Western Asset
A Franklin Templeton Company

Webcast Summary

Ken Leech
Co-Chief Investment Officer

John L. Bellows, PhD
Head of Broad Markets

Moderator:
Catherine Matthews
Product Specialist

2Q24 Market & Strategy Update

Global and US inflation has continued its steady but uneven decline while generally growth has remained resilient, allowing for eventual central bank rate cuts. Disinflation is occurring broadly across developed, emerging and frontier economies. Inflation in China has turned deflationary as the country stimulates its manufacturing sector to boost exports. The US economic outlook is stable, with a moderate growth slowdown expected, but no recession. Corporate fundamentals remain supportive with high profit margins, low debt growth and declining leverage for many non-financial issuers. We see value in sectors such as CMBS and EM debt, particularly in Latin America and Mexico.

Market Review

- Credit sectors and other risk assets have outperformed as government yields drifted higher over the year to date.
- European bank bonds have been a top performer, benefiting from the disinflationary environment in Europe.
- Investment-grade corporate bond spreads have tightened significantly, reaching levels characterized as richly valued.
- High-yield bond defaults have ticked up slightly but remain below historical averages.
- Foreign demand for US corporate bonds has remained robust so far in 2024, supporting spread tightening.
- Emerging market (EM) local currency bonds have underperformed this year despite prospects for central bank easing.

Inflation and US Economic Outlook

- The disinflationary progress over the past six months has been substantial, with inflation continuing to moderate globally in a broad-based manner across developed, emerging and frontier economies.
- We see a low level or moderate amount of job growth that we view as sustainable.
  - This moderation includes a dramatic decline in job openings over the last two years.
  - We think the wage growth that we're seeing could already be consistent with the Federal Reserve's (Fed) mandate.
  - While wage growth is somewhat higher than it was pre-pandemic, we don't necessarily see that as a problem provided there's continued productivity growth.

© Western Asset Management Company, LLC 2024. This publication is the property of Western Asset and is intended for the sole use of its clients, consultants, and other intended recipients. It should not be forwarded to any other person. Contents herein should be treated as confidential and proprietary information. This material may not be reproduced or used in any form or medium without express written permission.

- While there were unexpected bumps on inflation prints in January and February, we expect monthly inflation to decline back closer last year's levels. The following informs that view:
  - We believe the rent component of inflation will continue to decline.
  - We think it's very likely that goods prices will fall and/or goods inflation will decline due to goods prices continuing to be somewhat high relative to incomes, and China stimulating its economy via the manufacturing sector could mean lower prices for China imports to the US.
- Our long-standing view has been that the US could avoid a recession, a view that until recently, has been out of consensus. We maintain this view in part due to seeing no obvious imbalances in the US economy, and because ongoing disinflation has changed the risks regarding recession.
- With inflation lower, the Fed is now better positioned to provide countercyclical support if economic shocks arise.
- The outcome of the US presidential election could have significant implications for fiscal policy, including potential changes to taxation (i.e., the possible extension of 2017 tax cuts) and the tariff policy.

Global Economic Outlook

- In Europe, we see inflation moving close to target. We expect growth to be tepid at zero to 1% in 2024, and amid this disinflationary environment we may see the ECB cut rates.
- Global economic growth has shifted into a lower gear, and China's economic slowdown is now exerting disinflationary pressure on the rest of the world.
- Our expectation is that the growth rate in China is going to be low by their historical standards, and that the 4% to 5% growth rate no longer provides a strong market tailwind. Debt, demographics and deglobalization remain long-term secular growth headwinds.
- EM countries hiked rates pretty meaningfully before developed countries and this presents the opportunity for policy easing cycles by EM countries.

Investment Themes

- **Overall risk assets:** Spread sectors and risk assets are well-supported by the backdrop of moderating inflation and resilient growth.
- **Investment-grade:** Investment-grade corporate spreads have tightened to richly valued levels but can stay low given strong fundamentals; Rising foreign demand has contributed to investment-grade spread tightening in 2024 so far.
- **High-yield:** High-yield bond defaults have increased modestly but remain below long-term averages; higher interest rates pose limited refinancing risks for larger high-yield issuers. Fundamentals continue to be supportive.
- **Structured product:** Agency MBS offers value relative to corporates if convexity risk is managed; CMBS still presents opportunities after outperforming in Q1 with select exposure.
- **EM debt:** EM local currency bonds have underperformed but appear poised for outperformance as easing cycles begin; Mexico EM debt in particular could benefit from nearshoring of supply chains closer to the US.

Q&A Highlights

- The neutral rate of interest is an important long-term consideration for bond investors, but is not the Fed's focus in the near-term as it remains data-dependent on inflation.
- While wage growth remains somewhat elevated versus pre-pandemic levels at 3.5%-4.0%, it may already be consistent with the Fed's 2% inflation mandate given productivity gains.
- The upcoming 2024 US presidential election is not anticipated to be a major factor in determining the timing of Fed rate cuts if economic conditions warrant easing.
- Western Asset continues to favor the outperformance potential of rising stars, BB rated credits that could migrate to BBB amid improving fundamentals.

Past results are not indicative of future investment results. This publication is for informational purposes only and reflects the current opinions of Western Asset. Information contained herein is believed to be accurate, but cannot be guaranteed. Opinions represented are not intended as an offer or solicitation with respect to the purchase or sale of any security and are subject to change without notice. Statements in this material should not be considered investment advice. Employees and/or clients of Western Asset may have a position in the securities mentioned. This publication has been prepared without taking into account your objectives, financial situation or needs. Before acting on this information, you should consider its appropriateness having regard to your objectives, financial situation or needs. It is your responsibility to be aware of and observe the applicable laws and regulations of your country of residence.

Western Asset Management Company Distribuidora de Títulos e Valores Mobiliários Limitada is authorized and regulated by Comissão de Valores Mobiliários and Brazilian Central Bank. Western Asset Management Company Pty Ltd ABN 41 117 767 923 is the holder of the Australian Financial Services Licence 303160. Western Asset Management Company Pte. Ltd. Co. Reg. No. 200007692R is a holder of a Capital Markets Services Licence for fund management and regulated by the Monetary Authority of Singapore. Western Asset Management Company Ltd is a registered Financial Instruments Business Operator and regulated by the Financial Services Agency of Japan. Western Asset Management Company Limited is authorised and regulated by the Financial Conduct Authority ("FCA") (FRN 145930). This communication is intended for distribution to Professional Clients only if deemed to be a financial promotion in the UK as defined by the FCA. This communication may also be intended for certain EEA countries where Western Asset has been granted permission to do so. For the current list of the approved EEA countries please contact Western Asset at +44 (0)20 7422 3000.