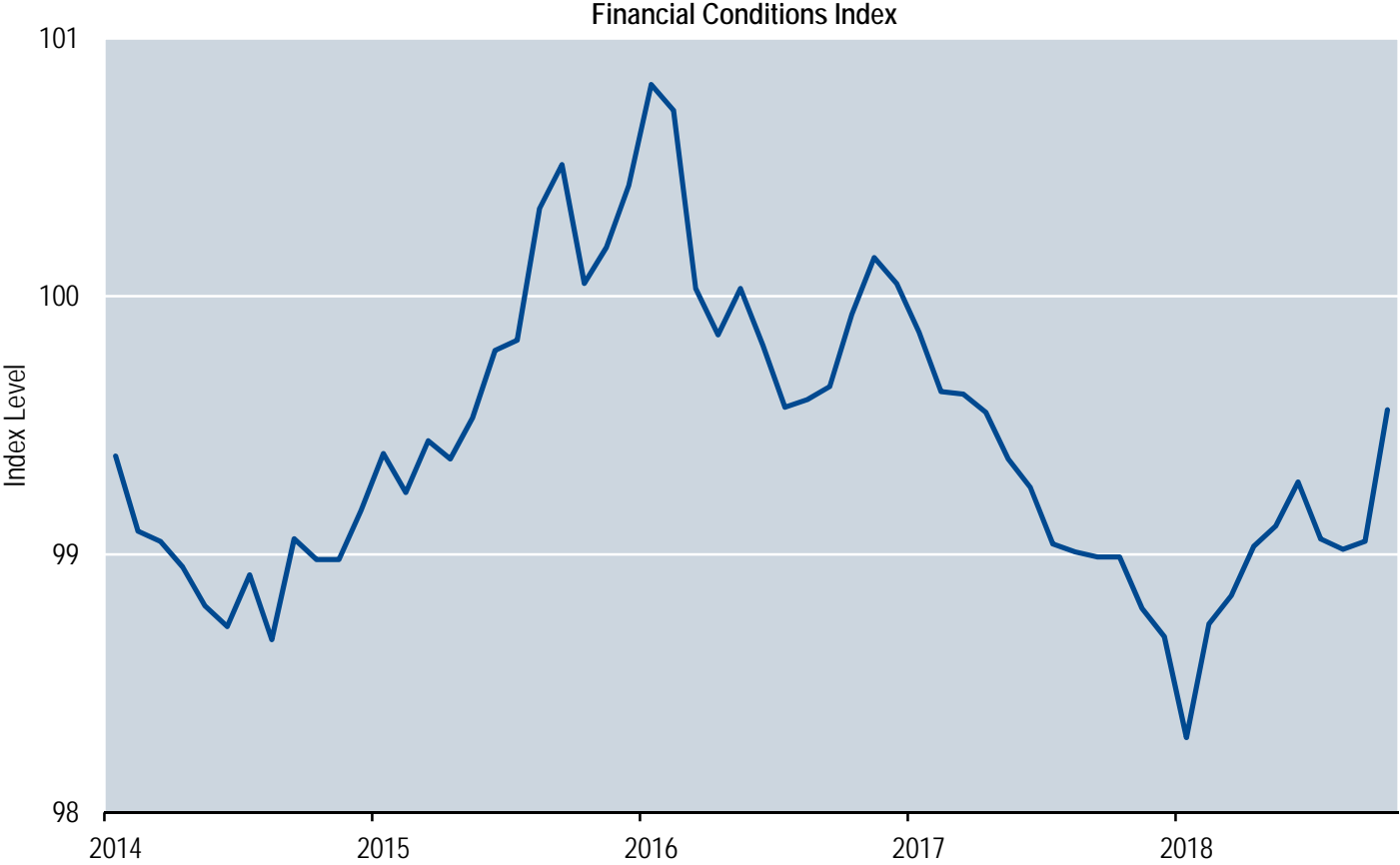
Source: Bloomberg Barclays. As of 28 Sep 18

So Far Wage Pressure Remains Benign



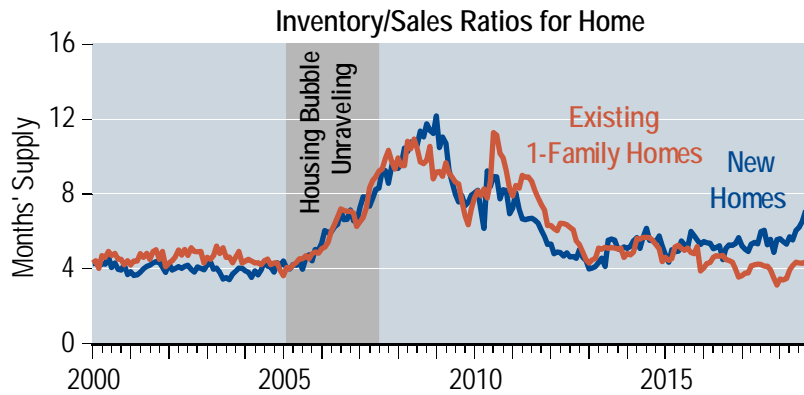
Source: Federal Reserve. As of 31 Aug 18

Financial Conditions Index

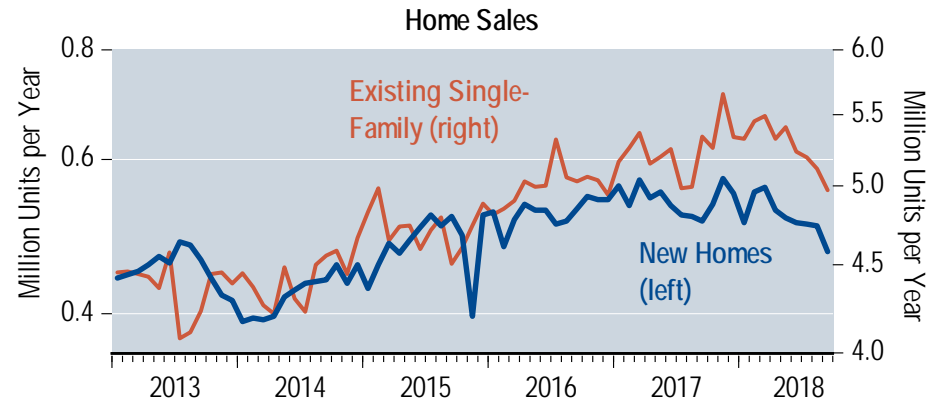


Source: Bloomberg. As of 23 Oct 18

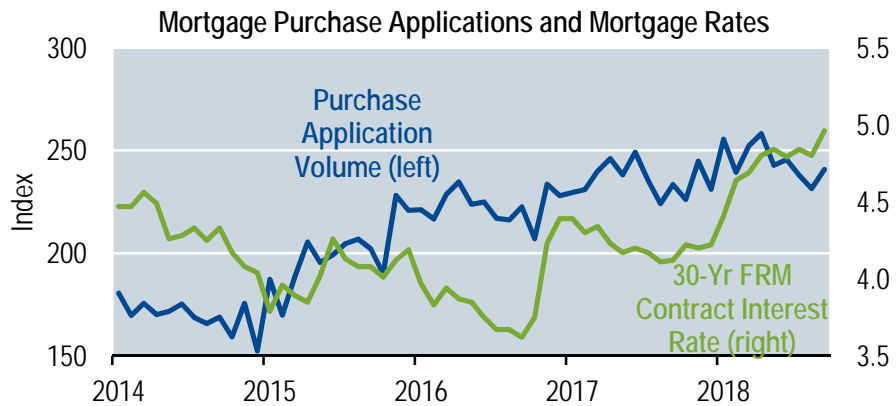
Is Housing Rolling Over?



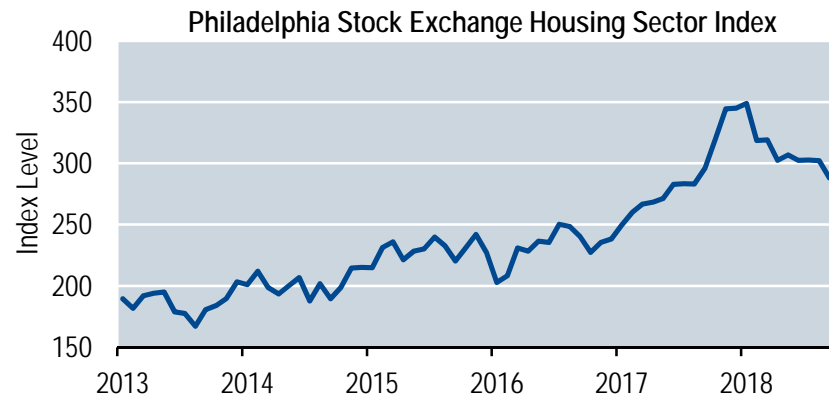
Source: Census Bureau, National Association of Realtors. As of 30 Sep 18



Source: National Association of Realtors, Census Bureau. As of 30 Sep 18



Source: Bloomberg. As of 30 Sep 18

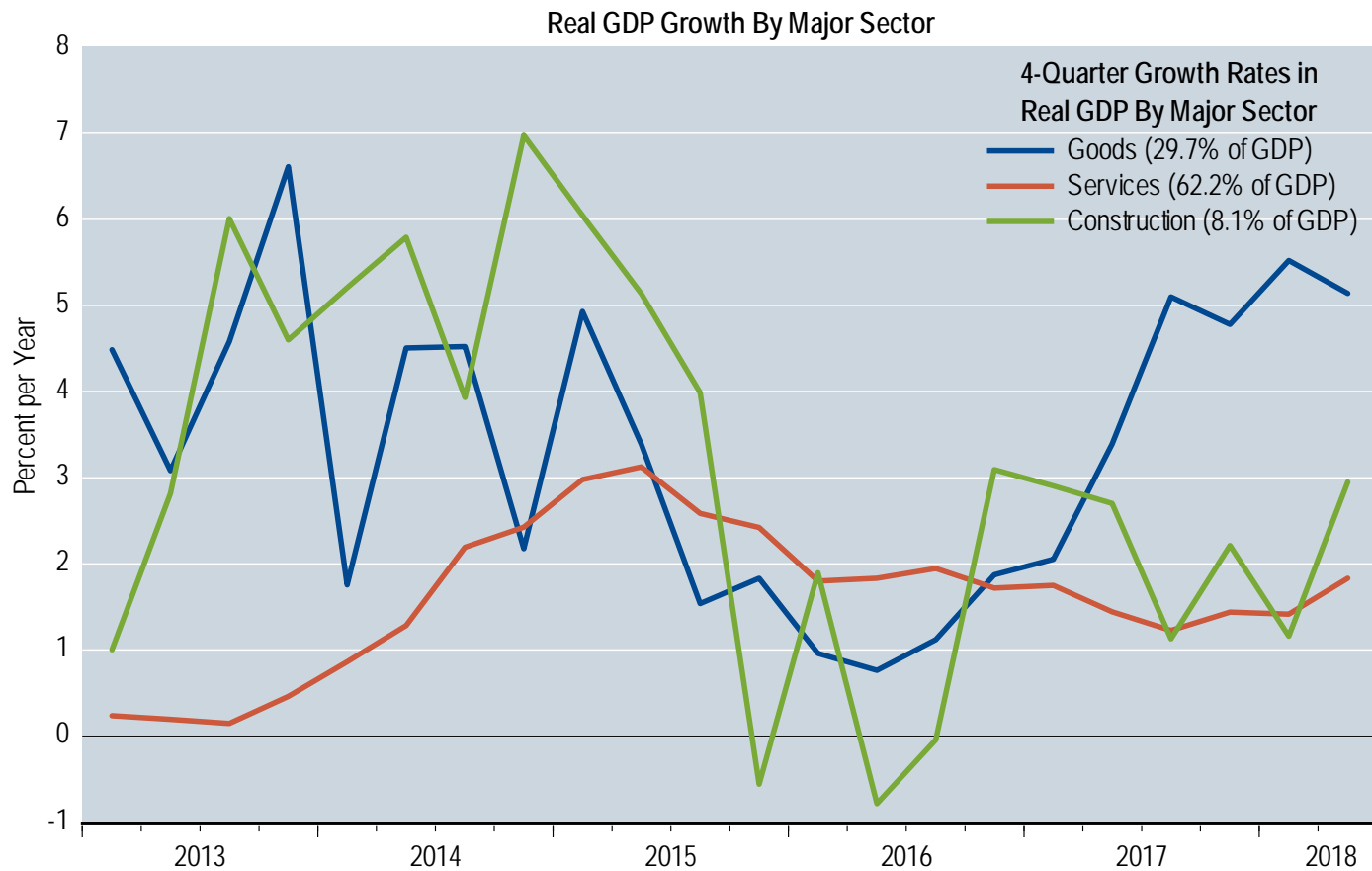


Source: Bloomberg. As of 30 Sep 18

...And It Is Manufacturing That Has Driven Better Recent Growth Rates

Despite the prevalence of the service sector within jobs data, major swings in US GDP growth invariably are driven by the goods sector in general and manufacturing in particular

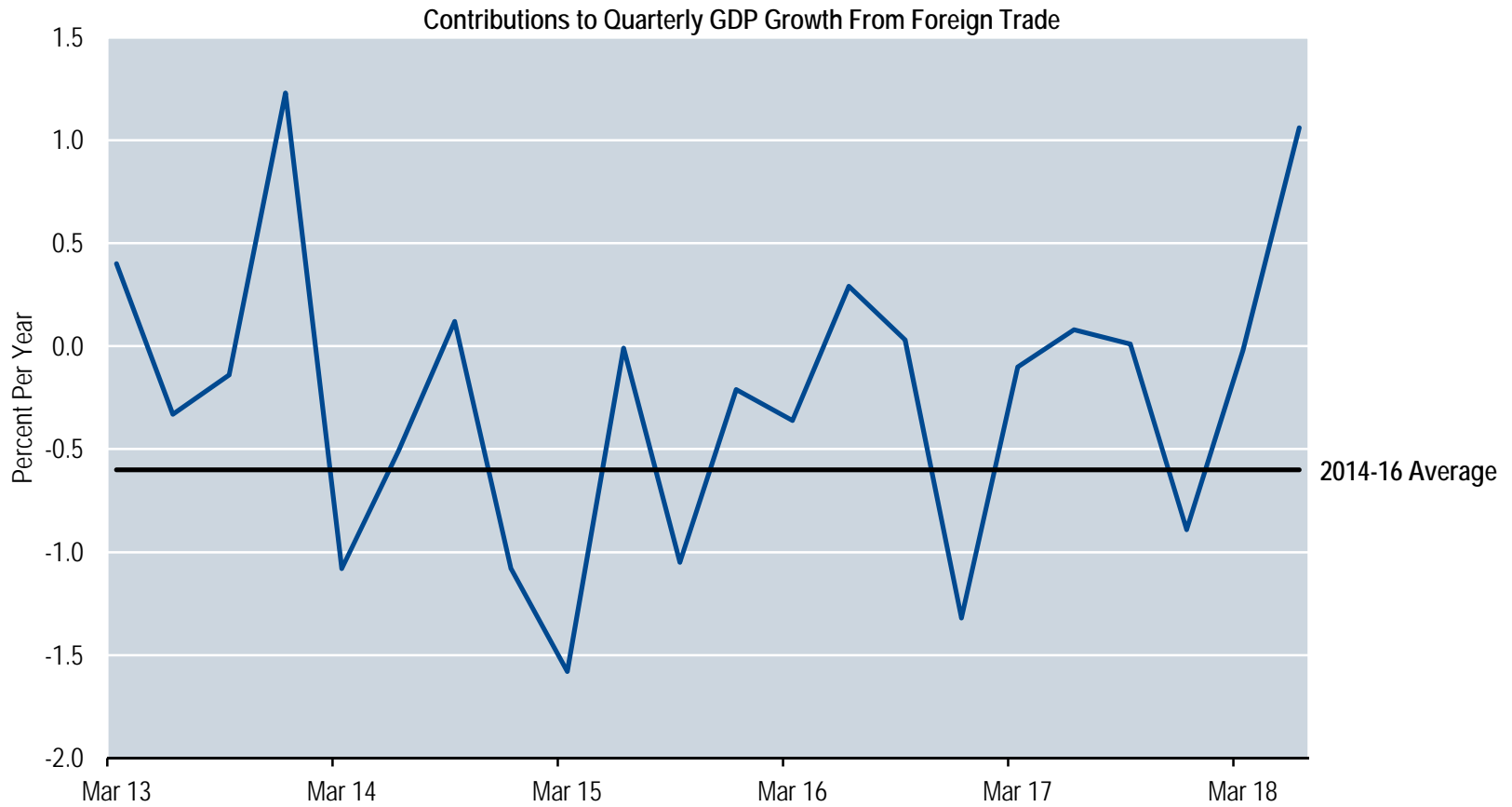
The recent spate of better GDP growth is no exception



Source: Bureau of Economic Analysis. As of 30 Jun 18

Contributions to Quarterly GDP Growth From Foreign Trade

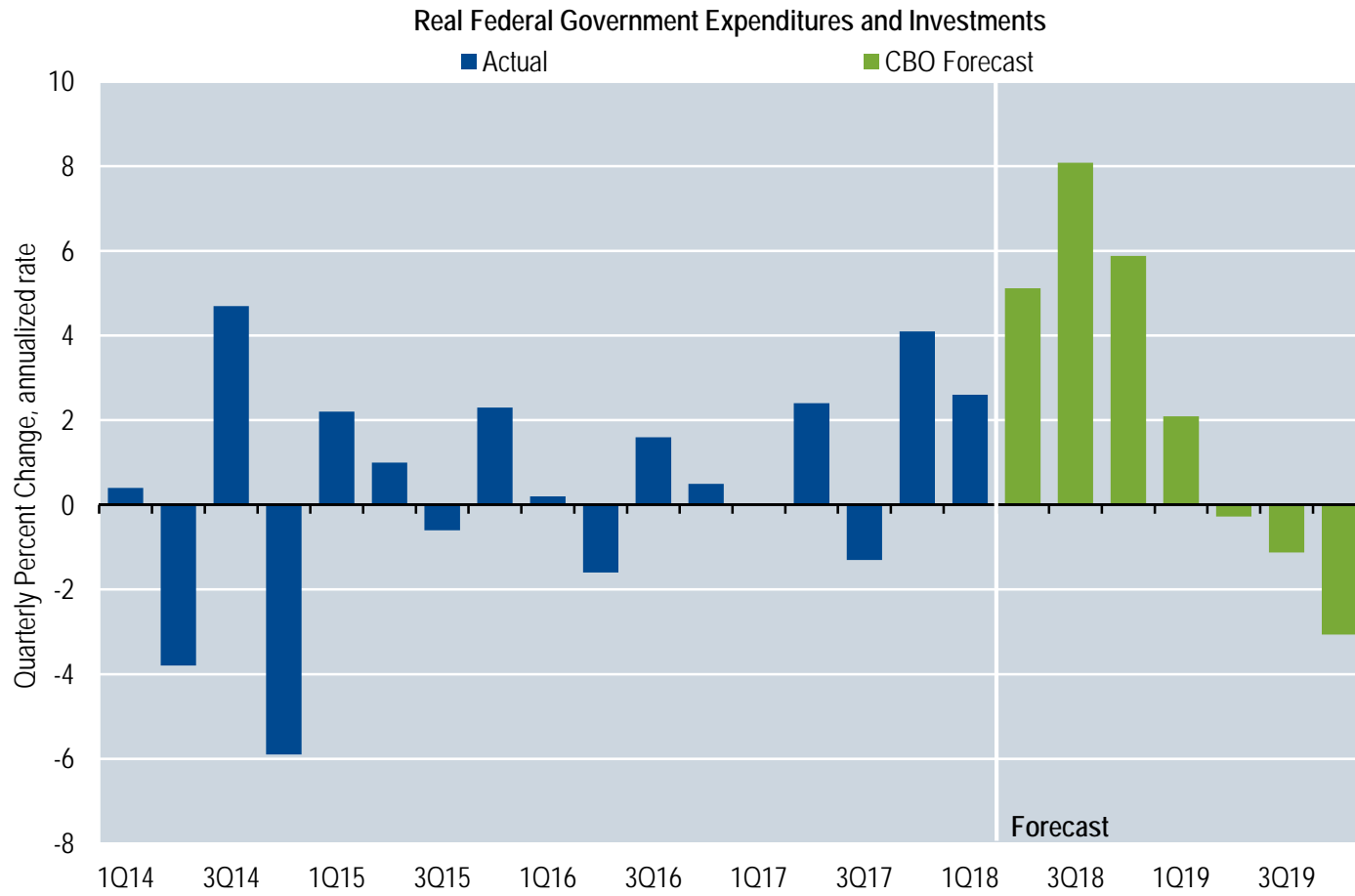
GDP upturn was in 2Q17, 3Q17 and 2Q18, exactly the quarters where foreign trade contributed positively to growth.



Source: Bureau of Economic Analysis. As of 30 Jun 18

US Fiscal Impulse

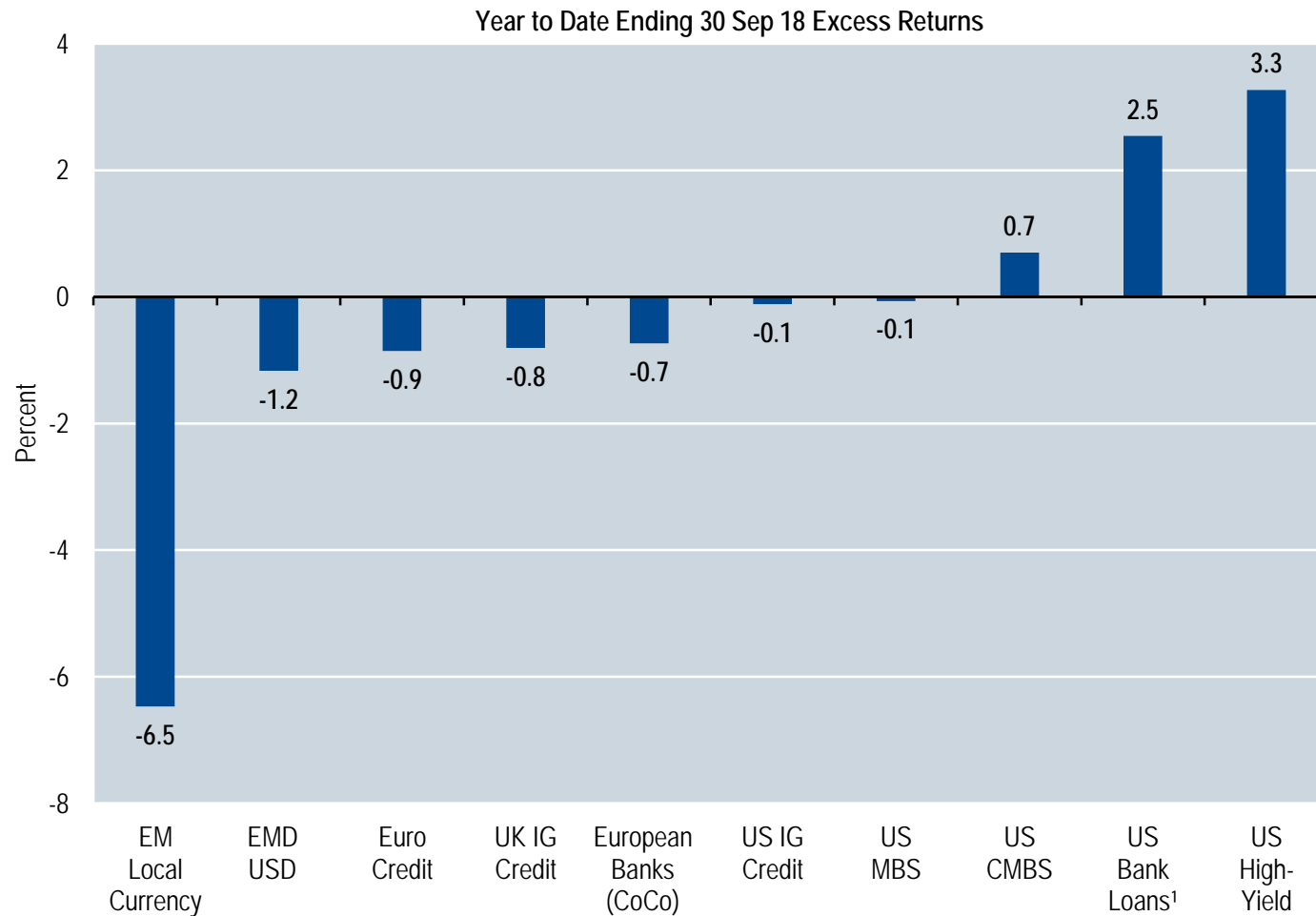
Federal purchases to peak by early 2019



Source: Census Bureau, Congressional Budget Office. As of 16 Aug 18

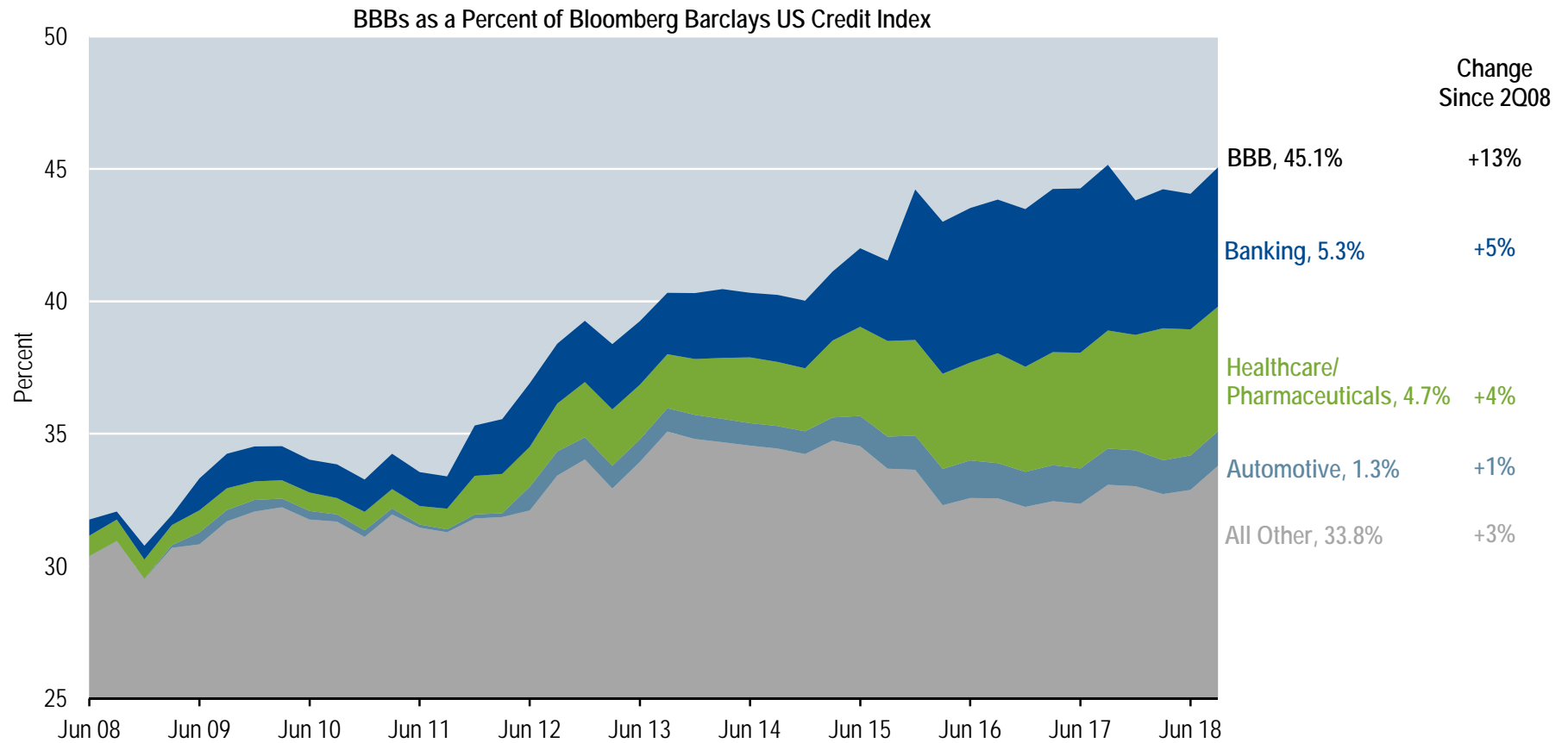
Spread Sector Divergence

The US has generally held up over the first half of 2018 while the rest of the world has been more challenged.



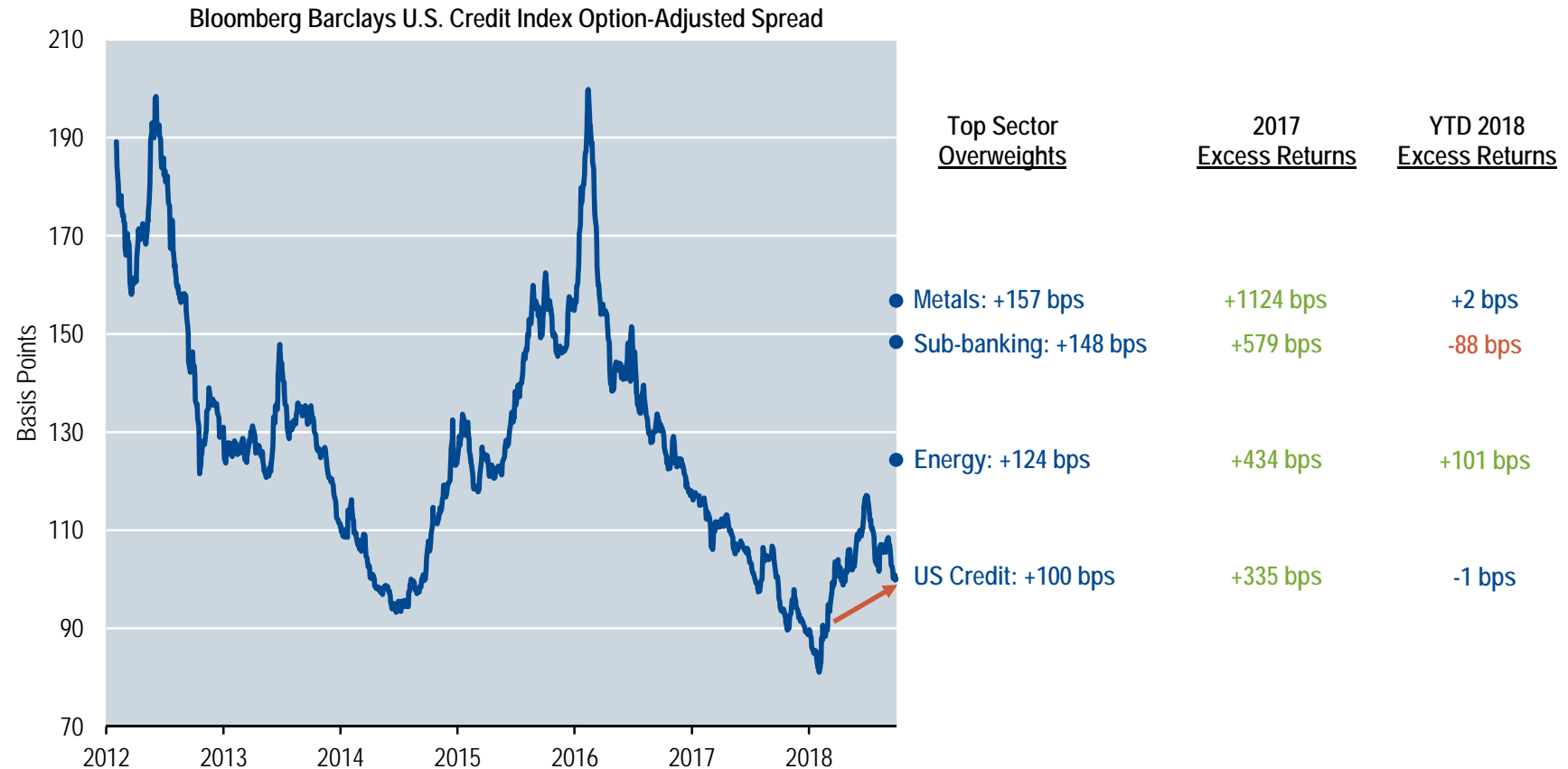
Source: Bloomberg Barclays, J.P. Morgan, S&P Global Market Intelligence, a division of S&P Global Inc, Western Asset. As of 30 Sep 18
¹S&P/LSTA Performing Loans Index excess return vs. 3-Month LIBOR

Hot Topic: Growth in BBBs and Fears of Large Future “Fallen Angels”



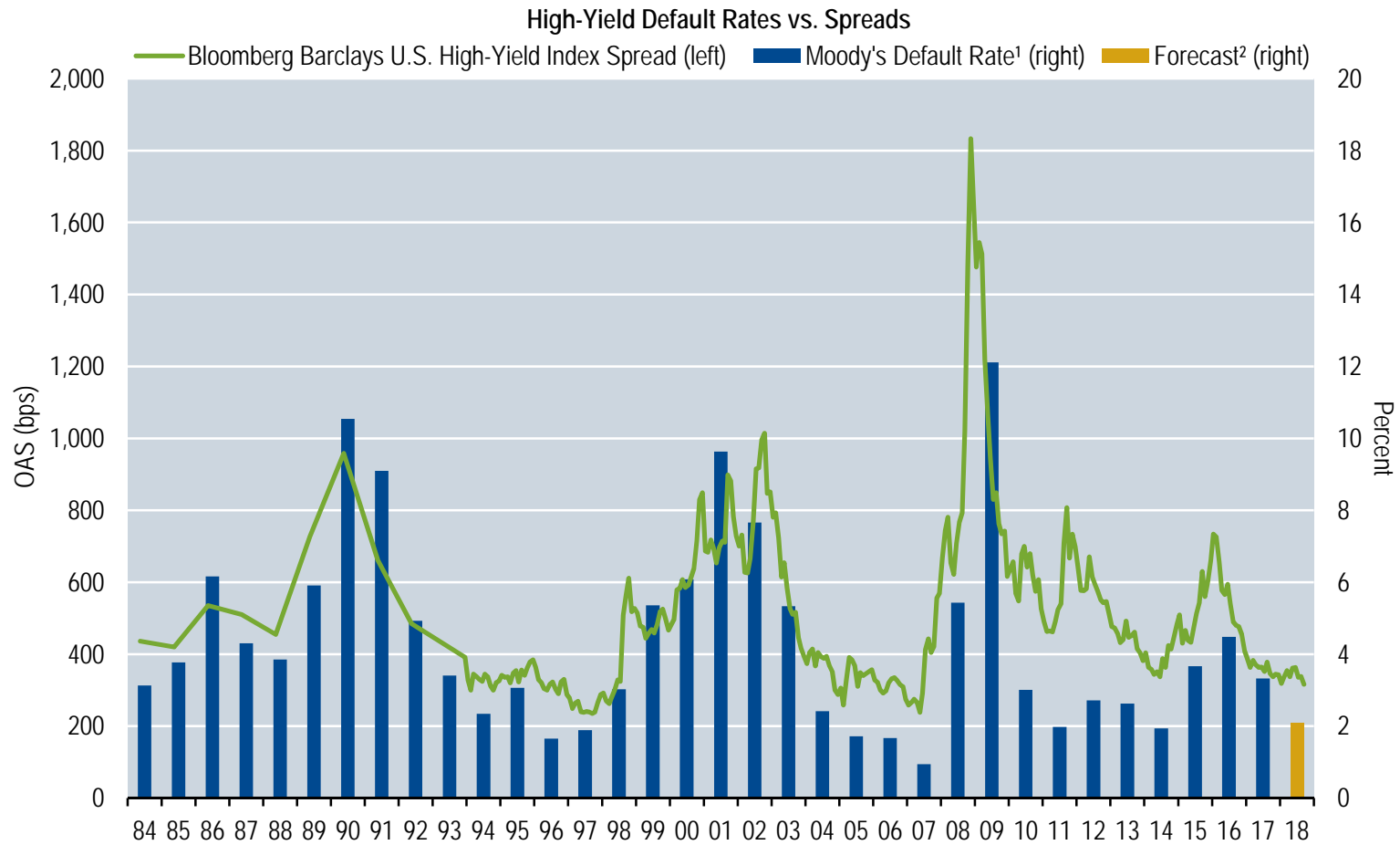
Investment-Grade Credit

Spreads 11 bps wider year to date. "Two steps forward...two steps back." Valuations "just OK."



Source: Bloomberg Barclays. As of 30 Sep 18

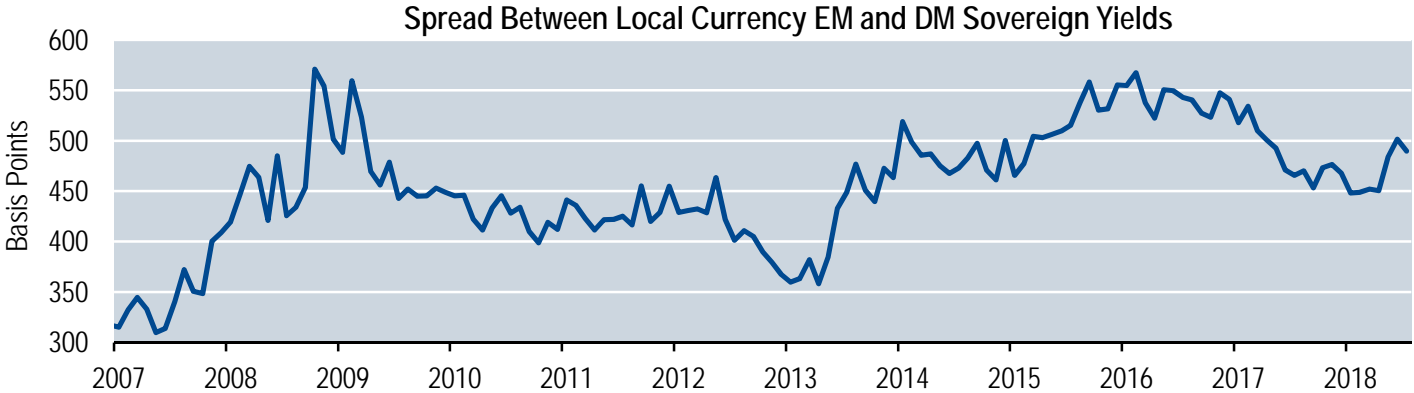
After the Energy-Fueled Spike the Default Rate Is Declining Sharply



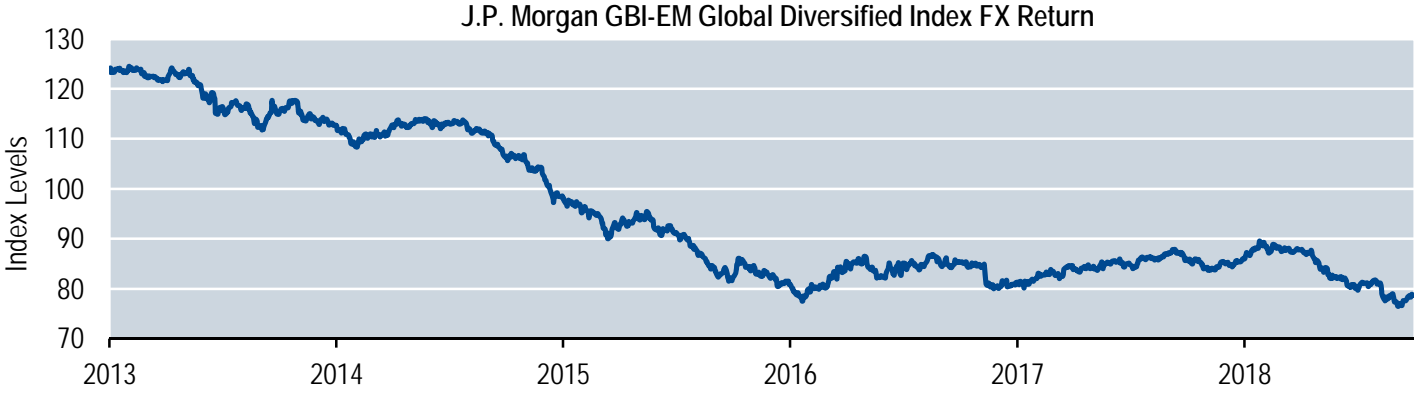
Source: Moody's, Bloomberg Barclays, Western Asset. As of 30 Sep 18
¹Moody's Trailing 12-Month Issuer-Weighted Spec-Grade Default Rate
²Moody's baseline forecast for 31 Dec 18 as of 31 Aug 18

Emerging Markets

Emerging markets valuations look attractive both on a historical basis and relative to developed markets.

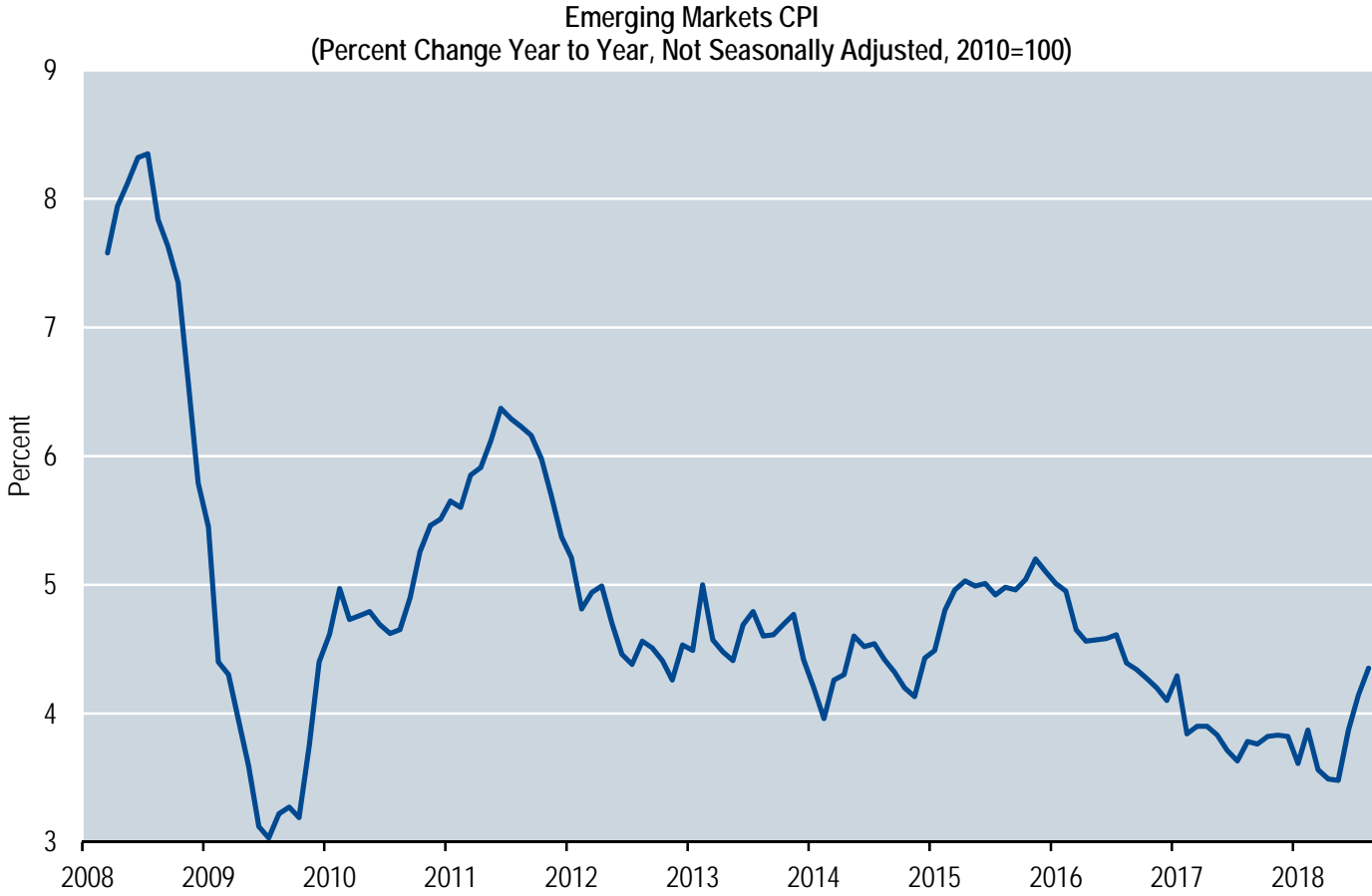


Source: J.P. Morgan. As of 28 Sep 18



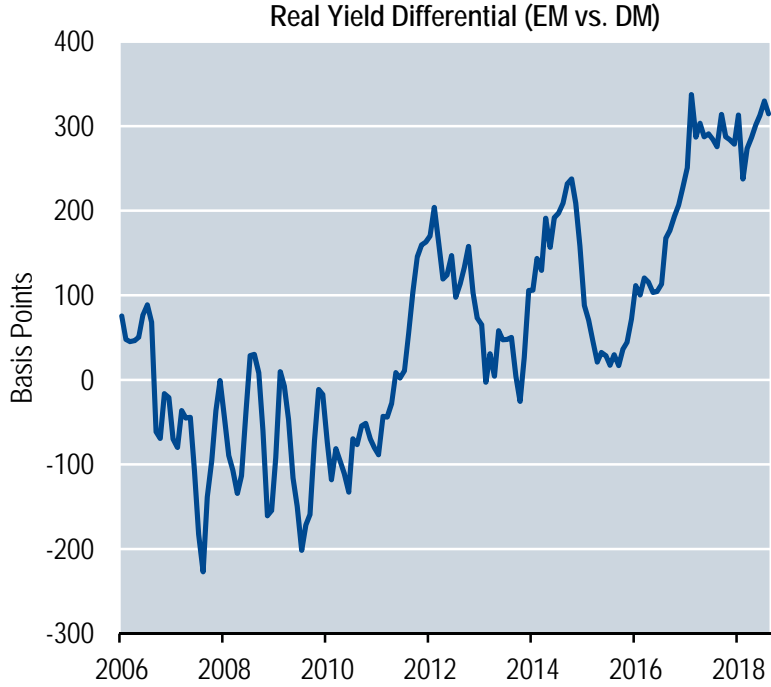
Source: J.P. Morgan, Bloomberg. As of 01 Oct 18

Emerging Markets Inflation Remains Remarkably Subdued

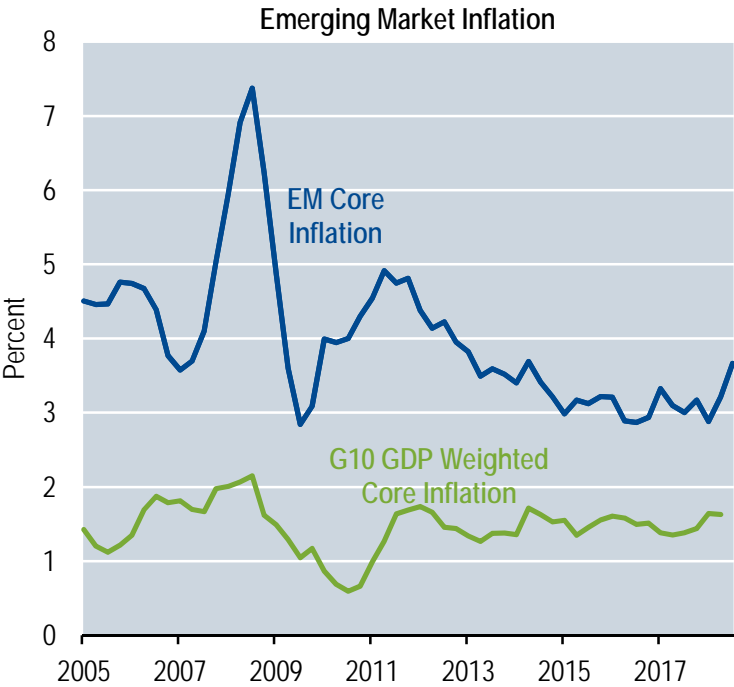


Source: Haver. As of 31 Aug 18

Real Yield Differential and Core Inflation Rates for Emerging and Developed Markets



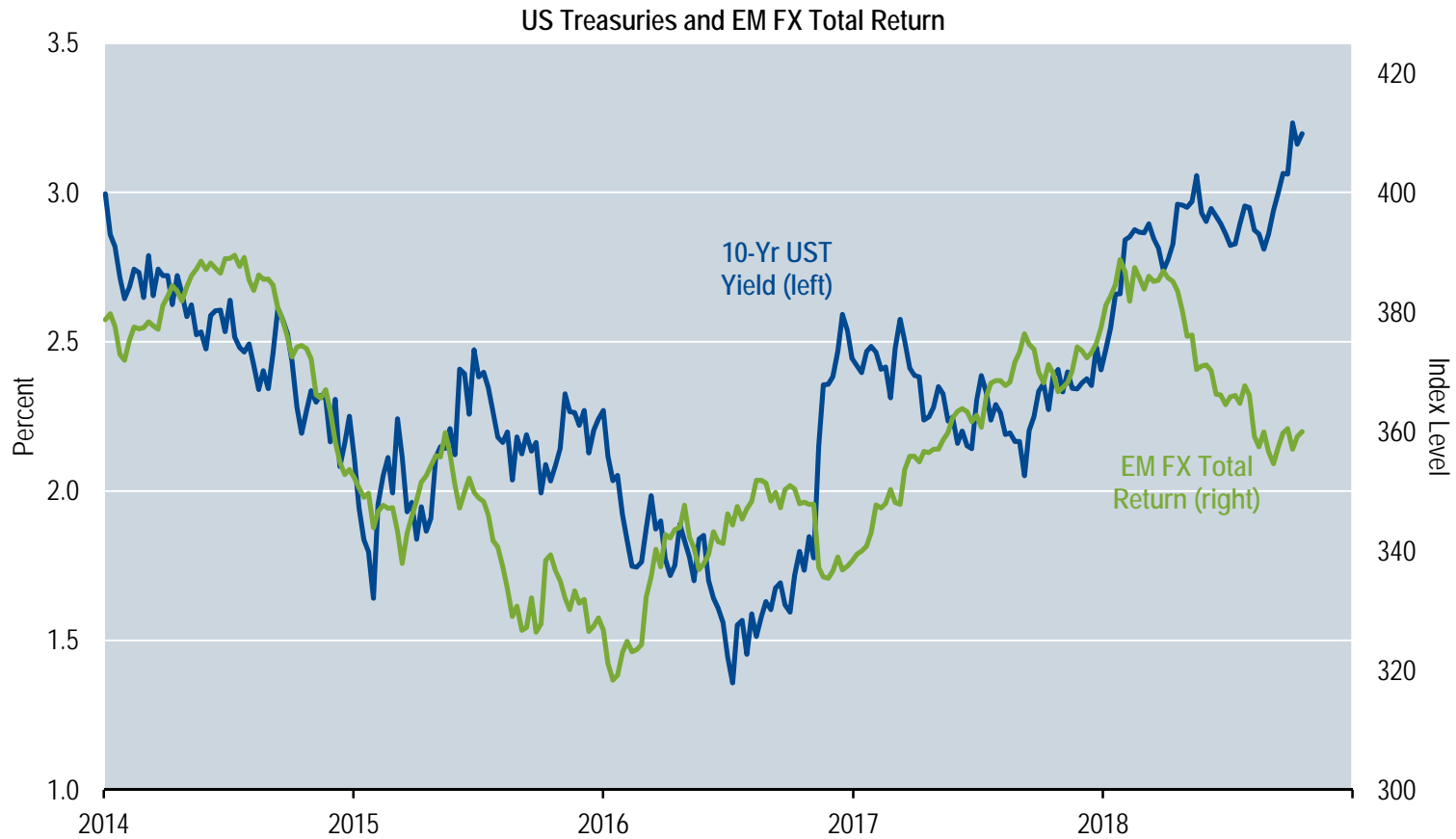
Source: Bloomberg, HSBC. As of 31 Aug 18



Source: J.P. Morgan. As of 30 Sep 18
 *G10 GDP Weighted Core Inflation updated through 30 Jun 18

US Treasuries as a Diversifier

US Treasuries have not been a diversifier for EM this year, but had been a very effective diversifier in previous years.



Source: Bloomberg, J.P. Morgan. As of 19 Oct 18

2019 Outlook

Global growth and inflation will moderate

US growth and inflation will moderate

Central bank normalization and communications will increase uncertainty

Trade policy poses substantial risks

Emerging markets, though volatile, should outperform

Questions & Answers



Thank you

Risk Disclosure

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