

# 2Q24 Market & Strategy Update

April 4, 2024

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# 2024 Global Outlook

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**Disinflation ongoing but uneven**

**Central banks will ease policy to normalize real interest rates**

**Economy has remained resilient, but is set to slow**

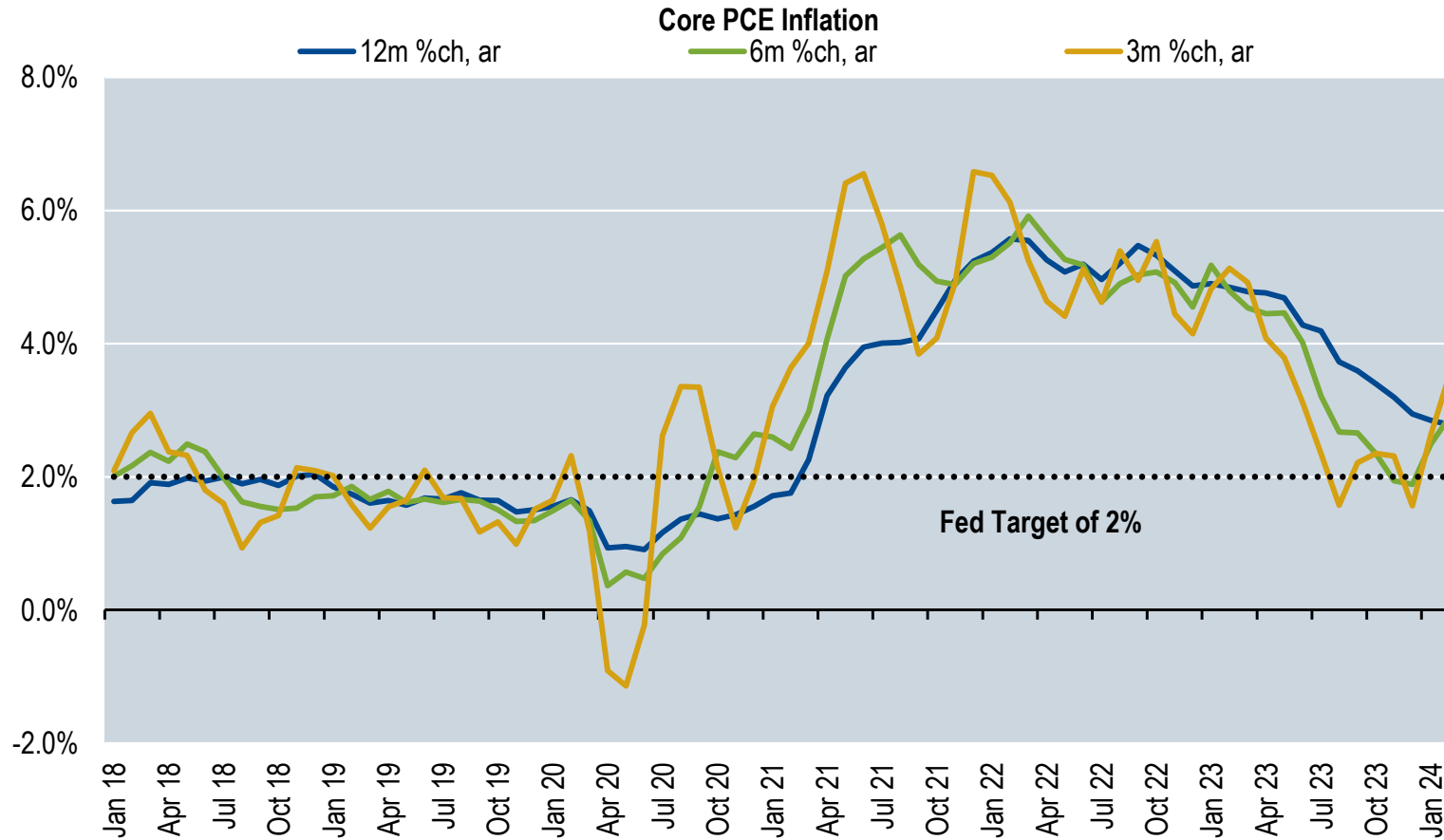
## **Fixed-income outlook**

- US growth will slow but should avoid recession
- Global growth has downshifted and China is now a source of deflation
- US Core PCE already near Fed target
- Global inflation will continue to recede
- The US dollar will weaken moderately
- Emerging markets—particularly in Latin America—should outperform
- Central Banks will need to pivot policy adroitly
- Spread sectors are still attractive but the outlook is clouded by macro risk
- Geopolitical uncertainty continues to add to volatility

# Inflation

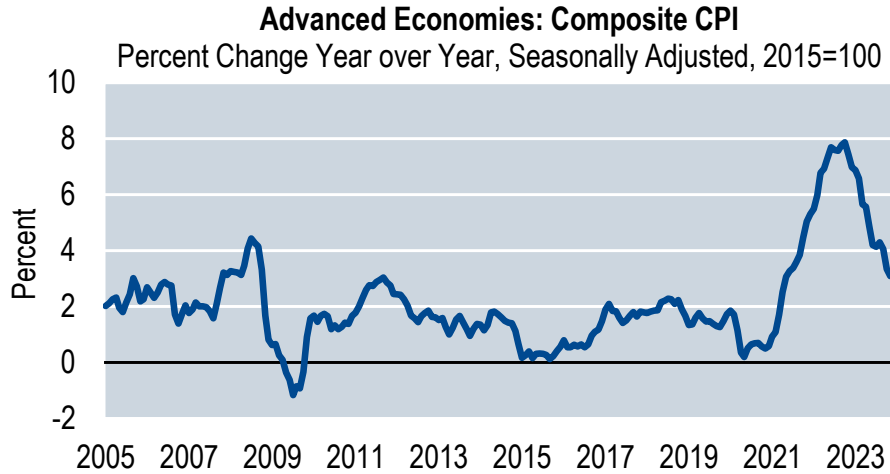
“I think they haven't really changed the overall story which is that of inflation moving **down gradually on a sometimes-bumpy road** toward two percent.”

— Chair Powell, March 20, 2024

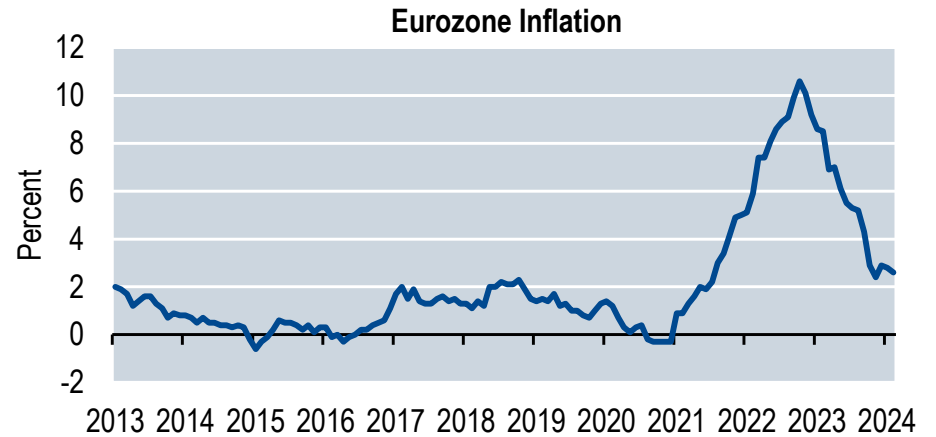


Source: BEA, Haver. As of 29 Feb 24

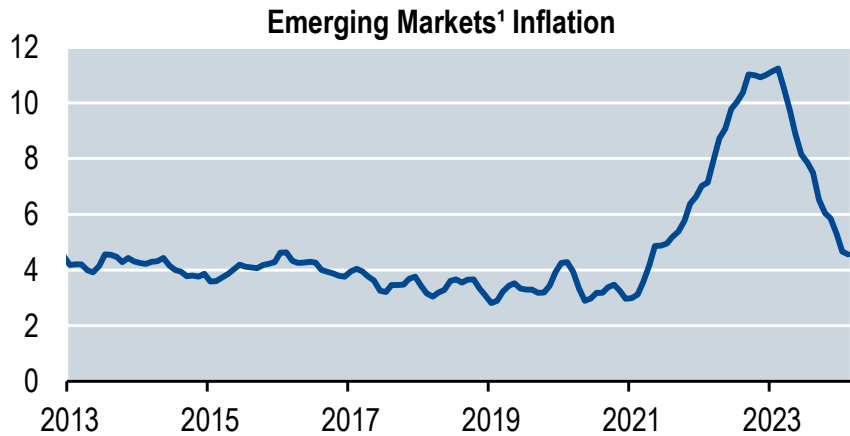
# Global Disinflation Is Broad-Based and Ongoing



Source: Haver Analytics. As of 31 Dec 23

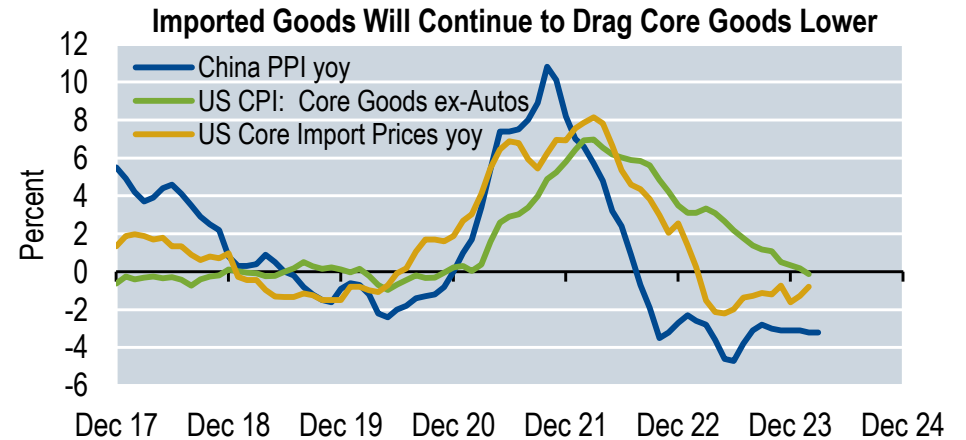


Source: Bloomberg. As of 29 Feb 24



Source: Bloomberg, Western Asset. As of 29 Feb 24

<sup>1</sup>EM = Brazil, Mexico, Colombia, Chile, South Africa, India, Indonesia and Poland

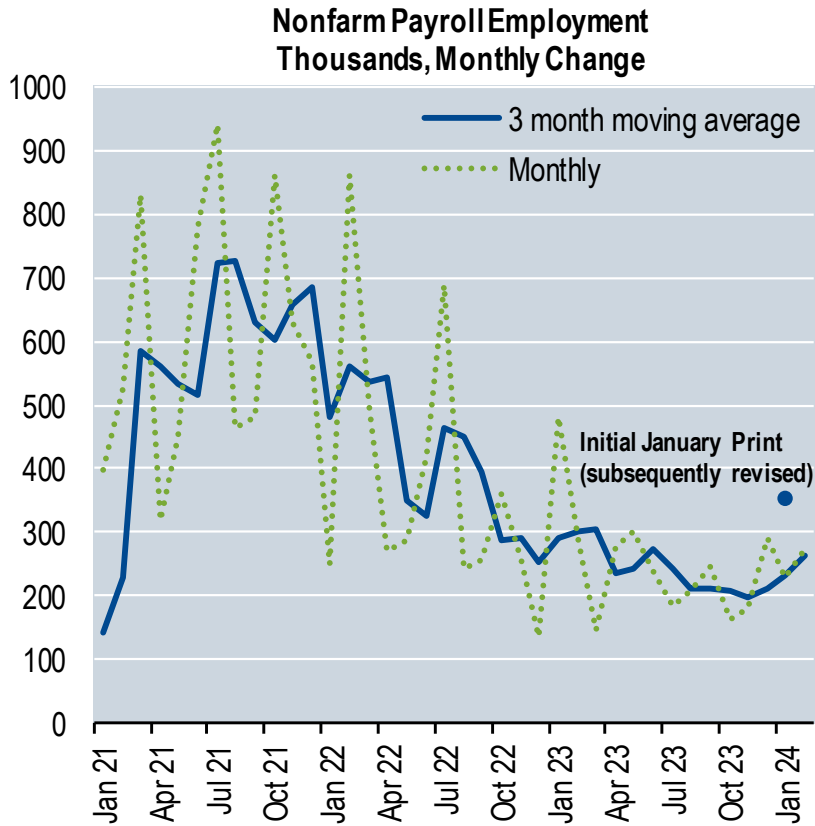


Source: Bureau of Economic Analysis. As of 31 Mar 24

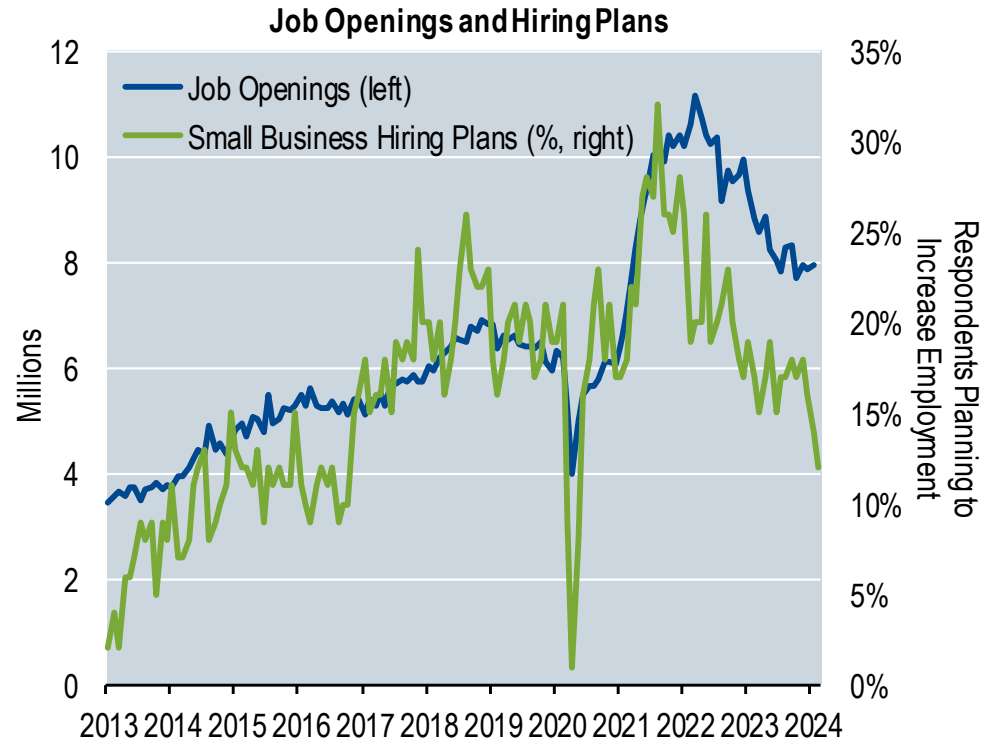
\*US CPI and US Core Import Prices as of 29 Feb 24

# Labor Demand Settling Into a Moderate Range

January payroll print subsequently revised down; job openings declining



Source: BLS, NFIB, Haver. As of 28 Feb 24

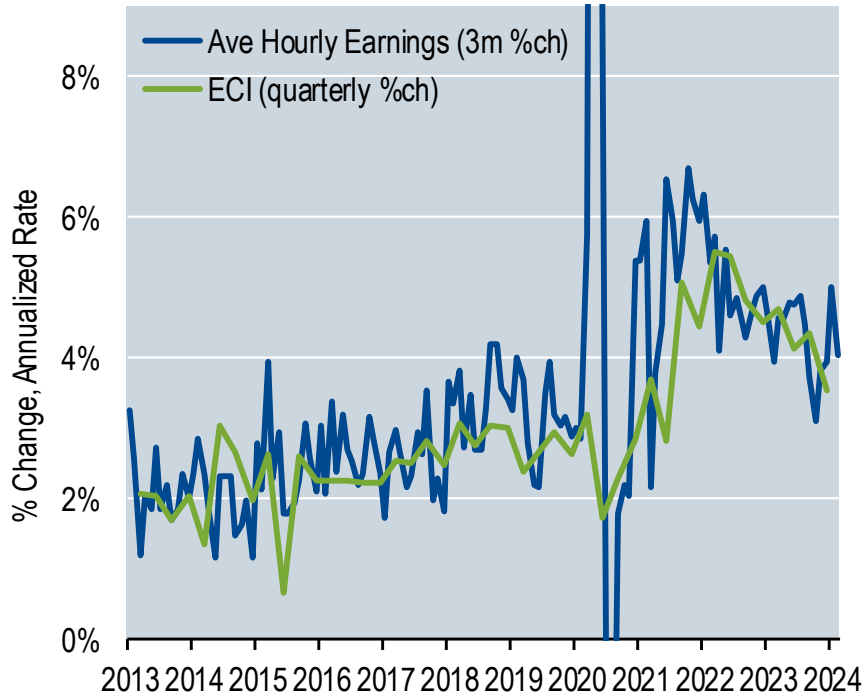


Source: BLS, NFIB, Haver. As of 28 Feb 24

# Wage Growth May Already Be Consistent With Fed Mandate

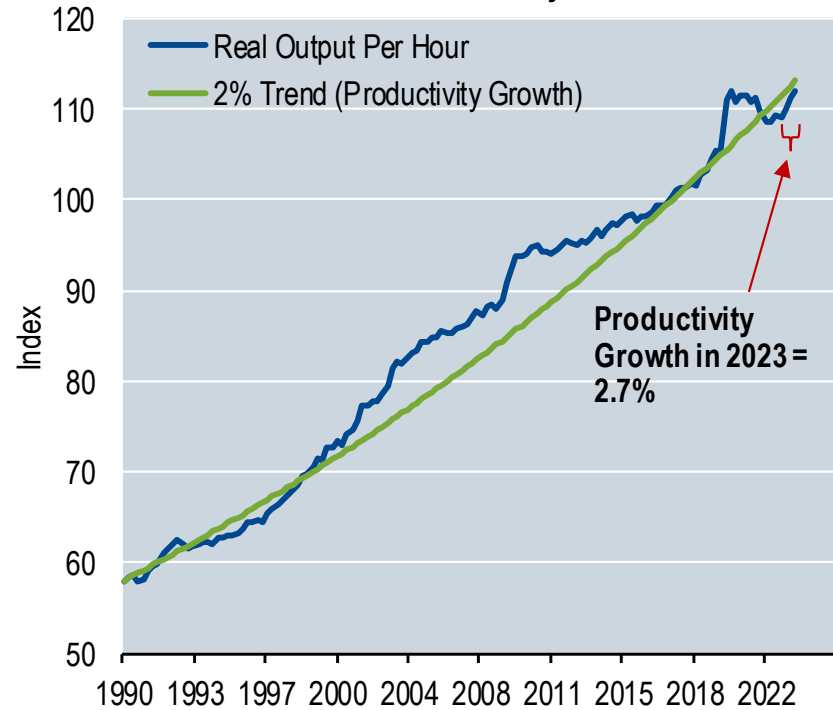
Wage growth ~4%, Productivity ~2% → Inflation ~2%

### Wage Growth



Source: BLS, NFIB, Haver. As of 28 Feb 24

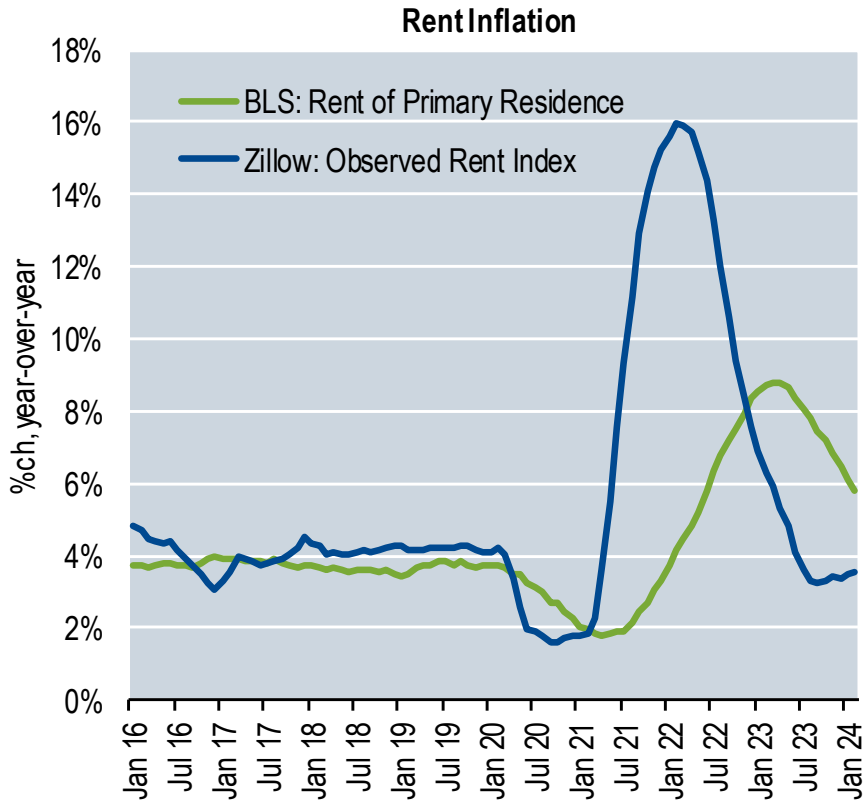
### Productivity



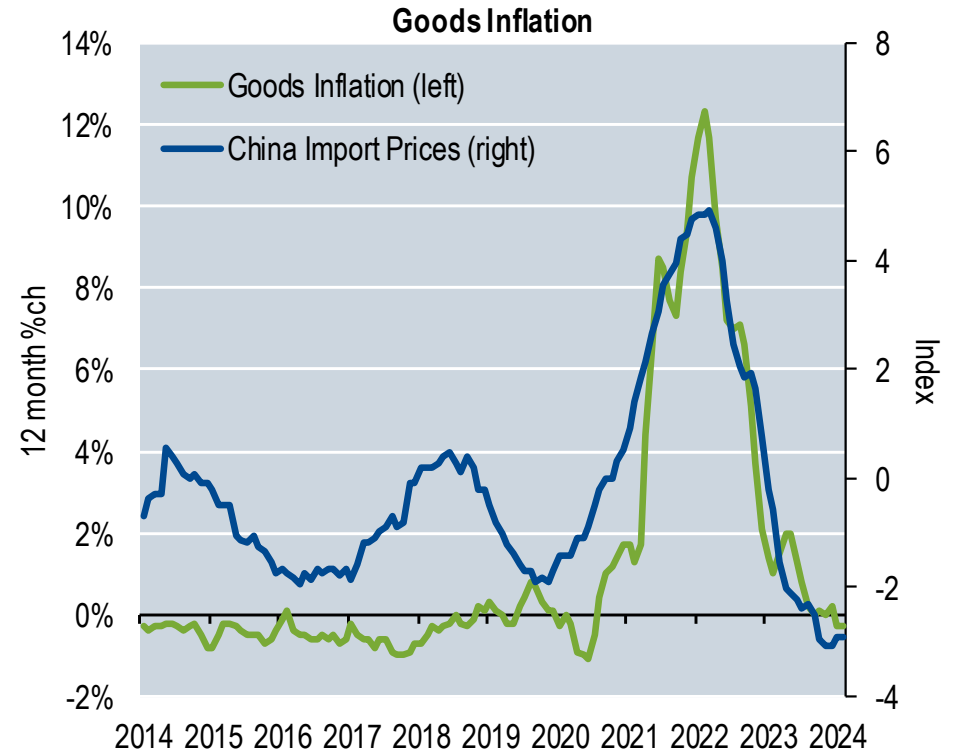
Source: BLS, NFIB, Haver. As of 28 Feb 24

# Inflation: More Disinflation Ahead

CPI housing inflation measures still elevated relative to surveys; goods prices can stay in deflation.



Source: BLS, Zillow, Haver. As of 28 Feb 24

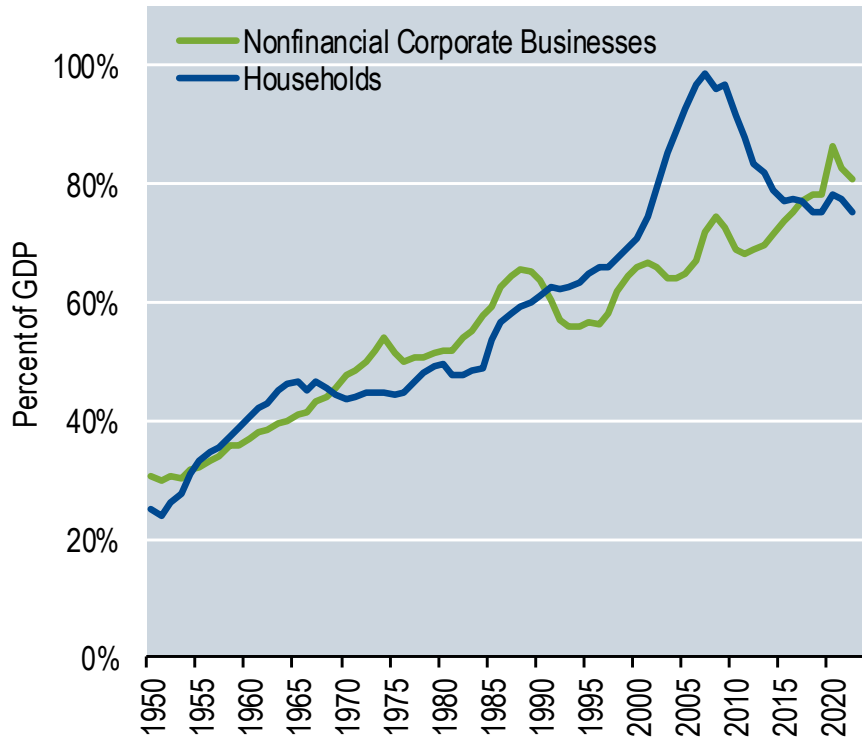


Source: BLS, Zillow, Haver. As of 28 Feb 24

# Receding Recession Risks

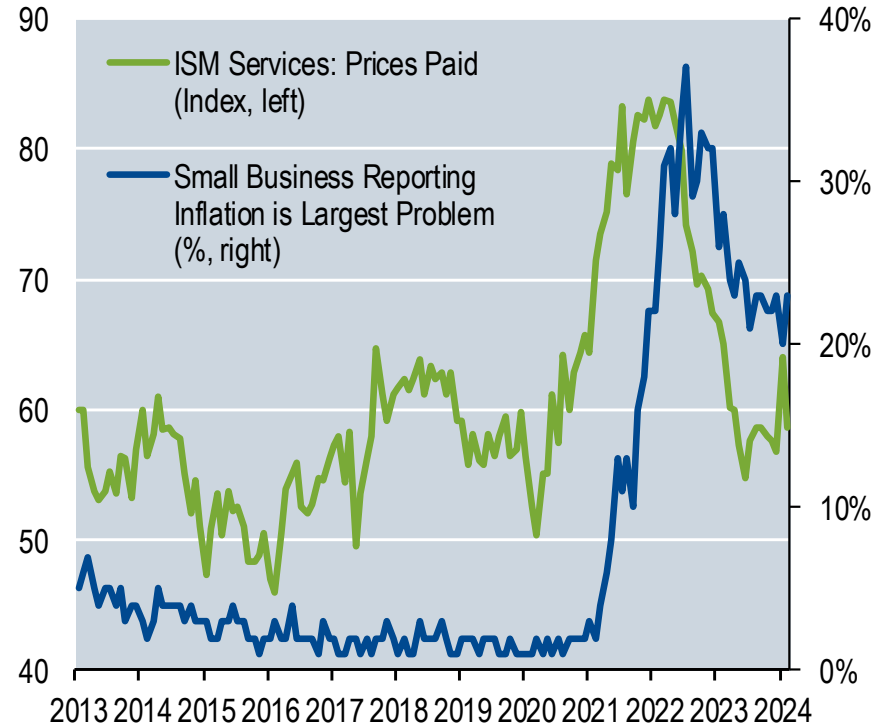
Balance sheets not problematic; Inflation was most cited concern.

### Debt Outstanding



Source: BLS, Zillow, Haver. As of 28 Feb 24

### Inflation Concerns

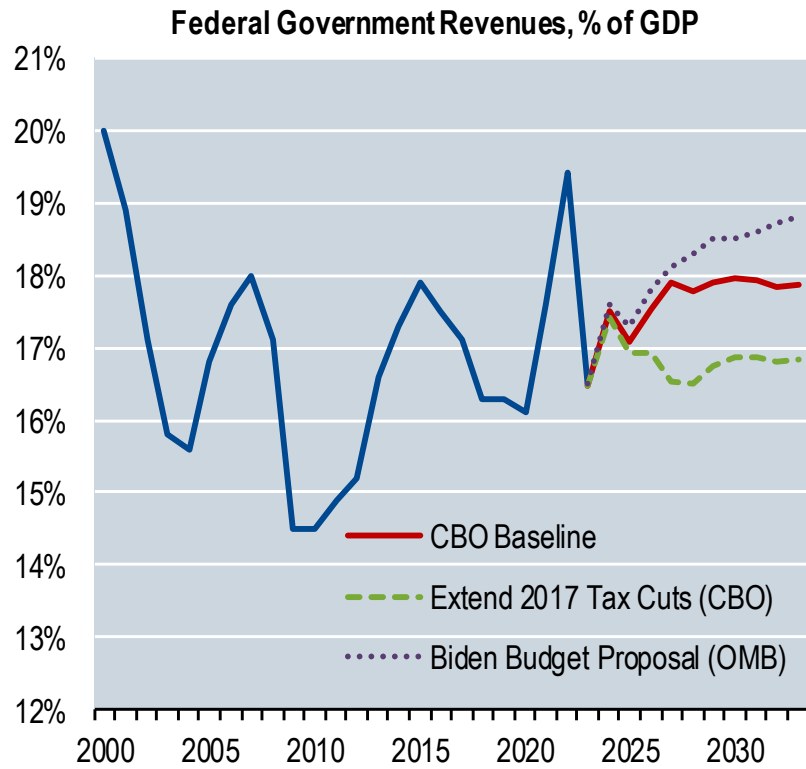


Source: BLS, Zillow, Haver. As of 28 Feb 24

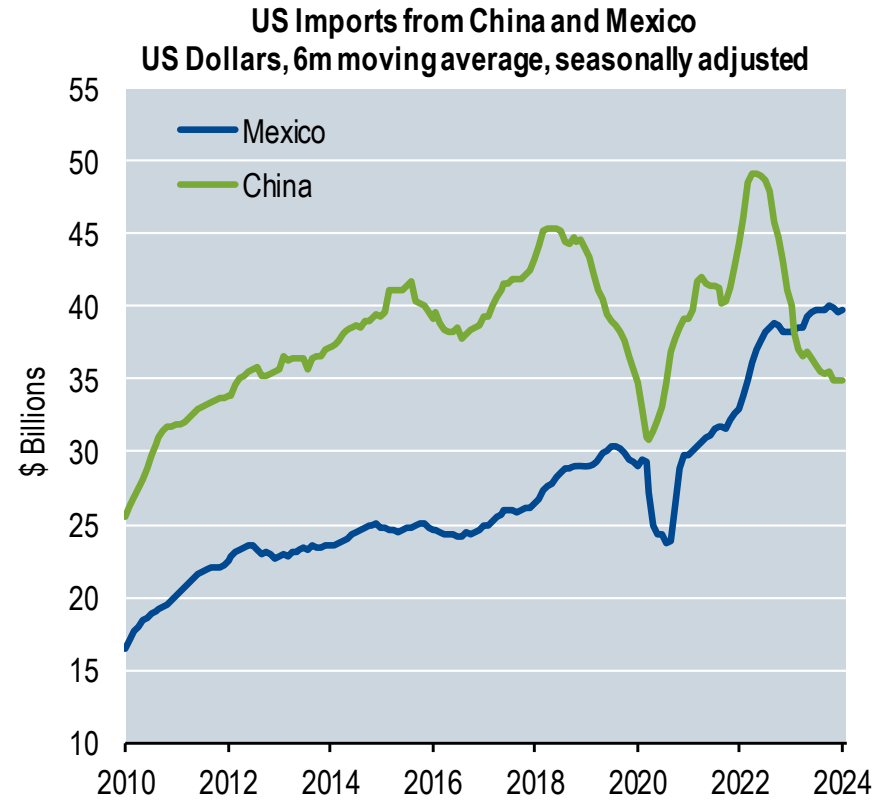


# US Presidential Election

## Major Differences: Tax Rates & Trade Policy



Source: CBO, OMB, Census Bureau, Haver. As of 31 Jan 24



Source: CBO, OMB, Census Bureau, Haver. As of 31 Jan 24

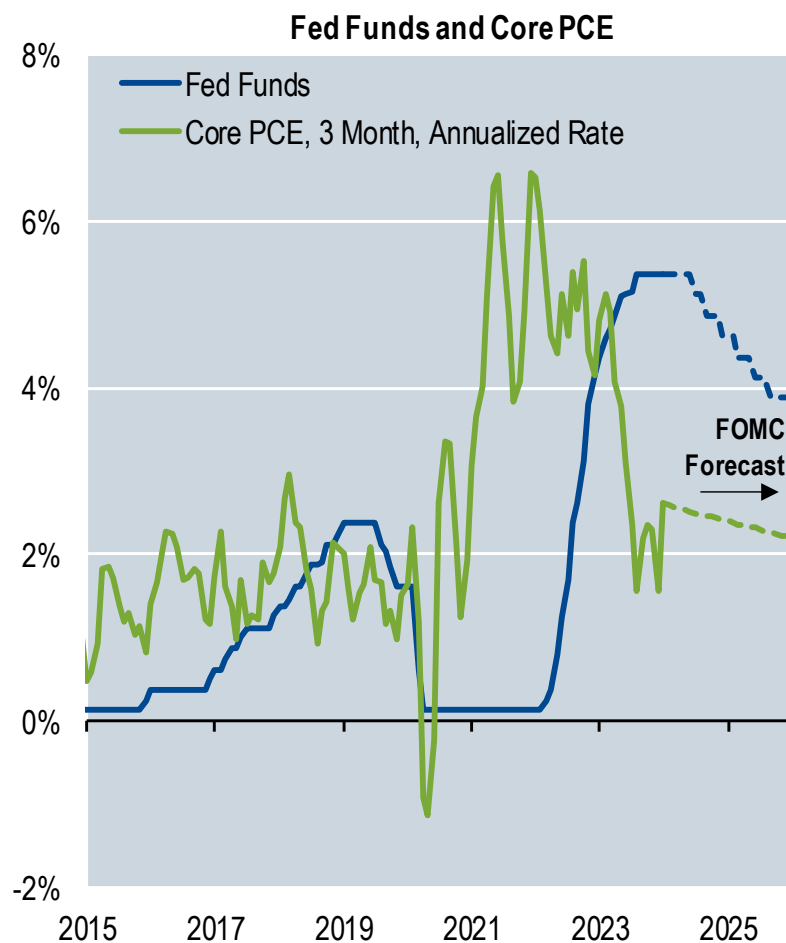
# US Federal Reserve

On track for a rate cut in June

“**[T]he risks are really two-sided here**; we're in a situation where if we ease too much or too soon, we could see inflation come back, and if we ease too late, we could do unnecessary harm to employment and people's working lives.”

“You saw last year very strong hiring and inflation coming down quickly. We now have a better sense that a big part of that was supply-side healing, particularly with, with growth in the labor force. So, in and of itself, **strong job growth is not a reason for us to be concerned about inflation**”

– Chair Powell, March 20, 2024



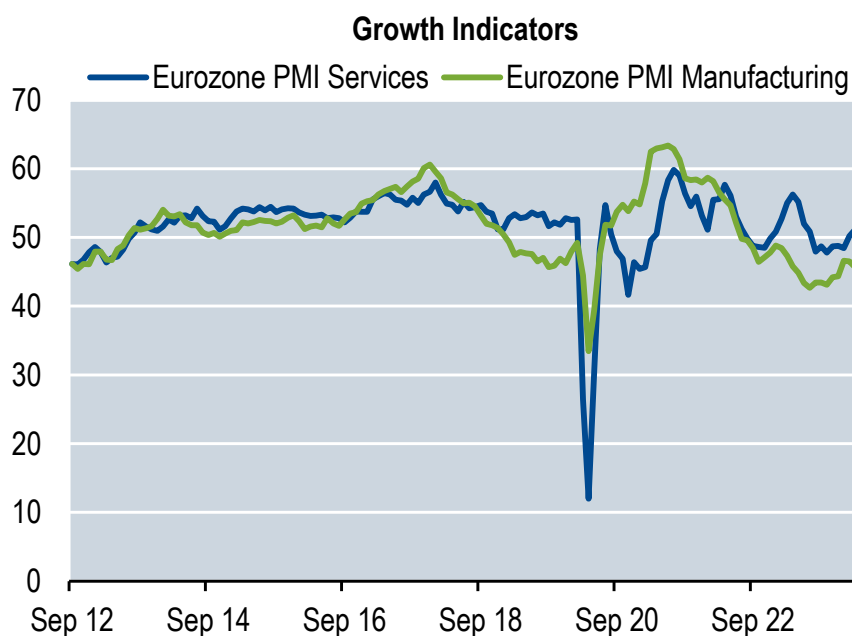
Source: Federal Reserve, Bureau of Economic Analysis, Haver Analytics  
As of 31 Mar 24

# Europe

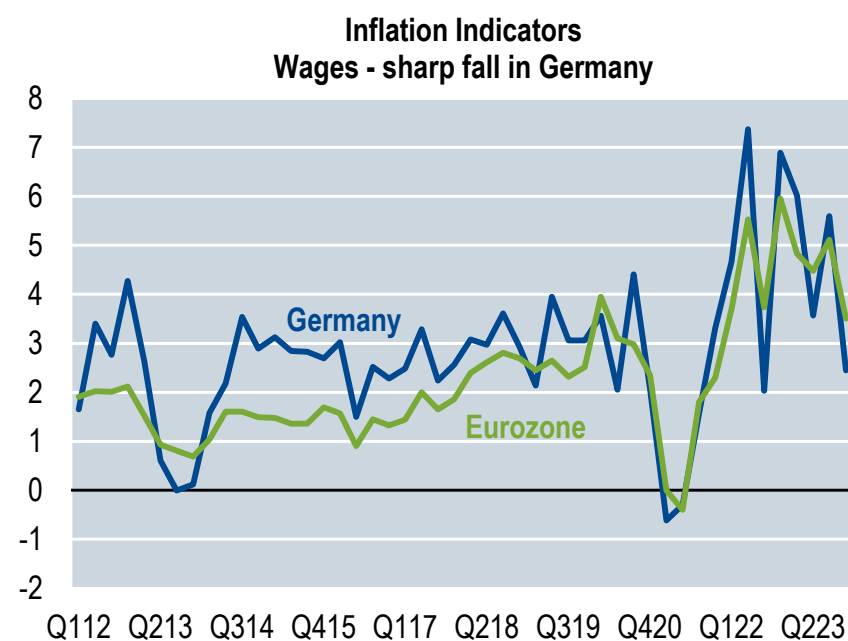
## Little growth, inflation close to target, wages moderating

- Growth: Modest at best – Service side a little better but manufacturing still slowing
- Inflation: Moving closer to target – Wage growth falling quickly
- ECB: More pieces of the disinflationary jigsaw coming into place – 1<sup>st</sup> cut likely in June
- ECB: Policy historically tight given growth and inflation

|                 | Policy | HICP | GDP  |
|-----------------|--------|------|------|
| 1999 to Current | 1.50   | 2.09 | 1.39 |
| Current         | 4.00   | 2.60 | 0.10 |



Source: S&P Global, Hamburg Commercial Bank, Haver Analytics. As of 25 Mar 24

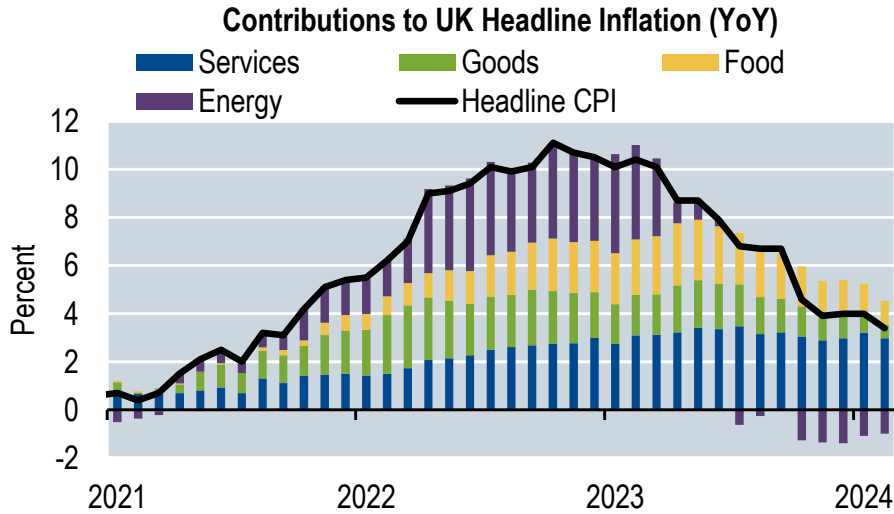


Source: Statistical Office of the European Communities, Haver. . As of 31 Dec 23

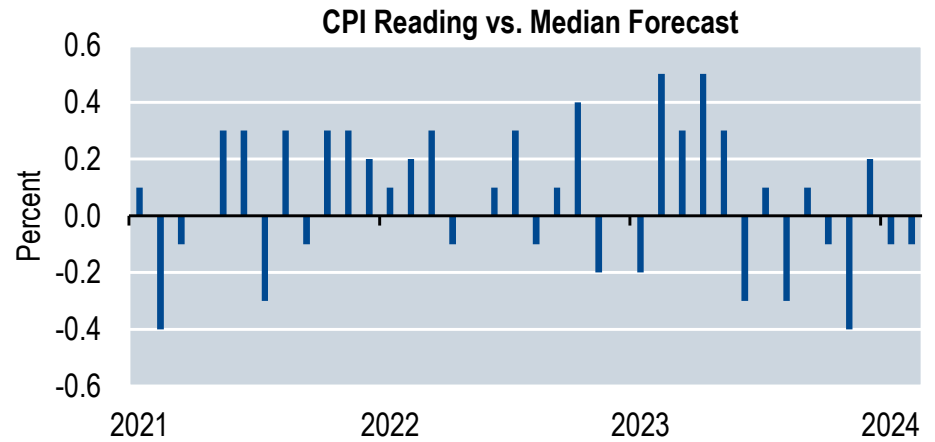
# United Kingdom

## BoE to cut by more than the market is pricing

- Energy and food price inflation is coming down forcefully. Goods and services inflation are also trending downwards.
- Inflation is likely to fall below target in April



Source: Office for National Statistics, Bloomberg. As of 29 Feb 24

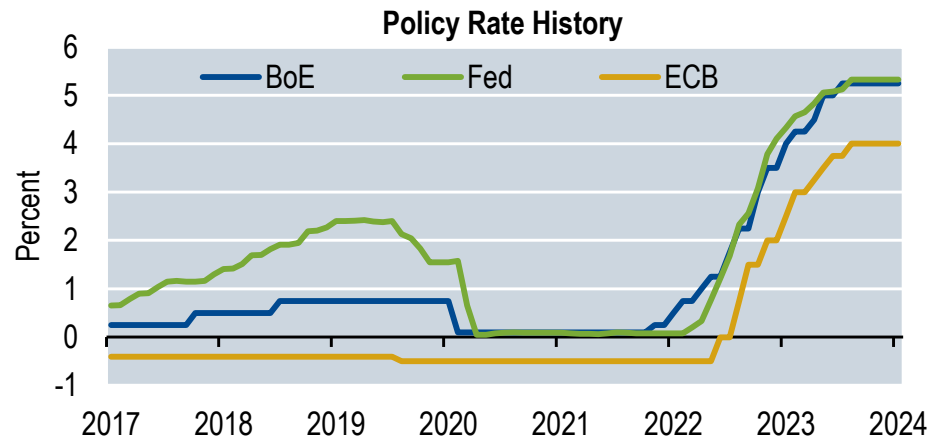


Source: Office for National Statistics, Bloomberg. As of 29 Feb 24

- Slack has returned to the labor market and nominal wage growth is slowing. Economic activity remains very subdued.
- Bank of England Governor Bailey has stated that “the question is how long rates must stay on hold”. We think that rates will be cut by more than is priced.

| IMF Real GDP Forecasts |             |      |      |
|------------------------|-------------|------|------|
|                        | Projections |      |      |
|                        | 2023        | 2024 | 2025 |
| <b>US</b>              | 2.5         | 2.1  | 1.7  |
| <b>Euro Area</b>       | 0.5         | 0.9  | 1.7  |
| <b>UK</b>              | 0.5         | 0.6  | 1.6  |

Source: International Monetary Fund. As of January 2024



Source: Bloomberg. As of 29 Feb 24

The above reflects current opinions of Western Asset and are subject to change with market conditions.

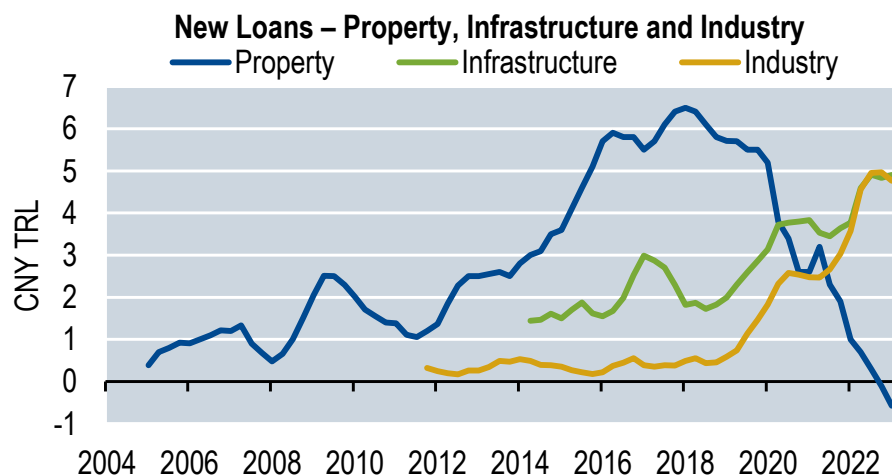
# China Likely to Avert Acute Contraction Amidst Ongoing Policy Response

But 5% growth no longer a market tailwind

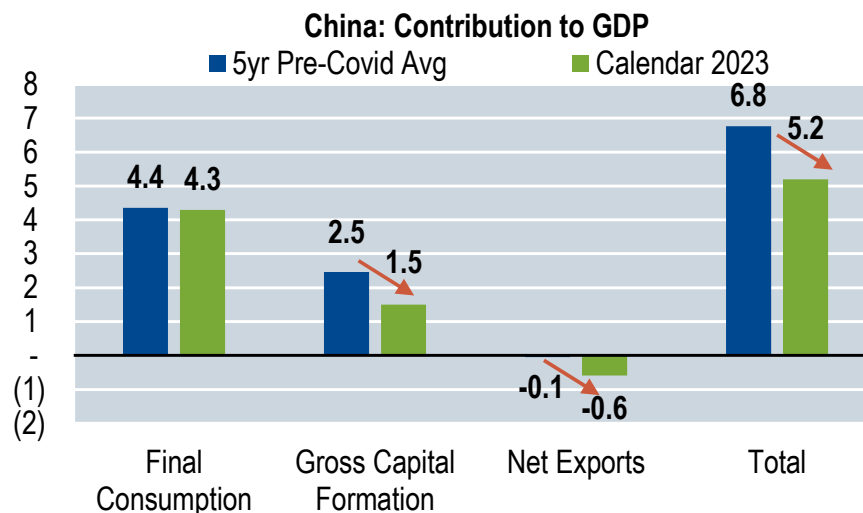
- Debt, demographics and de-globalization remain long-term secular growth headwinds
- China is prioritizing new economy infrastructure/manufacturing in order to meet its "around 5%" growth target this year
- Economic buffers including \$3.25 trillion of FX reserves, relatively closed capital account, lack of systematic leverage and government participation in large parts of the economy
- EM investors are focused on 2nd and 3rd order effects of China's reoriented growth priorities and implications for commodity prices, trade relations and regional growth



Source: Bloomberg. As of 31 Jan 24



Source: Citi. As of 31 Dec 23

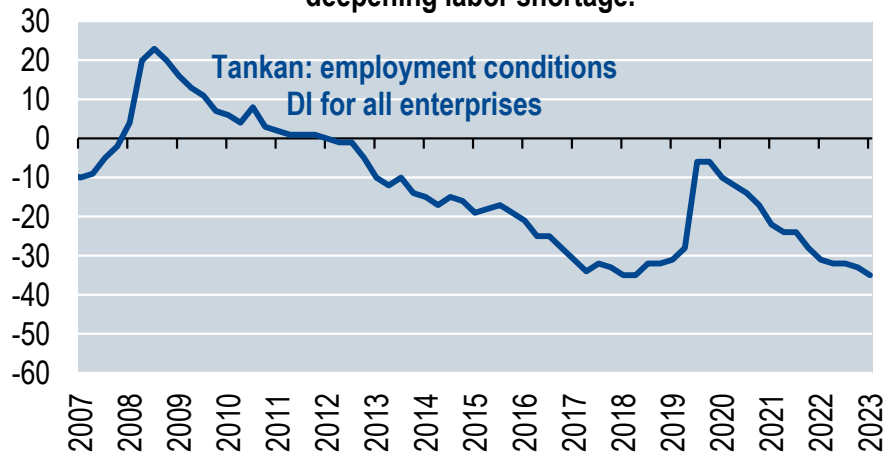


Source: Haver, Western Asset. As of 31 Dec 23

# Japan

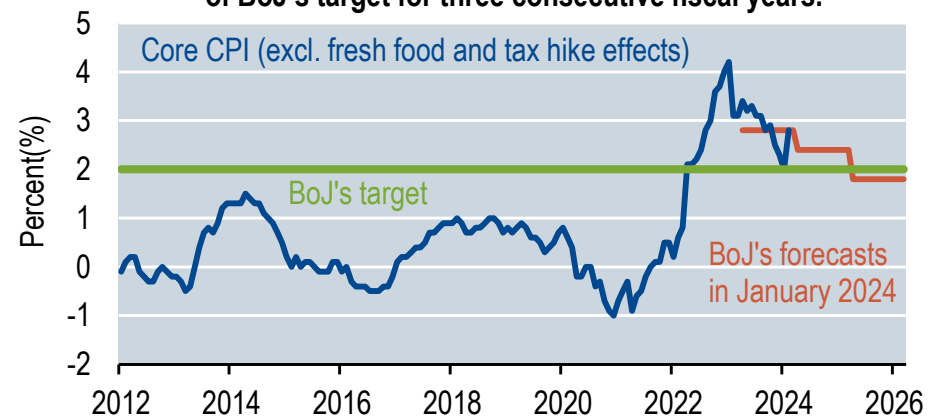
Positive development of growth and wages are expected with higher inflation forecasts.

**BoJ Tankan survey: employment conditions DI suggests a deepening labor shortage.**



Source: Bloomberg, Western Asset. As of 29 Mar 24

**Based on BoJ's forecasts, core CPI is expected to be above 2% of BoJ's target for three consecutive fiscal years.**



Source: Datastream, Western Asset. As of 29 Feb 24

**Base on the strong wage negotiation results released by Rengo, wages are expected to increase by approximately 3% Y/Y in 2024 on all industries basis.**



Source: Bloomberg, Western Asset As of 31 Jan 24

**Japanese trade union confederation (Rengo in Japanese) released the preliminary data of the wage negotiation (Shun-to) results on March 15, 2024, i.e., +5.28% Y/Y, the highest level in 30 years.**



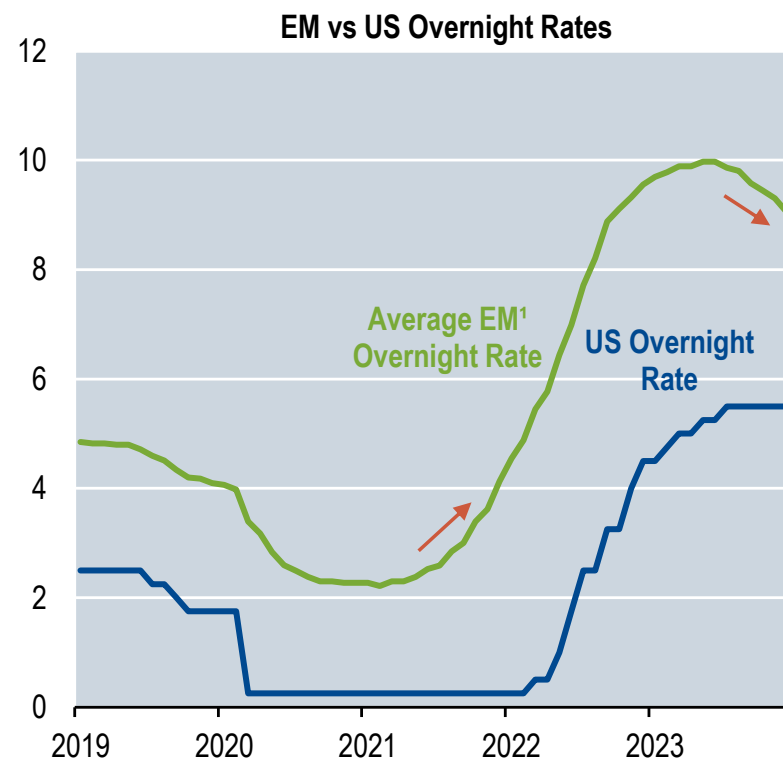
Source: Rengo, Western Asset. As of 15 Mar 24

# EM Central Banks Have Been Ahead of the Curve

EM policymakers tightened policy aggressively, starting in early 2021 well in front of the Fed.

With both EM and DM inflation having peaked, EM central banks have already started to cut rates despite the Fed indicating no cuts in the US until late 2024.

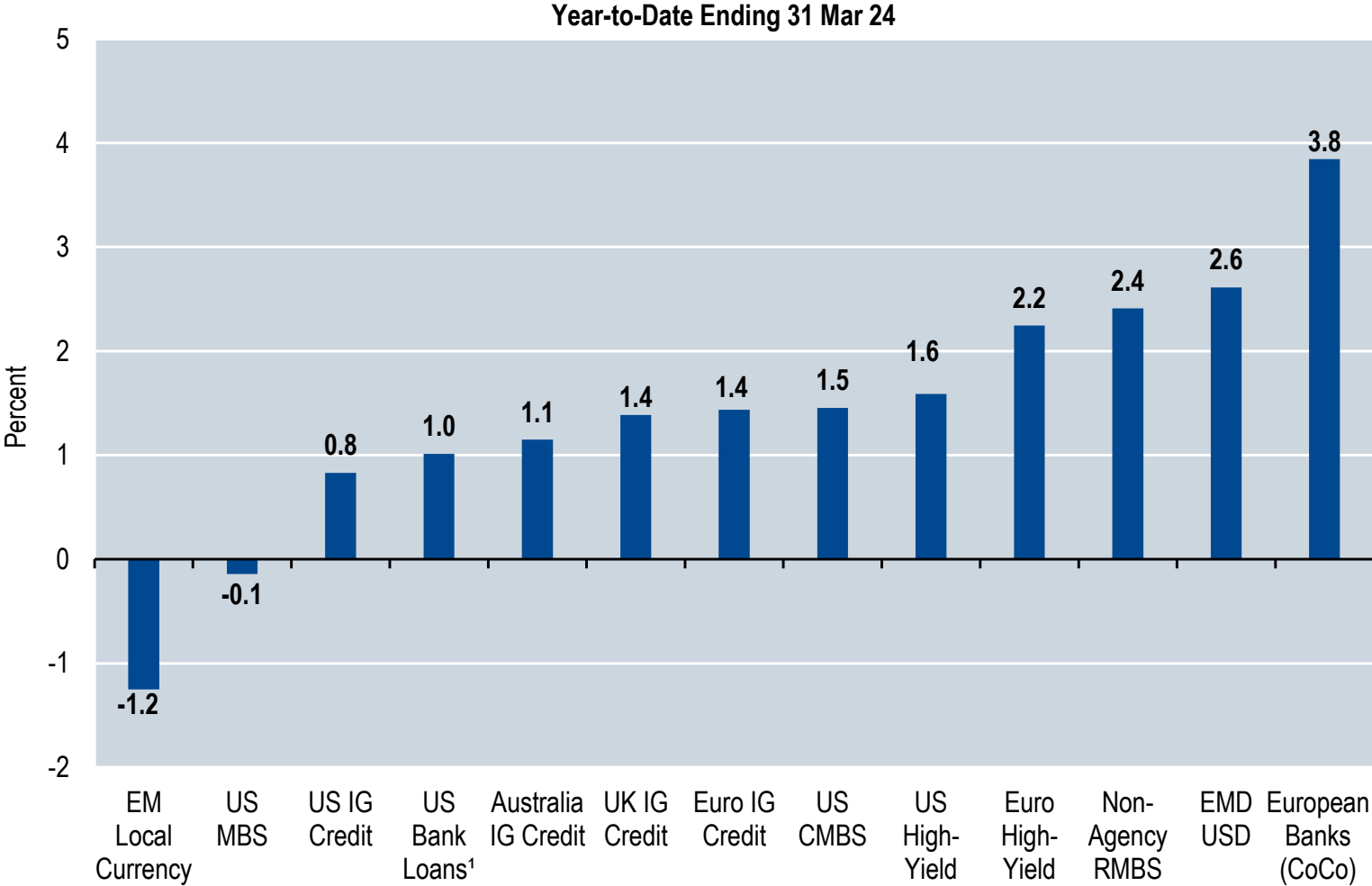
EM central banks' response to the recent inflation scenario has provided stability for EM FX and the opportunity for investors to benefit from attractive local yields.



Source: Bloomberg, Western Asset. As of 31 Dec 23

<sup>1</sup>EM = Brazil, Mexico, Colombia, Hungary, Chile, South Africa, India, Indonesia and Poland

# Spread Sector Excess Returns

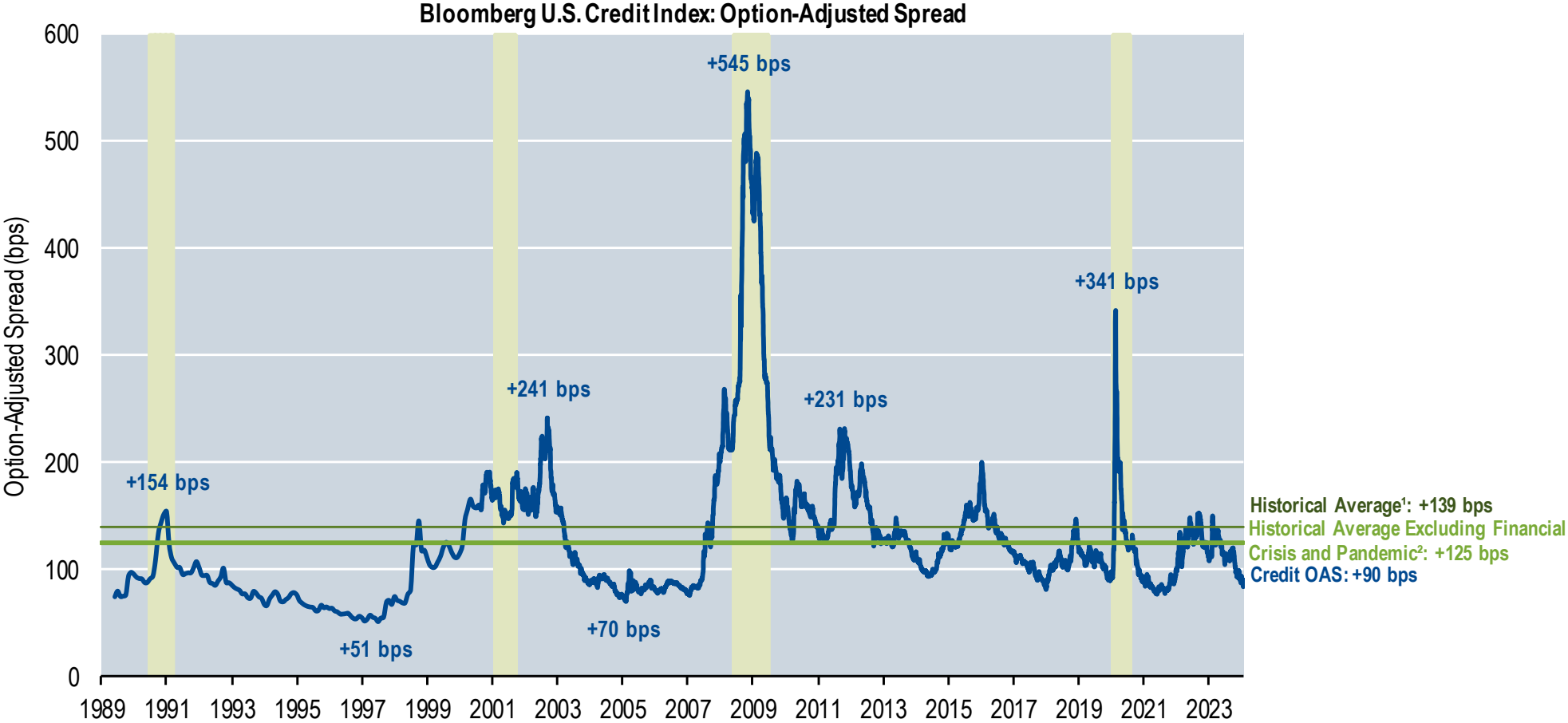


Source: Bloomberg, Citi, J.P. Morgan, Morningstar LSTA, Western Asset. <sup>1</sup>Morningstar LSTA US Leveraged Loan Total Return Index excess return vs. 3-Month LIBOR. As of 31 Mar 24  
 Past performance is not a reliable indicator of future results.





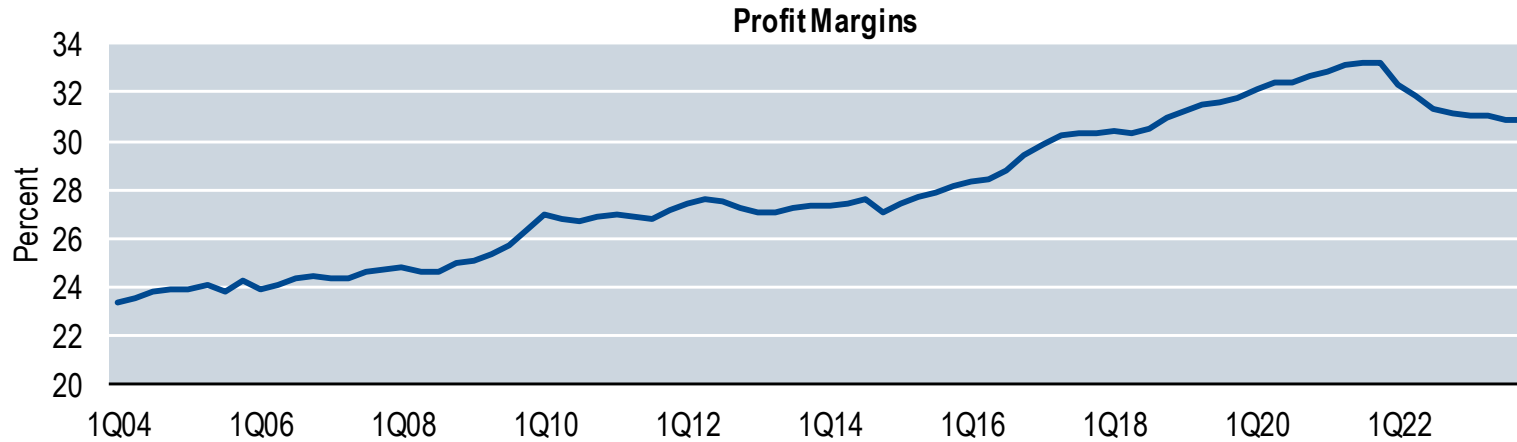
# Valuation: US Credit at +90 OAS, “Richly Valued”



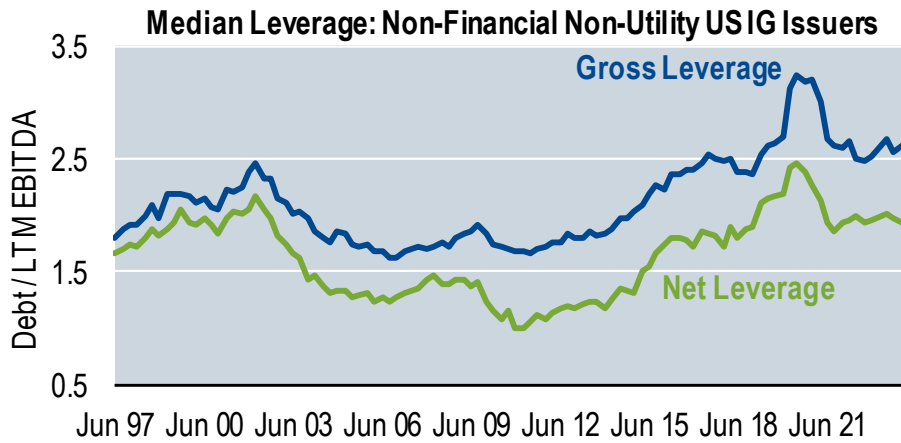
Source: Bloomberg. As of 29 Feb 24  
 Periods of recession highlighted in yellow

# Investment-Grade Credit

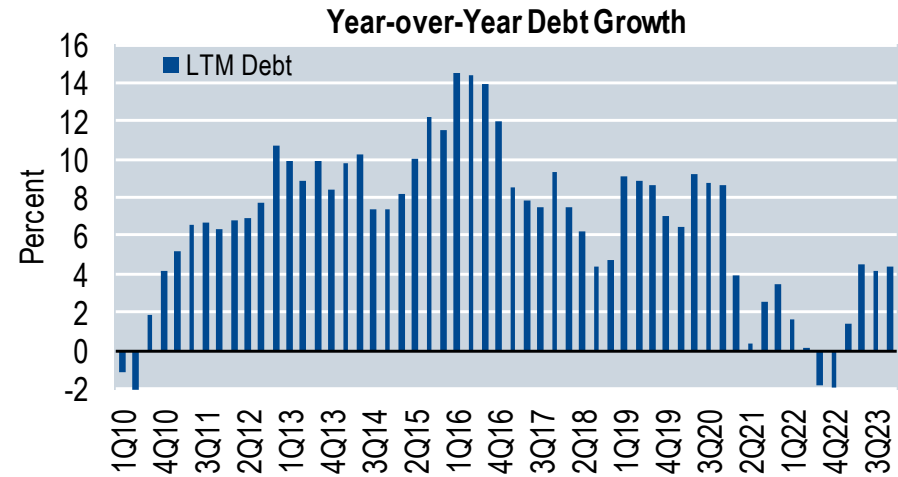
Cash flow and debt metrics are healthy.



~180 Non-Financial Companies (JULI Based)  
 Weighting based on amount of debt in the benchmark  
 Source: J.P. Morgan. As of 31 Dec 23



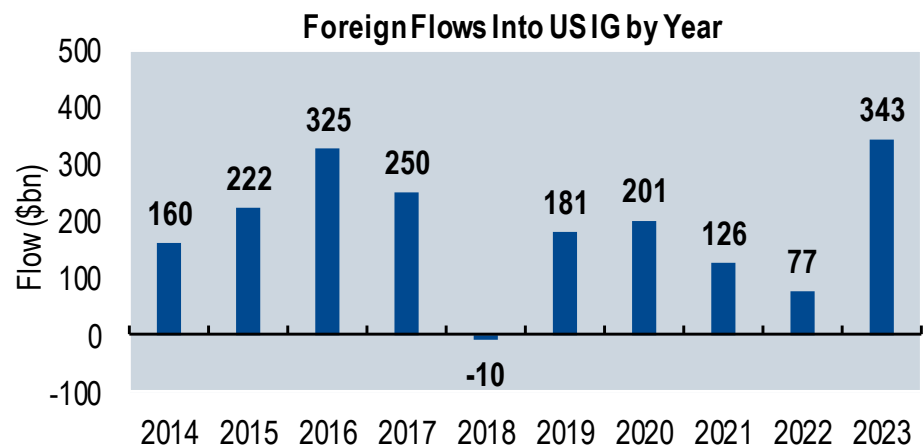
Source: BofA Global Research\*. As of 31 Dec 23



Source: J.P Morgan. As of 31 Dec 23

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# Foreign Demand Remains Elevated



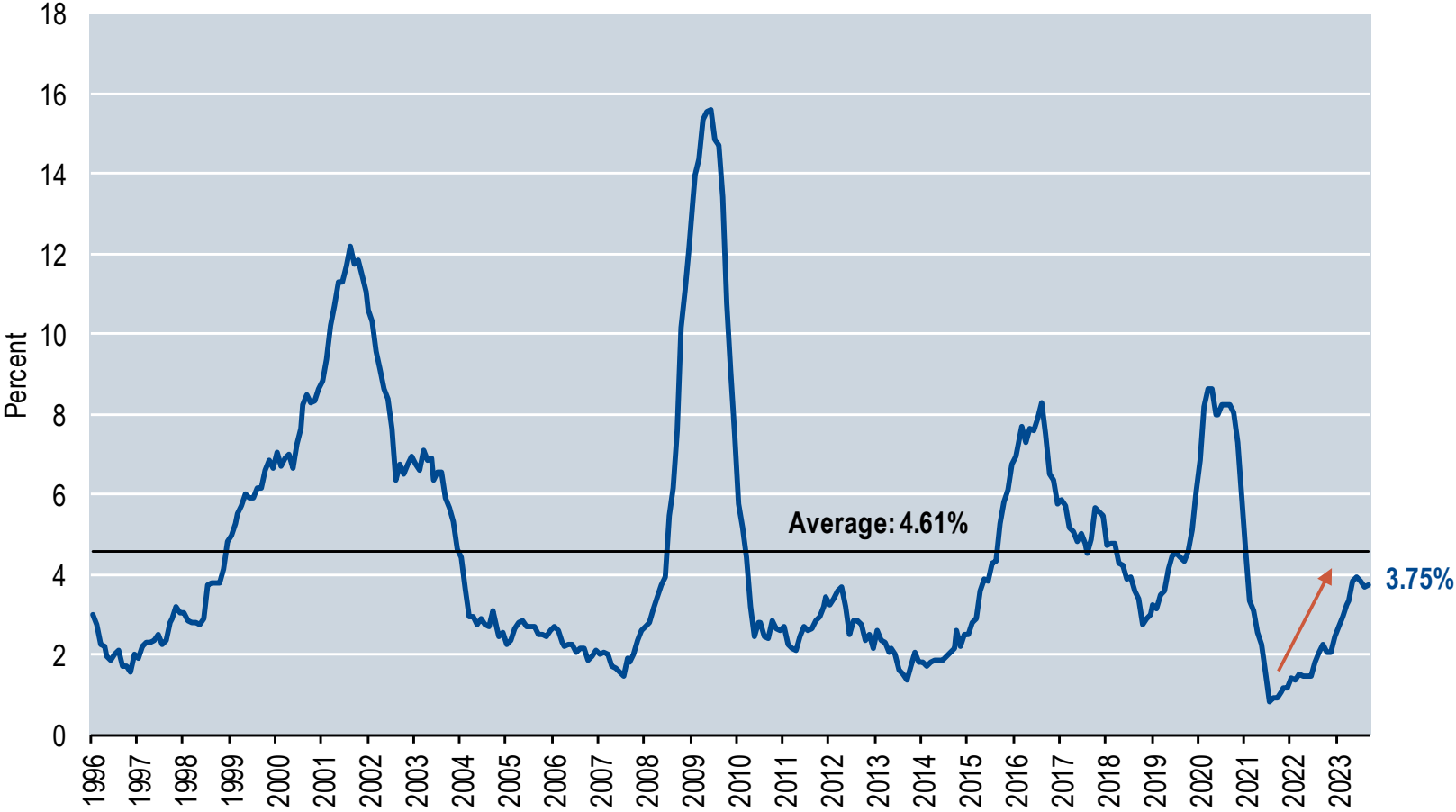
Source: Citi Research, Bloomberg, Department of Treasury, Haver Analytics. As of 31 Dec 23

## Foreign Demand Has Helped Absorb Healthy Net Supply

| Year | Net Supply | Adj Purchases | %   |
|------|------------|---------------|-----|
| 2016 | 521,588    | 325,206       | 62% |
| 2017 | 527,360    | 250,414       | 47% |
| 2018 | 329,012    | -9,538        | -3% |
| 2019 | 229,157    | 180,607       | 79% |
| 2020 | 540,191    | 200,957       | 37% |
| 2021 | 410,710    | 126,394       | 31% |
| 2022 | 460,175    | 77,459        | 17% |
| 2023 | 580,702    | 342,531       | 59% |

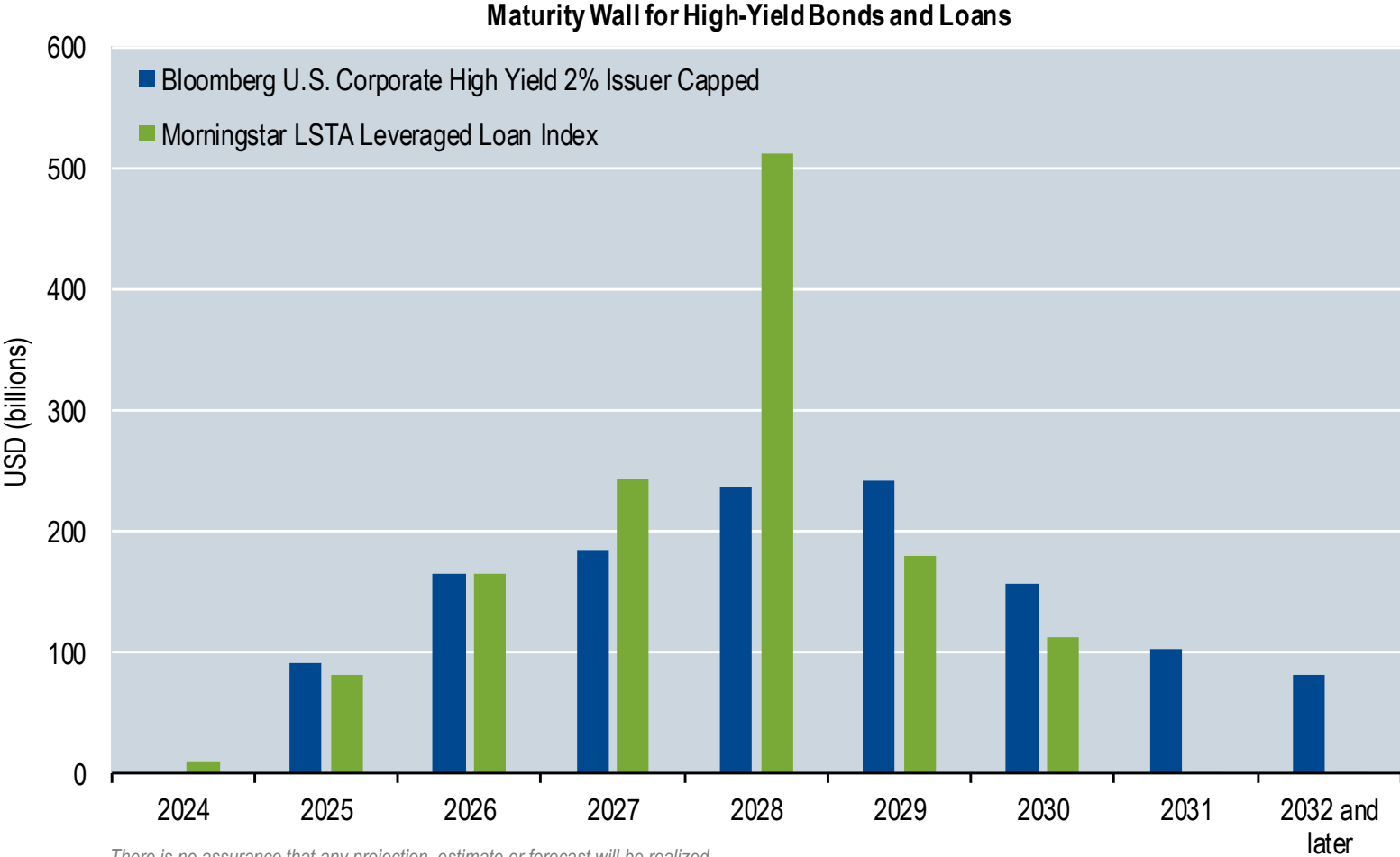
Source: Citi Research, Bloomberg, Department of Treasury, Haver Analytics, Refinitiv.  
As of 31 Dec 23

# High-Yield Default Rate Off Record Lows



Source: Moody's Investor Service. As of 29 Feb 24

# Low Refinancing Needs Should Support a Low Default Rate

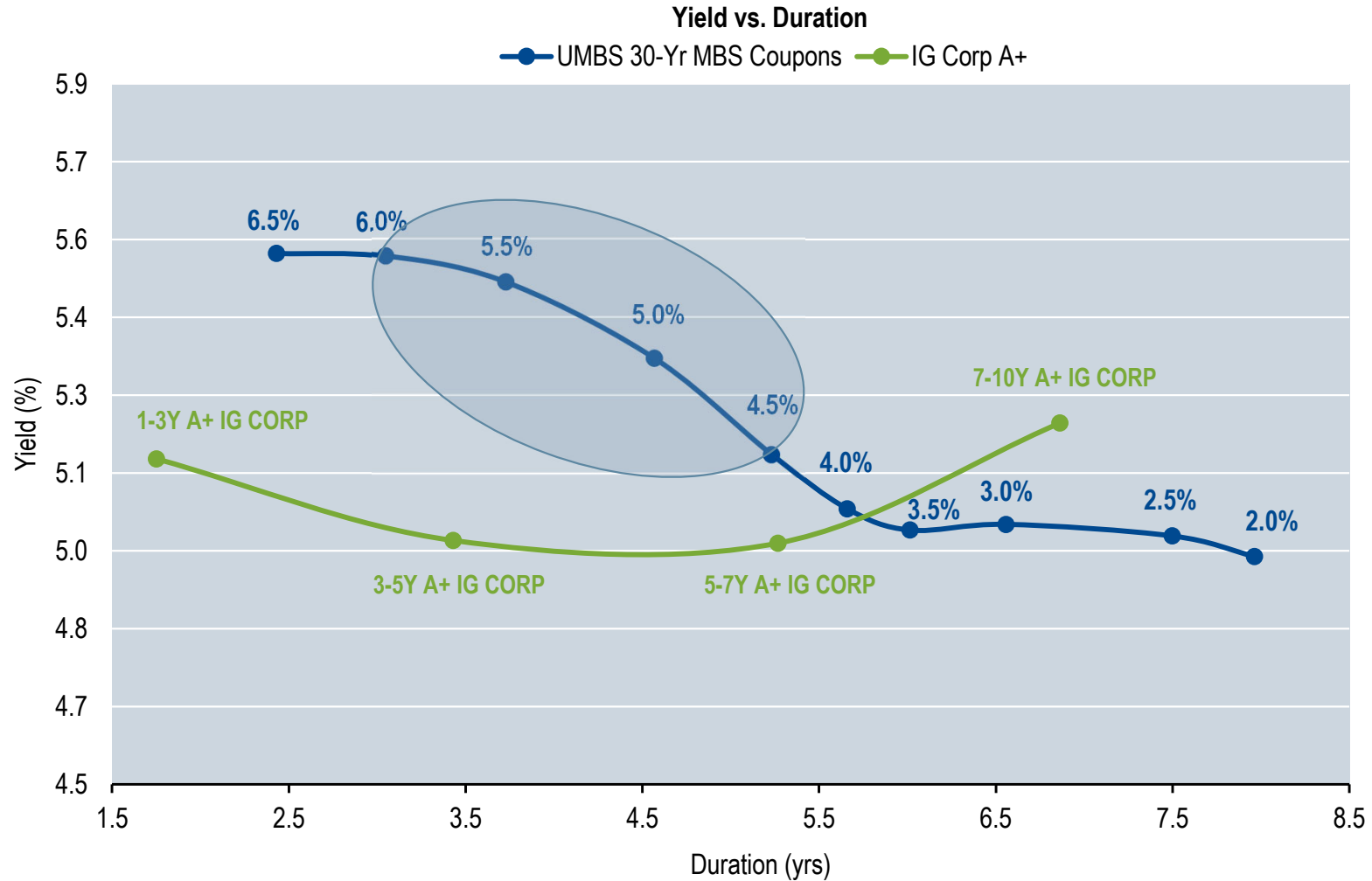


*There is no assurance that any projection, estimate or forecast will be realized.*

*Source: Bloomberg, Morningstar. As of 31 Dec 23*

# Agency MBS Are Attractive With Low Prepayment Risk and No Credit Risk

- With current mortgage rates at 7% and the average borrower locked into a sub 4% rate, prepayment risk is low
- Agency MBS offer yield pick over A+ Corporates in higher coupons



Source: Bloomberg. As of 24 Mar 24

# Commercial Mortgage (CMBS) Recovery Underway

- CMBS spreads have outperformed to start the year but the credit curve remains steep to historical norms
- Office sector has been uniquely impacted by Covid; however, the four other primary commercial real estate sectors exhibit neutral to positive fundamental performance since 2019

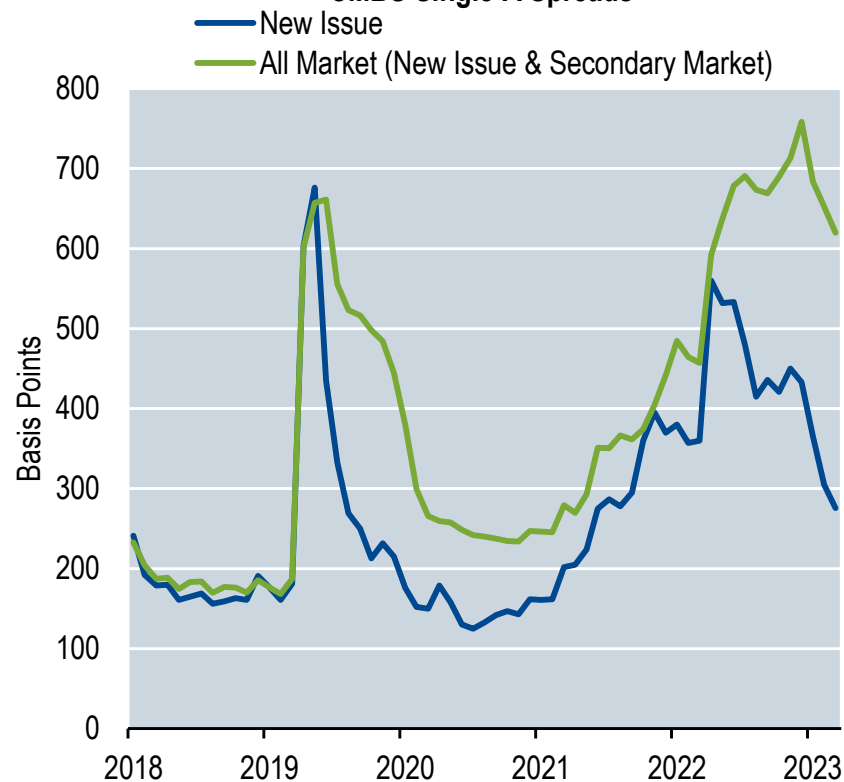
Property Sector Fundamental Changes from 2019

|                             | Office | Retail | Multifamily | Hotel | Industrial |
|-----------------------------|--------|--------|-------------|-------|------------|
| <b>Occupancy</b>            | -4.4%  | 0.3%   | -0.9%       | -2.9% | -0.9%      |
| <b>Rent Growth*</b>         | 0.7%   | 13.5%  | 16.1%       | 16.2% | 36.2%      |
| <b>Cap Rates</b>            | 1.1%   | -0.3%  | 0.2%        | 0.1%  | 0.1%       |
| <b>Price Change 4-Year*</b> | -4.9%  | 9.8%   | 17.9%       | 20.7% | 45.4%      |
| <b>Loan Payoff Rate</b>     | -34.7% | -5.1%  | -2.4%       | 24.0% | (NAV)      |

Source: Costar, Deutsche Bank, Real Capital Analytics, Western Asset. As of 31 Dec 23

\*Cumulative

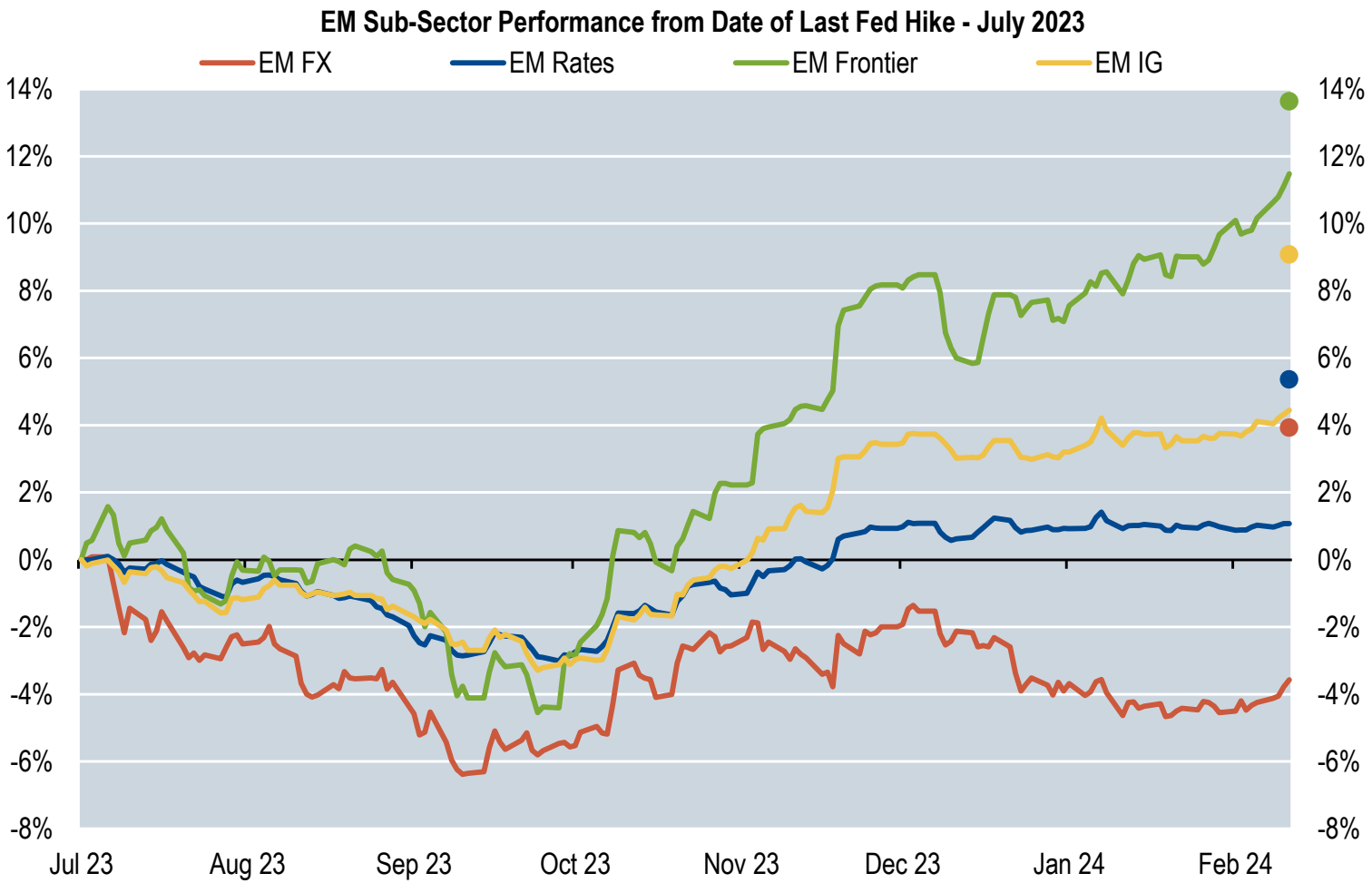
CMBS Single-A Spreads



Source: JP Morgan. As of 29 Feb 24

# EM Local Market Performance Has Underperformed Previous Cycles

US exceptionalism has weighed on returns.



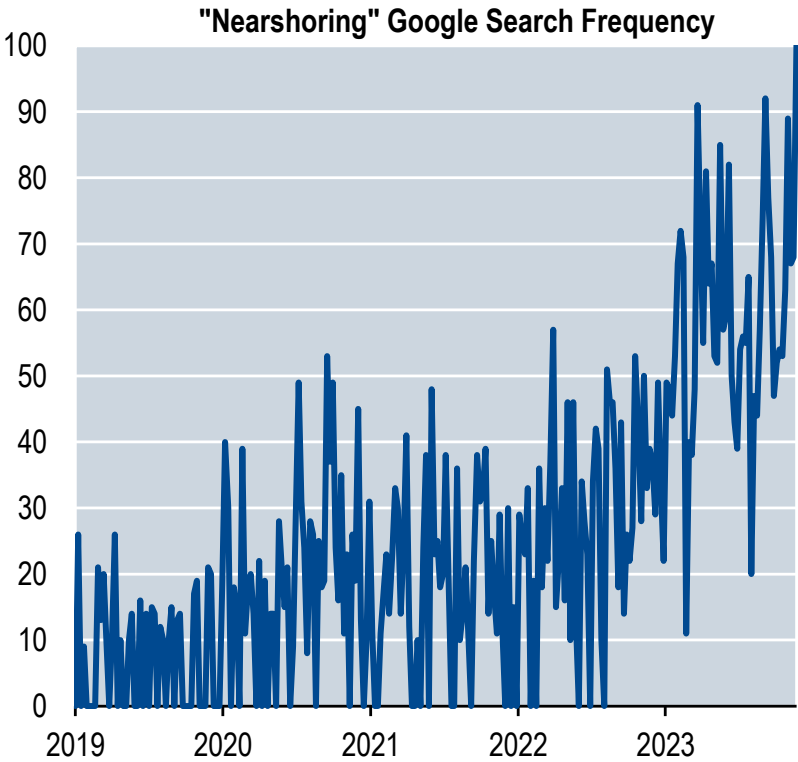
Source: J.P. Morgan. As of 07 Mar 24  
The dots are the average performance of the 4 subsectors at this point in the prior 2 Fed cycles



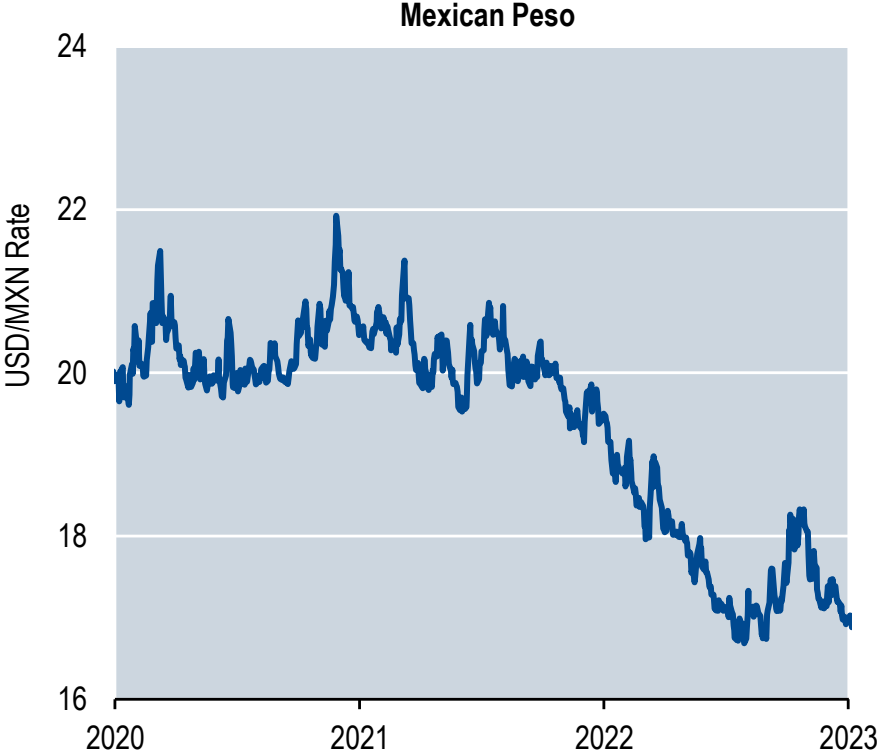


# Nearshoring Set to Benefit EM

- Some EM countries/regions are set to benefit from the evolution of global supply chains to reflect geopolitical considerations in addition to manufacturing costs
- We would highlight Mexico, Dominican Republic, Costa Rica and India as potential beneficiaries of nearshoring



Source: Google. As of 26 Nov 23



Source: Bloomberg. As of 31 Dec 23

**Disinflation ongoing but uneven**

**Central banks will ease policy to normalize real interest rates**

**Economy has remained resilient, but is set to slow**

## **Fixed-income outlook**

- US growth will slow but should avoid recession
- Global growth has downshifted and China is now a source of deflation
- US Core PCE already near Fed target
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- Spread sectors are still attractive but the outlook is clouded by macro risk
- Geopolitical uncertainty continues to add to volatility



**Thank you.**

# Risk Disclosure

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