



Thank you for joining Western Asset's *2019 Market and Strategy Update* webcast featuring CIO Ken Leech. The presentation will begin shortly.

UPCOMING EVENT



**2019 Milken Institute Global Conference**  
Deputy CIO Michael Buchanan and Global Head of ESG Investments Bonnie Wongtrakool will both present at the event.

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# 2Q19 Market and Strategy Update

April 4, 2019

Ken Leech  
Chief Investment Officer

## 2019 Outlook

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Global growth has downshifted but should remain sturdy

US growth and inflation to moderate

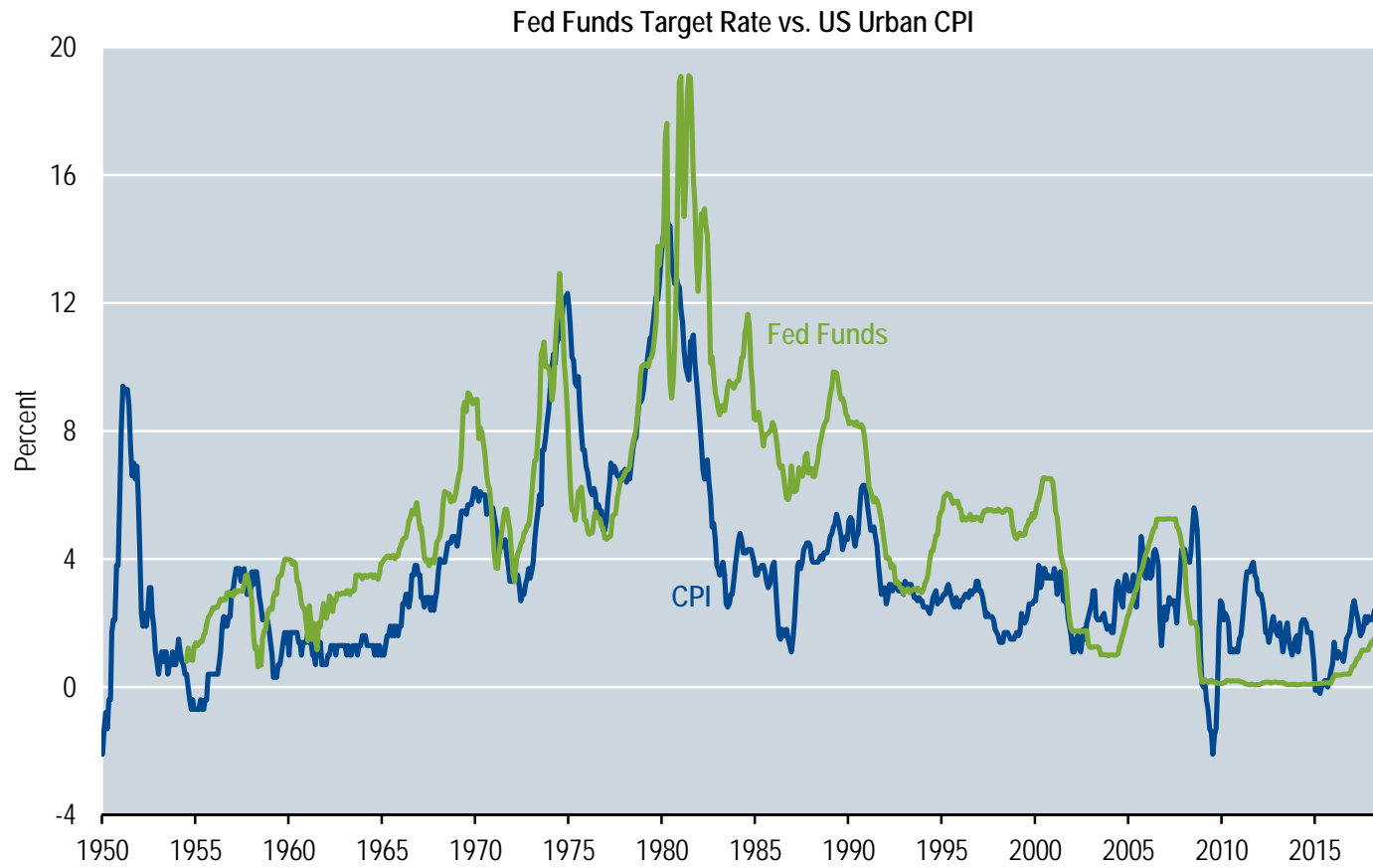
Central bank policy will be focused on accommodation

Trade policy poses substantial risks

Spread products should recover relative to Treasuries and sovereign bonds

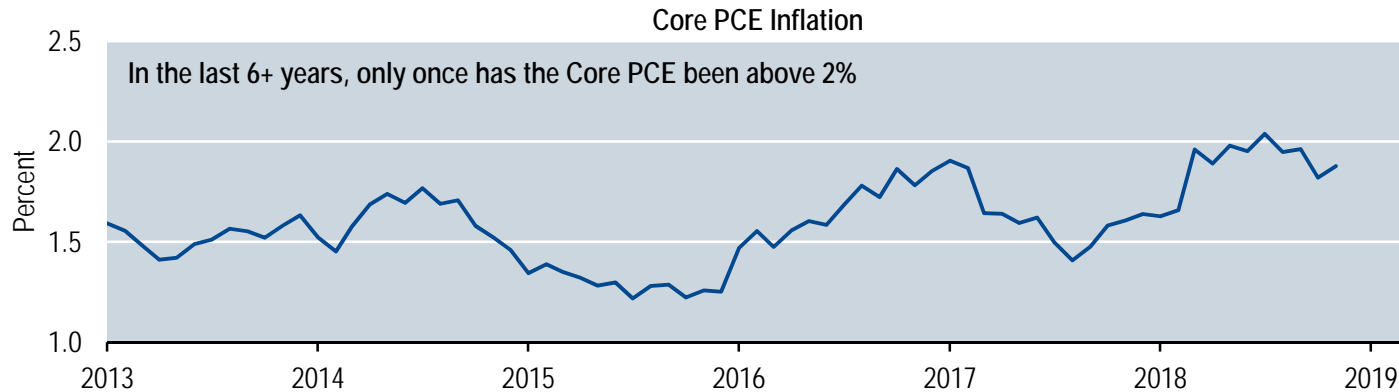
Emerging markets, though volatile, should outperform

# US Inflation and Fed Policy



Source: U.S. Bureau of Labor Statistics, Federal Reserve, Bloomberg. As of 31 Oct 18

# Inflation Refuses to Follow the Script

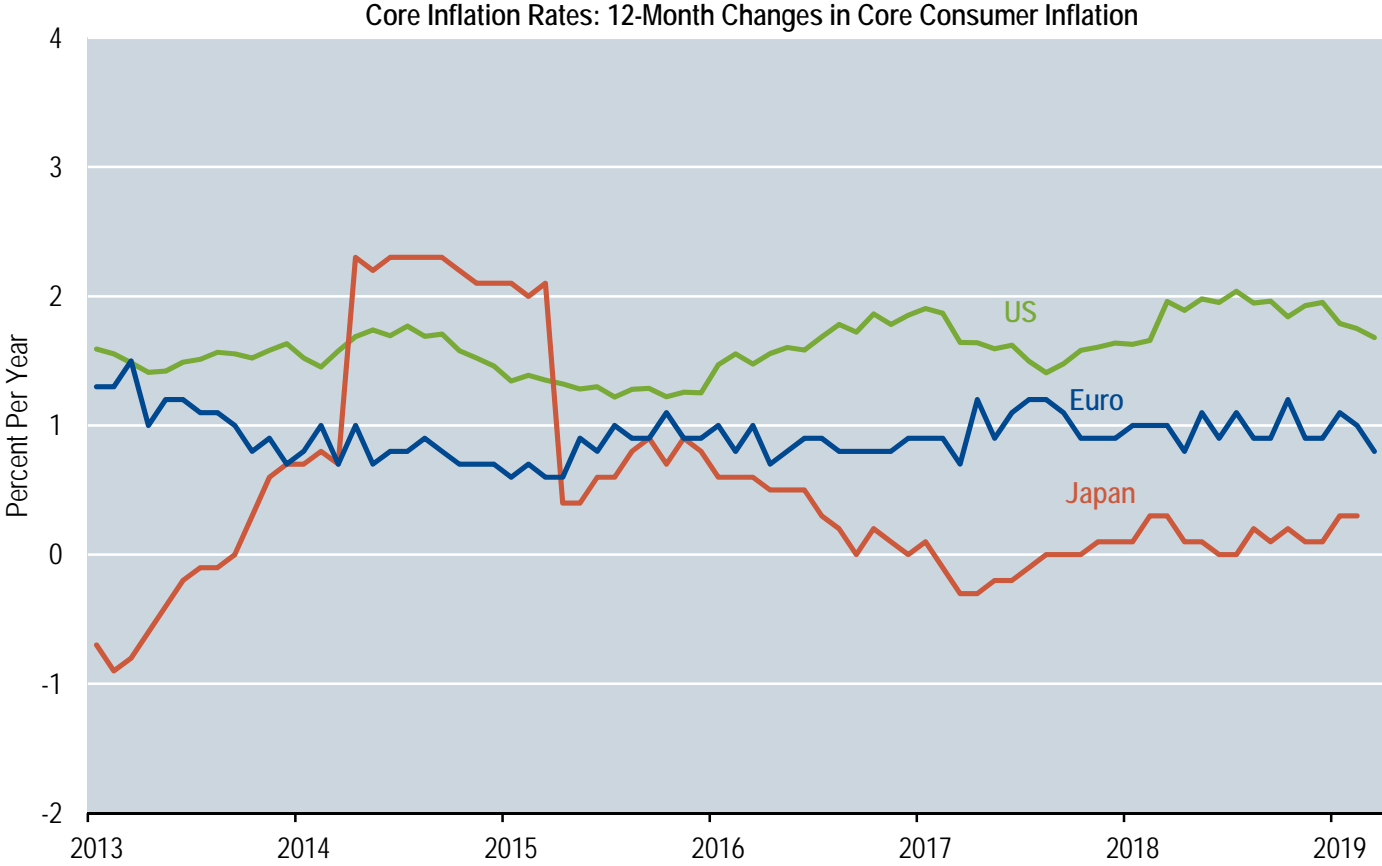


Source: Bureau of Economic Analysis. As of 30 Nov 18

“Ironically, the problem we need to solve these days is  
the risk of *inflation that is persistently too low*, rather than too high.”

– John Williams  
President, NY Fed  
December 6, 2018

# Chronically Below-Target Core Inflation Is a Global Phenomenon



Source: Bureau of Economic Analysis, Bloomberg. As of 31 Mar 19

## Powell's Focus: Protect the Recovery

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"...but what I do know is that we will be prepared to adjust policy quickly and flexibly, and to use all of our tools to support the economy, should that be appropriate, **to keep the expansion on track**, to keep the labor markets strong and to keep — to keep inflation near 2 percent."

January 4, 2019\*

"My colleagues and I have one **overarching goal** **to sustain the economic expansion**, with a strong job market and stable prices, for the benefit of the American people."

March 20, 2019\*\*

**"overarching goal"**

\*Federal Reserve Chairman Jerome Powell, joined in conversation with former Fed leaders Janet Yellen and Ben Bernanke during the American Economic Association's annual meeting in Atlanta on Friday, January 4, 2019.

\*\*FOMC Press Conference

Note: Bolded text is WA emphasis.

## The Current Asymmetric Nature of Fed Policy

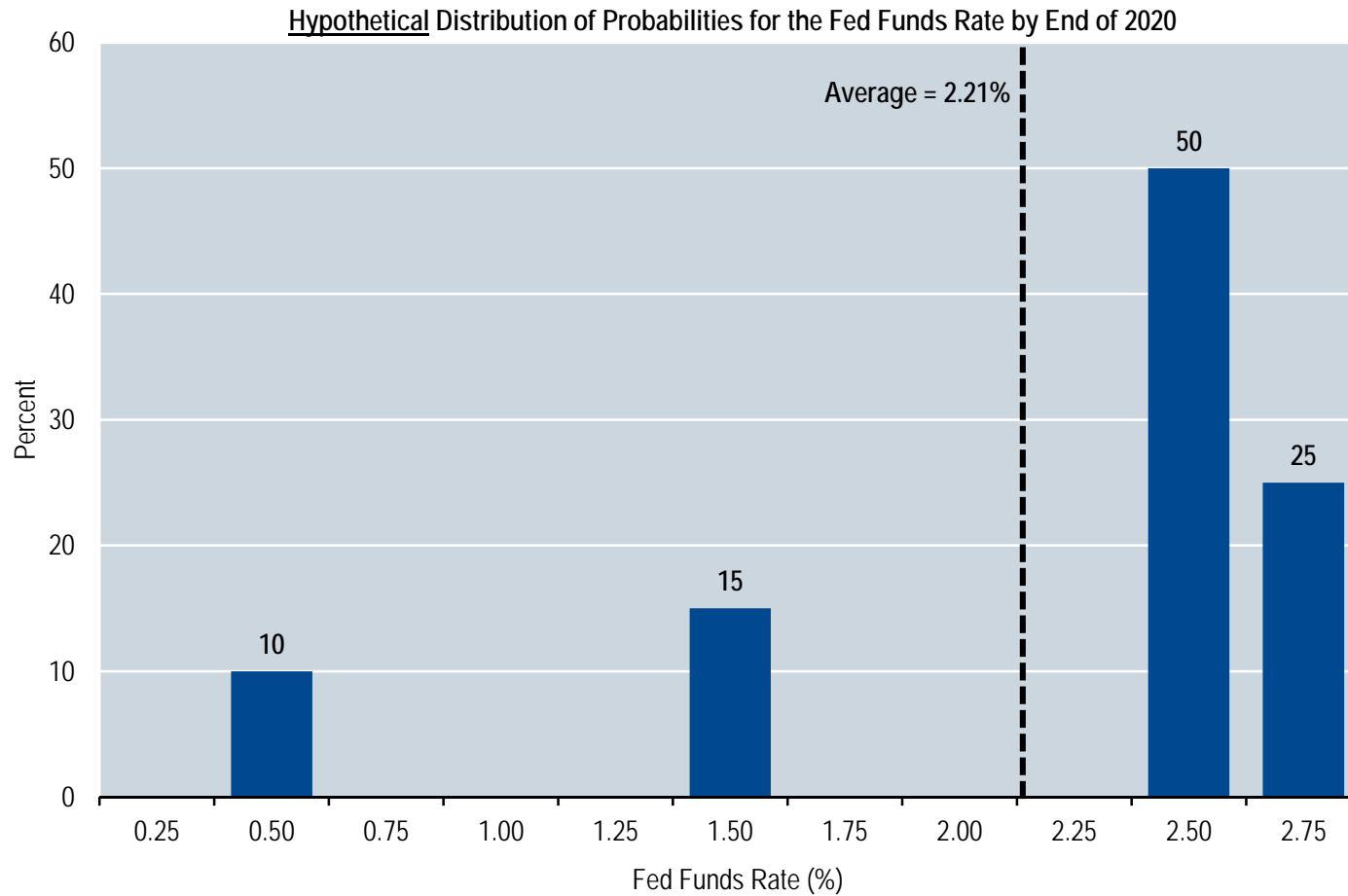
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If the economy strengthens — will the Fed tighten?

If the economy falters — will the Fed ease?



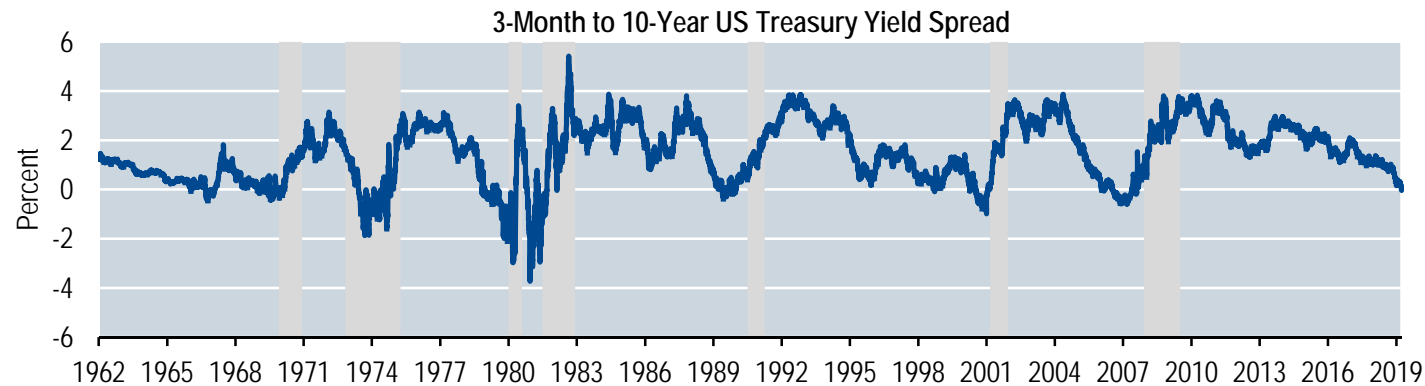
# The Asymmetric Distribution for Fed Funds



Source: Western Asset

Note: This is entirely hypothetical. Notice that the probability of the Fed raising rates is equal to the probability that the Fed lowers rates (both 25%). The model outcome is that the Fed is on hold.

## Does the Best Yield Curve Indicator Portend a US Recession?



Source: Bloomberg. As of 26 Mar 19  
Shaded areas are periods of recession.

“The term spread—the difference between long-term and short-term interest rates—is a strikingly accurate predictor of future economic activity. Every U.S. recession in the past 60 years was preceded by a negative term spread, that is, an inverted yield curve. Furthermore, a negative term spread was always followed by an economic slowdown and, except for one time, by a recession. *While the current environment is somewhat special—with low interest rates and risk premiums—the power of the term spread to predict economic slowdowns appears intact.*”

– San Francisco Federal Reserve Study, 2018

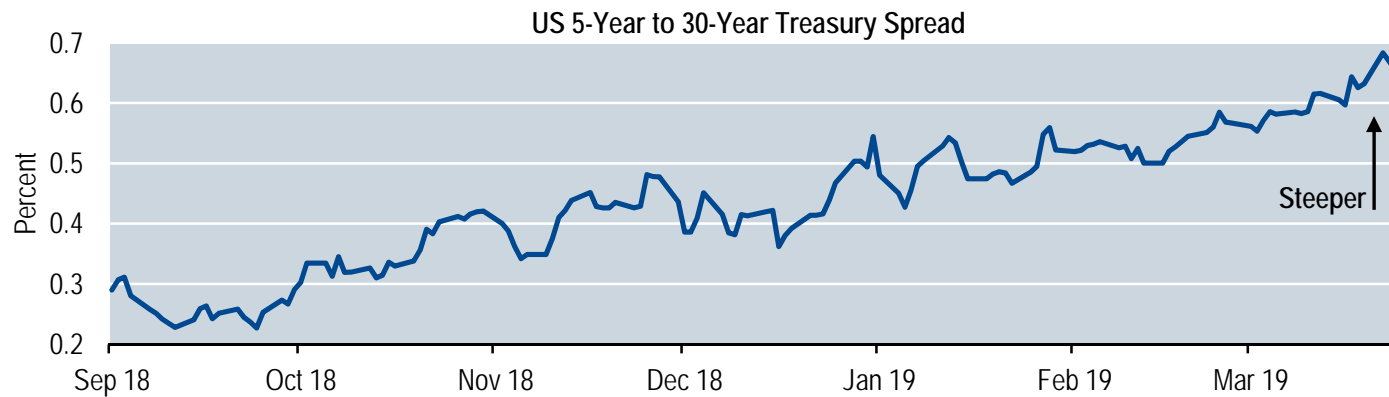
“strikingly accurate predictor”

# Will the Real Yield Curve Step Forward?

Flattening or steepening?

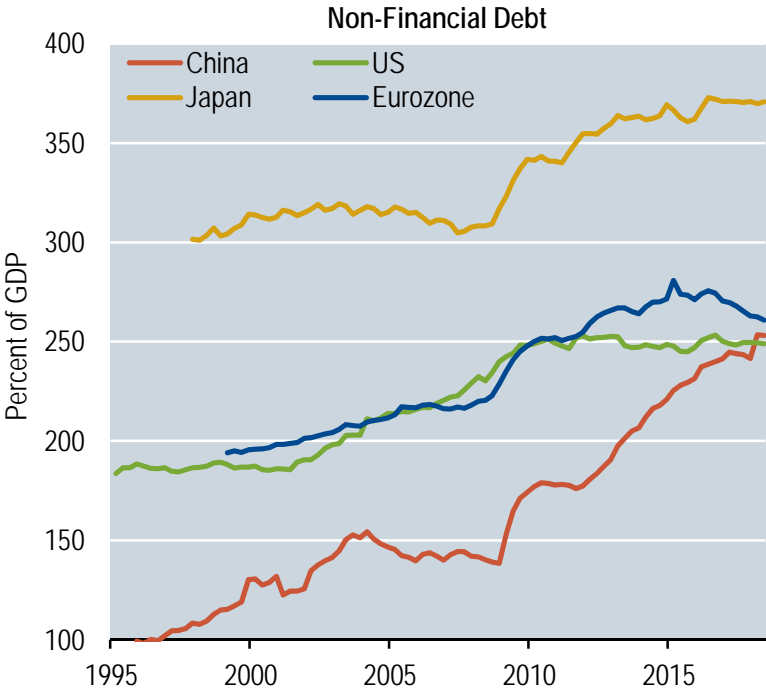


Source: Bloomberg. As of 28 Mar 19

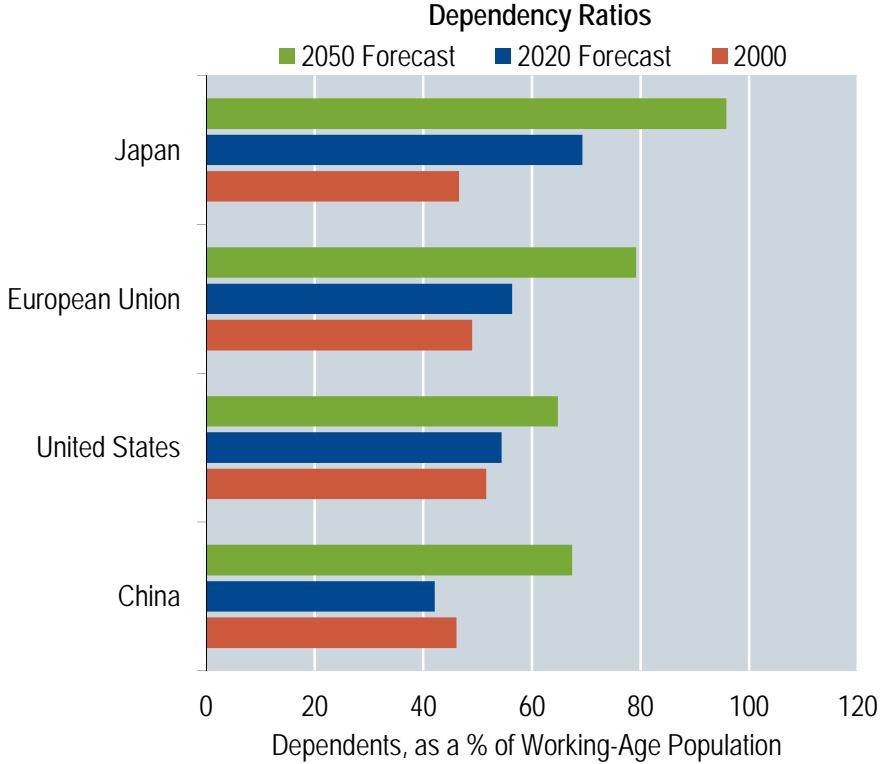


Source: Bloomberg. As of 28 Mar 19

# Global Headwinds: Debt and Demographics

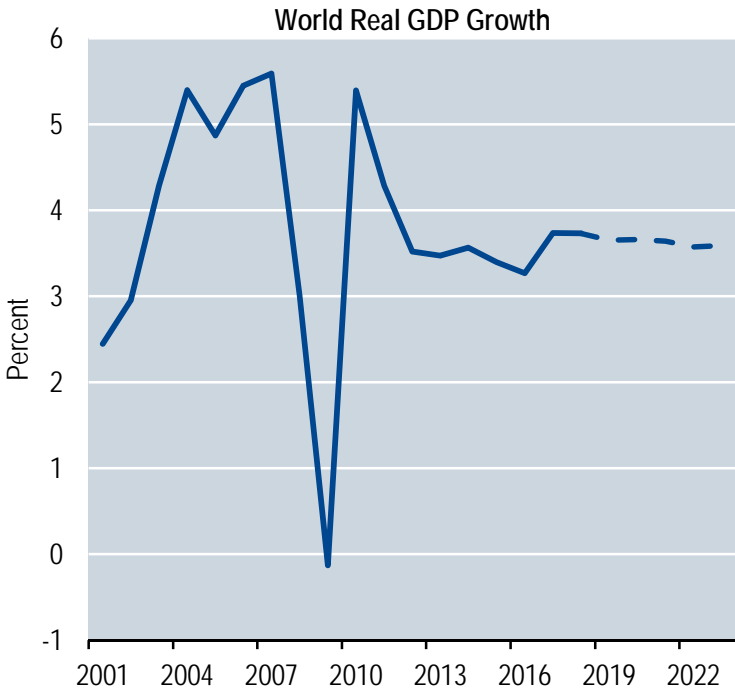


Source: Bank for International Settlements. As of 30 Jun 18



Source: World Bank. As of 30 Jun 18

# Global Growth Has Downshifted and Inflation Remains Subdued

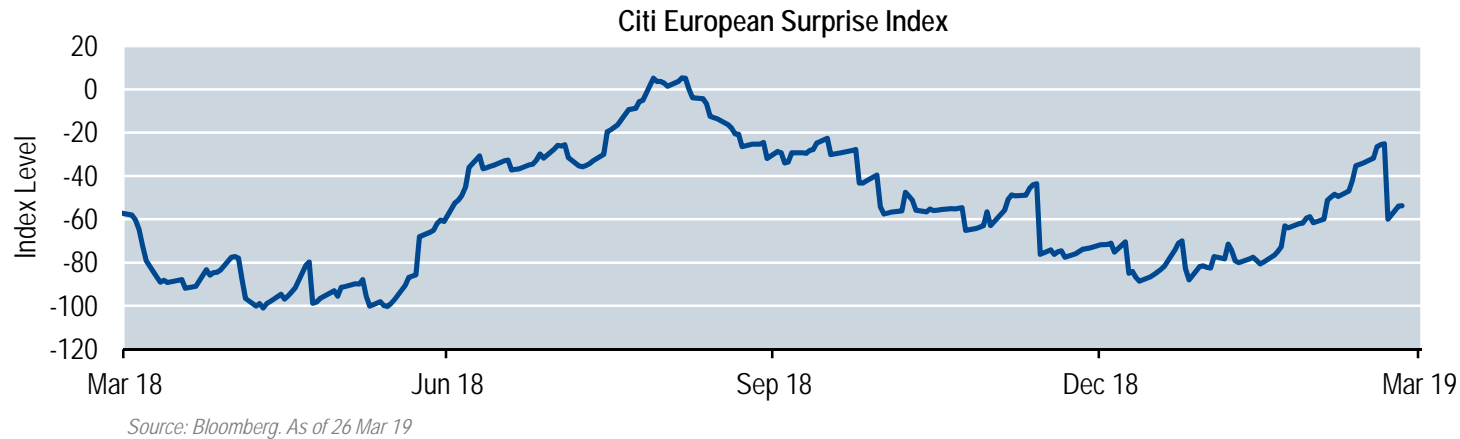


Source: International Monetary Fund. As of 31 Oct 18



Source: Bloomberg. As of 31 Dec 18

## How Sturdy Is Global Growth?

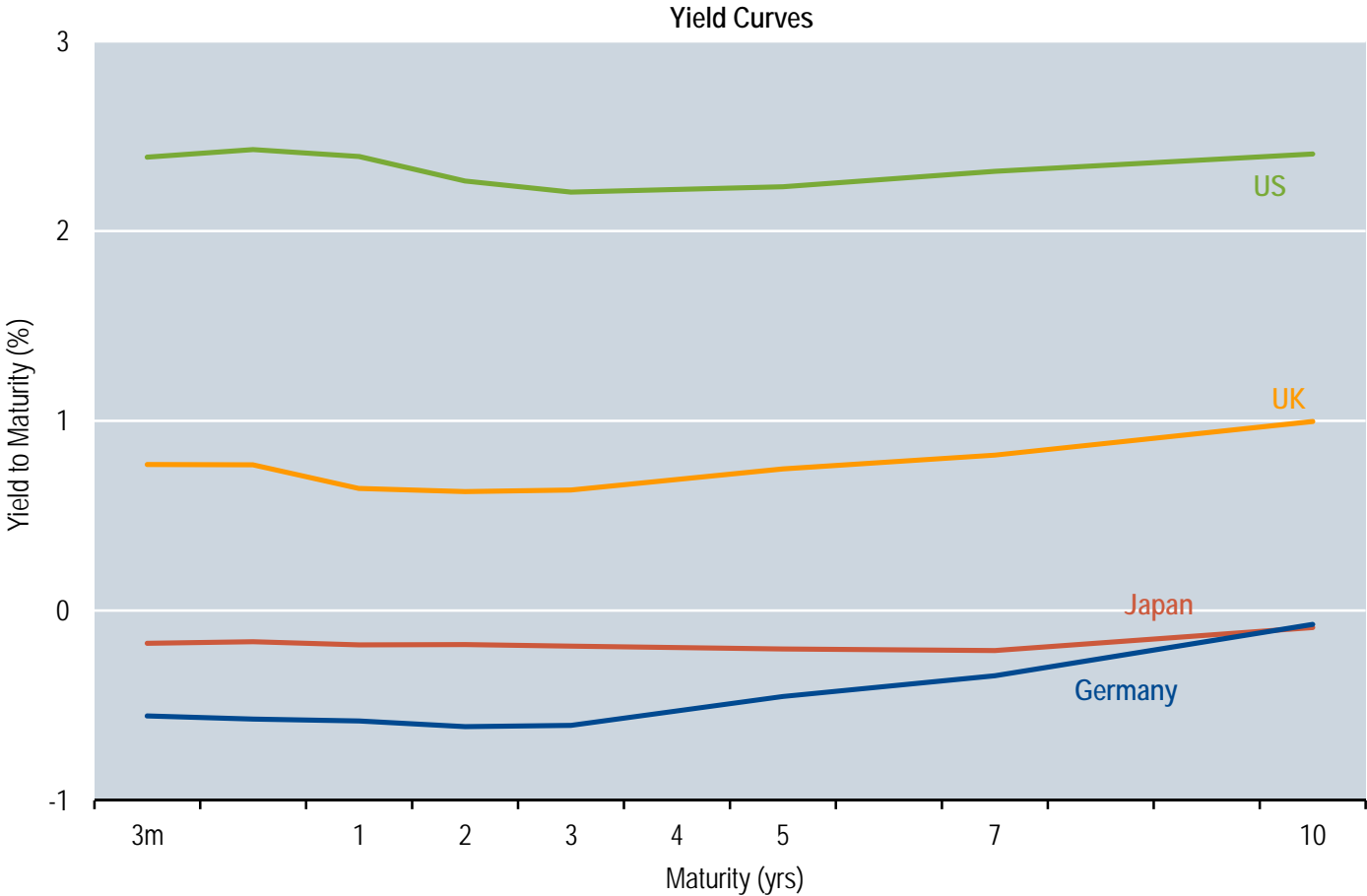


“Global growth has lost momentum.”

“We do not see a recession in the near term...indeed the global economy is at a delicate moment”

– Christine Lagarde  
April 2, 2019

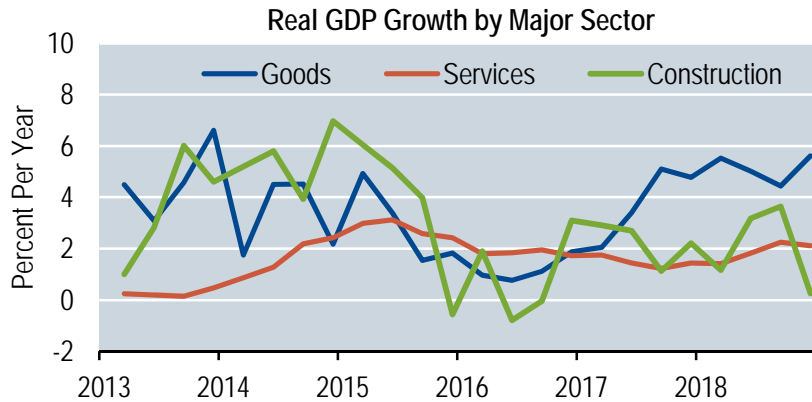
# US Interest Rates Remain Attractive Relative to Most of the Developed World



Source: Bloomberg. As of 31 Mar 19

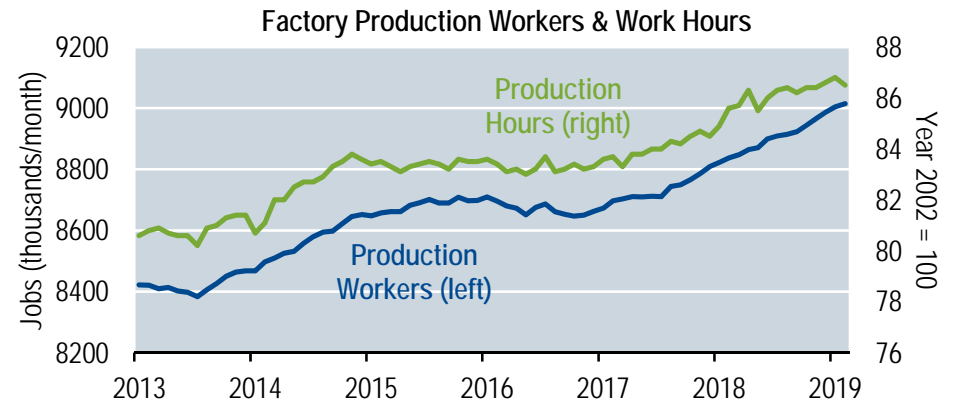
# Moderate US Economic Growth to Continue (2.0% – 2.25%)

Better US growth in last two years has been wholly contained in goods-producing sectors: manufacturing and mining (oil).



Source: Bureau of Economic Analysis. As of 31 Dec 18  
Note: 4-quarter growth rates in real GDP

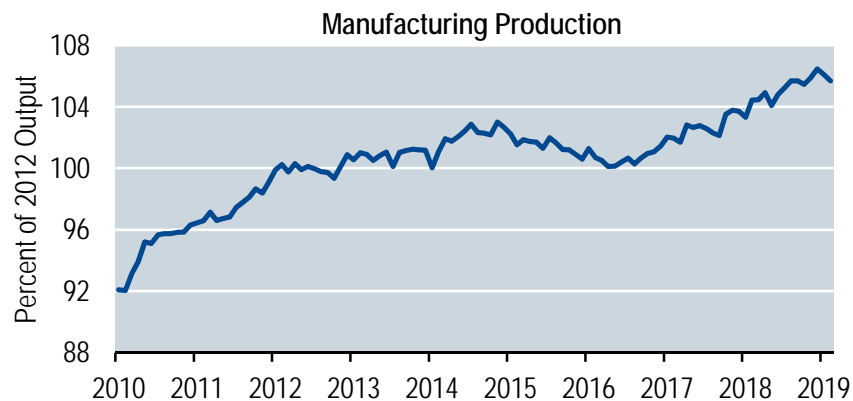
While manufacturing and oil have slowed some recently, they are still performing better than they did in 2015-16, which was NOT a recession.



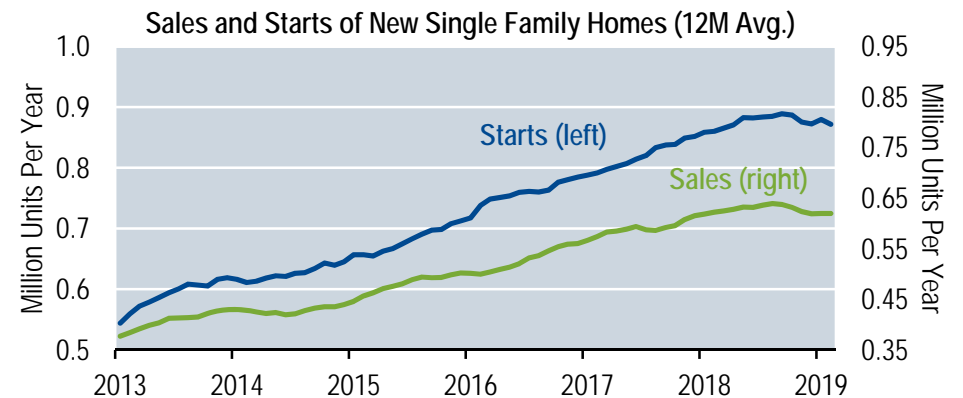
Source: Bureau of Labor Statistics. As of 28 Feb 19

Factory sector rebounding recently after five years of stagnation, so the “late cycle” story is not applicable/relevant.

Declines in homebuilding are also holding down US growth, but here too, the declines look like an inventory correction, not a rout (starts declining only mildly, sales holding up relatively well).



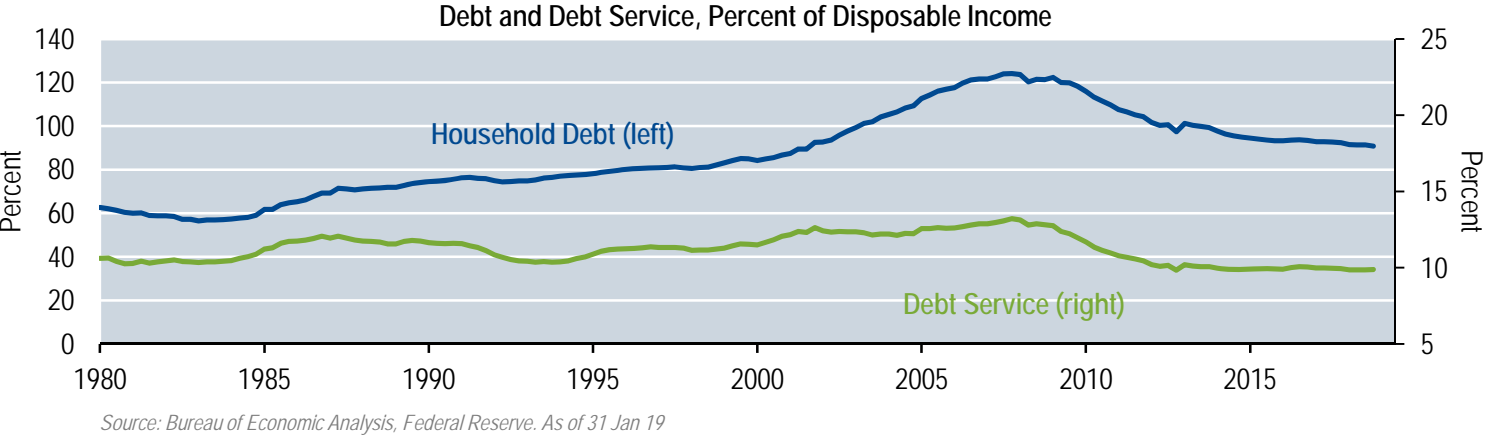
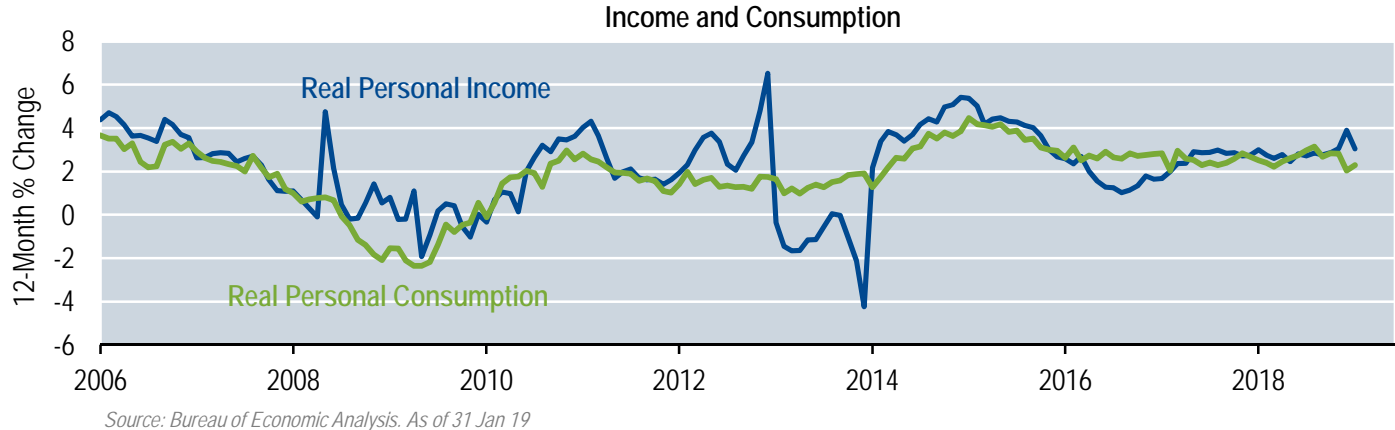
Source: Federal Reserve Board. As of 28 Feb 19



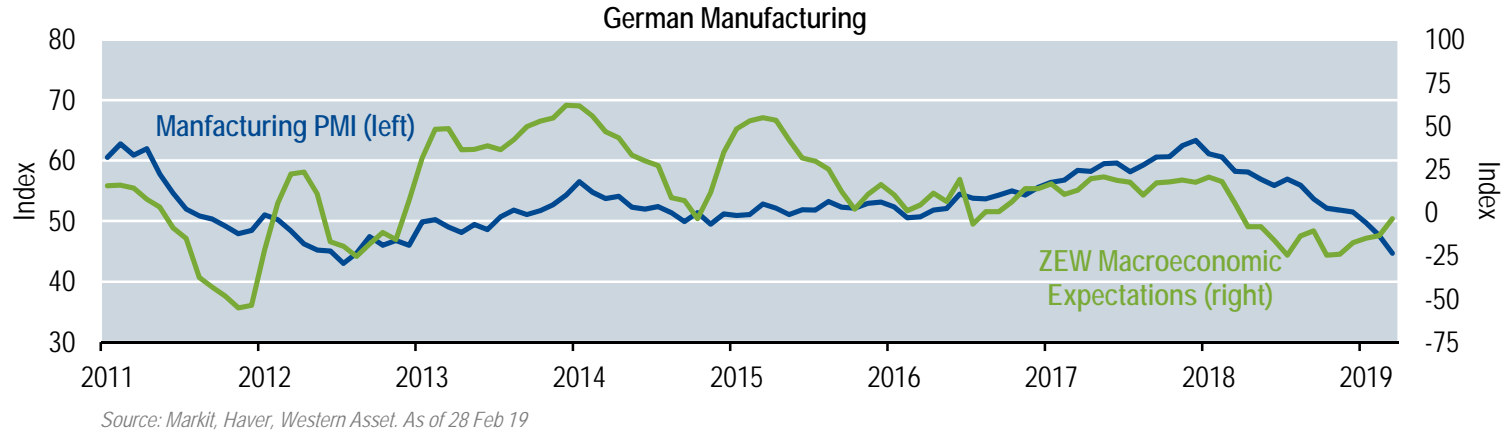
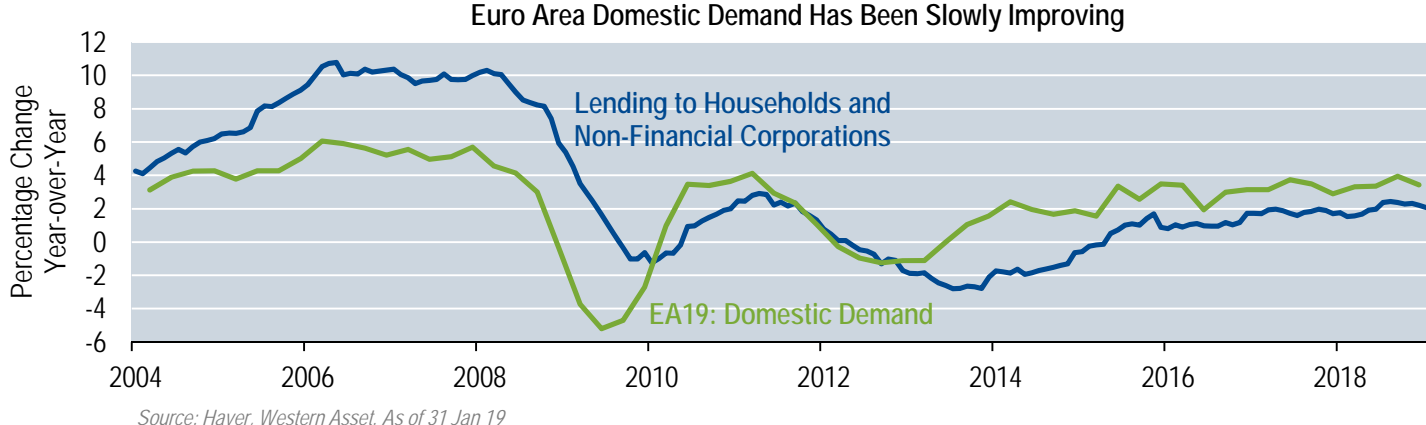
Source: Census Bureau. As of 28 Feb 19



# US Growth: Consumer Fundamentals OK

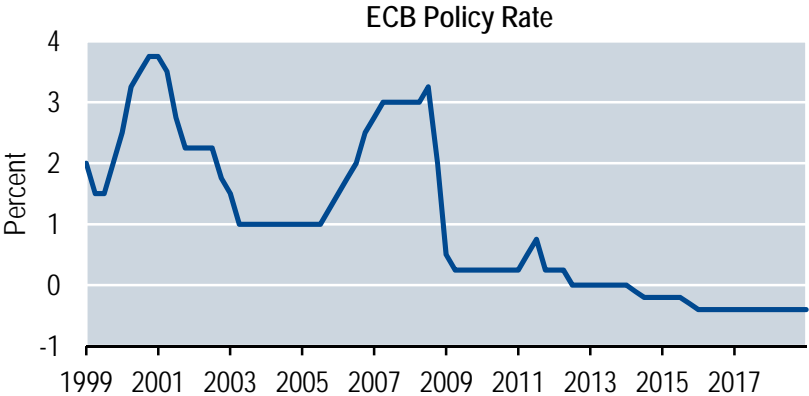


# Eurozone Domestic Demand Diverging From Manufacturing



# Eurozone Fiscal and Monetary Accommodation Should Bear Fruit

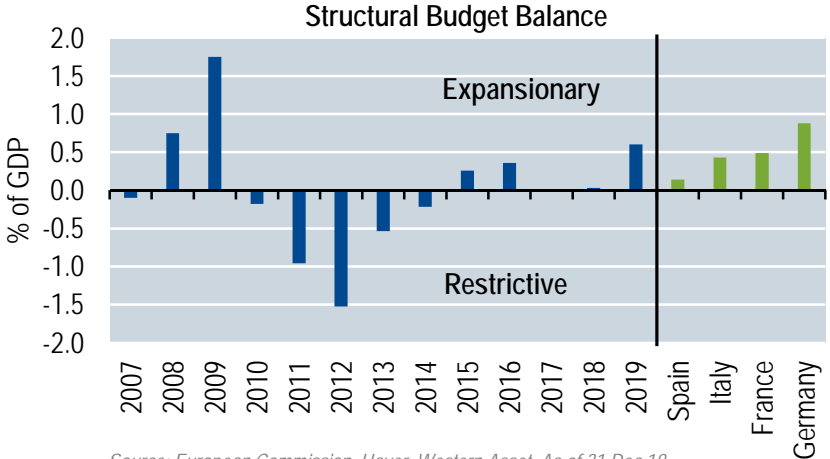
The structural budget balance is more accommodative.



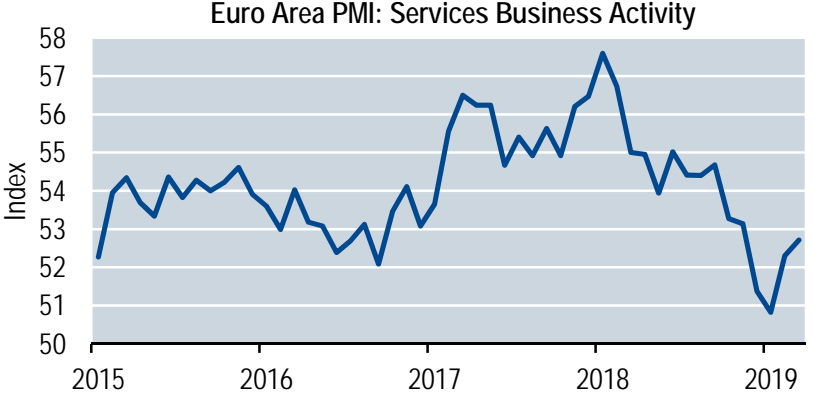
Source: Bloomberg. As of 02 Apr 19



Source: Bloomberg. As of 29 Mar 19



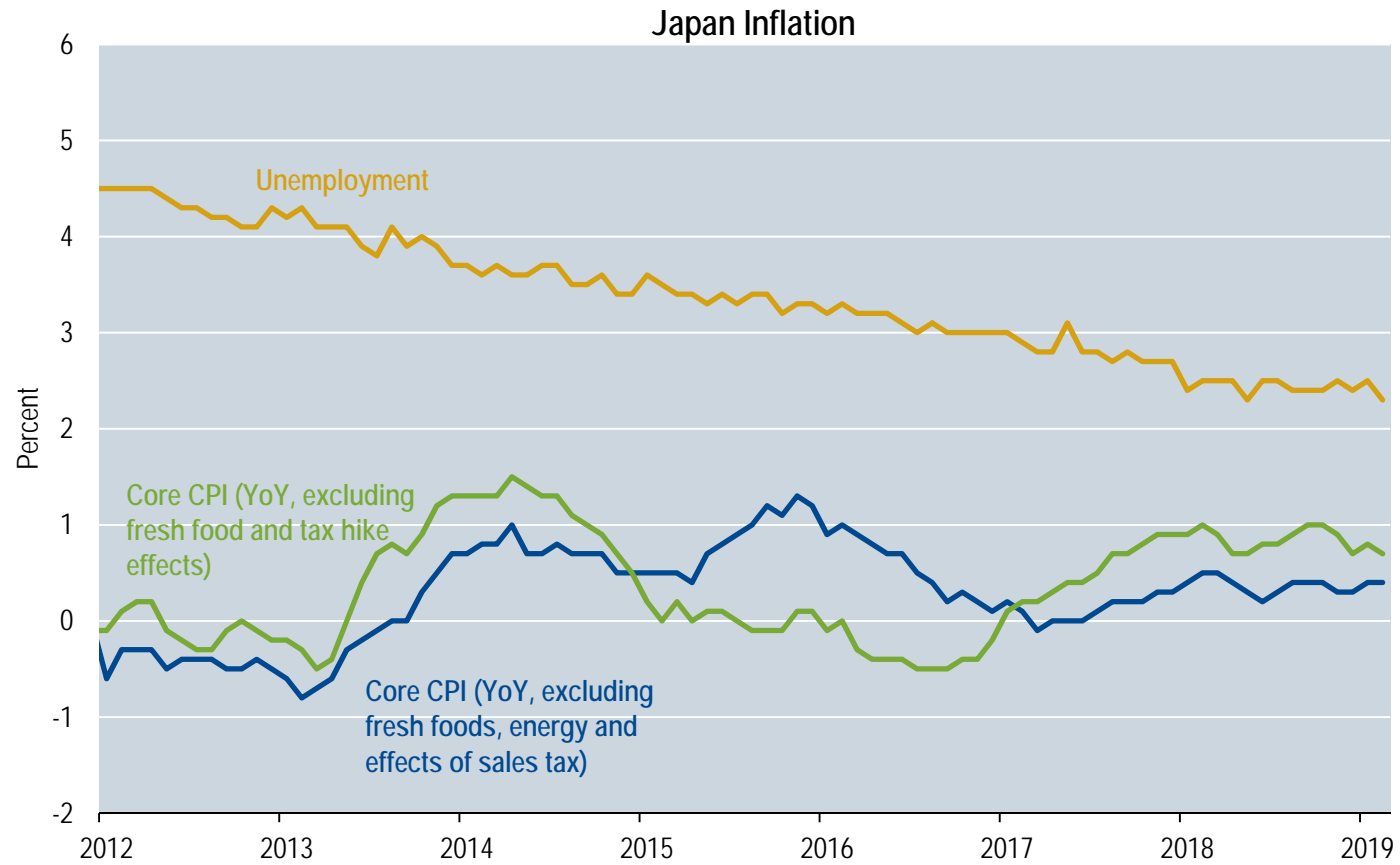
Source: European Commission, Haver, Western Asset. As of 31 Dec 18



Source: IHS Markit, Haver Analytics. As of 31 Mar 19

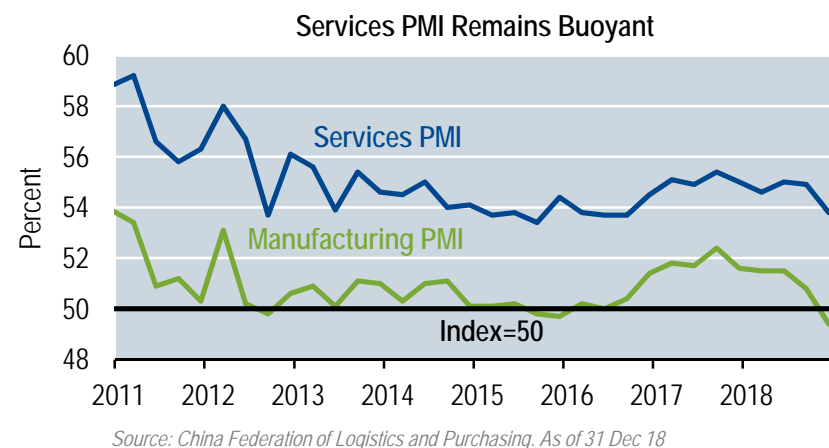
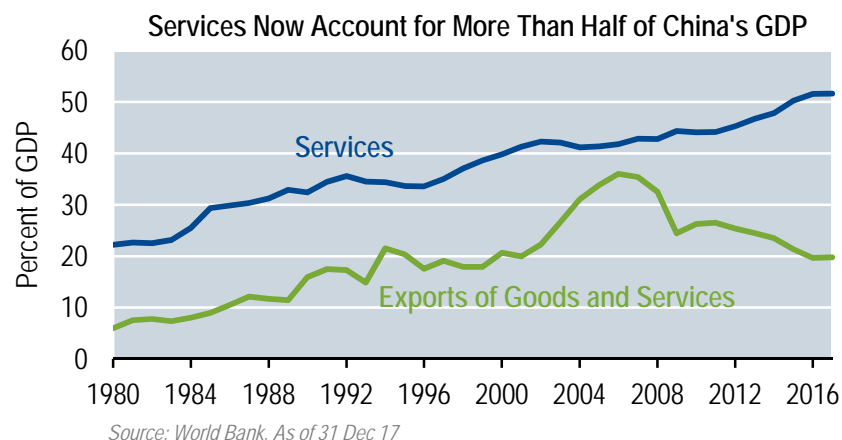
# Japan

The current fiscal and monetary policy mix supports moderate growth and higher inflation expectations.



Source: Datastream, Western Asset. As of 28 Feb 19

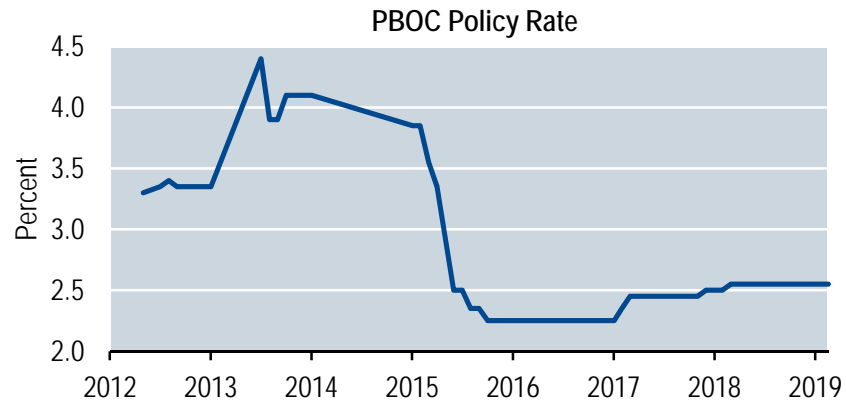
# Healthy Domestic Demand and Robust Stimulus Supportive of Growth in China



## China's Recent Measures to Ease Credit

<b>RRR</b>	<ul style="list-style-type: none"> <li>5 cuts from 2018 to Jan 2019</li> </ul>
<b>Tax cuts</b>	<ul style="list-style-type: none"> <li>Lowered VAT by 1% for manufacturing and other sectors</li> <li>Raising annual taxable income threshold of SMEs eligible for preferential corporate income tax from CNY500K to CNY1m</li> </ul>
<b>Credit market easing</b>	<ul style="list-style-type: none"> <li>PBoC injecting capital into China Bond Insurance Co</li> <li>Reviving Credit Risk Mitigation Warrant (CRMW) to help POEs to tap the domestic bond market by offering credit insurance</li> <li>Broadening the range of collateral for MTL operations to include lower rated bonds</li> </ul>
<b>Other measures</b>	<ul style="list-style-type: none"> <li>Expanded the scope of eligible loans to be classified as SME loans by increasing the min size to CNY10m from CNY5m, thus allowing more banks to be able to enjoy lower RRR rates based on targeted RRR cut criteria announced earlier</li> <li>Expanding debt-to-equity swap program</li> <li>Set up asset management plans (with funds contributed by 11 brokerages) for supporting POEs</li> <li>PBoC window guidance to banks for lending to POEs</li> </ul>

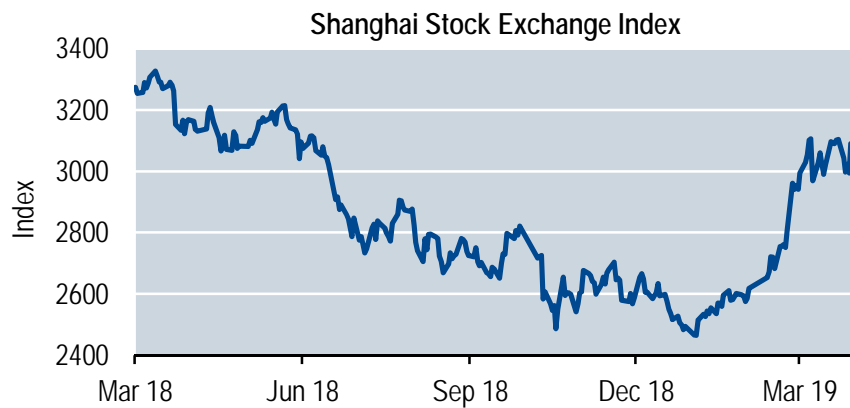
# Markets Are Reflecting Continued Policy Accommodation to Support Growth



Source: Bloomberg. As of 29 Mar 19



Source: Bloomberg. As of 29 Mar 19

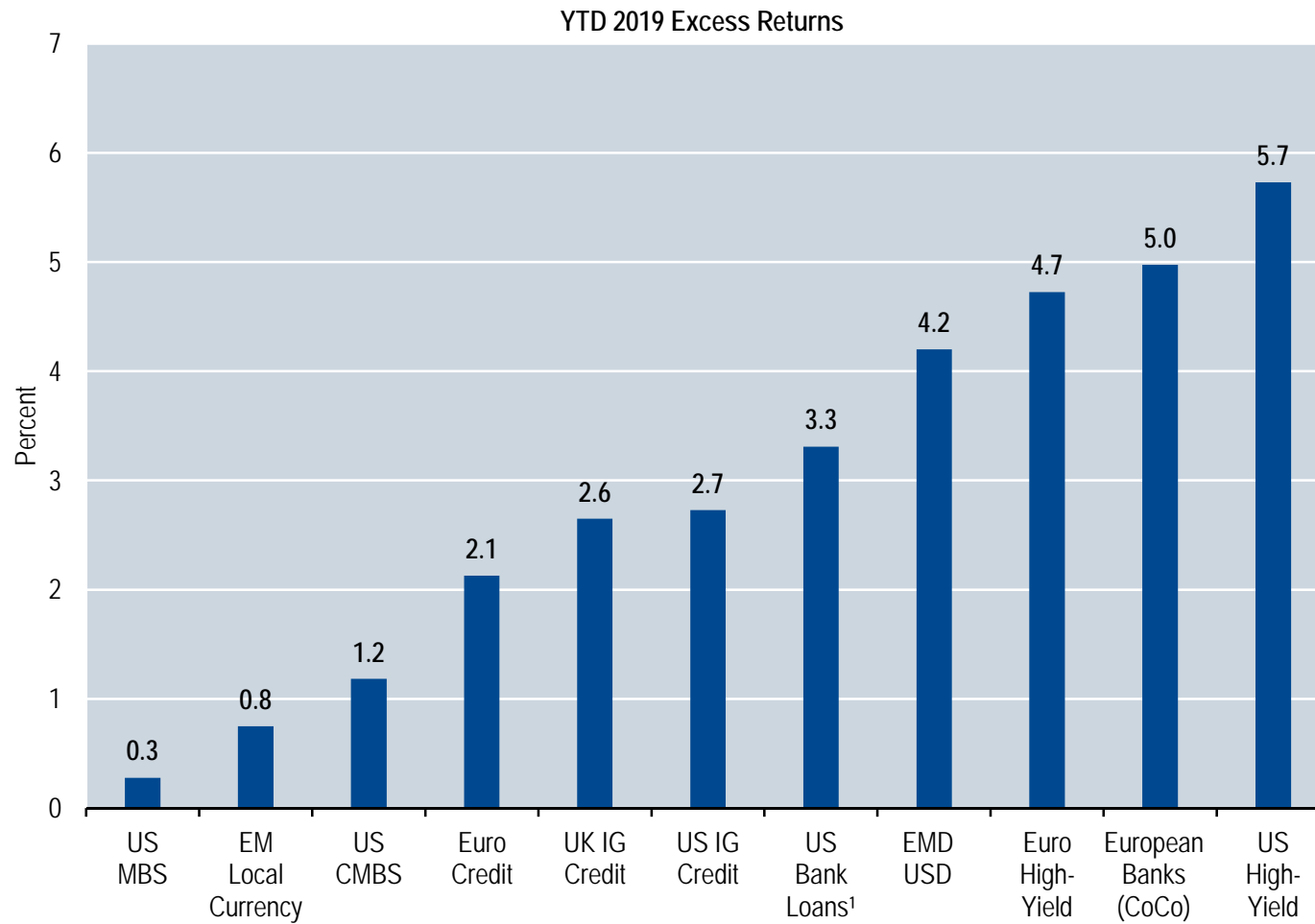


Source: Bloomberg. As of 31 Mar 19



Source: Haver Analytics. As of 31 Mar 19

# Spread Sector Excess Returns



Source: Bloomberg Barclays, J.P. Morgan, S&P Global Market Intelligence, a division of S&P Global Inc, Western Asset. As of 31 Mar 19  
<sup>1</sup>S&P/LSTA Performing Loans Index excess return vs. 3-Month LIBOR

# Investment-Grade Credit

2018 "BBB glut" to 2019 "Debt diet"

## 25 Largest BBB Issuers

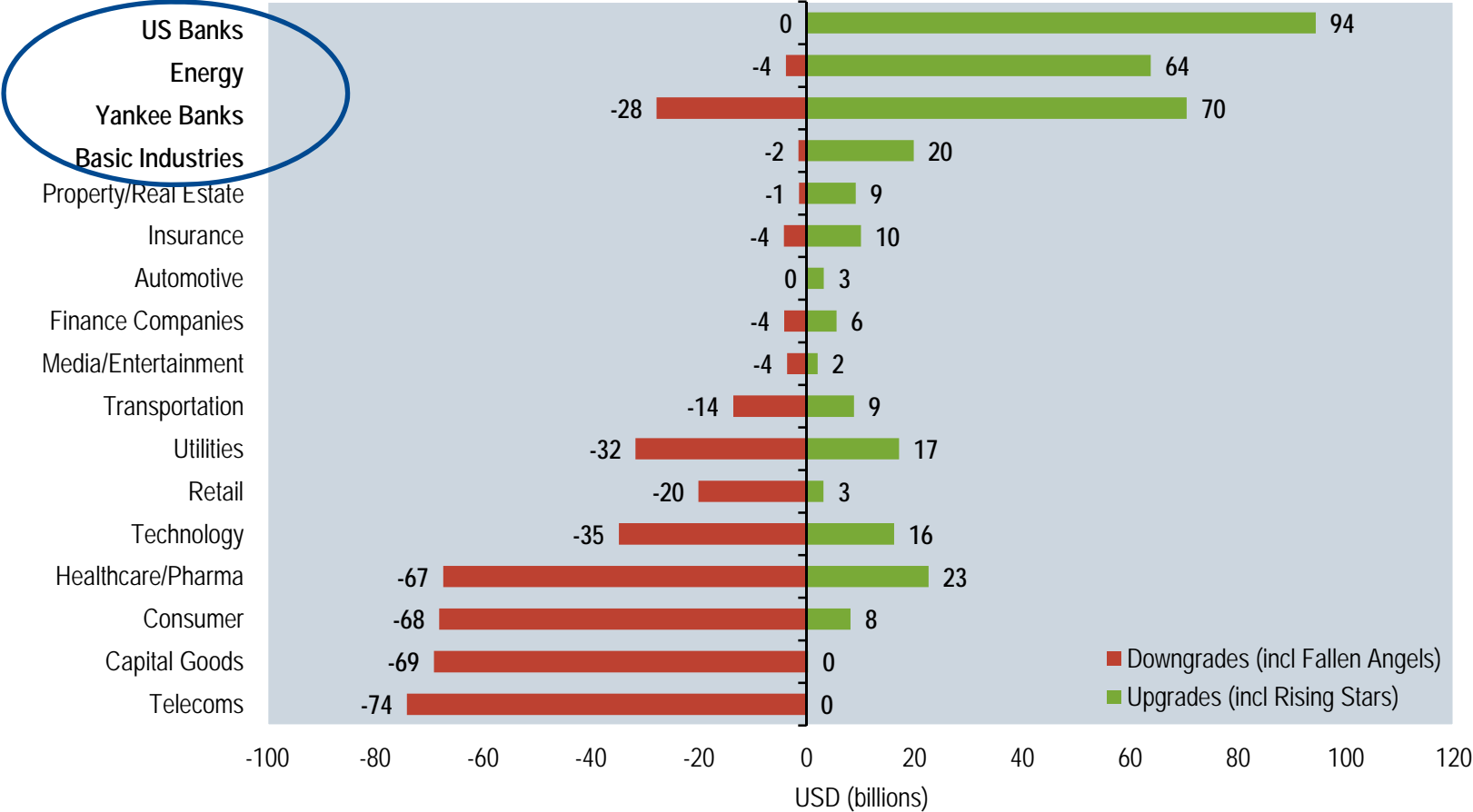
Ticker	Company Name	Index Rating	Total IG Index Debt, (USD, billions)	US IG Index Weight (%)	Industry	Leverage Trend	Management Explicitly Stated Leverage Target?	
1	T	AT&T	Baa2	\$100	1.6	Wireline	Lower	Yes
2	VZ	Verizon Communications	Baa1	\$73	1.2	Wireline	Stable	Yes
3	CVS	CVS Health	Baa2	\$66	1.1	Health Care	Lower	Yes
4	ABIBB	Anheuser-Busch Inbev	Baa1	\$64	1.0	Food & Beverage	Lower	Yes
5	GE	General Electric	Baa1	\$45	0.7	Diversified Manufacturing	Lower	Yes
6	GM	General Motors	Baa2	\$41	0.7	Automotive	Stable	No
7	CHTR	Charter Communications	Baa3	\$38	0.6	Cable Satellite	Stable	Yes
8	ABBV	Abbvie	Baa2	\$33	0.5	Pharmaceuticals	Stable	No
9	F	Ford Motor	Baa2	\$33	0.5	Automotive	Higher	No
10	CI	Cigna	Baa2	\$33	0.5	Health Care Insurance	Lower	No
11	ETP	Energy Transfer	Baa3	\$30	0.5	Midstream	Lower	Yes
12	UTX	United Technologies	Baa1	\$29	0.5	Aerospace/Defense	Lower	No
13	KMI	Kinder Morgan	Baa2	\$27	0.5	Midstream	Lower	Yes
14	AMGN	Amgen Inc	Baa1	\$25	0.4	Pharmaceuticals	Stable	No
15	BATSLN	British American Tobacco	Baa2	\$25	0.4	Tobacco	Lower	Yes
16	DWDP	DowDupont	Baa2	\$24	0.4	Chemical	Stable	No
17	EPD	Enterprise Products Partners	Baa1	\$24	0.4	Midstream	Lower	Yes
18	MO	Altria Group	Baa2	\$22	0.3	Tobacco	Lower	No
19	UNP	Union Pacific	Baa1	\$22	0.3	Railroad	Higher	No
20	KHC	Kraft Heinz	Baa3	\$22	0.3	Food & Beverage	Lower	Yes
21	WMB	Williams Cos	Baa2	\$21	0.3	Midstream	Lower	Yes
22	CELG	Celgene	Baa2	\$20	0.3	Pharmaceuticals	Lower	No
23	VOD	Vodafone Group	Baa1	\$18	0.3	Wireless	Higher	Yes
24	MCD	McDonald's	Baa1	\$18	0.3	Restaurants	Stable	No
25	AGN	Allergan	Baa3	\$17	0.3	Pharmaceuticals	Lower	Yes

Source: Bloomberg, Western Asset. As of 18 Mar 19



# Path of Credit Quality Varies Substantially by Sector

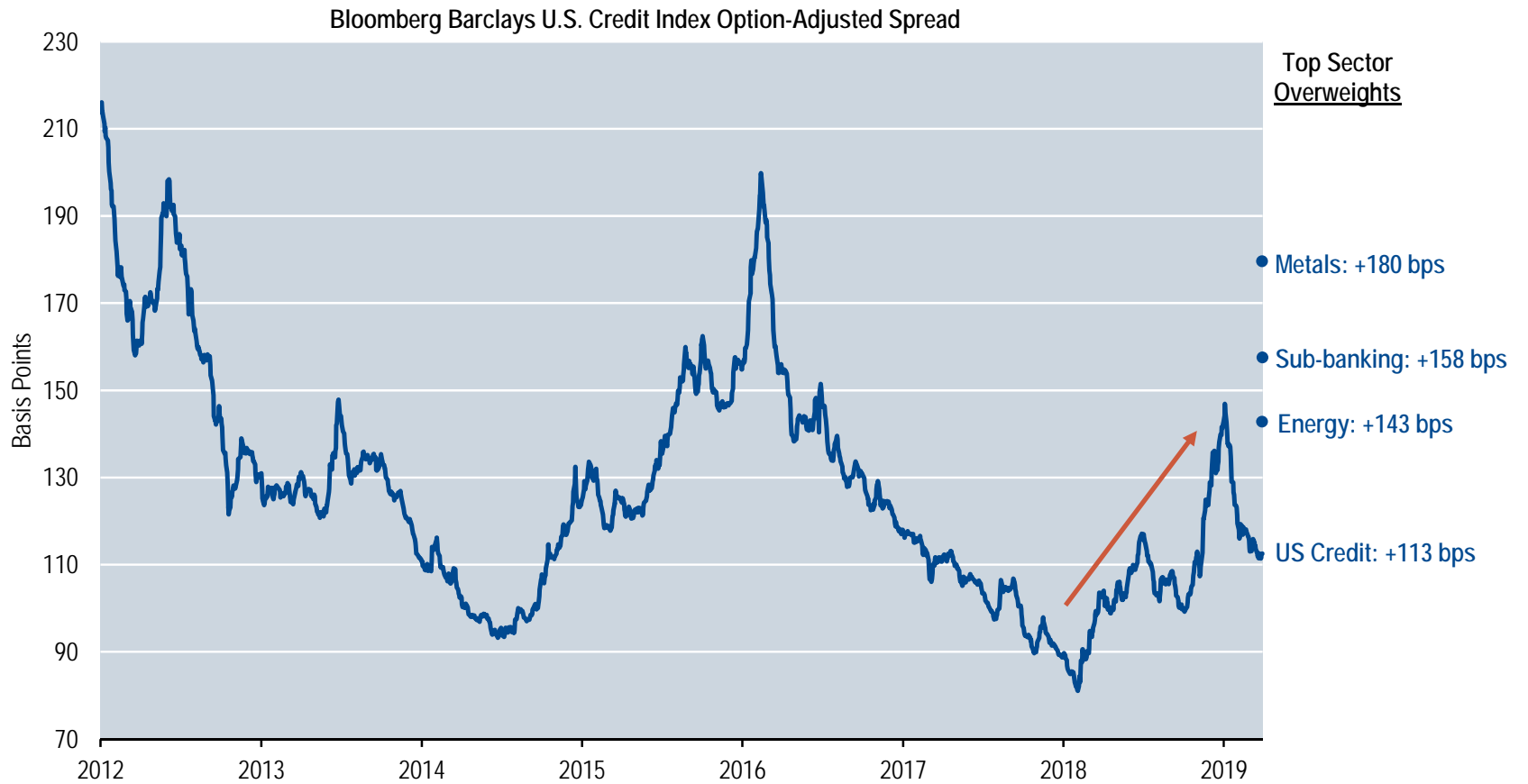
2018 Upgrades Concentrated in Banks, Energy and Metals



Source: J.P. Morgan. As of 31 Dec 18

# Investment-Grade Credit

Spreads 54 bps wider in 2018 provided an opportunity. Subsector overweights still have room to run.

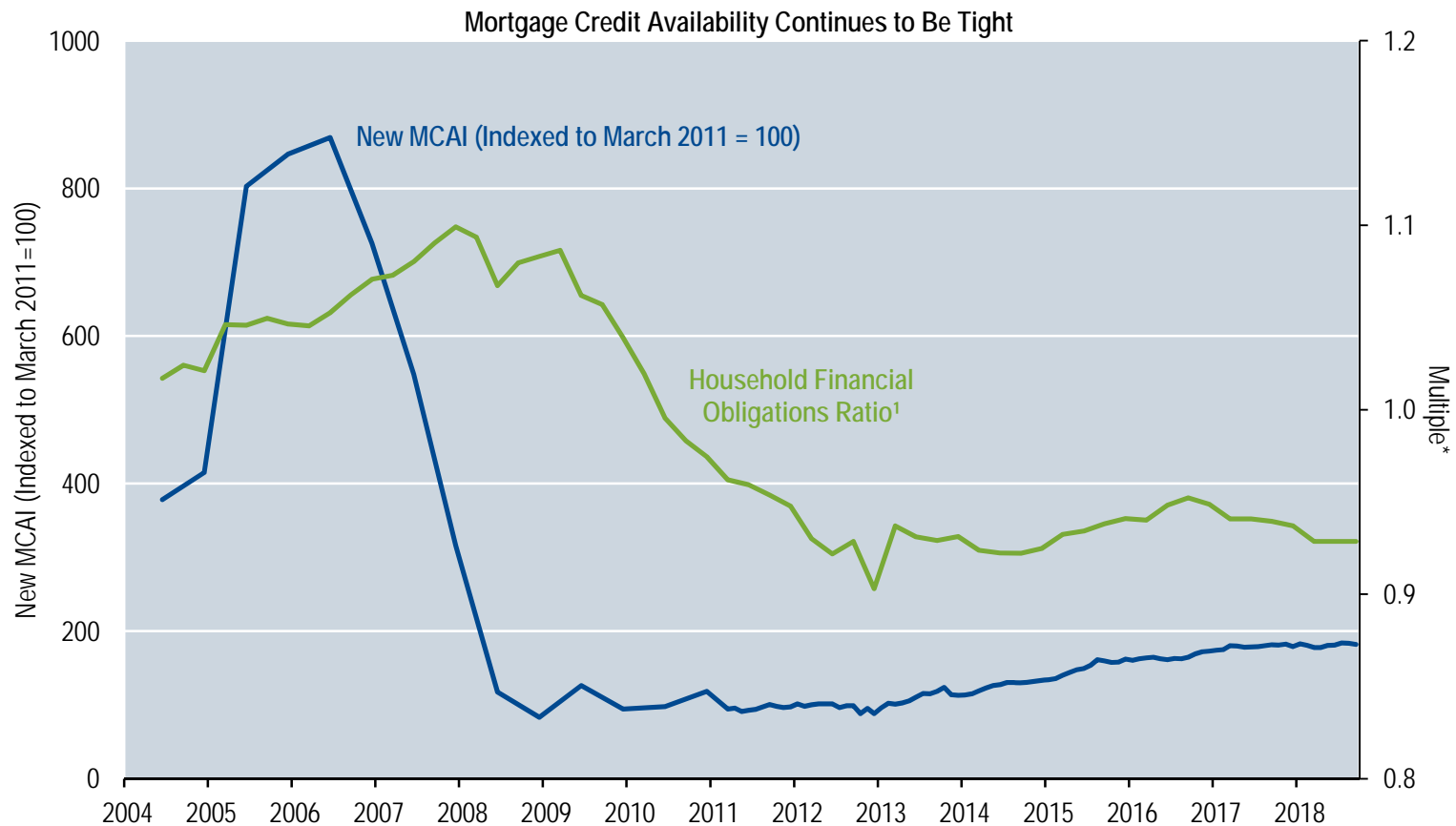


Source: Bloomberg Barclays. As of 29 Mar 19  
Excess return is the difference between total returns of the security and an implied Treasury portfolio matching the term-structure profile of that security.

# Investment Themes – Mortgage-Backed Bonds

Consumer and housing fundamentals are on solid footing.

Favor credit risk on recently originated mortgages due to stringent underwriting standards



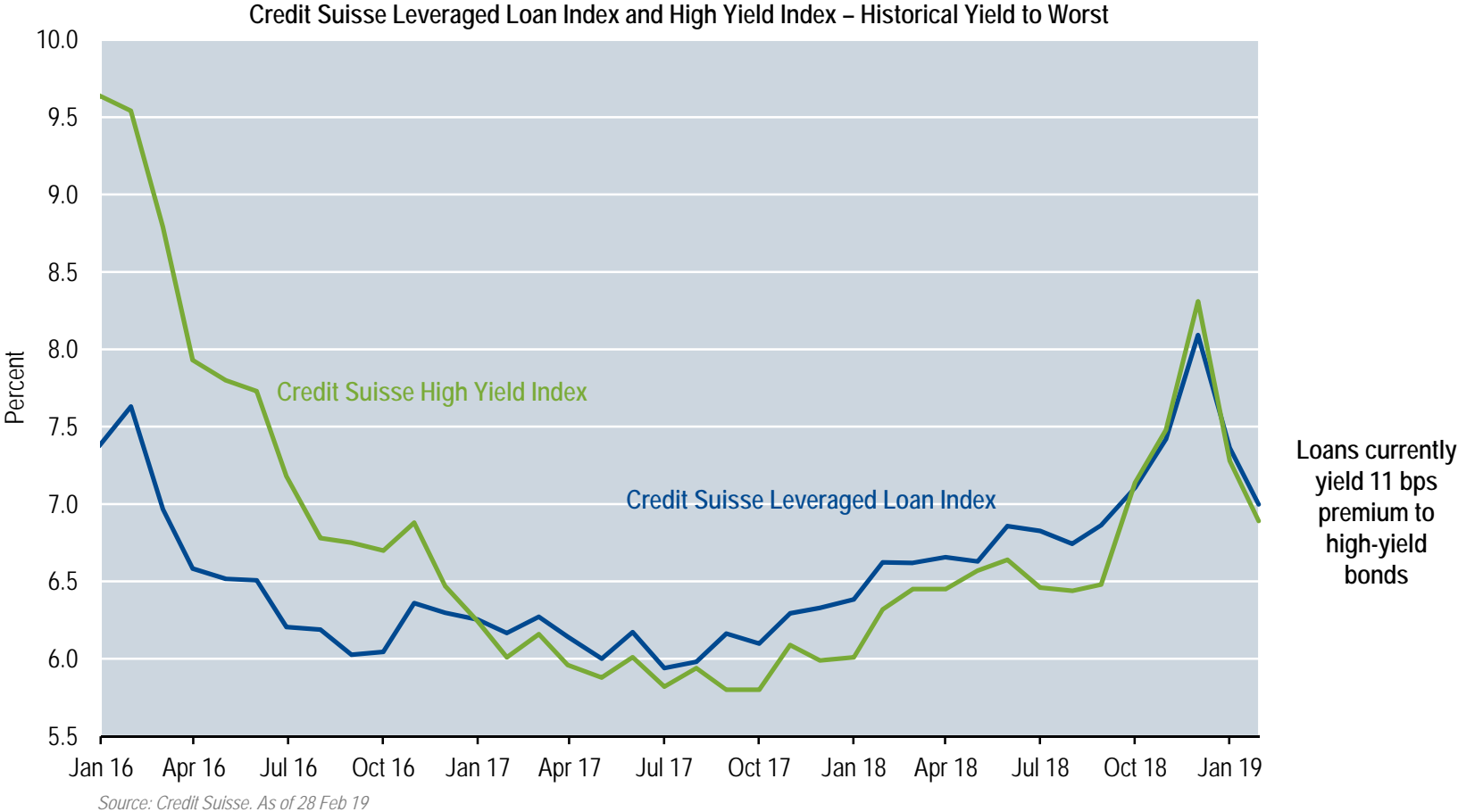
Source: BAML, Federal Reserve, MBA, Western Asset. As of 30 Sep 18

<sup>1</sup>Household debt to total disposable income in the United States

\*Multiple of long-term average

# Bank Loan Valuations Look Attractive Relative to High-Yield

Since 1992, high-yield has historically had a YTW with 110 bps premium over leveraged loans and 106 bps spread over loans driven by a higher risk profile due to unsecured, subordinated position in capital structure relative to loans



## 2018 Emerging Market Challenges

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Higher US rates

Higher US dollar

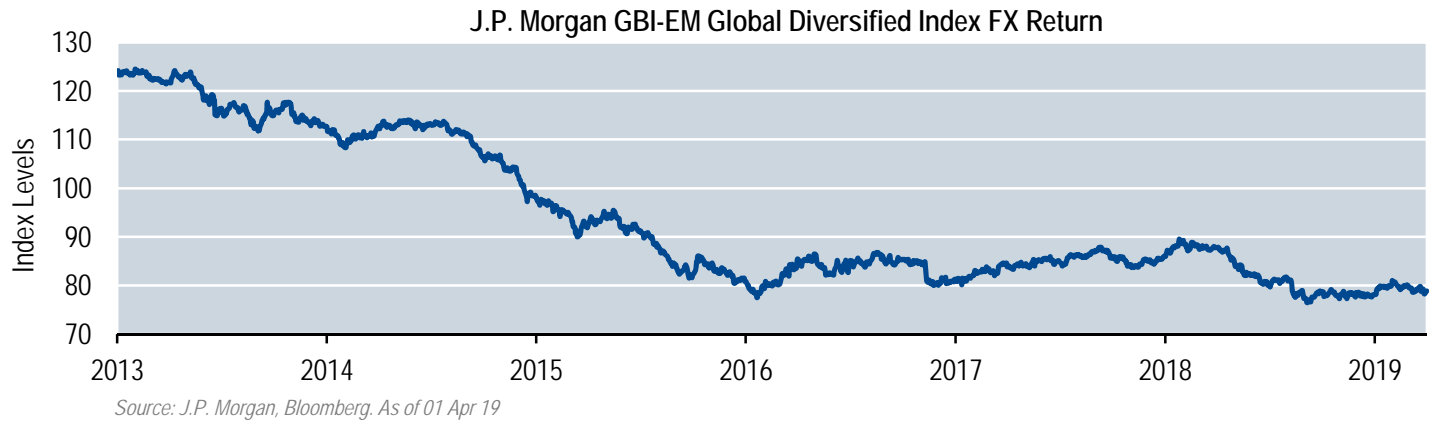
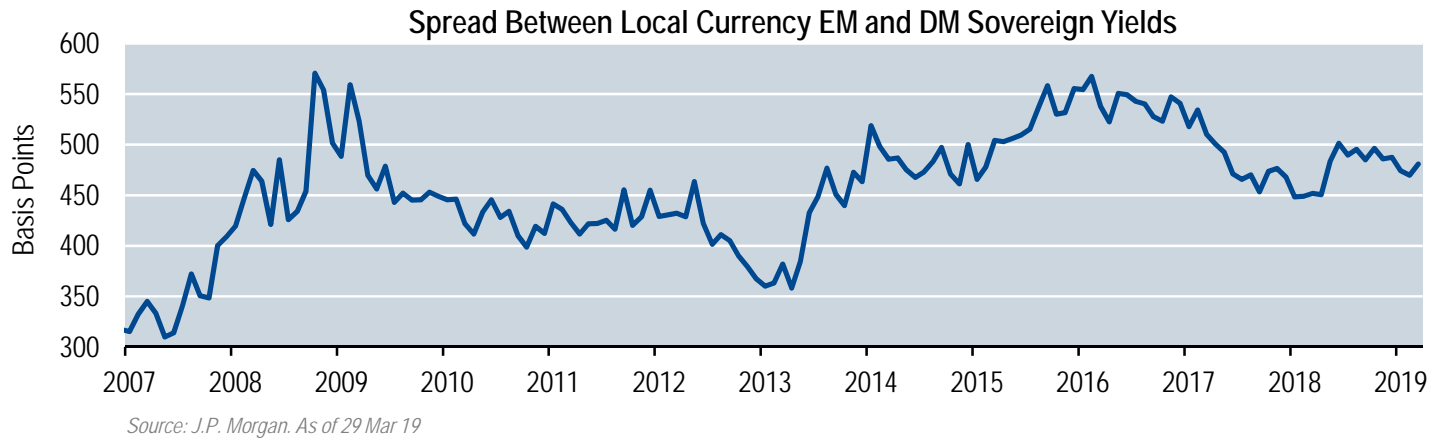
Downshifting European, Chinese and Japanese growth

Higher oil prices

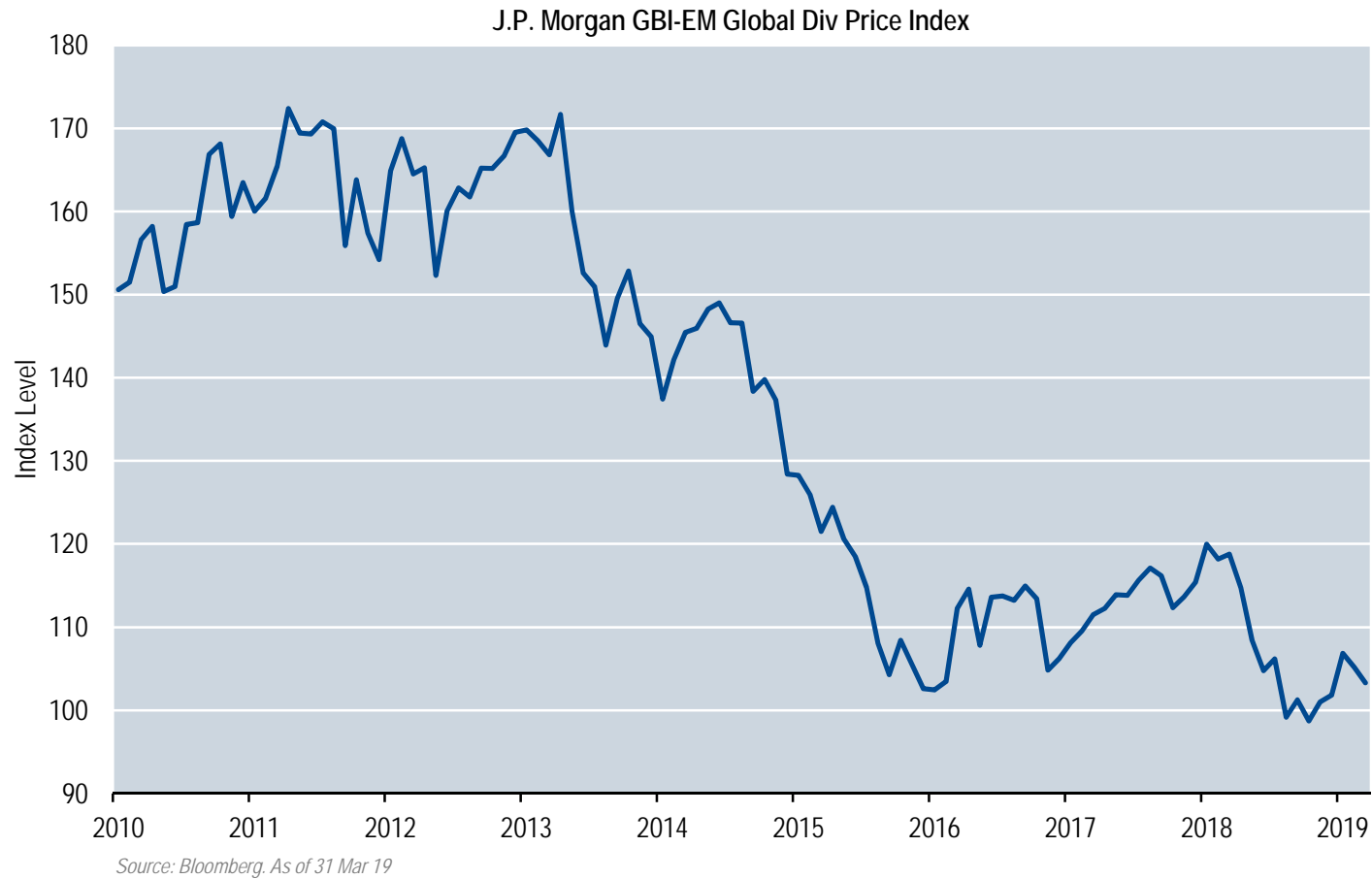
Potential trade war

# Emerging Markets

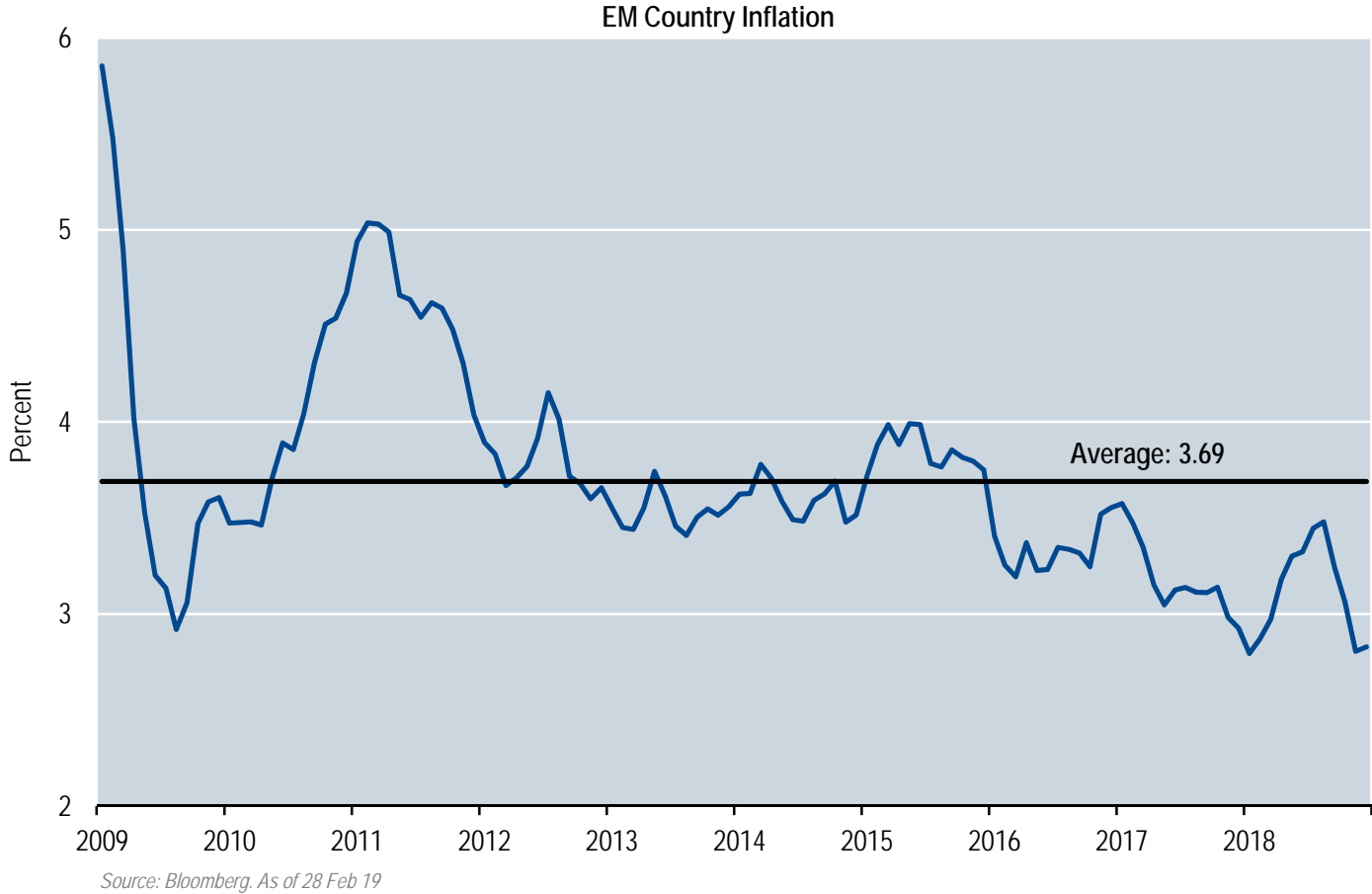
Emerging markets valuations look attractive both on a historical basis and relative to developed markets.



## Higher EM Yields Compiled With Weak Currency Presents Buying Opportunity

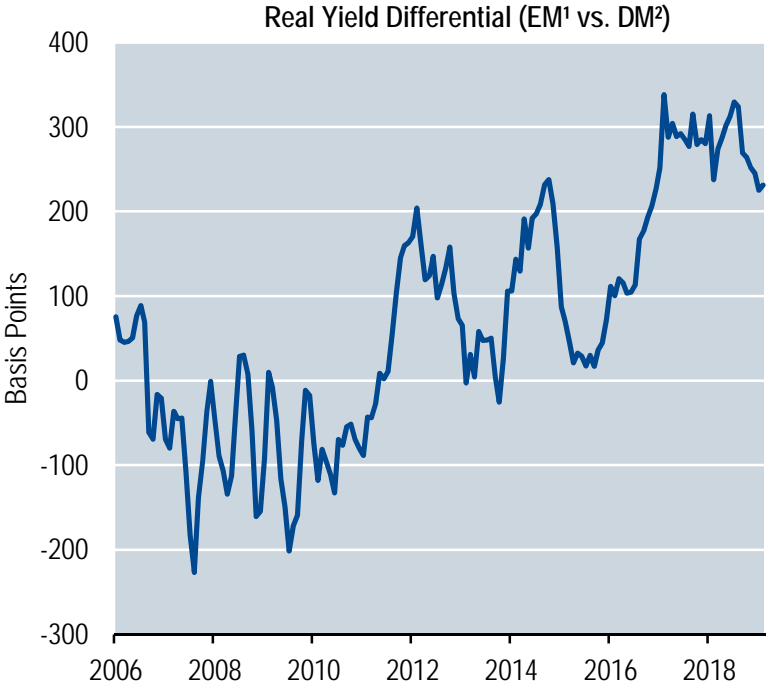


# EM Inflation Near 10-Year Low

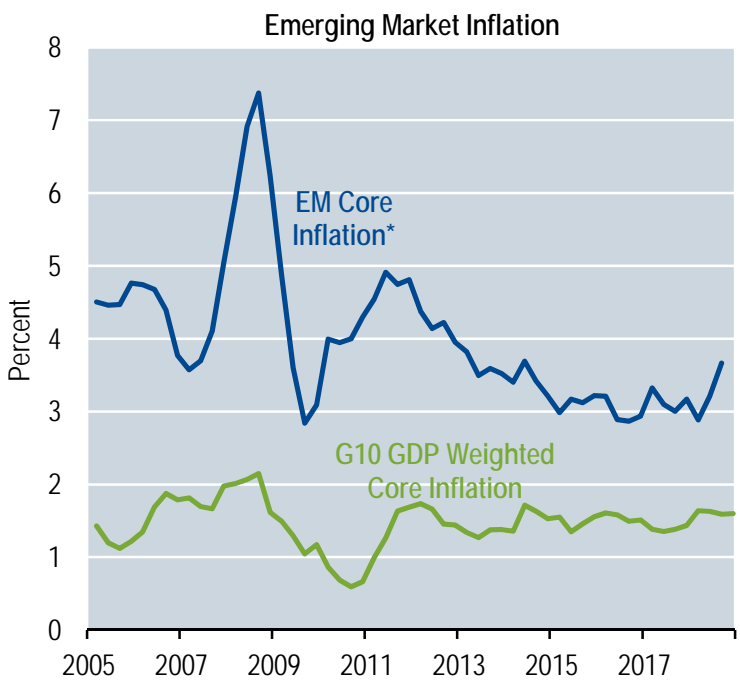




# Real Yield Differential and Core Inflation Rates for Emerging and Developed Markets



Source: Bloomberg, HSBC. As of 28 Feb 19  
 ¹EM (Emerging Markets): weighted average of Brazil, China, India, Indonesia, Mexico, Poland, Russia, S. Africa, and Turkey  
 ²DM (Developed Markets): weighted average of Germany, Japan, UK, and the US



Source: J.P. Morgan. As of 31 Dec 18  
 \*EM core inflation as of 30 Sep 18

## 2019 Outlook

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Global growth has downshifted but should remain sturdy

US growth and inflation to moderate

Central bank policy will be focused on accommodation

Trade policy poses substantial risks

Spread products should recover relative to Treasuries and sovereign bonds

Emerging markets, though volatile, should outperform

## Questions & Answers

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Thank you.

## Risk Disclosure

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