WESTERN ASSET

Webcast Summary

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2Q20 Market & Strategy Update

The unexpected outbreak of a novel coronavirus called COVID-19 took the world by storm in early 2020. In addition to presenting a clear humanitarian crisis, the impact of the pandemic on economies and financial markets across the globe is unparalleled in modern history. In March, the effects of government-ordered business closures, fear and, above all, uncertainty contributed to unprecedented levels of volatility and the sharpest monthly decline in risk assets on record. At the same time, an oil price war between Russia and Saudi Arabia added fuel to the fire in the form of additional deflationary pressures. We are encouraged by the extremely accommodative reactions of central banks to keep rates ultra-low and to unleash additional quantitative easing and other measures. We expect monetary policy support to continue along with extraordinary fiscal stimulus. While we cannot estimate how long the pandemic will keep normal day-to-day business sidelined, we view the current economic slowdown as a transitory event. Ultimately, we believe spread product should be the primary beneficiary of the eventual recovery.

COVID-19 Update

- The virus is extremely contagious and hard to predict; a vaccine would be a game-changer, but is likely many months away.
- Peak US health care utilization suggests containment measures will be in place through at least early May; after peak hospitalizations, there is likely an opportunity to relax containment, starting in late Q2.
- Economic recovery is likely to start in Q3 and accelerate in Q4.
- Looking at China as a case study: economic activity is back to 70%-80% of pre-virus levels two months after the lockdown.

Market Review

- We are in uncharted territory as this market decline is the result of no physical destruction, and because formerly healthy economies have voluntarily shut down to address the virus, creating both demand and supply shocks.
- Stress related to equities has reached levels not seen since the global financial crisis (GFC), with the volatility index (VIX) spiking to exceed 80.
- This sudden downturn is not the same as the GFC, as the global economy was generally healthy going into the pandemic.
- The oil price war between Russia and Saudi Arabia has added a deflationary shock, with barrel prices dipping below $30.
- The Federal Reserve (Fed) quickly dropped rates to zero and Chair Jerome Powell went on *The Today Show* to reassure the public that the Fed is "not going to run out of ammunition"; the Fed has also pledged to continue to stabilize the Treasury market "as needed."

US Economic Outlook

- Projected growth has been dramatically downgraded for 2020, with estimates as low as 0.5%.
- Inflation expectations have also declined, currently at 1.16% according to 10-year breakevens.

Global Economic Outlook

- The length and depth of the virus-related downdraft is unknown, but we see a strong likelihood for eventual economic recovery; our base case calls for a longer, U-shaped recovery.
- Central banks around the globe will remain extremely accommodative, with policy rates expected to remain ultra-low even after the recovery begins; fiscal policy will continue to ramp up to provide relief efforts.
- **China:** Despite the outbreak abating, China maintains systematic control; leading indicators in March showed encouraging signs.

Investment Themes

- Preservation of capital is now our top priority; we are building portfolios that we believe will endure a longer period of downturn as the timing of the comeback is uncertain.
- Spread product ultimately should be the primary beneficiary of the eventual recovery.
- **Investment-grade:** This is our favorite investment sector as the US market is still the largest in the world and offers attractive yields compared with other developed markets. While we have seen an intense flight to quality recently, demand for safe income will return and we believe will be found in US investment-grade credit. In addition, this sector should benefit strongly from the Fed's upcoming buying program.
- **High-yield:** Valuations look attractive on a historical basis; high-yield should benefit from fiscal stimulus as 48% of high-yield issuers will be eligible for loans under the CARES Act.
- **Bank loans:** While this sector has been extremely damaged, we believe it still offers significant return prospects as evidenced by investors staying the course through 2008 during the GFC.
- **EM:** Valuations are displaced across all EM sectors; EM is particularly growth-sensitive given existing balance sheet quality and external vulnerability; capacity for fiscal and monetary policy stimulus is more limited.

Q&A Highlights

- Fears of nationalism returned as relations with China have deteriorated across the globe as a result of the pandemic, forcing the highly integrated global economy to take a step back. Looking ahead, we expect the reliance on global versus national supply chains to be questioned.
- We believe that the short end of the Treasury curve is a safer place to be in advance of eventual rising rates. The potential returns may be muted, but with the Fed holding its rate at zero and the promise of continued QE, short-term Treasuries should act as a successful hedge.