



Thank you for joining Western Asset's *3Q19 Market and Strategy Update* webcast featuring CIO Ken Leech. The presentation will begin shortly.

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3Q19 Market and Strategy Update

June 27, 2019

Ken Leech
Chief Investment Officer

2019 Second Half Outlook

Downside risks have risen, but global growth should remain resilient

US and global inflation rates continue to moderate

Aggressive central bank easing is designed to truncate downside risks

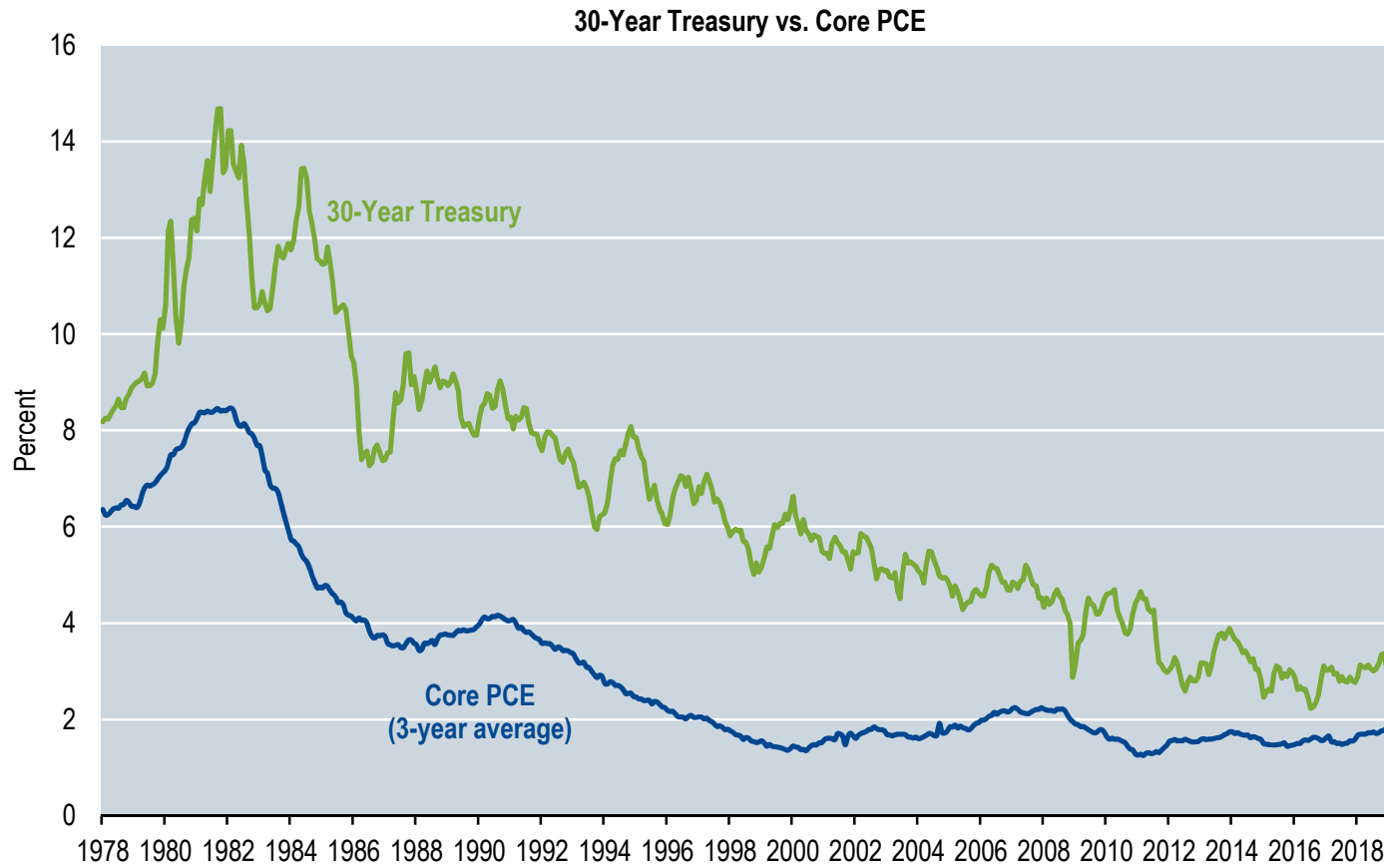
Central bank focus on core inflation outcomes suggests “low for long”

Trade friction will be an ongoing source of risk

Spread products should prove superior to Treasuries and sovereign bonds

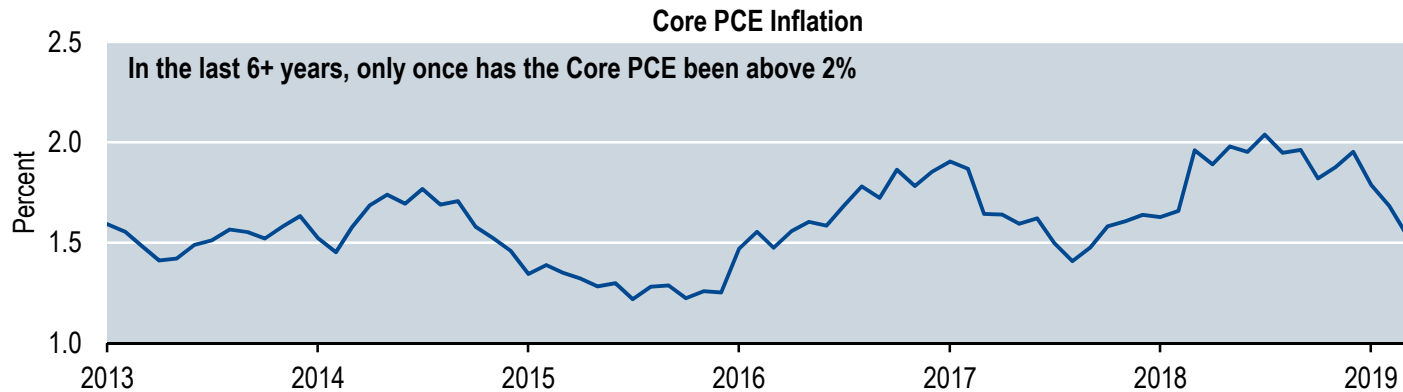
Emerging markets, though volatile, should outperform

The Story of Long-Term Interest Rates Is Largely the Story of Inflation



Source: Bloomberg. As of 30 Apr 19
Personal Consumption Expenditures (PCE) is an inflation index excluding food and energy.

Inflation Refuses to Follow the Script

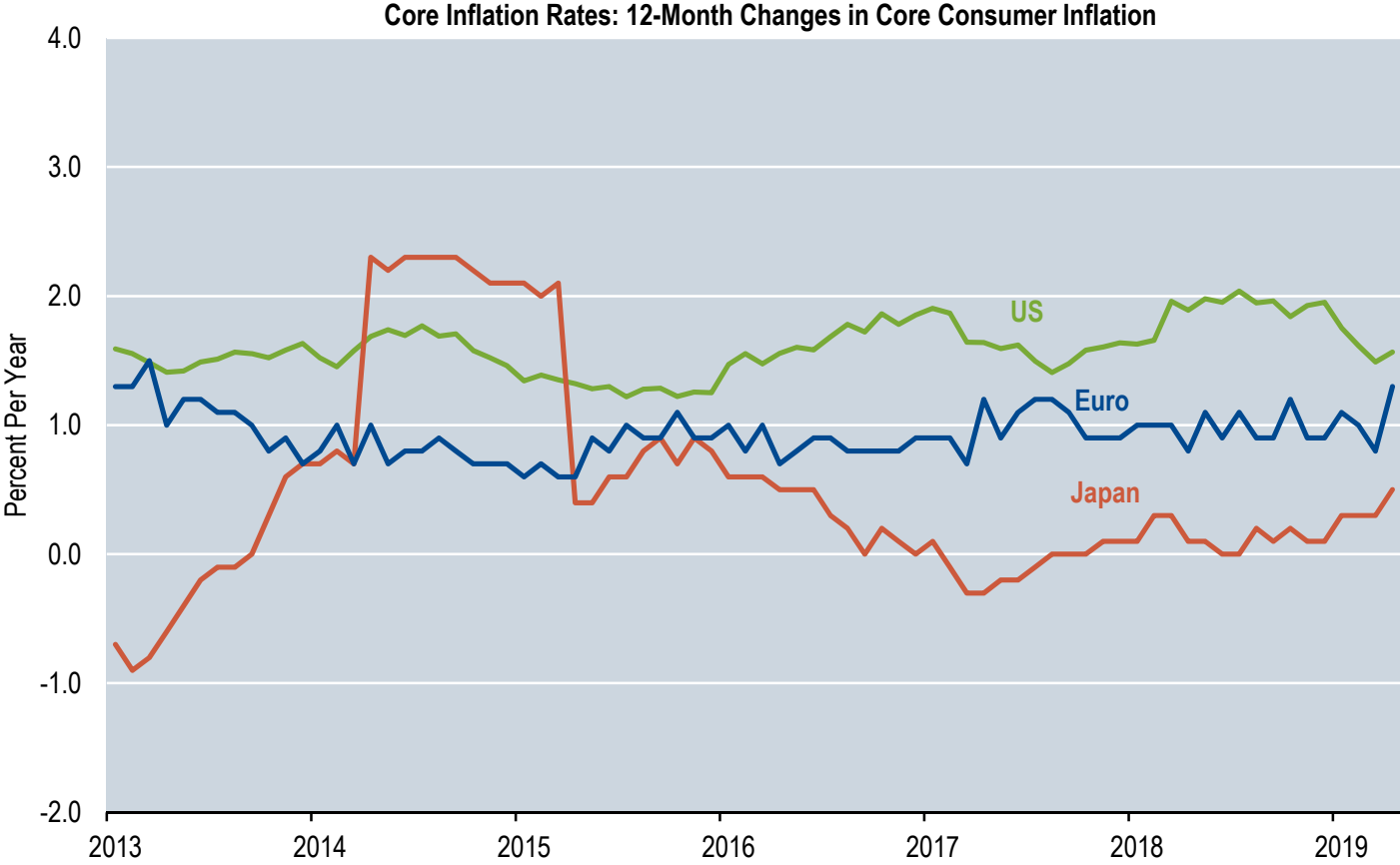


Source: Bureau of Economic Analysis. As of 31 Mar 19

**“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 30 Apr 19

Fed Shifts Focus to Inflation and Risk Management

May Press Conference

Inflation

“Core inflation unexpectedly fell as well, however, and as of March stood at 1.6 percent for the previous 12 months. We suspect that some **transitory factors** may be at work. Thus, our baseline view remains that, with a strong job market and continued growth, inflation will return to 2 percent over time and then be roughly symmetric around our longer-term objective.”

Risk Management

“At the start of the year, a number of crosscurrents presented risks to the outlook, including weak global growth, particularly in China and Europe; the possibility of a disruptive Brexit; and uncertainty around unresolved trade negotiations. While concerns remain in all of these areas, it appears that **risks have moderated somewhat**.

– Jerome Powell
May 1, 2019

June Press Conference

Inflation

“Committee participants **expressed concerns** about the pace of inflation’s return to 2 percent. Wages are rising, as noted above, but not at a pace that would provide much upward impetus to inflation. Moreover, weaker global growth may continue to hold inflation down around the world.”

Risk Management

Uncertainties surrounding the baseline outlook have **clearly risen** since our last meeting... Thus, my colleagues and I will be looking to see whether these uncertainties will continue to weigh on the outlook. And, **we will use our tools as appropriate to sustain the expansion**.

– Jerome Powell
June 19, 2019

Inflation and Downside Risks

Inflation

“In the absence of improvement, such that the **sustained return of inflation** to our aim is threatened, additional stimulus will be required.”

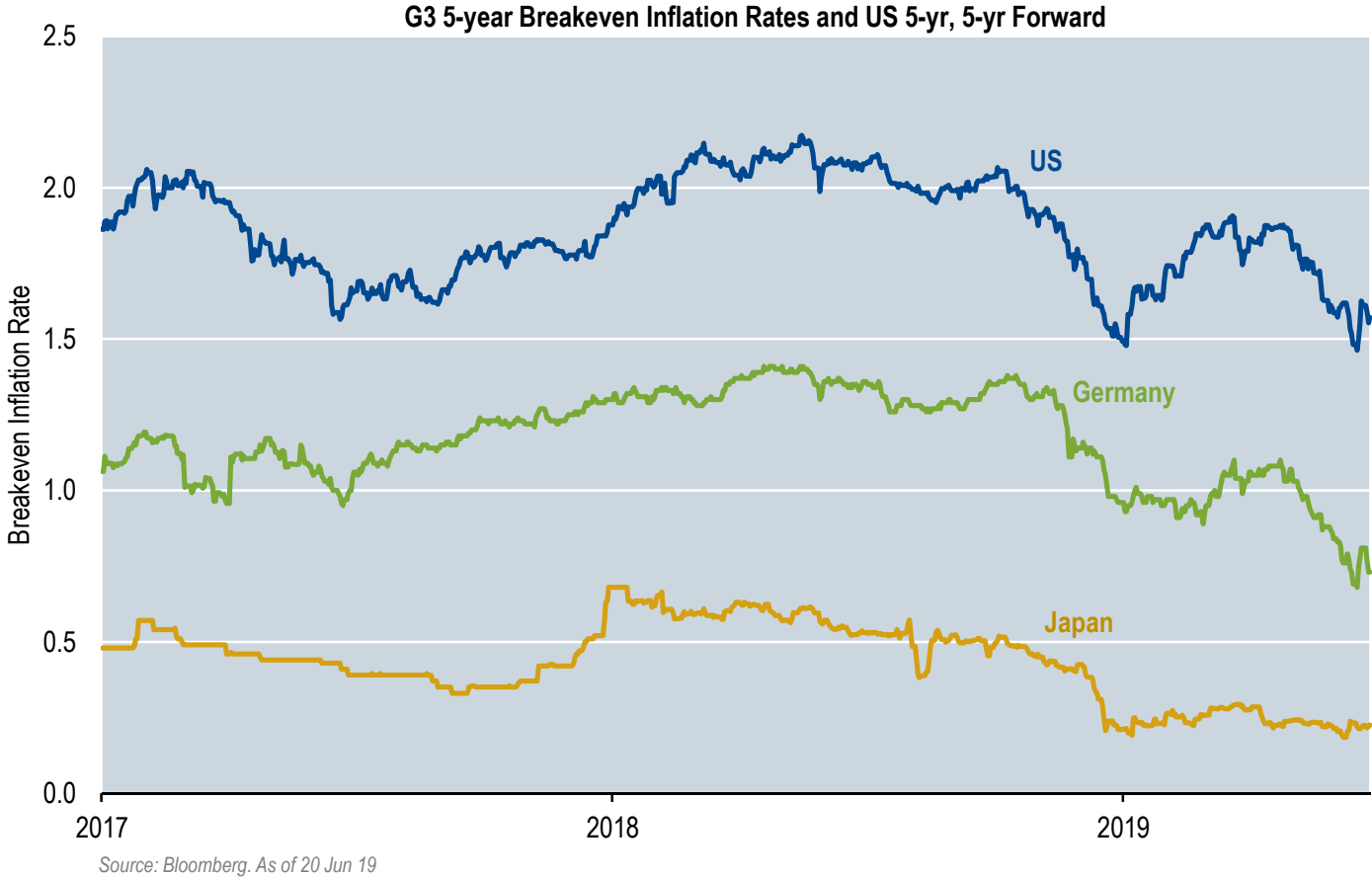
“we clarified that symmetry meant not only that we **would not accept persistently low inflation**, but also that there was no cap on inflation at 2%.”

Downside risks to growth

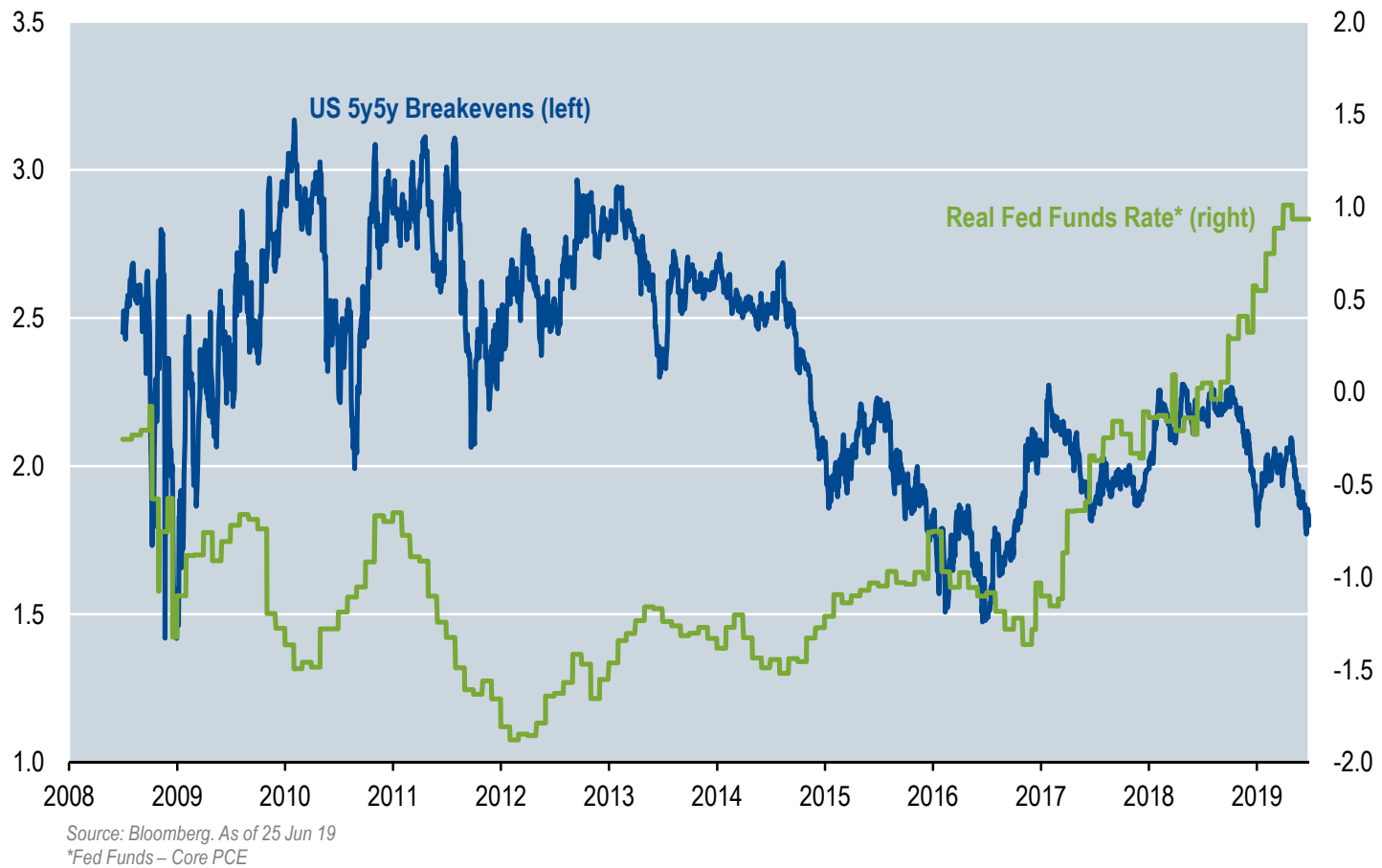
“Looking forward, the risk outlook remains tilted to the downside, and indicators for the coming quarters point to lingering softness. The risks that have been prominent throughout the past year, in particular geopolitical factors, the rising threat of protectionism and vulnerabilities in emerging markets have not dissipated. The prolongation of risks has weighed on exports and in particular on manufacturing. In the absence of improvement, **such that the sustained return of inflation to our aim is threatened, additional stimulus will be required.**”

– Mario Draghi
June 18, 2019

Global Inflation Expectations Fell Despite Trend Growth



Is Fed Easing Essentially a “Normalizing” Process?

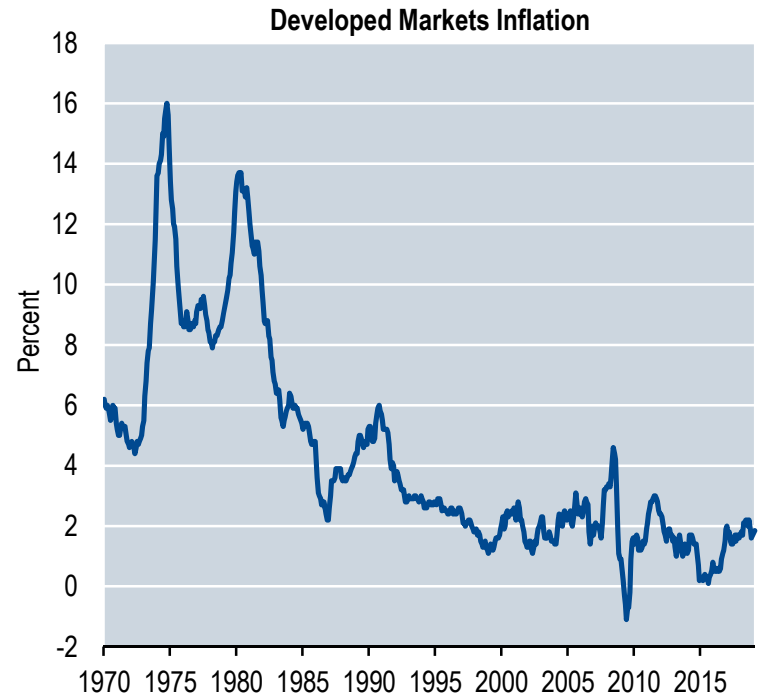


“Reflation Trade” vs. “Secular Stagnation”

Global growth has downshifted and inflation remains subdued.



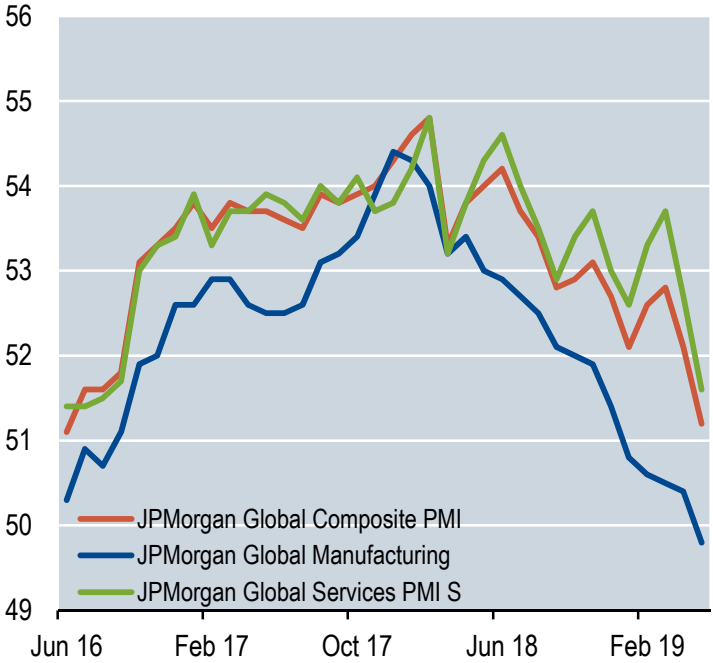
Source: International Monetary Fund. As of 30 Apr 19



Source: Bloomberg. As of 31 Mar 19

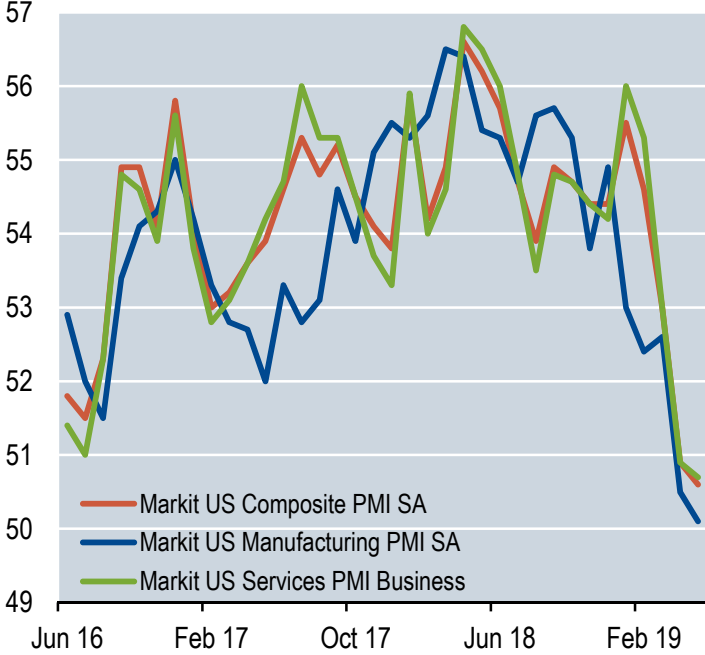
Global Weakness in Manufacturing Accentuates Downside Risks

**Global Government Bonds Markets Spooked:
Global PMIs from Synchronized Upwing to Synchronized Decline**



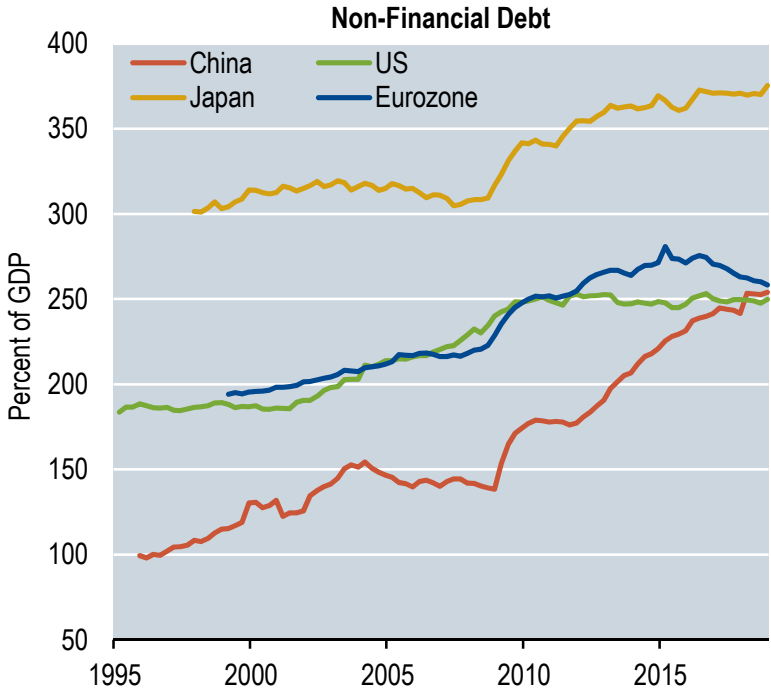
Source: Bloomberg. As of 31 May 19

**United States – Held in Through Early
2019, But No Longer Impervious**

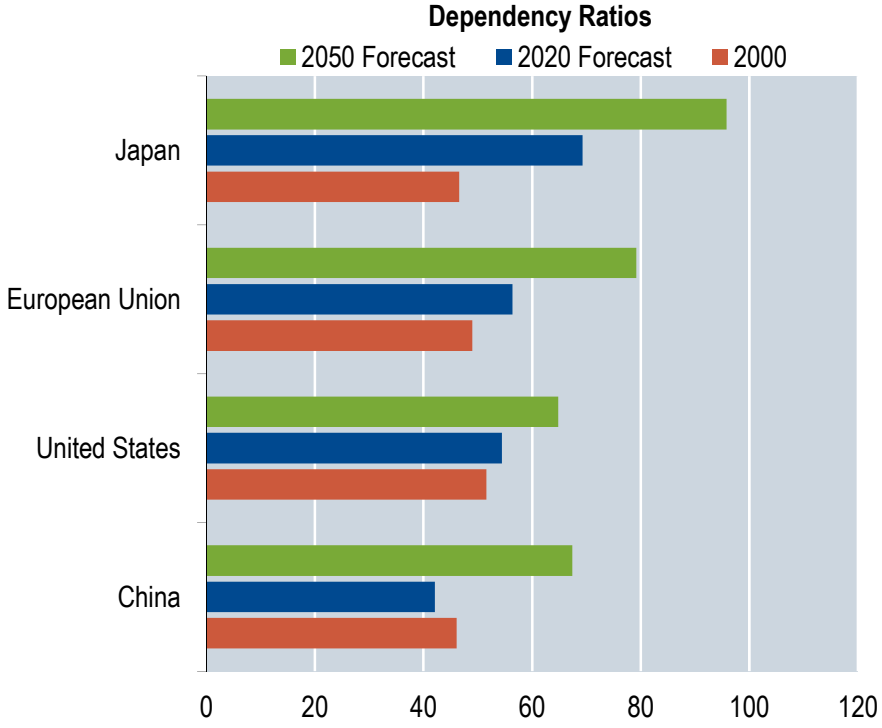


Source: Bloomberg. As of 31 May 19

Global Headwinds: Debt and Demographics

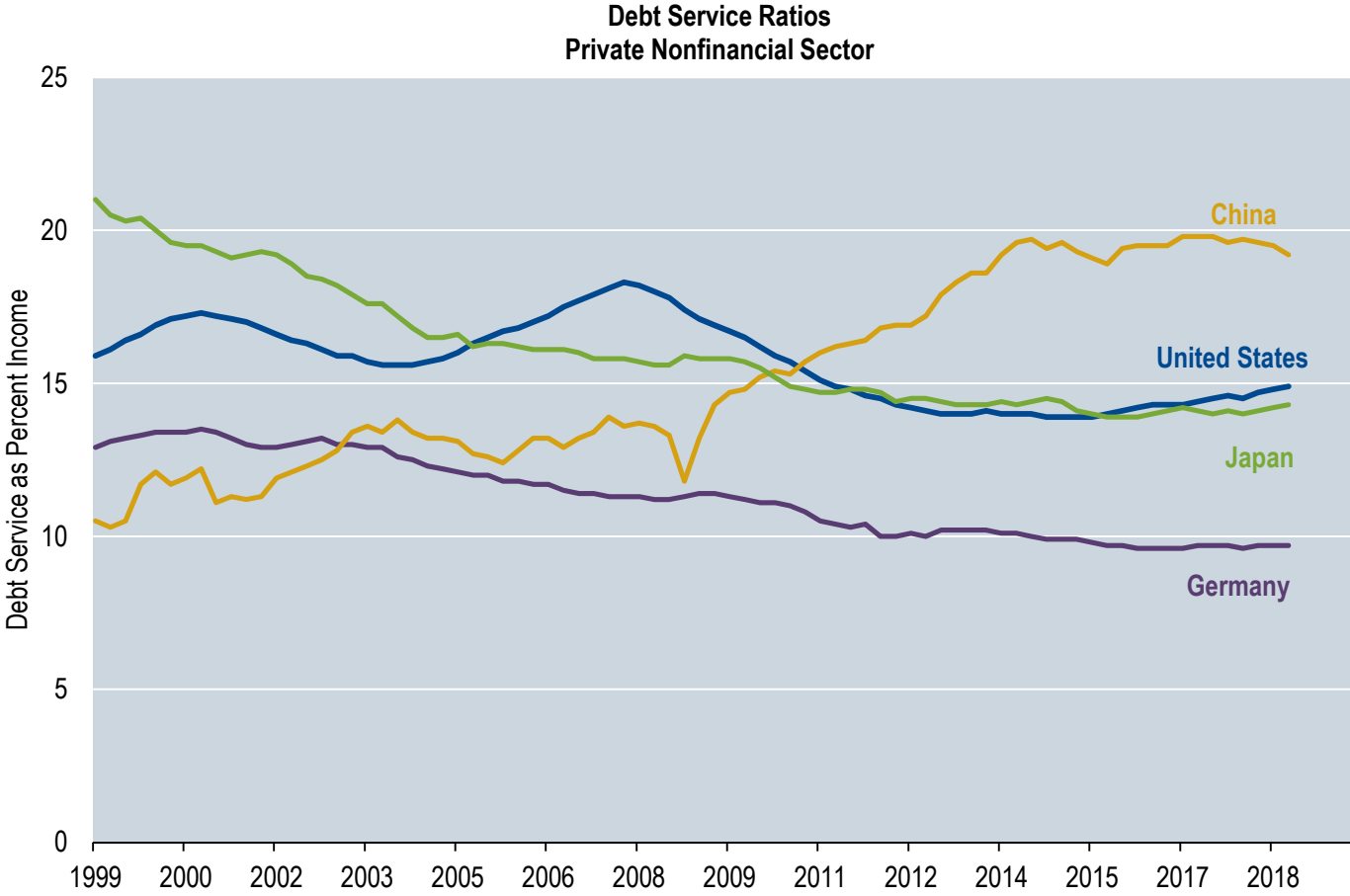


Source: Bank for International Settlements. As of 31 Dec 18



Source: World Bank. As of 25 Apr 19

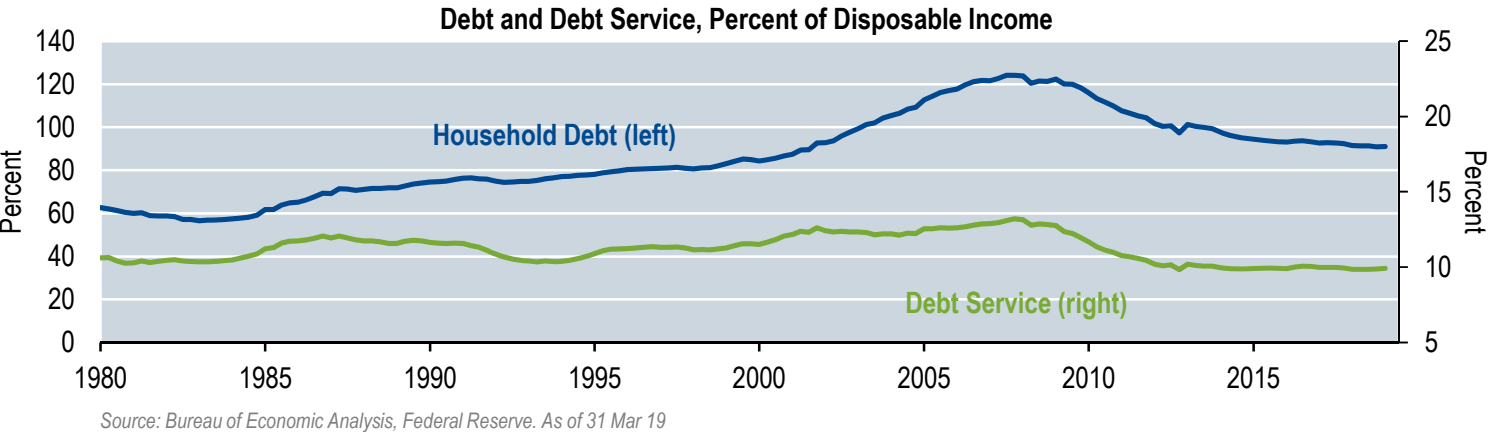
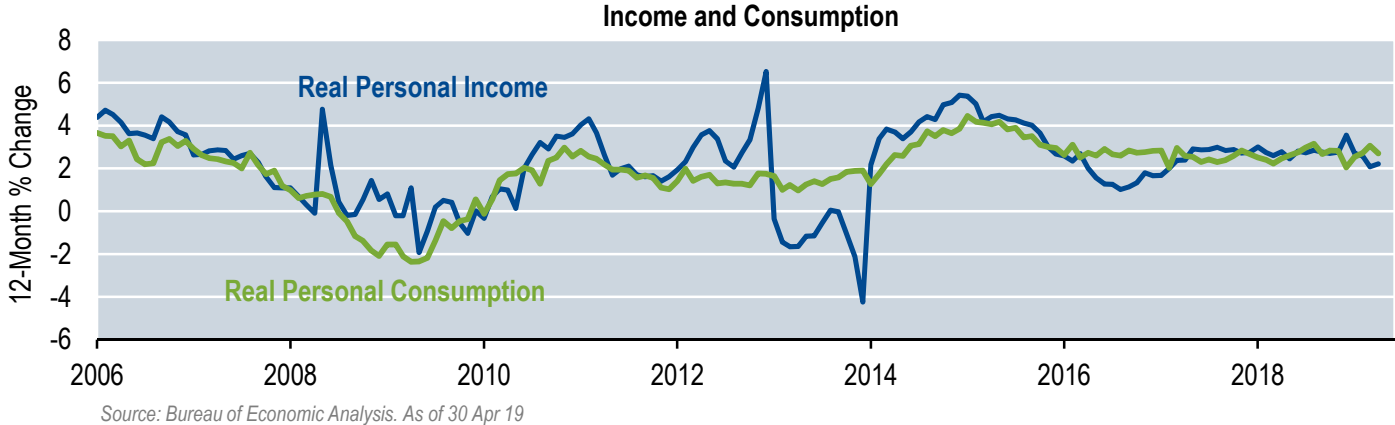
But Private Non-Financial Debt Issue Not as Challenging



Source: BIS. As of 31 Dec 18

Moderate US Economic Growth to Continue (1.75% – 2%)

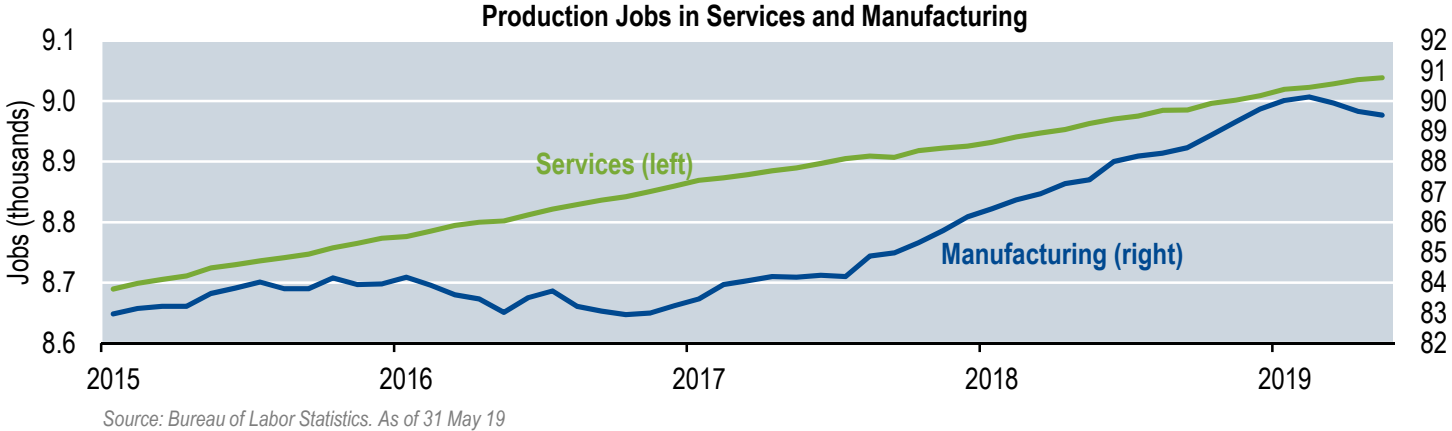
US Growth: Consumer Fundamentals OK



Manufacturing Uncertainty Weighs on the Fed

“If you look at the real economy data, consumer is very solid. That makes a ton of sense. Low unemployment, high confidence readings still, wages moving up. You have surveys that show businesses think it is hard to find good workers, workers think that jobs are plentiful. This is a good time for consumers and spending data has been strong. **What has happened is you have seen weakness in manufacturing really around the world.**”

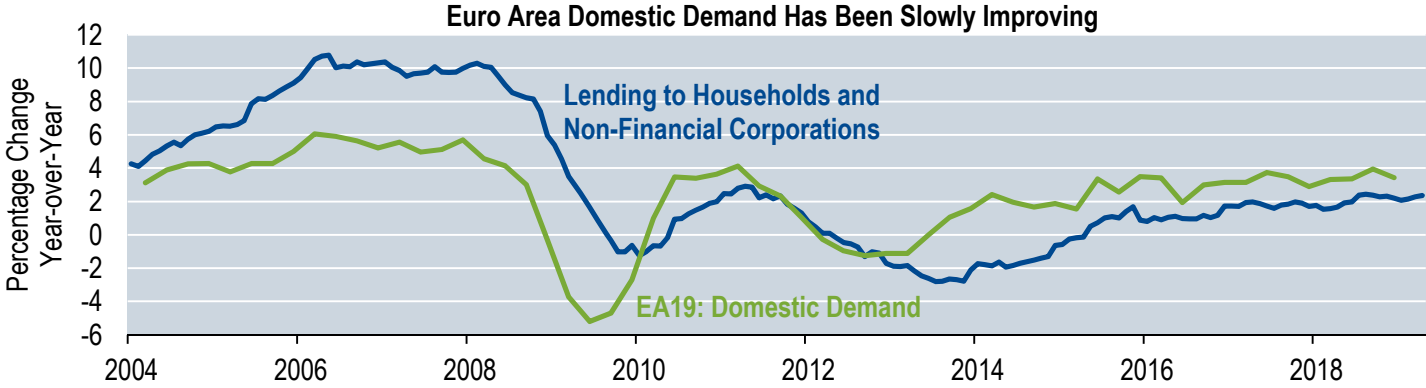
– Jerome Powell
Bloomberg TV
June 25, 2019



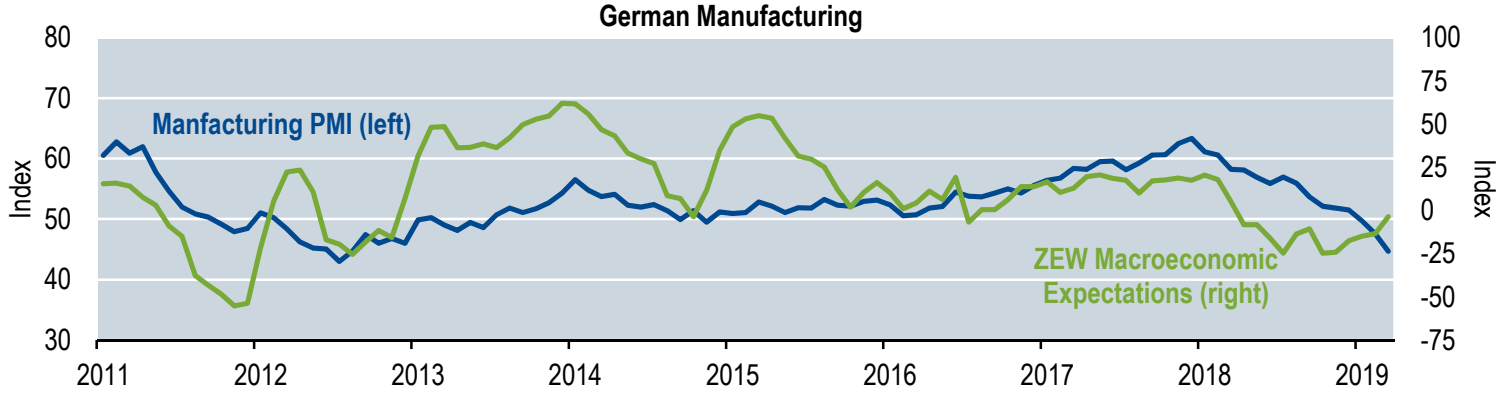
Quote is courtesy of RBC Capital Markets, LLC. Bolded text is RBC emphasis



Eurozone Domestic Demand Diverging From Manufacturing



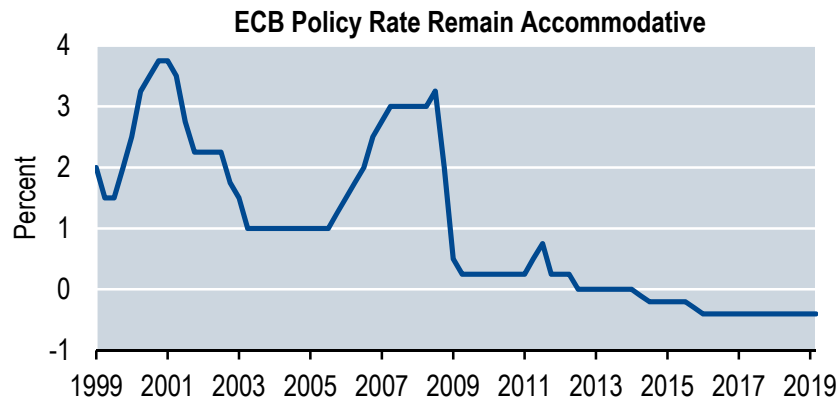
Source: Haver, Western Asset. Domestic Demand As of 31 Mar 19. Lending as of 30 Apr 19



Source: Markit, Haver, Western Asset. As of 30 Apr 19

Eurozone Growth: Fiscal and Monetary Accommodation Should Bear Fruit

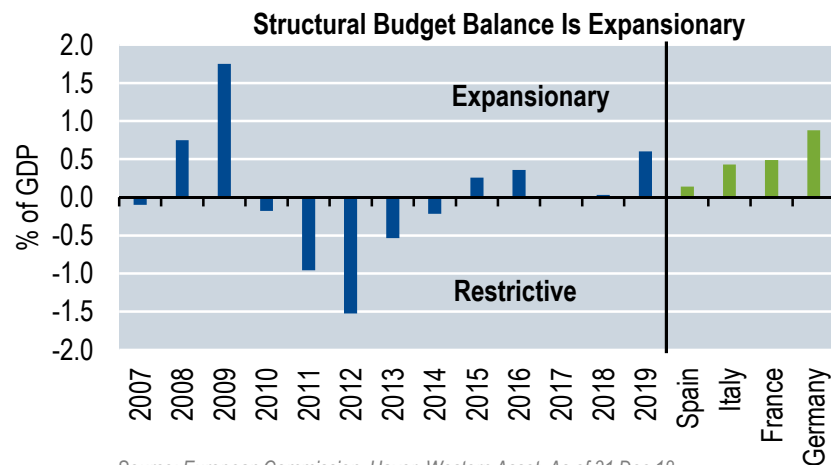
European fiscal policy has begun to show signs of easing following years of restrictive policy. Additionally, the ECB has made clear that it is willing to add further extended accommodation.



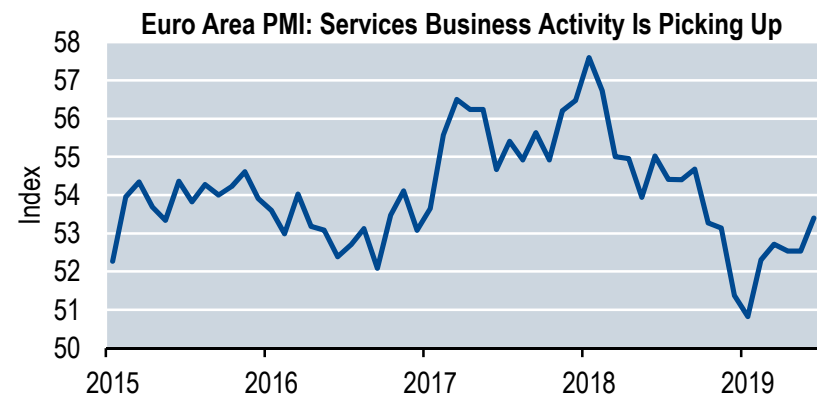
Source: Bloomberg. As of 31 May 19



Source: Bloomberg. As of 31 May 19



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



Source: IHS Markit, Haver Analytics. As of 21 Jun 19

Eurozone Growth Outlook

After evidence of weaker European growth earlier this year, the overall outlook is now improving.



Source: Bloomberg. As of 24 Jun 19

China Growth: Healthy Domestic Demand and Robust Stimulus Is Supportive

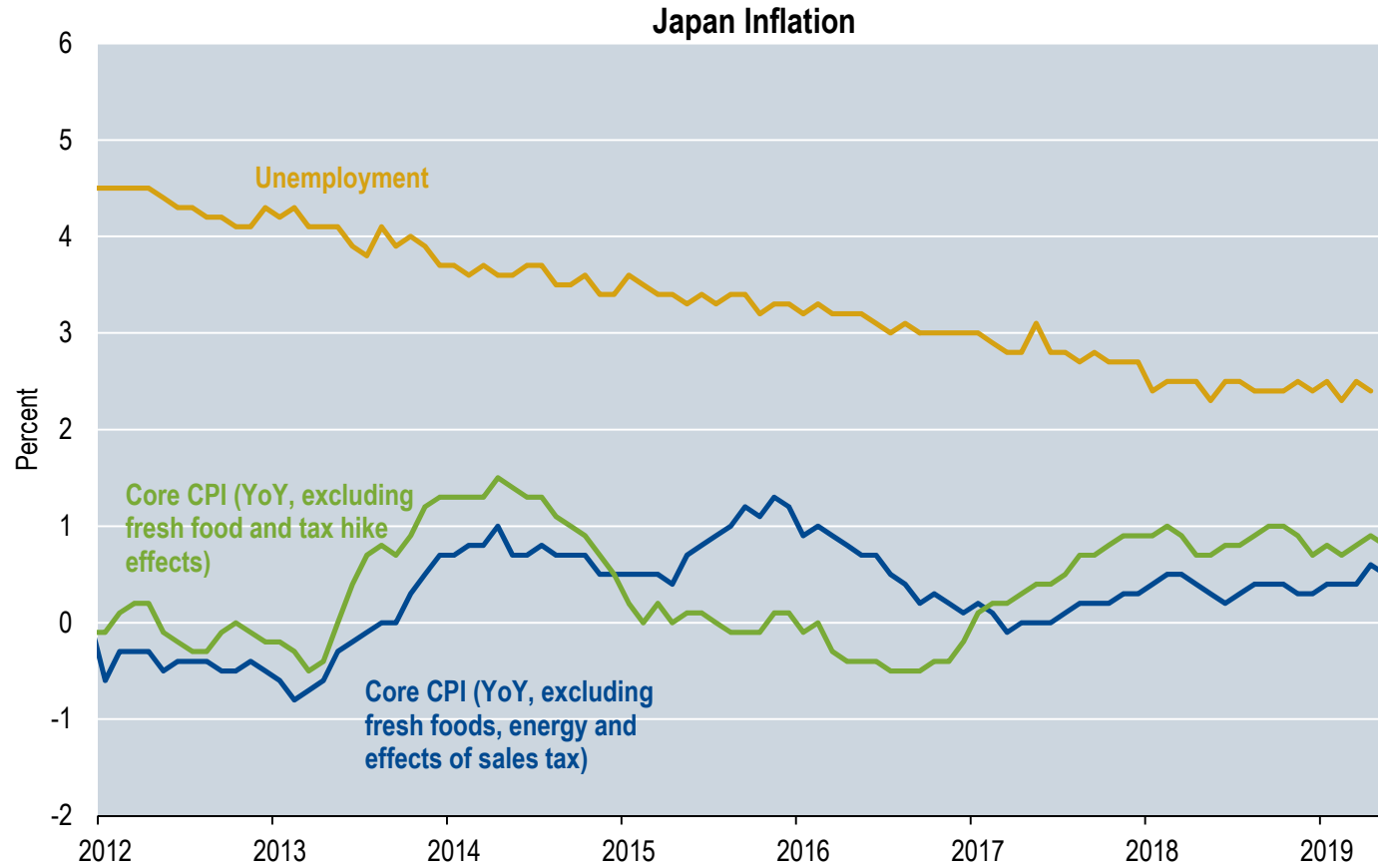
We expect to see better growth in China as China's stimulus measures will have had time to take effect.

	China's Recent Measures to Ease Credit and Stabilize Growth	Room to Ease Further?	Comments
RRR	<ul style="list-style-type: none"> Six cuts from 2018 to May 2019 	Yes	Current ratio 13.5% remains high compared to other markets
Tax cuts	<ul style="list-style-type: none"> Lowered VAT for manufacturing and other sectors by 1% in May 2018 and another 1%-3% in April 2019 Raised annual the maximum taxable income threshold of SMEs eligible for preferential corporate income tax from CNY500,000 to CNY1mm Raised the minimum threshold for personal income tax exemption from CNY3,500 to CNY5,000 per month 	Yes	e.g., Further VAT cut and targeted cut of corporate income tax on selected supported sectors
Fiscal stimulus	<ul style="list-style-type: none"> Increased headline budget deficit by 0.2 percentage points to 2.8% of GDP in 2019 Expanded Local Government Special Bond issuance quota to CNY2.15trn in 2019 from CNY1.35trn in 2018 	Yes	Government has room to lever up given manageable government debt (central+local) at 70% of GDP
Credit market easing	<ul style="list-style-type: none"> PBoC injecting capital into China Bond Insurance Co Reviving Credit Risk Mitigation Warrant (CRMW) to help privately owned enterprises (POE) to tap the domestic bond market by offering credit insurance Broadening the range of collateral for Medium-term Lending Facility (MTL) operations to include lower-rated bonds 	Yes	Room to loosen bond issuance regulation and quota for targeted corporates
Other measures	<ul style="list-style-type: none"> Lowered employer's contribution rate for basic pension insurance to 16% (from 19%~20%) in May 2019. This is expected to benefit labor-intensive POEs and SMEs the most Expanded the scope of eligible loans to be classified as SME loans by increasing the minimum size to CNY10mm from CNY5mm, thus allowing more banks to be able to enjoy lower RRR rates based on targeted RRR cut criteria announced earlier Expanding debt-to-equity swap program Set up asset management plans (with funds contributed by 11 brokerages) for supporting POEs PBoC window guidance to banks for lending to POEs 	Yes	e.g., Stimulate domestic consumption by providing sweeteners for buying home appliances, cars, etc. Relax property curbs

Source: Bloomberg, Western Asset

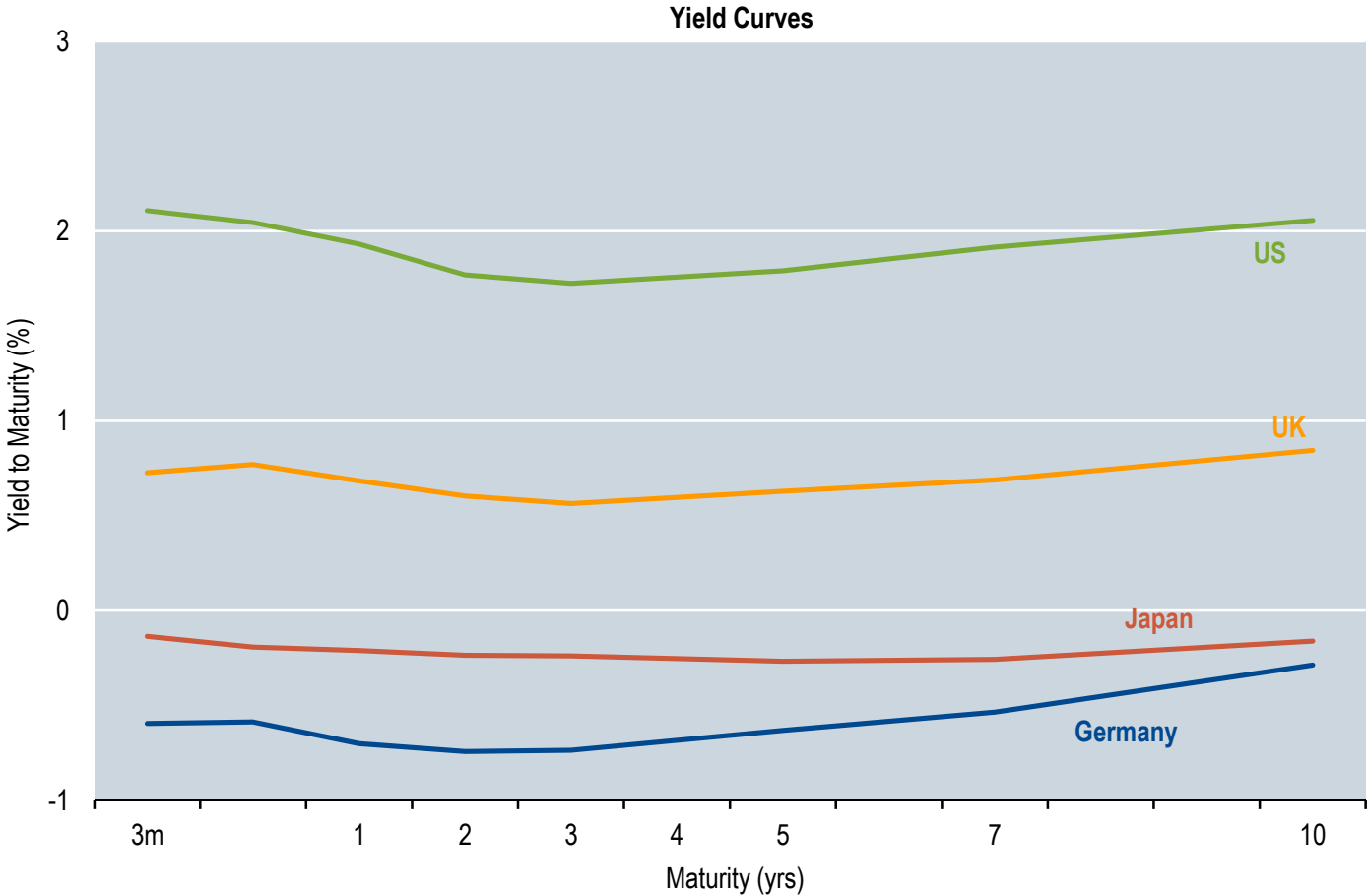
Japan

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



Source: Datastream, Western Asset. As of 31 May 19

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



Source: Bloomberg. As of 21 Jun 19

Central Bank Easing Goes Global

Poised to ease

- US
- Europe
- Japan

Already easing policy

- Australia
- *China
- India
- Russia
- Chile
- New Zealand
- Malaysia
- Egypt
- Venezuela
- Iceland
- Ukraine
- Oman

**Cut reserve requirements*

Global Governments

The prevalence of negative yields remains.

Country	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	20-Year	30-Year	Lowest Credit Rating
Switzerland	-0.89	-0.92	-0.91	-0.88	-0.84	-0.77	-0.73	-0.66	-0.61	-0.50	-0.25	-0.11	0.02	AAA
Germany	-0.69	-0.74	-0.73	-0.70	-0.63	-0.59	-0.53	-0.46	-0.38	-0.29	-0.08	0.09	0.30	AAA
Austria	-0.61	-0.66	-0.60	-0.53	-0.44	-0.36	-0.24	-0.20	-0.11	0.00	0.33	0.42	0.71	AA+
Japan	-0.20	-0.23	-0.23	-0.25	-0.26	-0.26	-0.25	-0.24	-0.20	-0.16	0.04	0.21	0.34	A
Sweden		-0.64		-0.64	-0.54	-0.40		-0.24	-0.11	0.02	0.19	0.48		AAA
Netherlands		-0.67	-0.71	-0.70	-0.61	-0.46	-0.38	-0.28	-0.21	-0.12	0.03	0.14	0.33	AAA
Finland	-0.64	-0.64	-0.60	-0.53	-0.50	-0.36	-0.30	-0.16	-0.09	0.01	0.26		0.56	AA+
Denmark		-0.74	-0.71		-0.66	-0.55		-0.41		-0.23		0.05		AAA
Belgium	-0.57	-0.66	-0.62	-0.49	-0.36	-0.29	-0.20	-0.09	0.01	0.11	0.46	0.70	1.08	AA-
France	-0.59	-0.66	-0.64	-0.59	-0.47	-0.36	-0.27	-0.17	-0.06	0.05	0.41	0.53	0.99	AA
Ireland	-0.57		-0.45	-0.44	-0.35	-0.20	-0.11		0.11	0.24	0.61	0.81	1.18	A+
Spain	-0.40	-0.42	-0.35	-0.21	-0.11	-0.02	0.11	0.22	0.31	0.43	0.94	0.95	1.43	BBB
Italy	-0.06	0.26	0.87	1.04	1.41	1.43	1.62	1.80	1.85	2.15	2.61	2.78	3.13	BBB+
United Kingdom			0.75	0.68	0.57	0.57	0.59	0.63	0.64	0.69	1.06	1.23	1.44	AA
United States	1.93	1.77	1.72		1.79		1.91			2.05			2.58	AA+
Norway		1.20		1.20	1.21	1.22	1.29	1.35	1.39	1.45				AAA
Poland	1.39	1.53	1.69	1.83	1.98	2.12	2.23	2.31	2.34	2.37				A-
Singapore	1.93	1.64			1.76					1.96	2.23	2.33	2.53	AAA
South Korea	1.47	1.45										1.60		AA-
China	2.64	2.79	2.88		3.02		3.26			3.23			3.85	A+
Malaysia	3.20		3.33		3.42		3.58			3.65	3.98	4.12	4.42	A-
Mexico	8.16	7.82	7.63	7.57	7.55	7.54		7.57		7.68		7.85	7.92	BBB+
Indonesia	6.53	6.77	6.90	6.89	6.87	7.27	7.38	7.39	7.44	7.42	7.81	7.99	8.31	BBB-
South Africa		6.39	7.27				8.12			8.86	9.56	9.84	9.86	BB

Total Negative Yielding Global Aggregate Debt: \$12.9 Trillion

Source: Bloomberg. As of 21 Jun 19

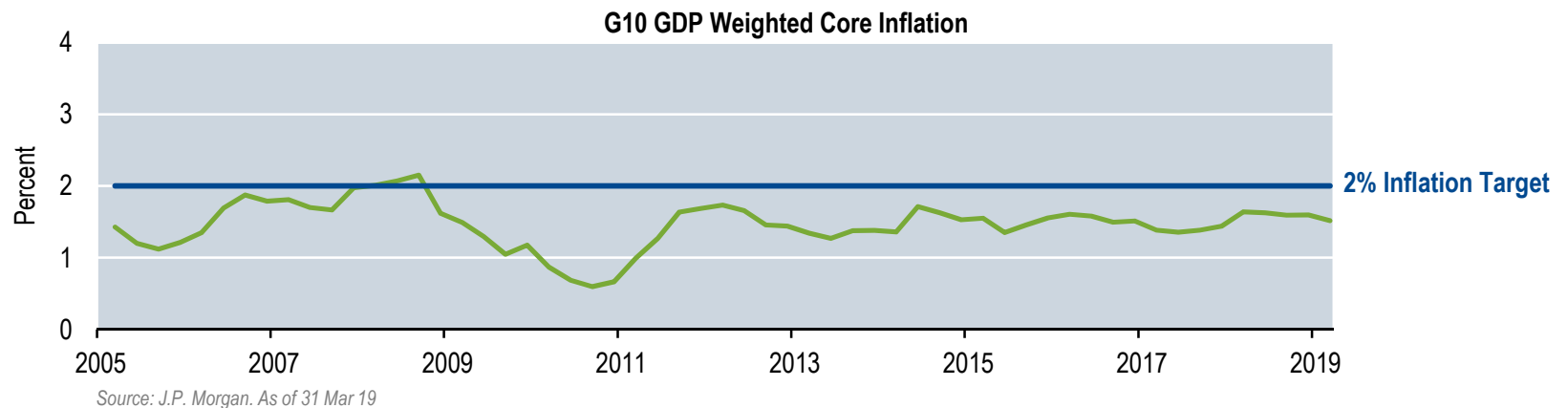
Interest Rates

“Low for Long”

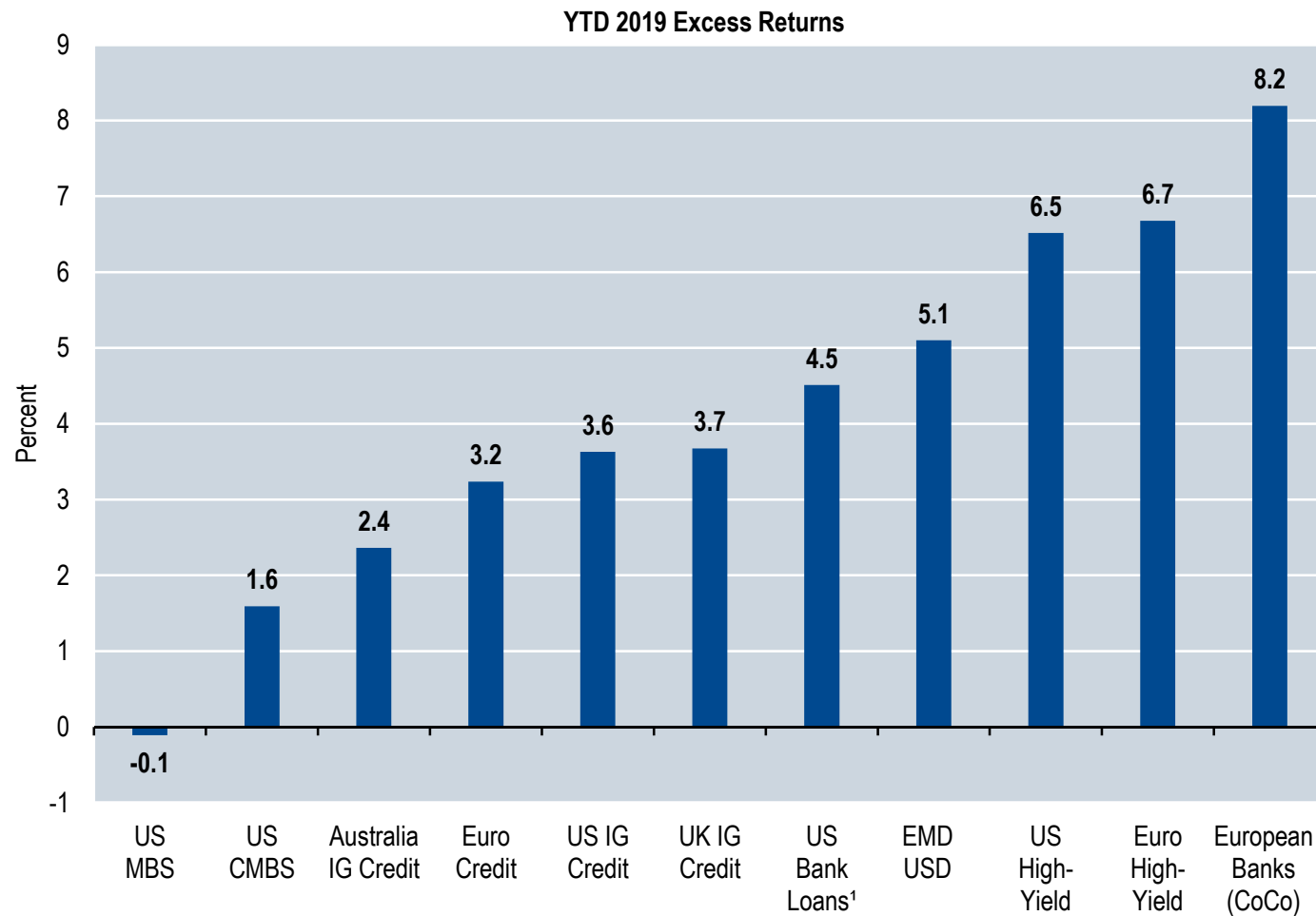
Central bank shifting almost exclusively focused on core inflation outcomes

Core inflation remains persistently and seemingly intractably below-target

Horizon for above-target core inflation outcomes will take many years



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 21 Jun 19
¹S&P/LSTA Performing Loans Index excess return vs. 3-Month LIBOR

Investment-Grade Credit – No Near-Term “Avalanche” of BBB Downgrades

2018 "BBB glut" to 2019 “debt diet”

YTD Excess Returns ¹	bps
Bloomberg Barclays US Credit Index	+315
BBB	+432
A	+268

25 Largest BBB Issuers

Ticker	Company Name	Index Rating	Total IG Index Debt ² , (USD, billions)	US IG Index Weight ² (%)	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	Lower	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	Bristish 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

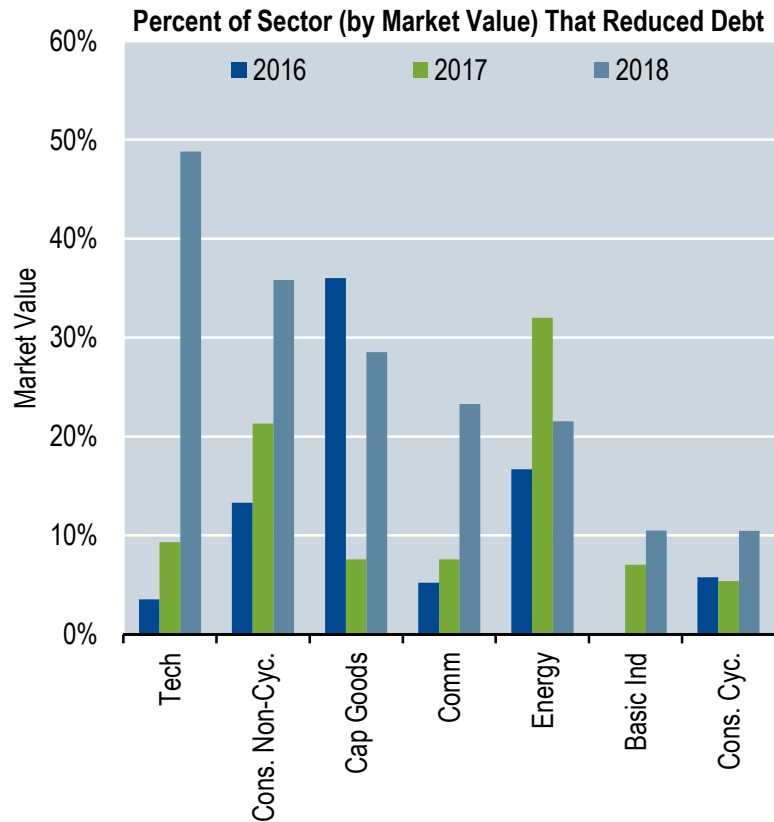
Source: Bloomberg, Western Asset

¹As of 20 Jun 19

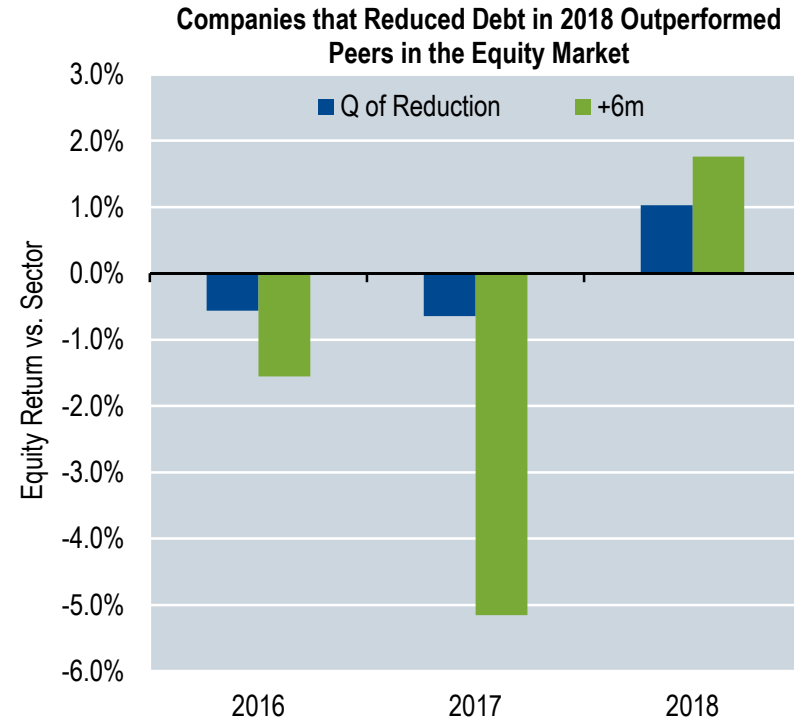
²As of 14 Mar 19

Sentiment Shift

More companies are reversing debt and being rewarded in the equity market.



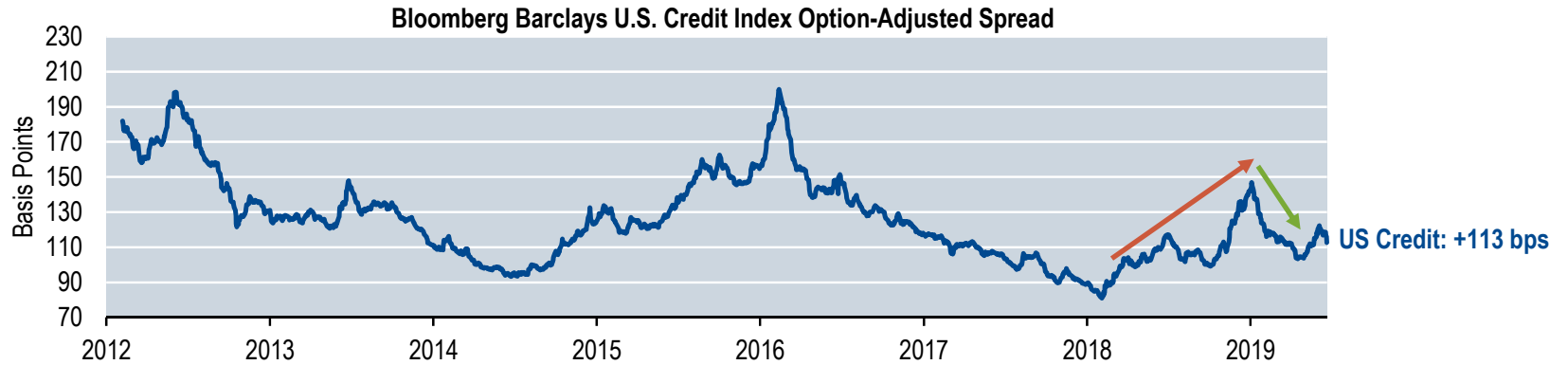
Source: Bloomberg Barclays. As of 31 Dec 18



Source: Bloomberg Barclays. As of 31 Dec 18

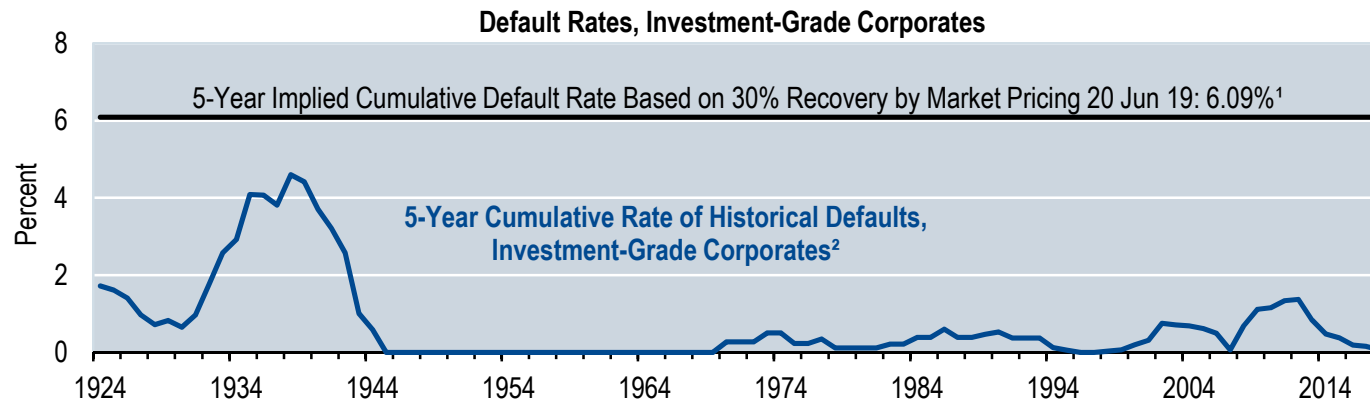
Investment-Grade Credit

Spreads 54 bps wider in 2018 provided an opportunity in 2019.



Source: Bloomberg Barclays. As of 20 Jun 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.

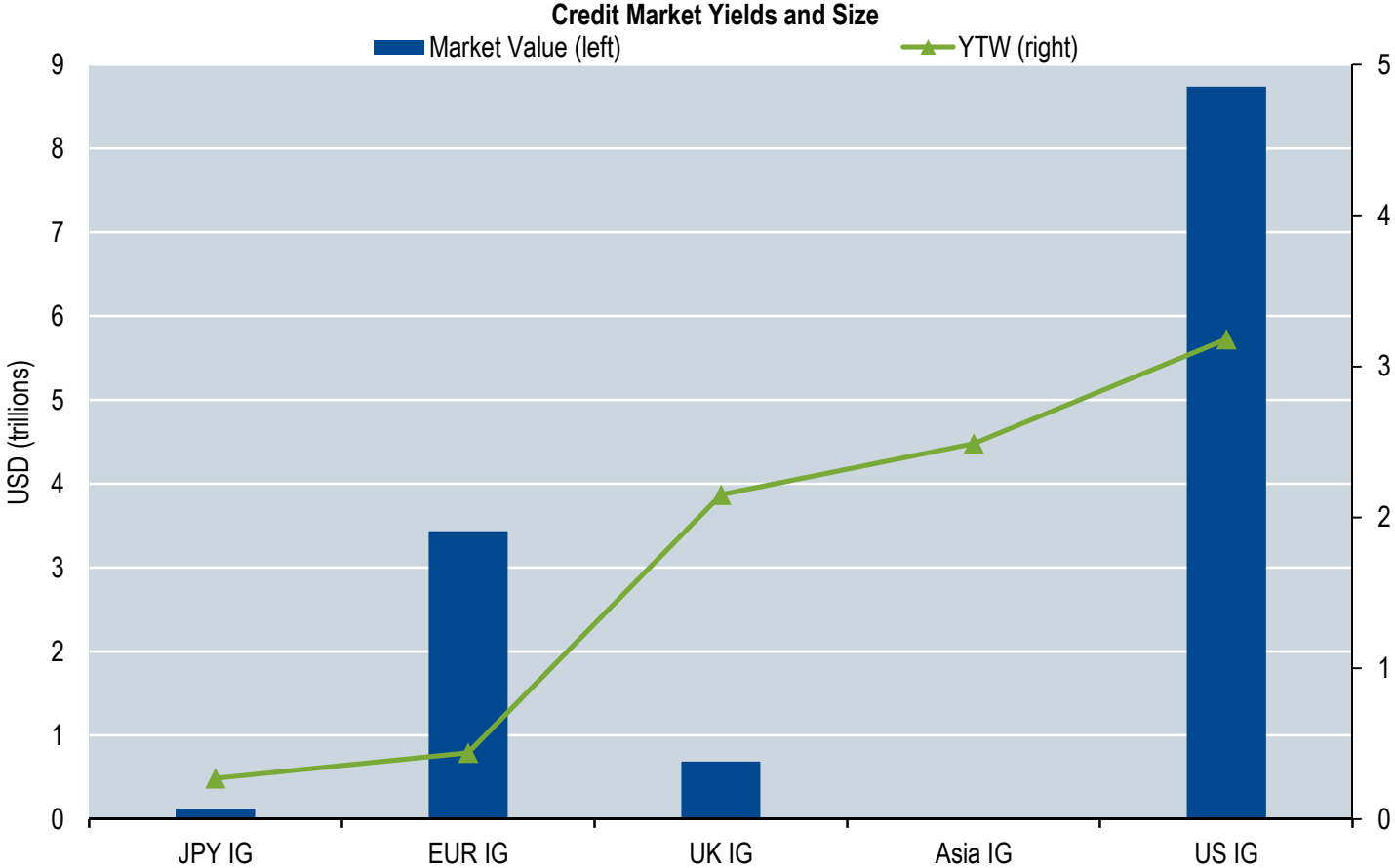


Source: Moody's, Bloomberg Barclays, Bloomberg. As of 20 Jun 19

¹Calculation assumes 25 bps liquidity premium

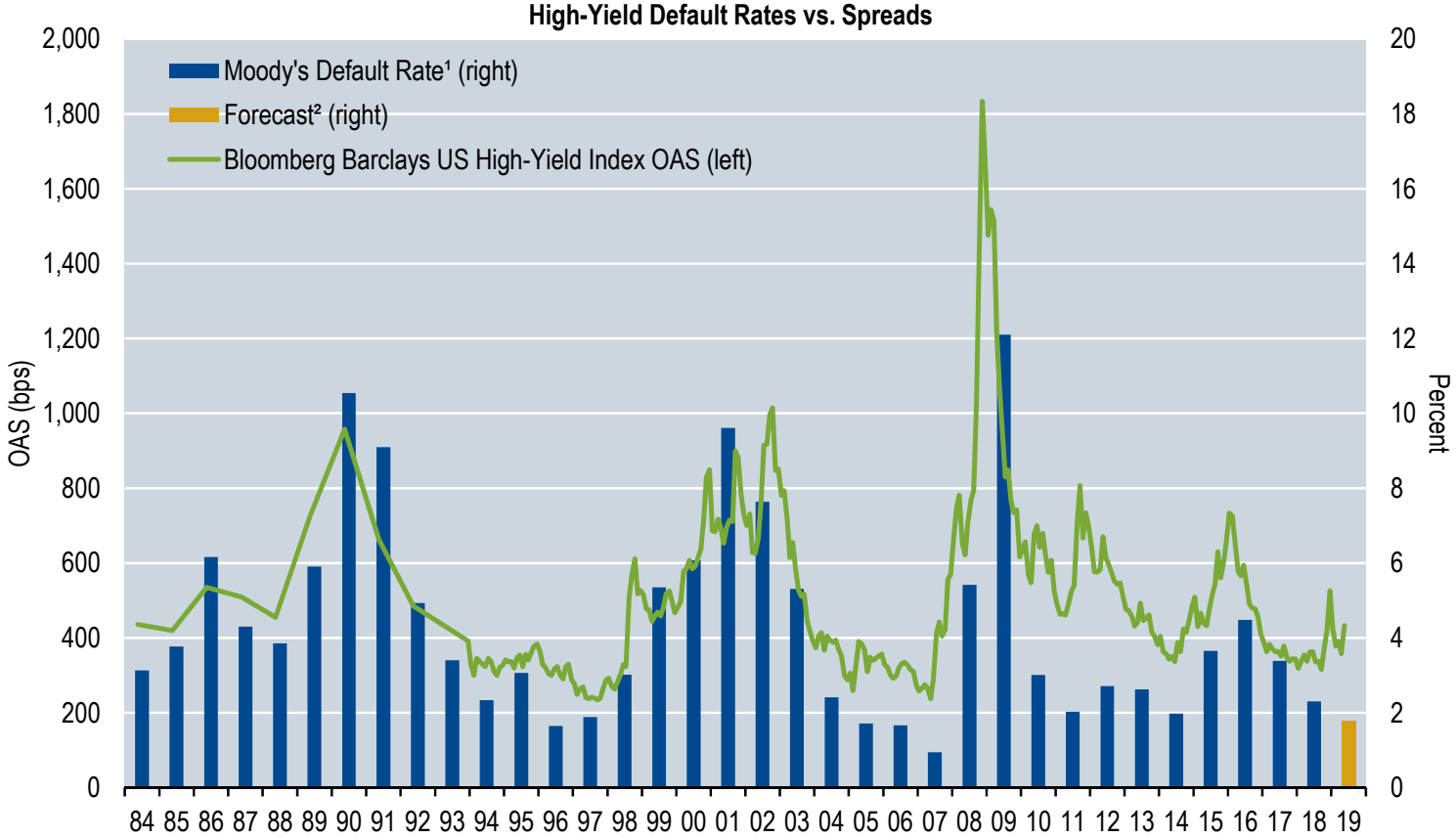
²As of 31 Dec 18

US Credit Markets Offer Both Yield and Size



Source: Bloomberg Barclays. As of 21 Jun 19
 Bloomberg Barclays Global Credit Index by Currency

Default Rates Remain Below the Long-Term Average



Source: Moody's, Bloomberg Barclays, Western Asset. As of 31 May 19
¹Moody's Trailing 12-Month Issuer-Weighted Spec-Grade Default Rate
²Moody's baseline forecast for 31 Dec 19 as of 31 Mar 19

Moody's long-term annual speculative default rate average (1984-2018): 4.3%

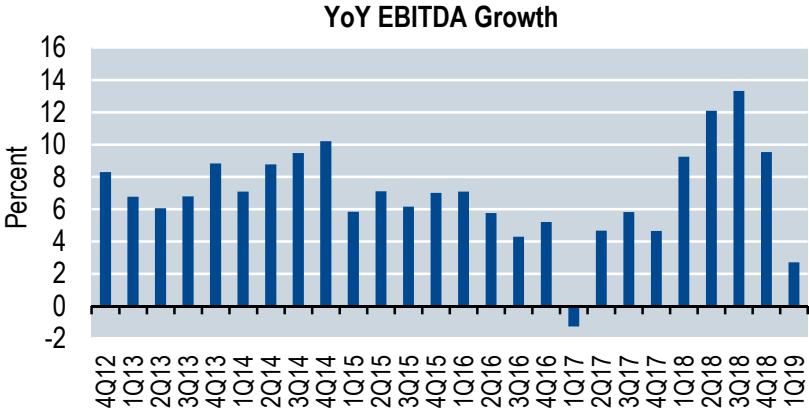


High-Yield Supply/Demand Balance

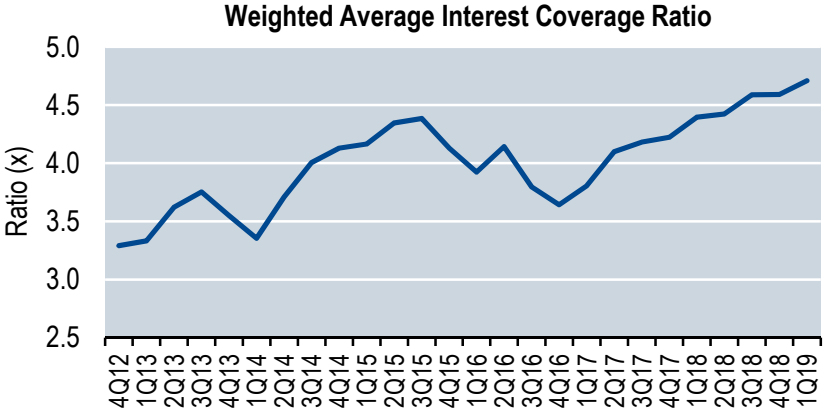
High-Yield Bond Supply Shortage (USD, billions)									
	2011	2012	2013	2014	2015	2016	2017	2018	YTD
Gross New Issuance	245.6	368.1	398.5	355.7	293.2	286.2	328.1	187.4	111.6
Calls	-73.4	-102.1	-122.8	-137.2	126.3	-127.5	176.1	-140.4	-40.3
Tenders	-49.4	-50.9	-47.2	-47.2	-49.8	-70.6	-59.0	-43.7	-25.6
Maturities	-47.4	-42.6	-48.8	-40.1	-44.2	-50.9	37.5	-46.5	-24.1
Net New Issuance	75.4	172.4	179.7	131.2	72.9	37.1	55.4	-43.1	21.7
Fallen Angels	38.4	26.7	41.2	37.2	143.1	184.7	19.9	47.5	3.6
Net Supply	113.8	199.1	221.0	168.4	216.0	221.9	75.3	4.4	25.3
Rising Stars	34.7	51.9	83.7	45.9	50.3	23.8	22.2	57.4	31.0
Coupon Reinvestment at 75%	82.3	83.0	88.3	89.3	93.8	98.2	87.4	82.7	33.7
Mutual Fund Flows	15.6	29.0	-4.7	-23.8	-16.6	9.6	-20.3	-46.9	10.4
Demand	132.6	163.9	167.4	111.5	127.5	131.6	89.3	93.2	75.1
Supply Surplus/(Shortfall)	-18.8	35.2	53.6	56.9	88.6	90.3	-14.0	-88.8	-49.8

Source: J.P. Morgan, Bloomberg, Lipper FMI. As of 31 May 19

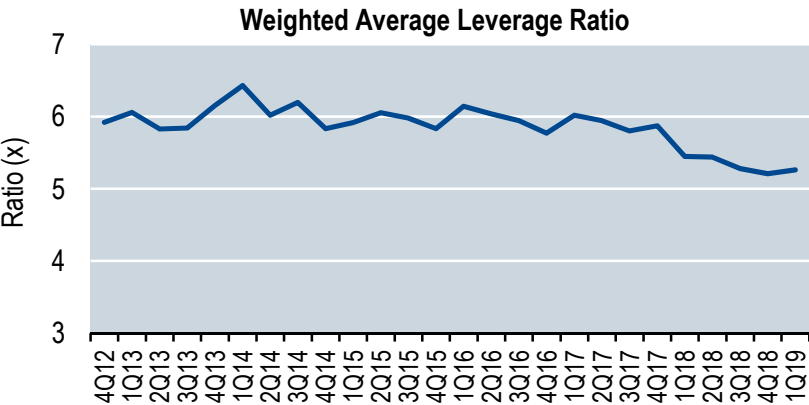
Bank Loan Fundamentals Solid With Improving Leverage Profiles



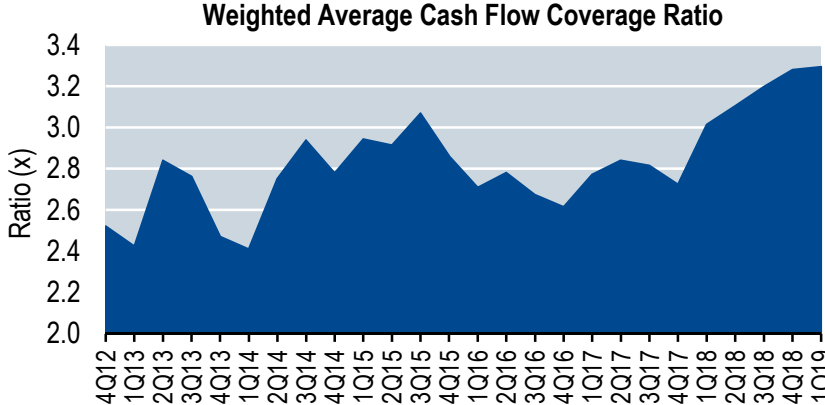
Source: S&P/LSTA, LCD. As of 31 Mar 19



Source: S&P/LSTA, LCD. As of 31 Mar 19



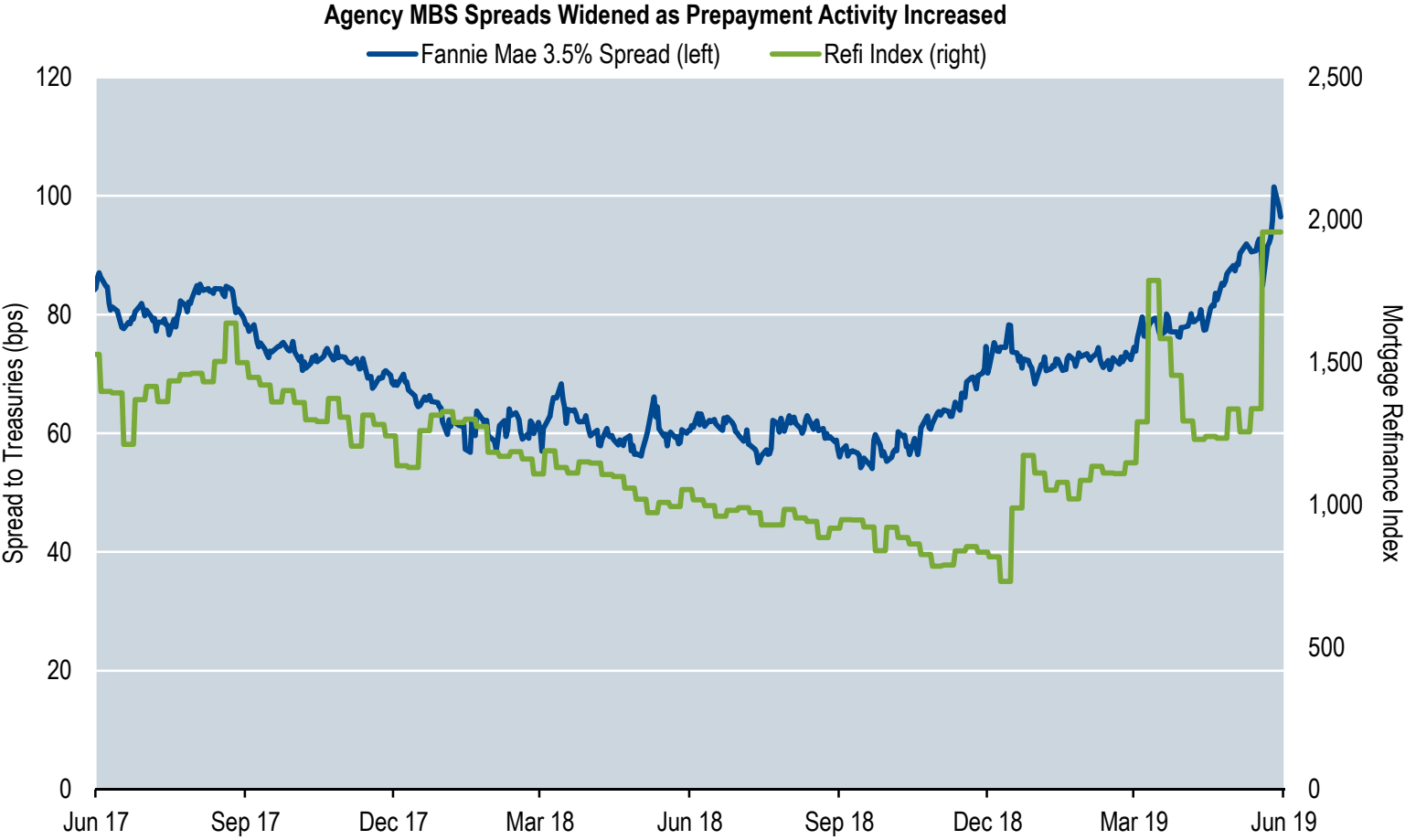
Source: S&P/LSTA, LCD. As of 31 Mar 19



Source: S&P/LSTA, LCD. As of 31 Mar 19

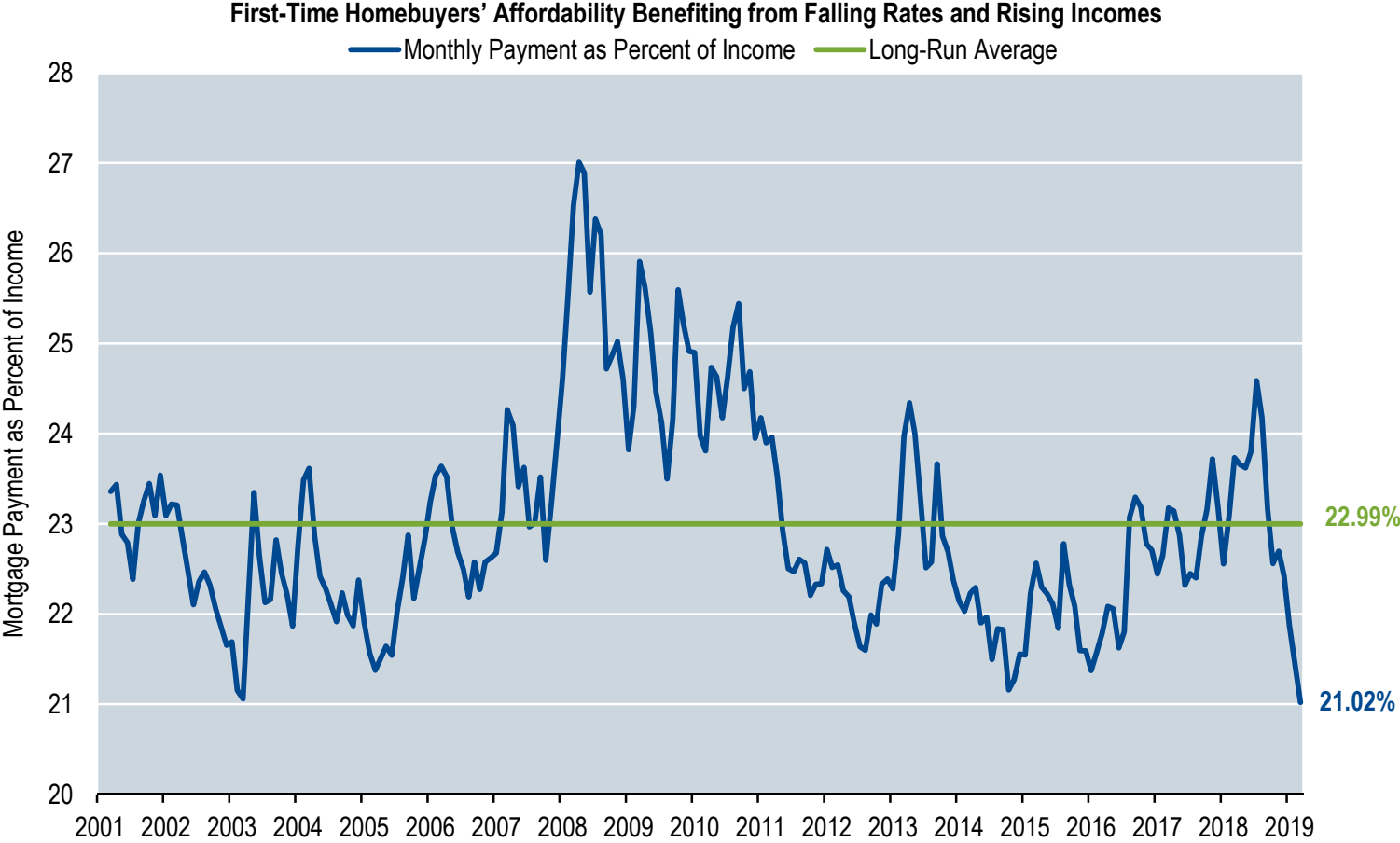


Lower Mortgage Rates Have Caused Agency Mortgages to Underperform Treasuries



Source: Bloomberg, Mortgage Bankers Association. As of 18 Jun 19

But Lower Mortgage Rates Have Improved Affordability and Outlook for Housing



Source: Case-Shiller, FHA, Morgan Stanley Research, NAR. As of 19 Jun 19

2018 Emerging Market Challenges

Higher US rates

Higher US dollar

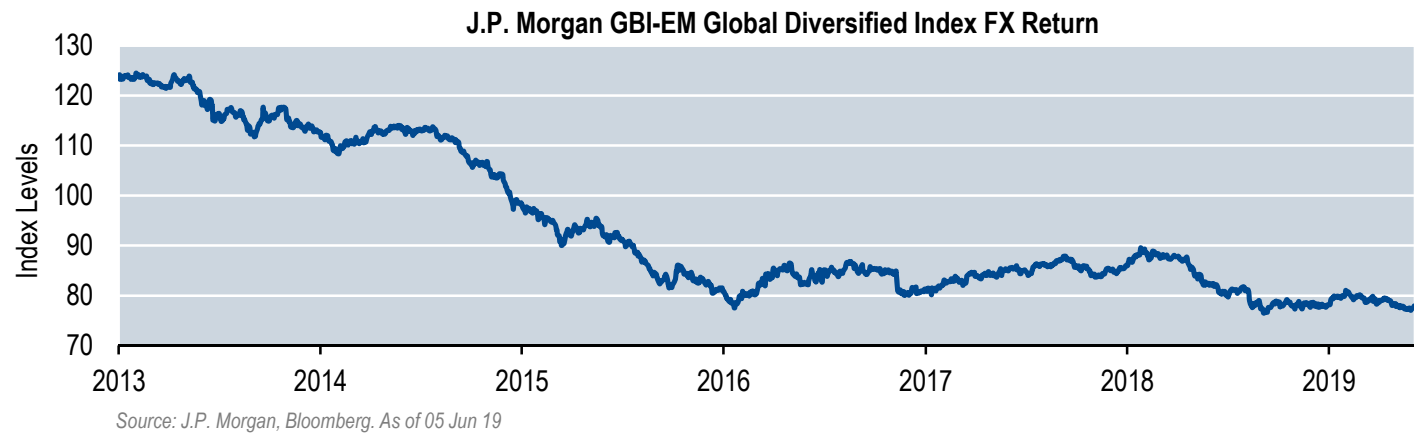
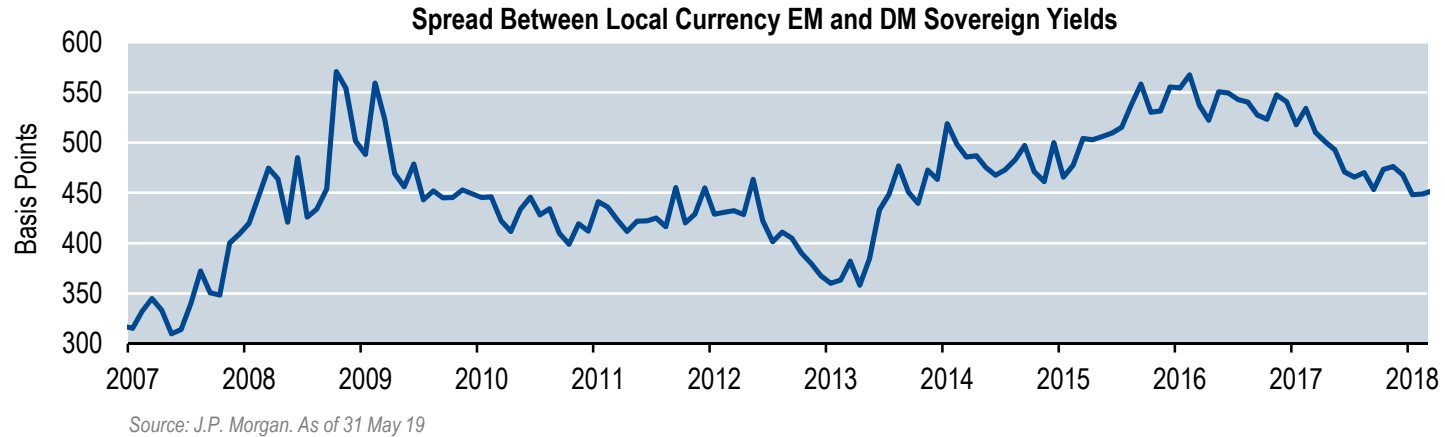
Downshifting European, Chinese and Japanese growth

Higher oil prices

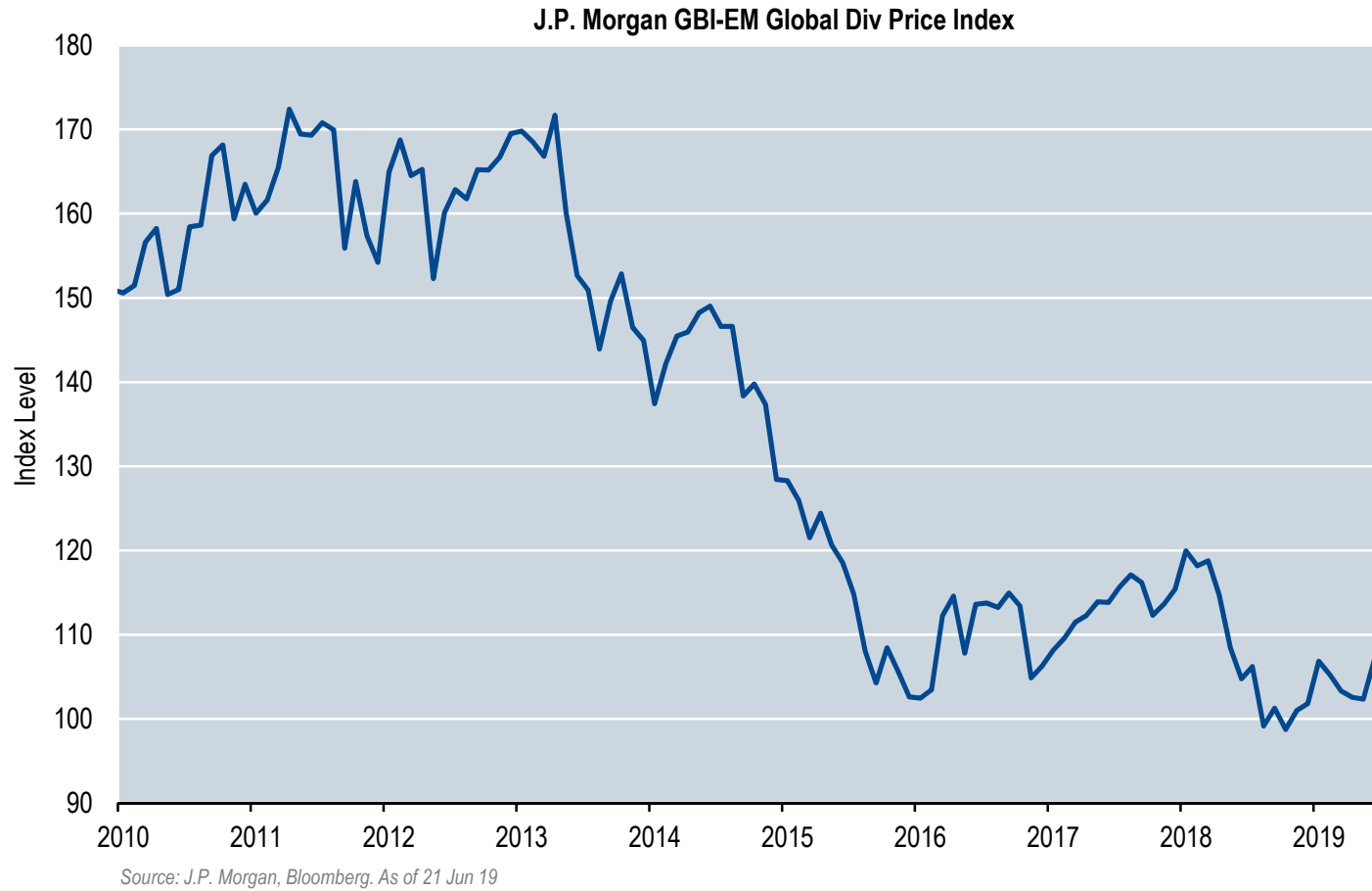
Potential trade war

Investment Themes – Emerging Markets

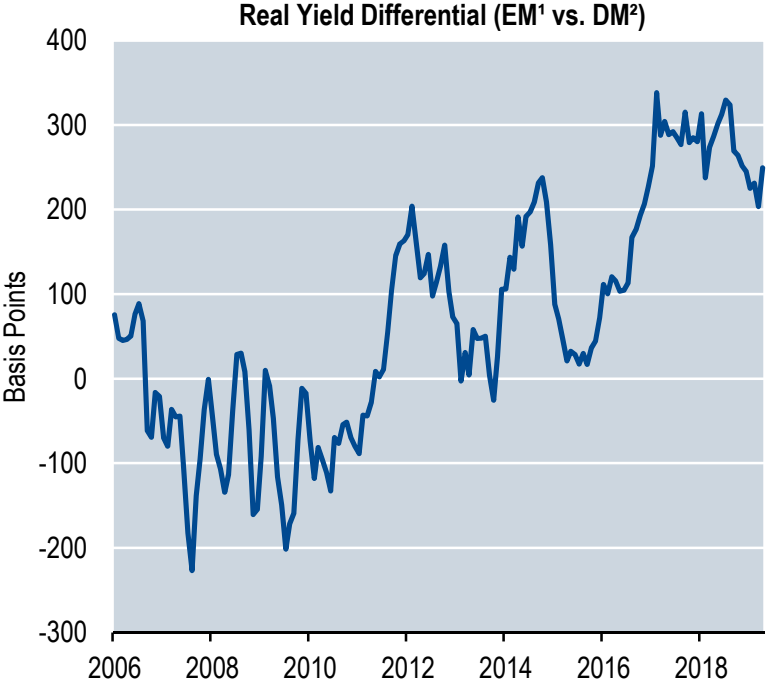
Valuations look attractive on a historical basis and relative to developed markets.



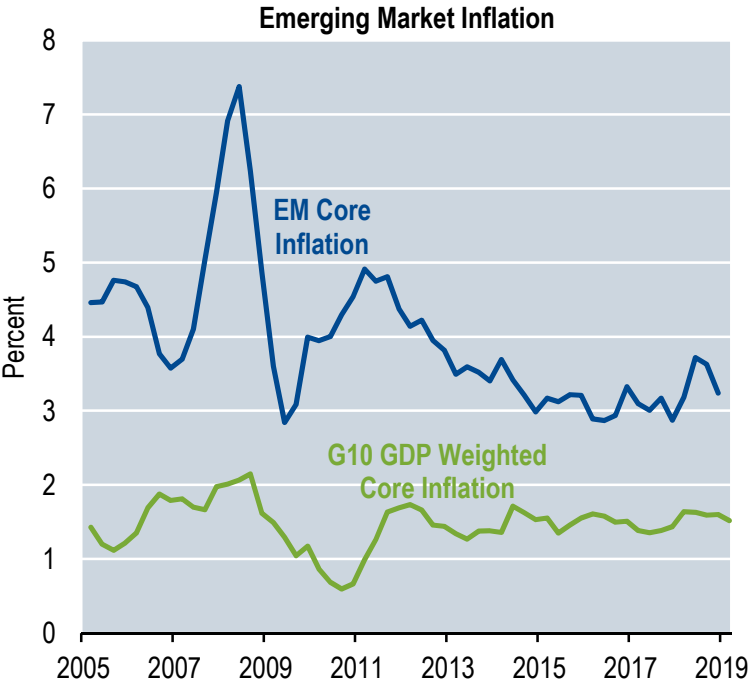
Higher EM Yields Compiled With Weak Currency Presents Buying Opportunity



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



Source: Bloomberg, HSBC. As of 30 Apr 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 Mar 19

2019 Second Half Outlook

Downside risks have risen, but global growth should remain resilient

US and global inflation rates continue to moderate

Aggressive central bank easing is designed to truncate downside risks

Central bank focus on core inflation outcomes suggests “low for long”

Trade friction will be an ongoing source of risk

Spread products should prove superior to Treasuries and sovereign bonds

Emerging markets, though volatile, should outperform

Questions & Answers



Thank you.

Risk Disclosure

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