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WESTERN ASSET

Webcast Summary

3Q19 Market & Strategy Update

Although downside risks to the global outlook have risen in the last quarter, our base case is that global growth will be resilient. As central banks around the globe reaffirmed their commitments to underpin the expansion with policy accommodation—with most citing that core inflation is well below target—we feel that rates will be "low for long." Robust growth is clearly not as imminent as the market was anticipating just a few months ago, but we're cautiously optimistic. Of course the unresolved trade issues and intractably low inflation don't help matters but this is a market made for active managers. Bond issue selection is more important than ever. In this environment, spread products should outperform both Treasuries and sovereign bonds, and emerging markets, though volatile, should also outperform.

Market Review

- While global growth has downshifted recently and faces continued headwinds from high debt loads, trade risks and declining demographics, our view continues to be that it will be resilient.
- Core inflation has remained persistently and seemingly intractably below-target over the course of this entire expansion, now 10 years and counting.
- The Federal Reserve (Fed) and other central banks have started focusing on core inflation outcomes—a decisive shift in policy—which suggests that rates will be "low for longer" than previously expected.
- European Central Bank (ECB) President Mario Draghi recently declared that the ECB would be willing to be more accommodative going forward, citing downside risks to growth, low inflation and the need for greater fiscal policy.
- Manufacturing activity has weakened globally—with uncertainty due to trade tensions increasing downside risk—while US demand is holding up, but not remarkably so.
- Negative yields have reached nearly $13 trillion in the global aggregate index; we're surprised by this as we felt negative yields were non-orthodox monetary policy in 2016, and were used to forestall secular stagnation.

US Economic Outlook

- Our baseline forecast for US growth in 2019 is 1.75% to 2.00%, a slight diminution from our estimate earlier this year.
- Low unemployment and high confidence readings bode well for US consumers, but trade uncertainty continues to weigh on the outlook for manufacturing.
- We think the Fed will likely cut rates twice this year to ensure that the real funds rate relative to core personal consumption expenditures (PCE) is at a more appropriate level.

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Global Economic Outlook

- Downside risks to the global outlook have clearly risen since last quarter as trade disputes become more tense, manufacturing continues to slow and demographic challenges persist.
- Global debt loads are not only as high as they were before the crisis, they're much, much higher, and therefore much more of a challenge.
- Trade friction will be an ongoing source of risk, although we expect a deal between the US and China will help temper global trade tensions.
- **Europe:** Our outlook is modestly positive despite weakness in manufacturing; given continued central bank support, we expect annual growth in Europe will be approximately 1.00% to 1.25%.
- **Japan:** We continue to be constructive on growth in Japan, considering its very low unemployment rate and very accommodative policy.
- **China:** We believe growth in the second half of 2019 will be better than in the first half of the year given the government's very aggressive fiscal stimulus and tax cuts aimed at reinvigorating the private sector.

Investment Themes

- Core PCE inflation has been hovering near the lows for the last eight years, and there's a risk it will move even lower. This is essentially why interest rates are so low.
- **High-yield:** While spreads are not compelling, a move wider may not come without a recession; default rates remain below the long-term average of 4.3%. Of course, default risk will rise if we do see a recession. Our guiding principle here is that high-yield credit follows fundamentals.
- **Investment-grade:** Spreads were 54 basis points wider in 2018, which provided an opportunity in 2019. We resist the temptation to become bearish on investment-grade credit and continue to believe that all BBBs are not created equal—carefully selecting issues is key.
- **China:** We expect to see better growth in China as its stimulus measures will have had time to take effect.
- **Japan:** The current fiscal and monetary policy mix supports moderate growth and higher inflation expectations.
- **EM:** Valuations look attractive on a historical basis and relative to developed markets. Although volatile, we expect emerging markets (EM) to outperform.
- **MBS:** This sector has performed basically in line with US Treasuries (USTs) over the year but lower mortgage rates recently have caused agency mortgages to underperform USTs. This is due to the low interest rates, which increase mortgage prepayment risk. As a result, we continue to be focused very strongly on low coupons where the prepayment risks are much lower.

Q&A Highlights

- We believe that if the fed funds rate eventually hits the zero bound, Fed Chair Jerome Powell will use quantitative easing (QE)—in lieu of negative interest rates—as there is reasonable evidence that QE was successful in mitigating some of the downside aspects of the financial crisis and its aftermath.
- We're not uncomfortable with the market pricing as it is currently, even though we're probably not as optimistic about the number of Fed cuts as are priced in the market. The bigger question, then, is whether or not, when we do get to the bottom of the easing cycle, we will see rates go back up. We think it is going to be quite some time before rates go back up.
- The Fed has been on the right track in our opinion, honoring the zero bound, using its balance sheet and QE. Negative interest rates in the US would create an extraordinary challenge that brings about disintermediation, which would put the government at war with average consumers, who would want to take their money out of the banks.

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