



Thank you for joining our webcast, *Navigating Risk and Reward at This Stage of the Expansion* featuring Deputy CIO Michael Buchanan.

The presentation will begin shortly.



### New Paper: ESG Investing in Sovereigns

Matt Graves and Bonnie Wongtrakool explore how ESG investing principles can complement traditional sovereign investment analysis.

Available on our homepage: [westernasset.com](http://westernasset.com).



# Navigating Risk and Reward at This Stage of the Expansion

September 13, 2018

Michael Buchanan  
Deputy Chief Investment Officer

## Navigating Risk and Reward at This Stage of the Expansion

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- The credit cycle endures, but what about relative value?
- Returns since the beginning of the cycle have been impressive, leaving valuations compressed
- Fundamentals ... still strong, but experiencing a degree of erosion
- Market concerns: BBB build-up, M&A, bank loans
- Areas of opportunity

## Western Asset Has Maintained That the Current Credit Cycle Is One That Would Very Likely Extend Well Beyond the Length of Normal Credit Cycles

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- Central bank accommodation
  - Regulation
  - Risk aversion
- In January 2009, we wrote a white paper titled “Credit: A Historic Opportunity,” in which we highlighted the credit market at that time as being “one of the best risk/reward opportunities since our inception in 1971.”
- Since then, we have continually communicated our positive view on the credit markets through various client communications, white papers and webcasts.
- Over the past few years, our bullish view on credit has appeared more out-of-consensus as the cycle grew longer. However, we continued to see a strong fundamental backdrop and opportunity in the market.

February 2016: Market fear of a US recession is unwarranted as focus appears to be on perception not reality.

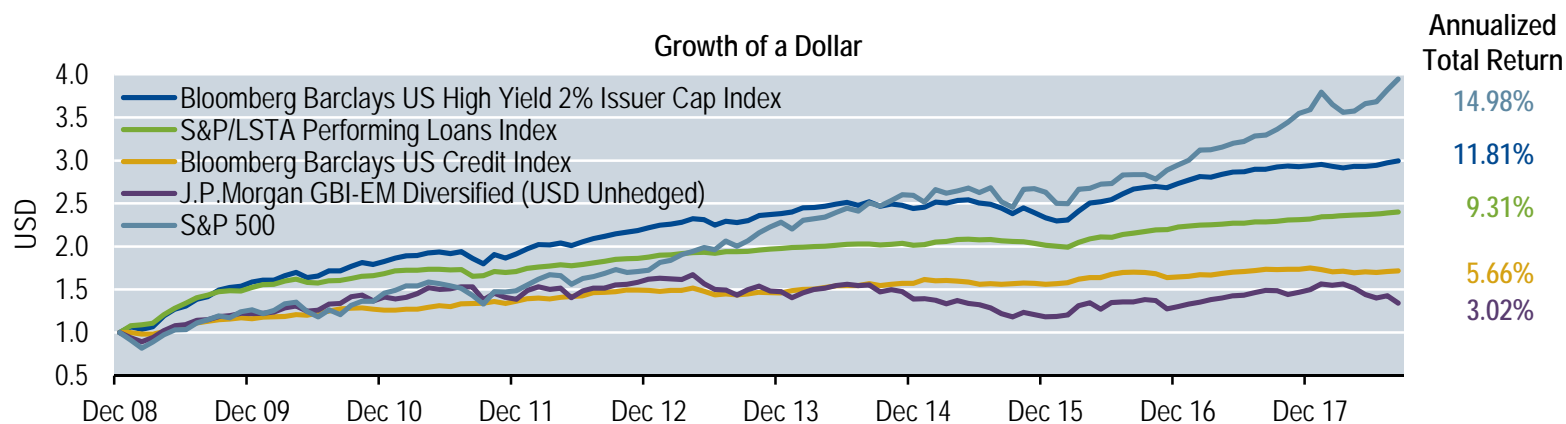
June 2016: Notwithstanding the large rally since February, valuations remain attractive.

December 2016: The new administration’s agenda includes strong pro-growth measures.

September 2017: Opportunities remain as reduced central bank accommodation does not necessarily mean harm to the fixed-income market.

March 2018: Length of the expansion cycle is causing increased concern as the Fed continues to hike rates. We continue to see pockets of value.

## Returns: Impressive, Some More Than Others



Source: Bloomberg Barclays, J.P.Morgan, S&P. As of 31 Aug 18

### Historical Annual Excess Returns (bps)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018*
US Agency	-110	238	72	19	97	-10	55	8	39	69	4
US MBS	-232	495	225	-106	91	98	40	-5	-11	52	-17
US ABS	-2,223	2,496	169	52	246	24	53	44	95	92	18
US CMBS	-3,274	2,960	1,501	47	841	97	108	-28	236	158	41
US Investment-Grade Credit	-1,786	1,990	192	-322	693	226	-18	-169	442	335	-76
US High-Yield Credit	-3,832	5,955	974	-240	1,394	923	-112	-577	1,573	610	222
US Bank Loan <sup>1</sup>	-3,233	5,183	1,003	116	932	514	-119	-540	1,004	303	200
Emerging Markets Local Currency <sup>2</sup>	-2,037	2,506	768	-1,283	1,364	-538	-1,055	-1,690	864	1,334	-276

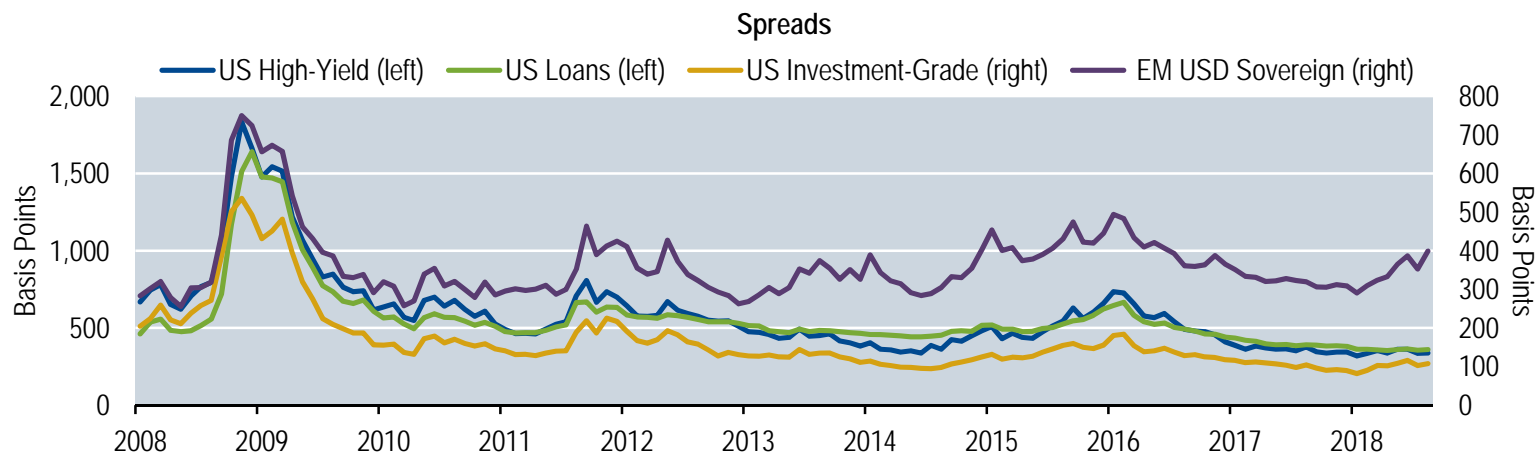
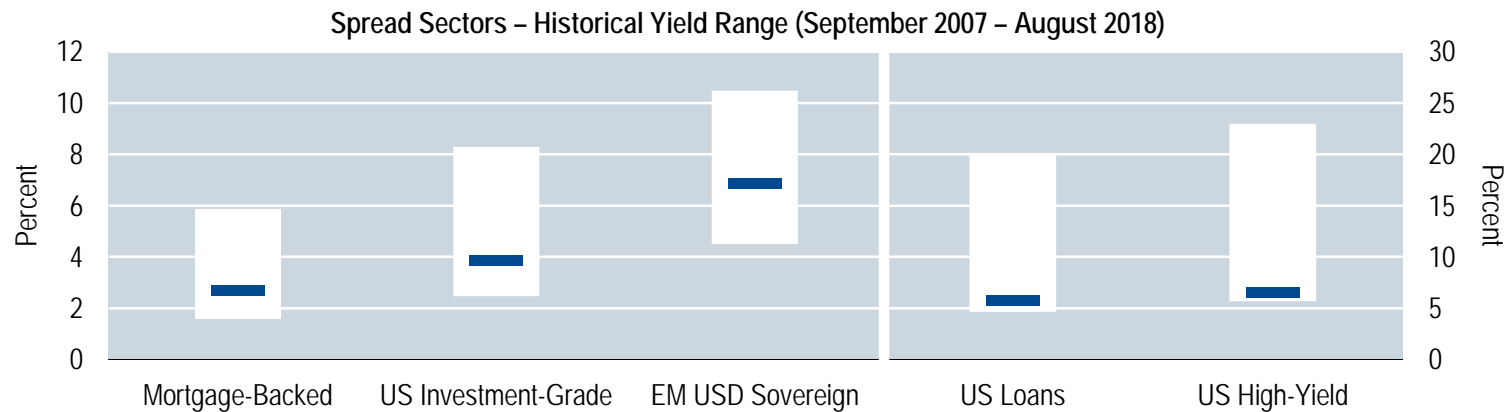
Source: Bloomberg Barclays, J.P. Morgan, S&P Global Market Intelligence, a division of S&P Global Inc.

<sup>1</sup>S&P/LSTA Leveraged Performing Loan Index. Sectors represented by Bloomberg Barclays U.S. indices unless otherwise noted; All figures shown in basis points

<sup>2</sup>J.P. Morgan GBI-EM Global Diversified Index USD Unhedged.

\*As of 31 Aug 18

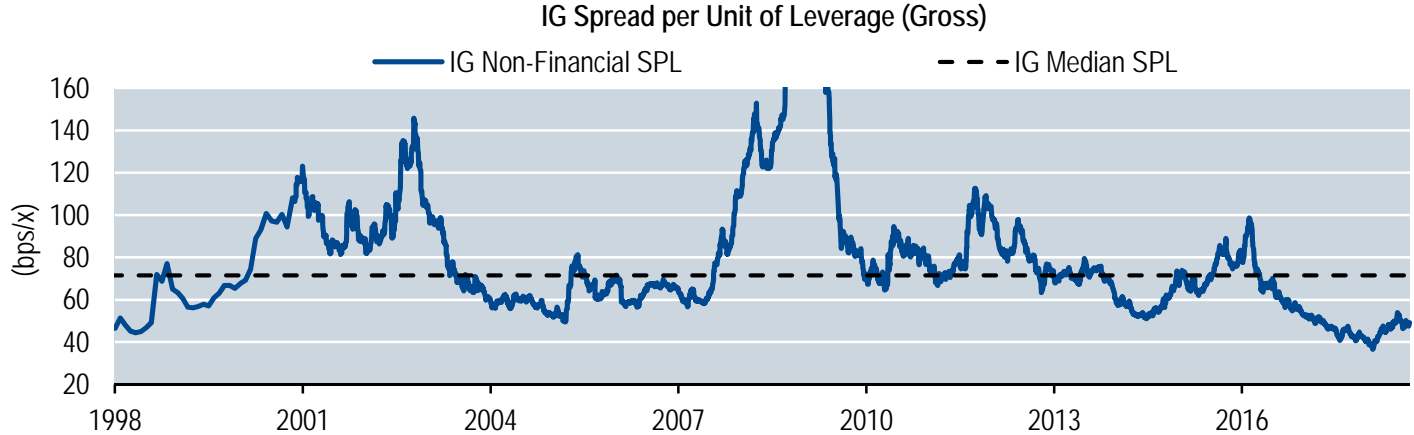
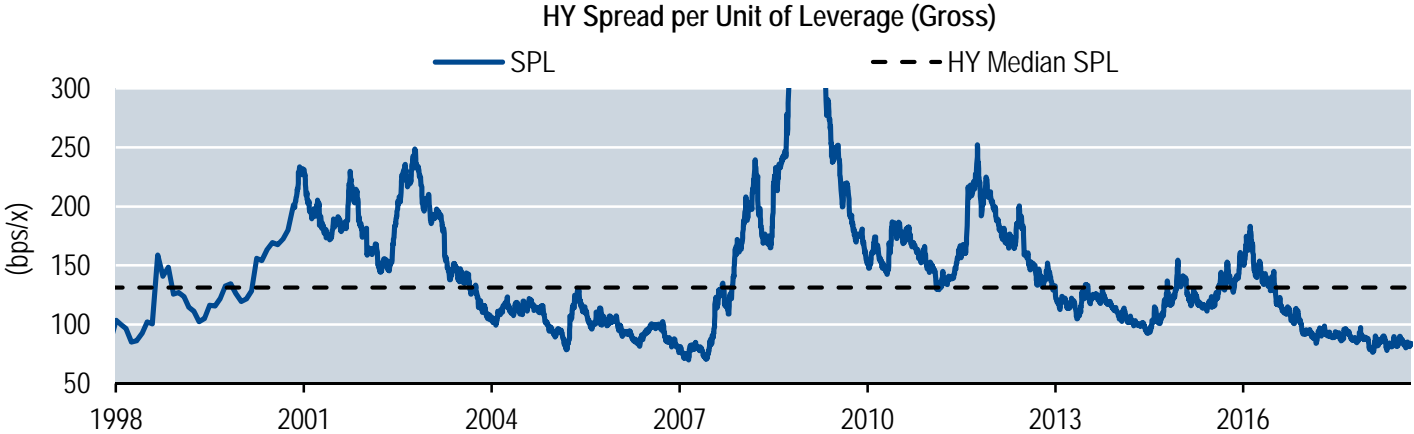
# Valuations: As a Consequence, Risk Premiums Have Compressed and Yields Have Declined



US Investment-Grade represented by Bloomberg Barclays US Credit Index  
 US High-Yield represented by Bloomberg Barclays US High-Yield Index  
 EM USD Sovereign represented by J.P. Morgan Emerging Market Bond Index Global (EMBI Global)  
 Mortgage-Backed represented by Bloomberg Barclays US MBS Index  
 US Loans represented by S&P/LSTA US Leveraged Loan Index  
 Source: Bloomberg Barclays, J.P. Morgan, S&P Global Market Intelligence, a division of S&P Global Inc.  
 As of 31 Aug 18

# But What About Relative Value?

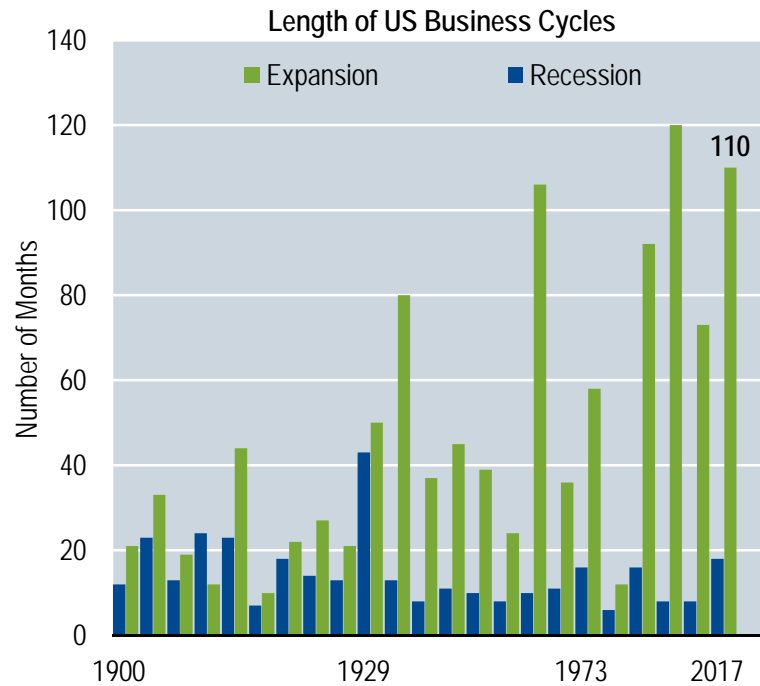
Intersection of fundamentals and valuations determines value



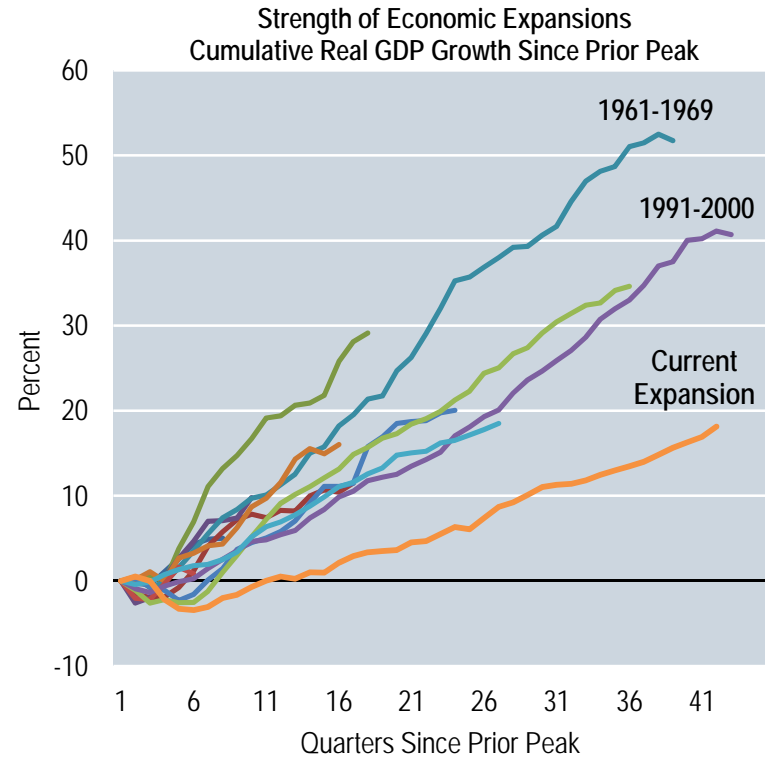
Source: Morgan Stanley Research, Citigroup Index LLC, Bloomberg Finance LP, S&P Capital IQ. As of 05 Sep 18



# Macro Backdrop: Fear of Late Cycle



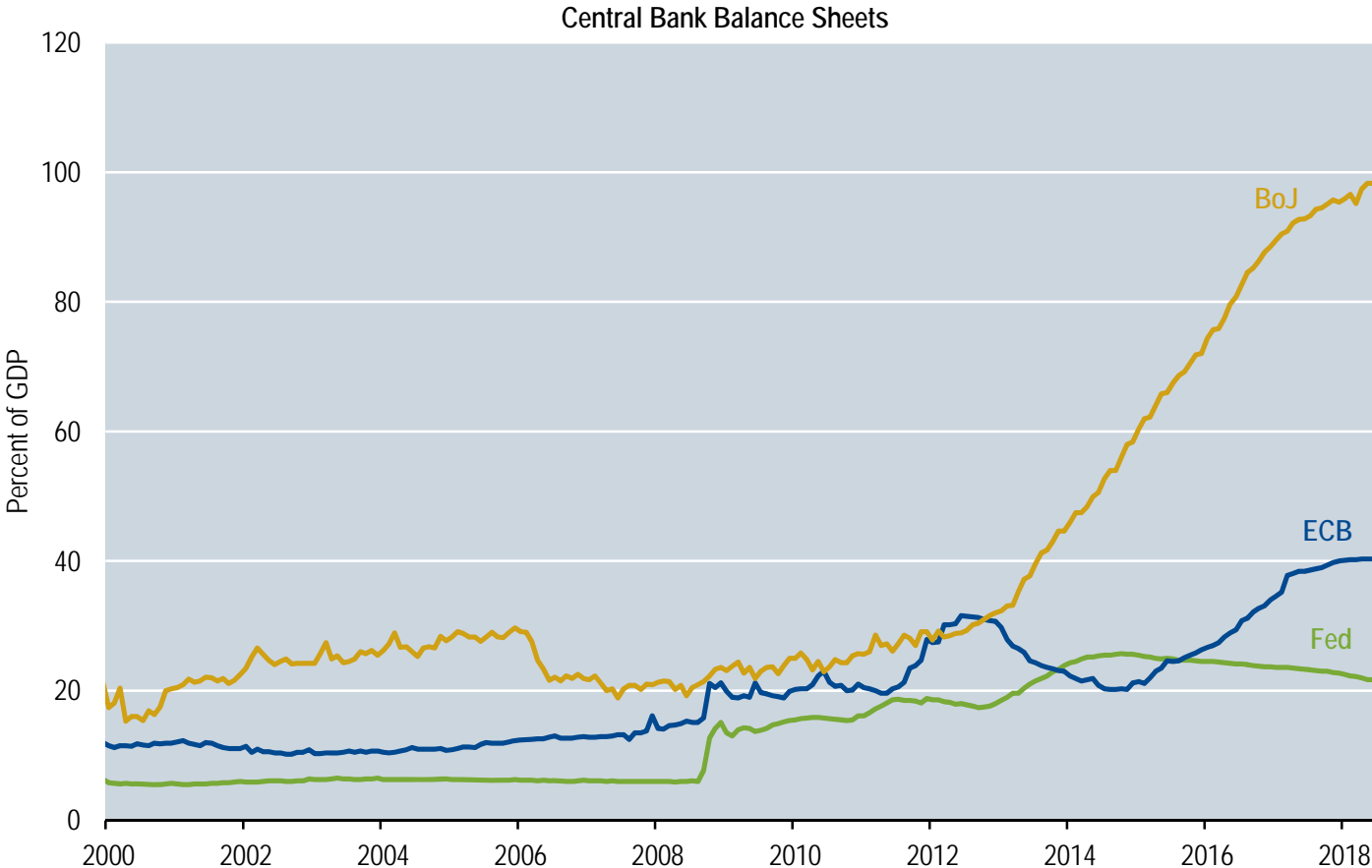
Source: J.P. Morgan, National Bureau of Economic Research, and Bureau of Economic Analysis. As of 31 Aug 18



Source: J.P. Morgan, National Bureau of Economic Research, Bureau of Economic Analysis. As of 31 Mar 18

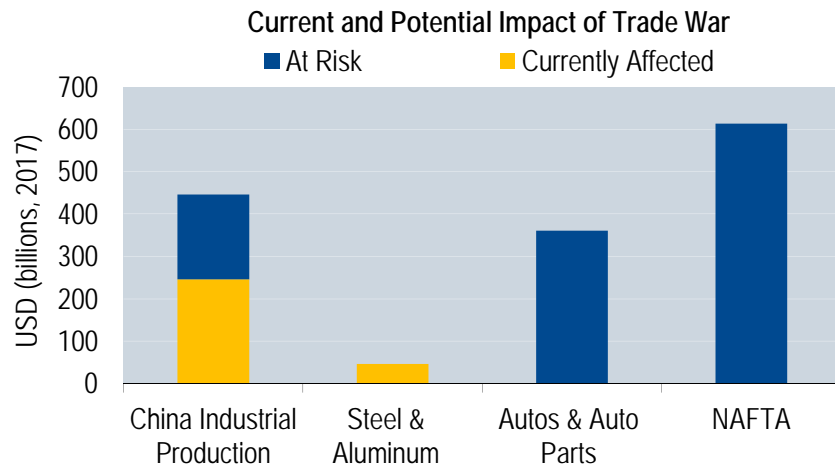


# Macro Backdrop: Fear of Central Bank Balance Sheet Normalization

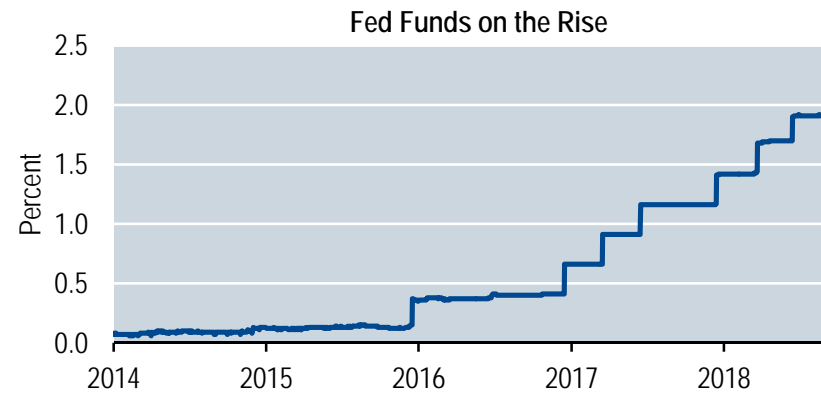


Source: Bloomberg. As of 30 Jun 18

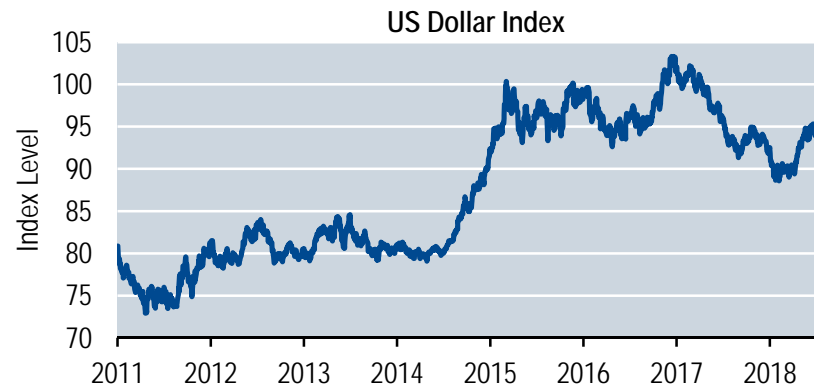
# Macro Headwinds: Trade, Fed, US Dollar



Source: Nomura. As of 10 Jul 18

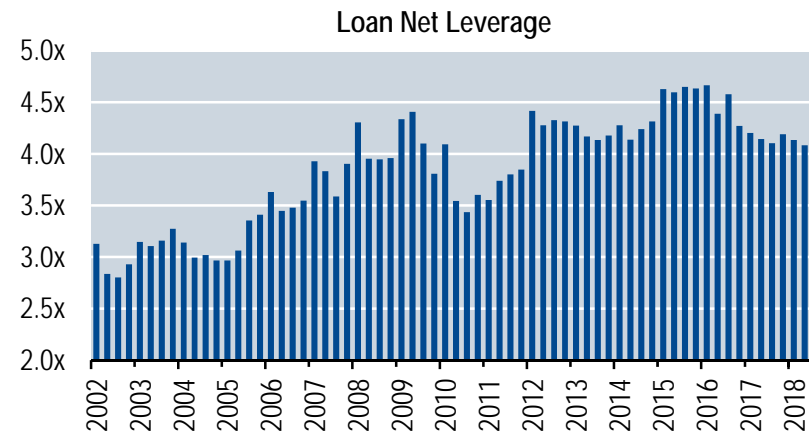
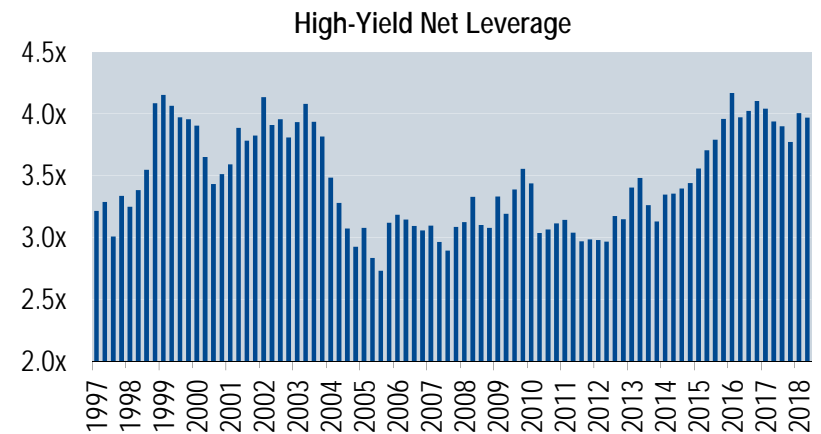
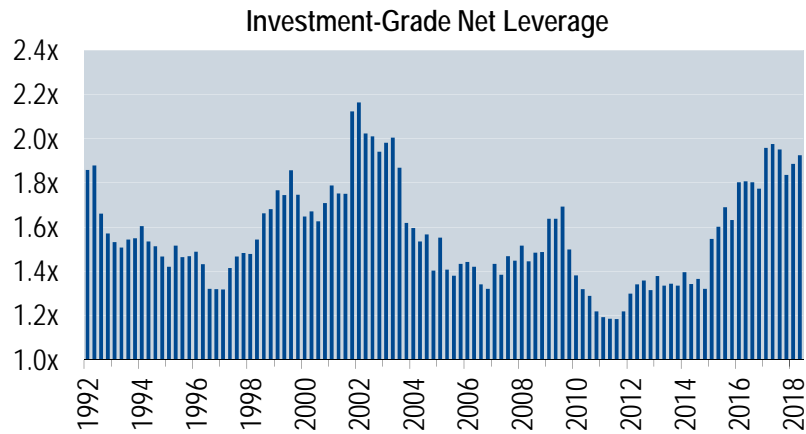


Source: Federal Reserve Bank of New York. As of 31 Aug 18



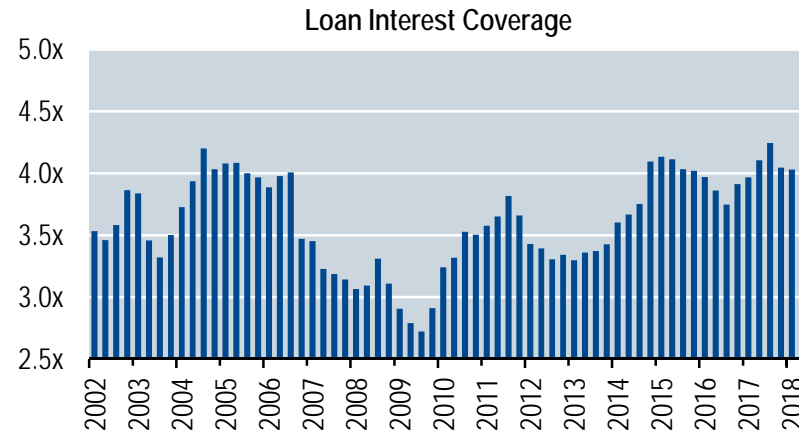
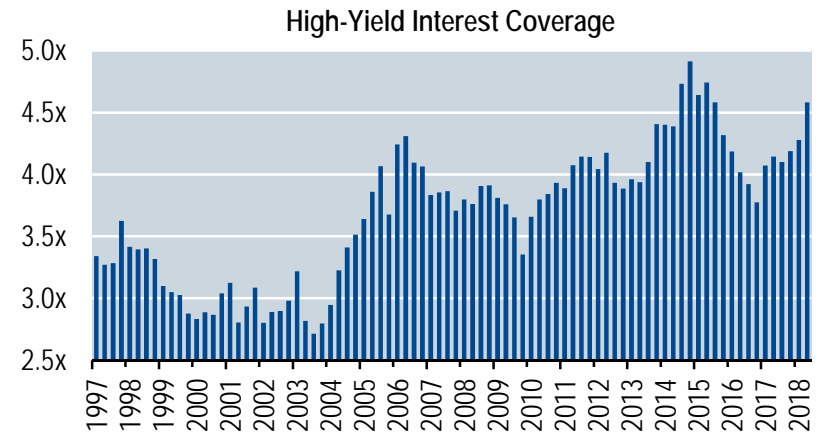
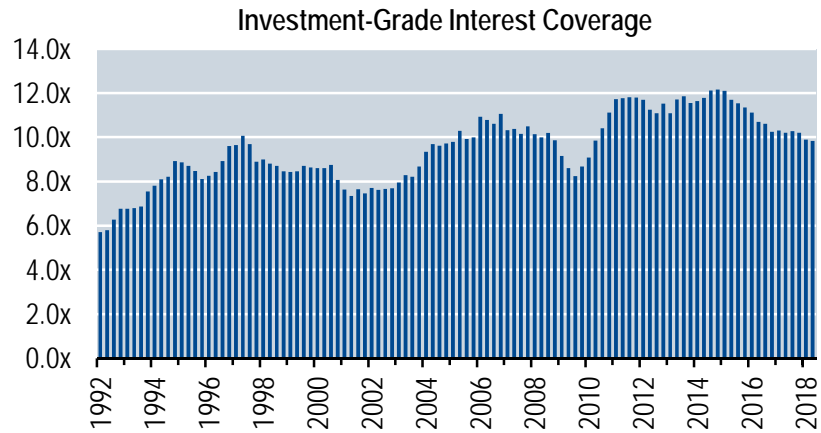
Source: Bloomberg. As of 11 Sep 18

# Corporate Credit Fundamentals: Net Leverage



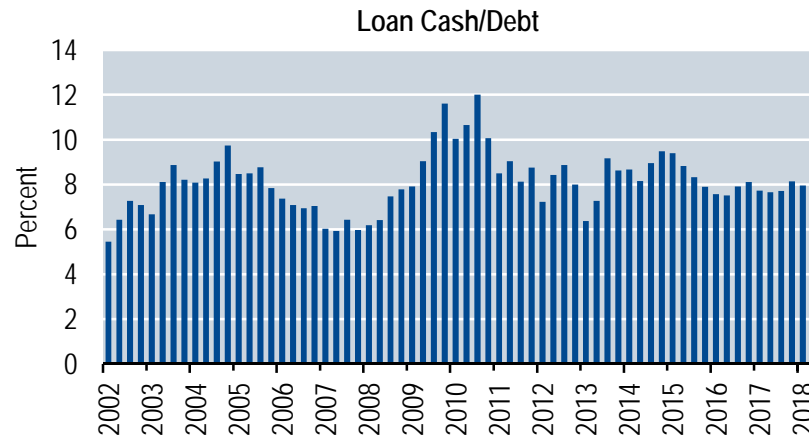
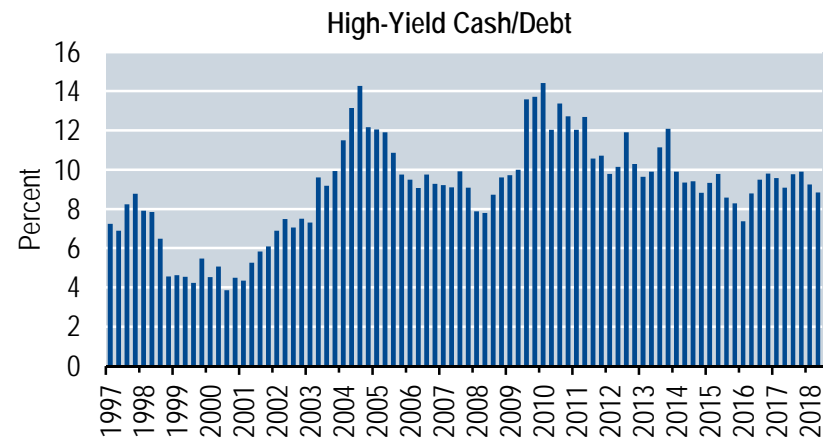
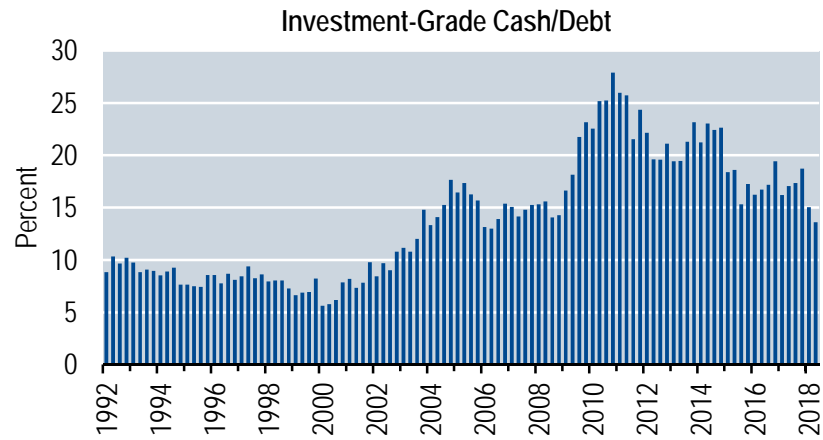
Source: Bloomberg Finance LP, Capital IQ, Citigroup Index LLC, FTSE Fixed Income LLC, Morgan Stanley Research, FTSE Fixed Income LLC. As of 30 Jun 18

# Corporate Credit Fundamentals: Interest Coverage



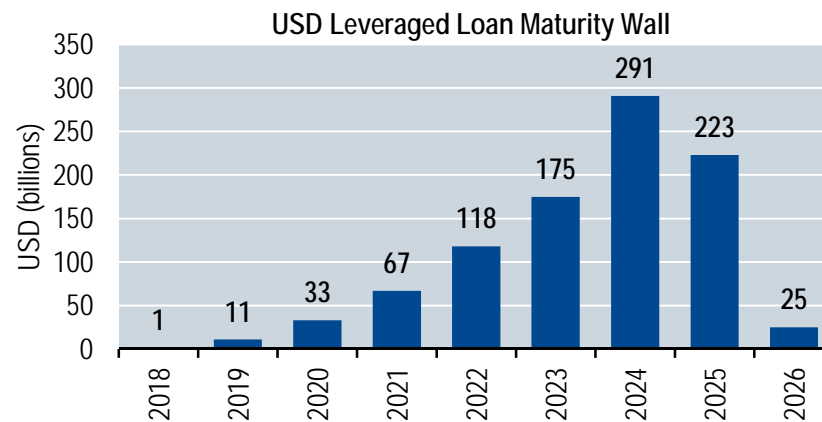
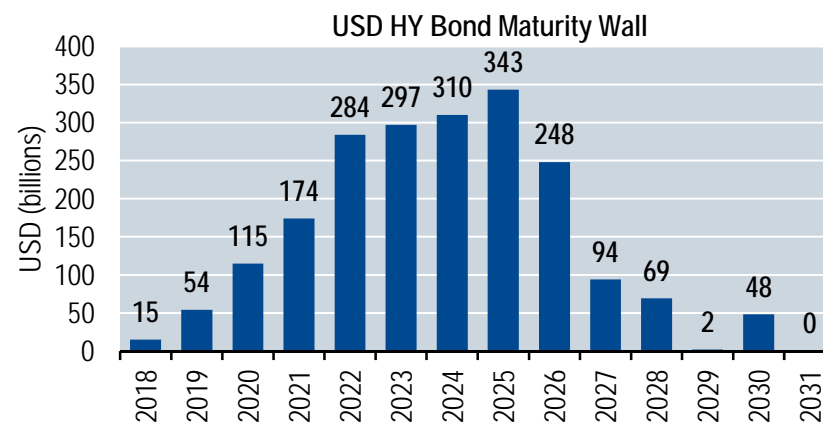
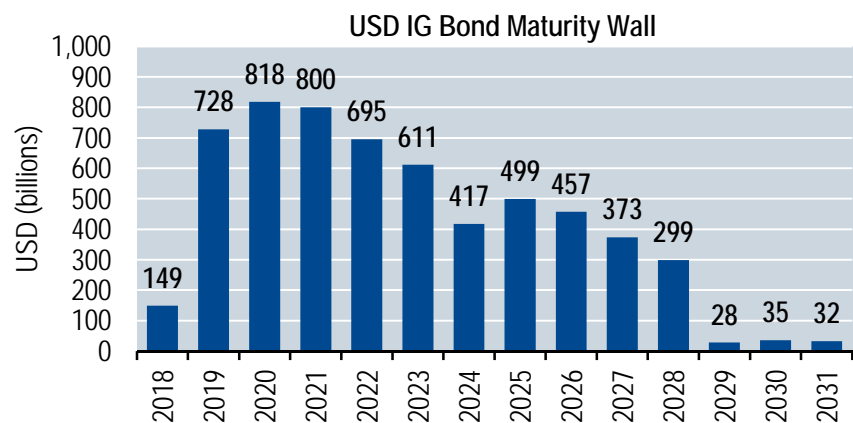
Source: Bloomberg Finance LP, Capital IQ, Citigroup Index LLC, FTSE Fixed Income LLC, Morgan Stanley Research, FTSE Fixed Income LLC. As of 30 Jun 18

# Corporate Credit Fundamentals: Cash as a Percentage of Debt



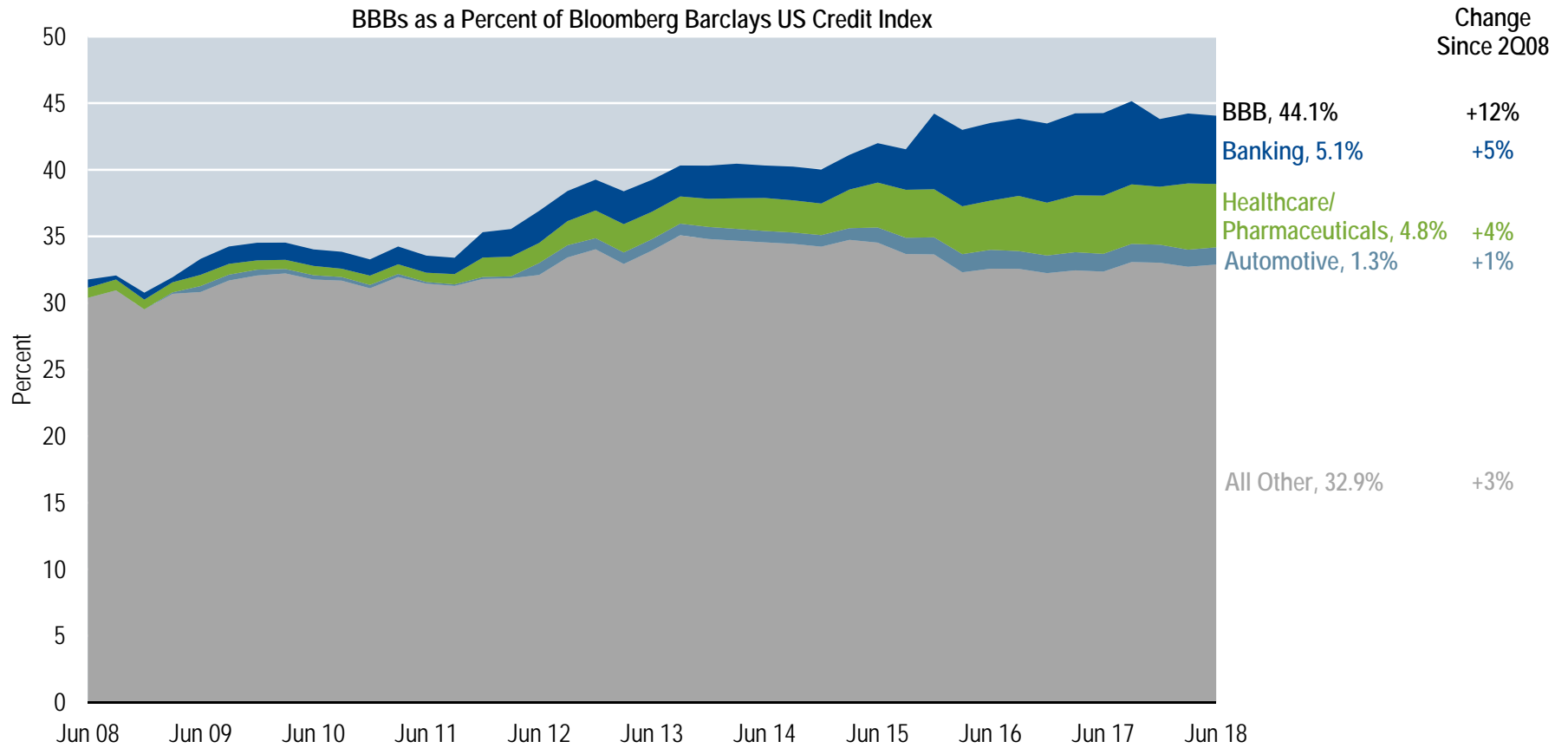
Source: Bloomberg Finance LP, Capital IQ, Citigroup Index LLC, FTSE Fixed Income LLC, Morgan Stanley Research, FTSE Fixed Income LLC. As of 30 Jun 18

# Corporate Credit Fundamentals: Maturity Walls



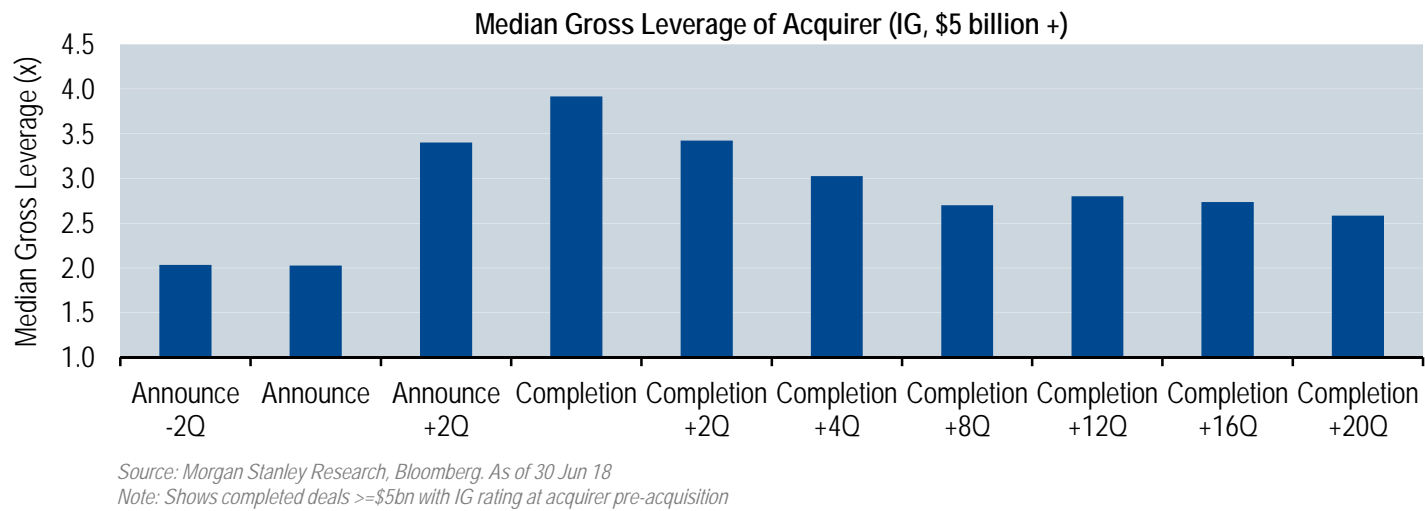
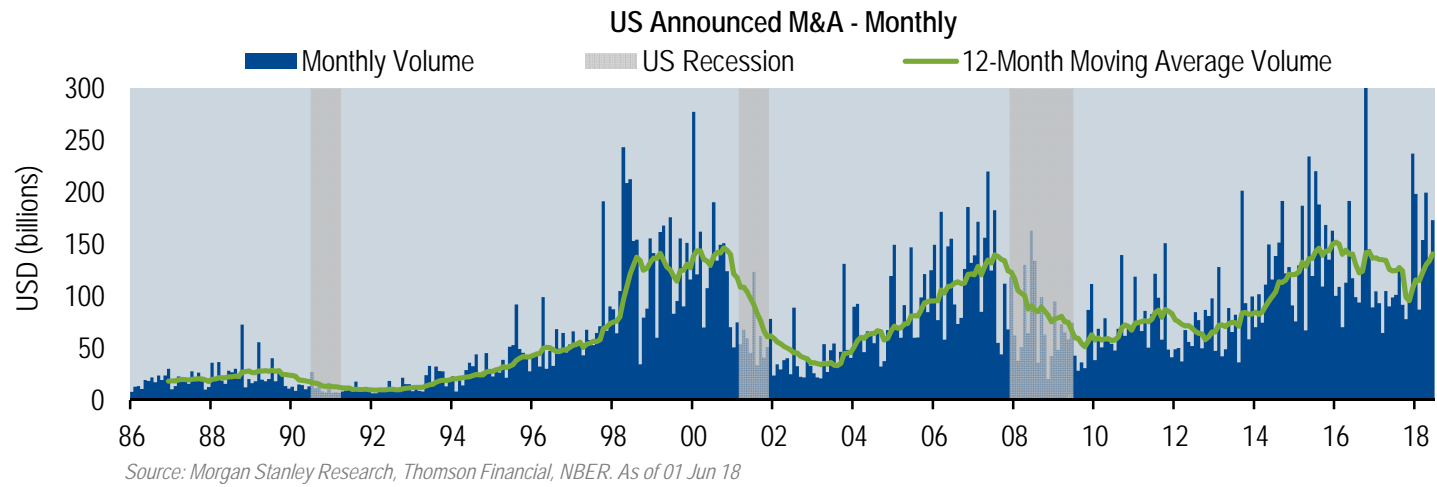
Source: Goldman Sachs. As of 07 Sep 18

# Market Concern: Growth of BBBs



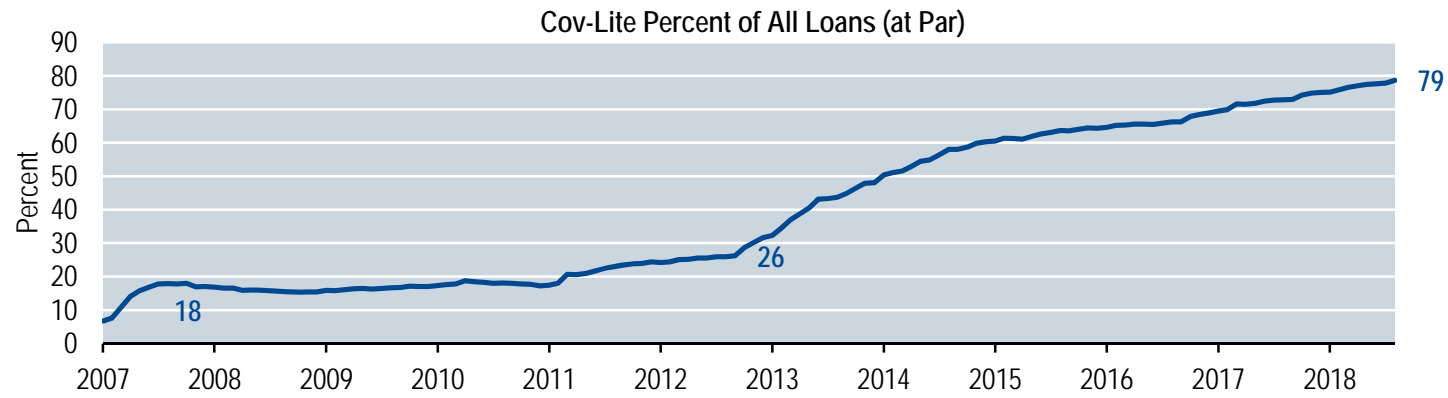
Source: Bloomberg Barclays. As of 30 Jun 18

# Market Concern: M&A Activity

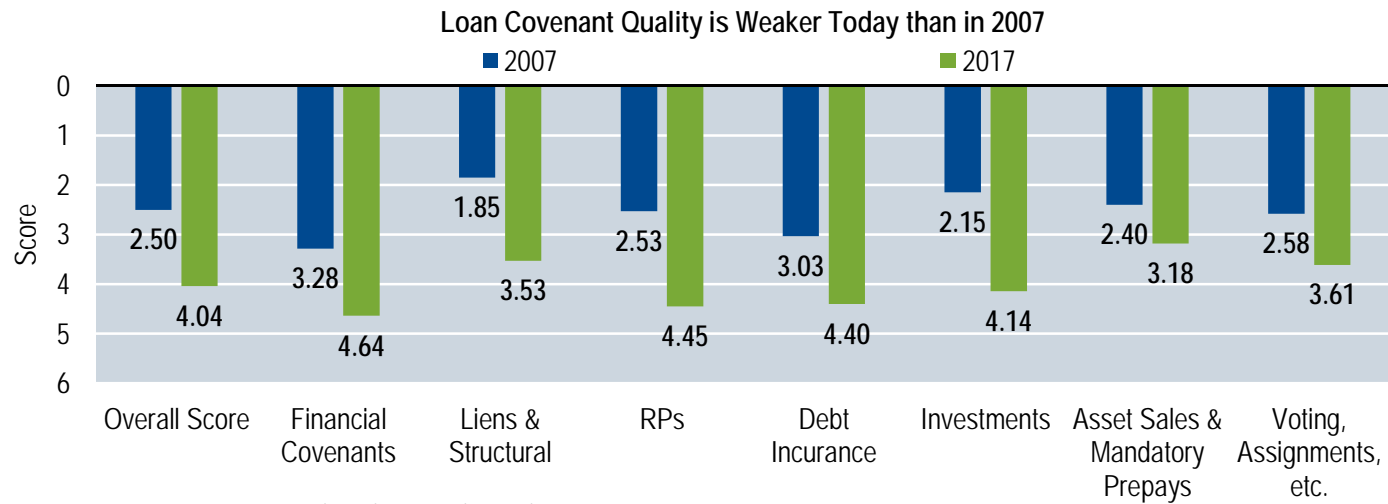




# Market Concern: Bank Loan Underwriting

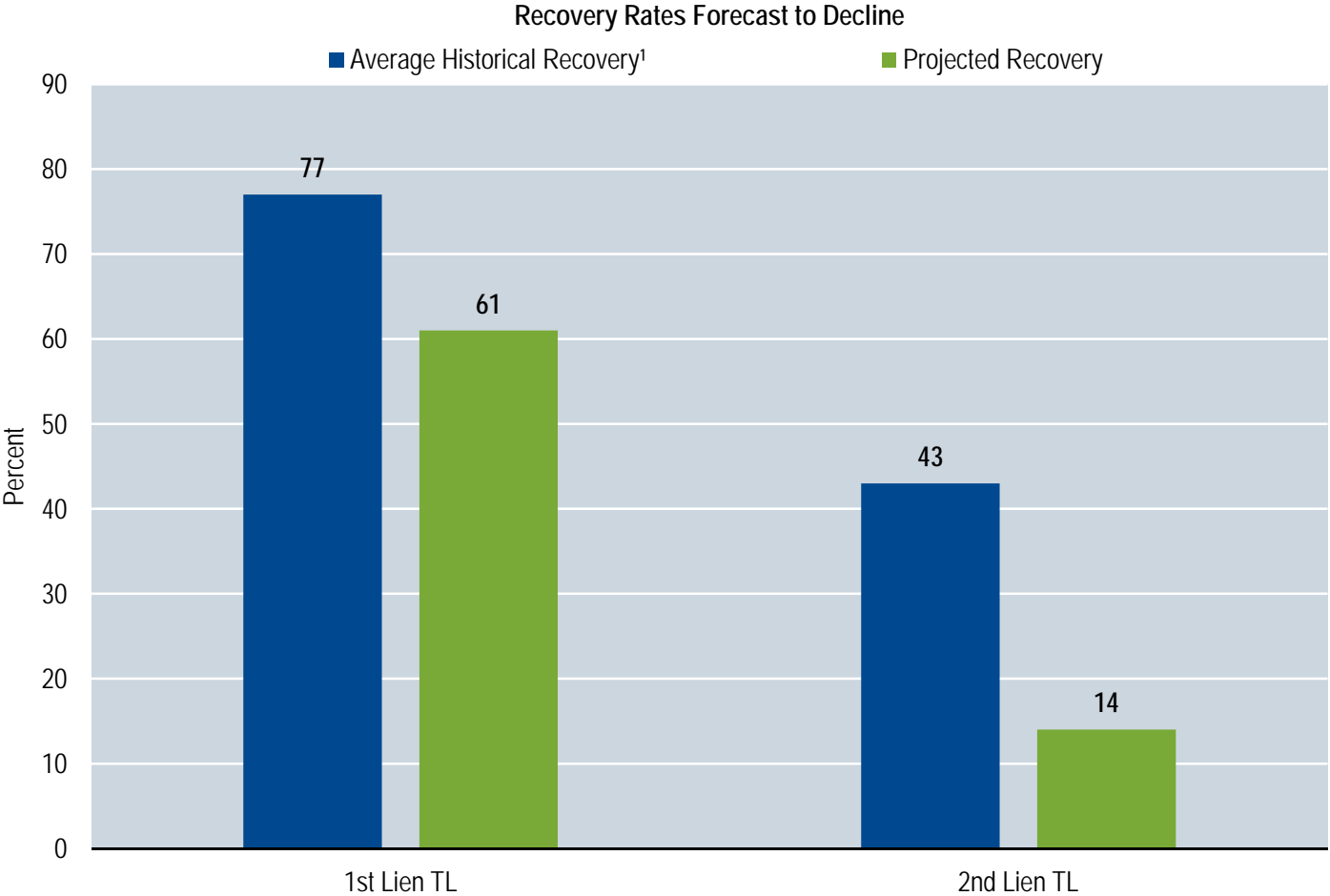


Source: S&P Global Market Intelligence, a division of S&P Global Inc. As of 31 Aug 18



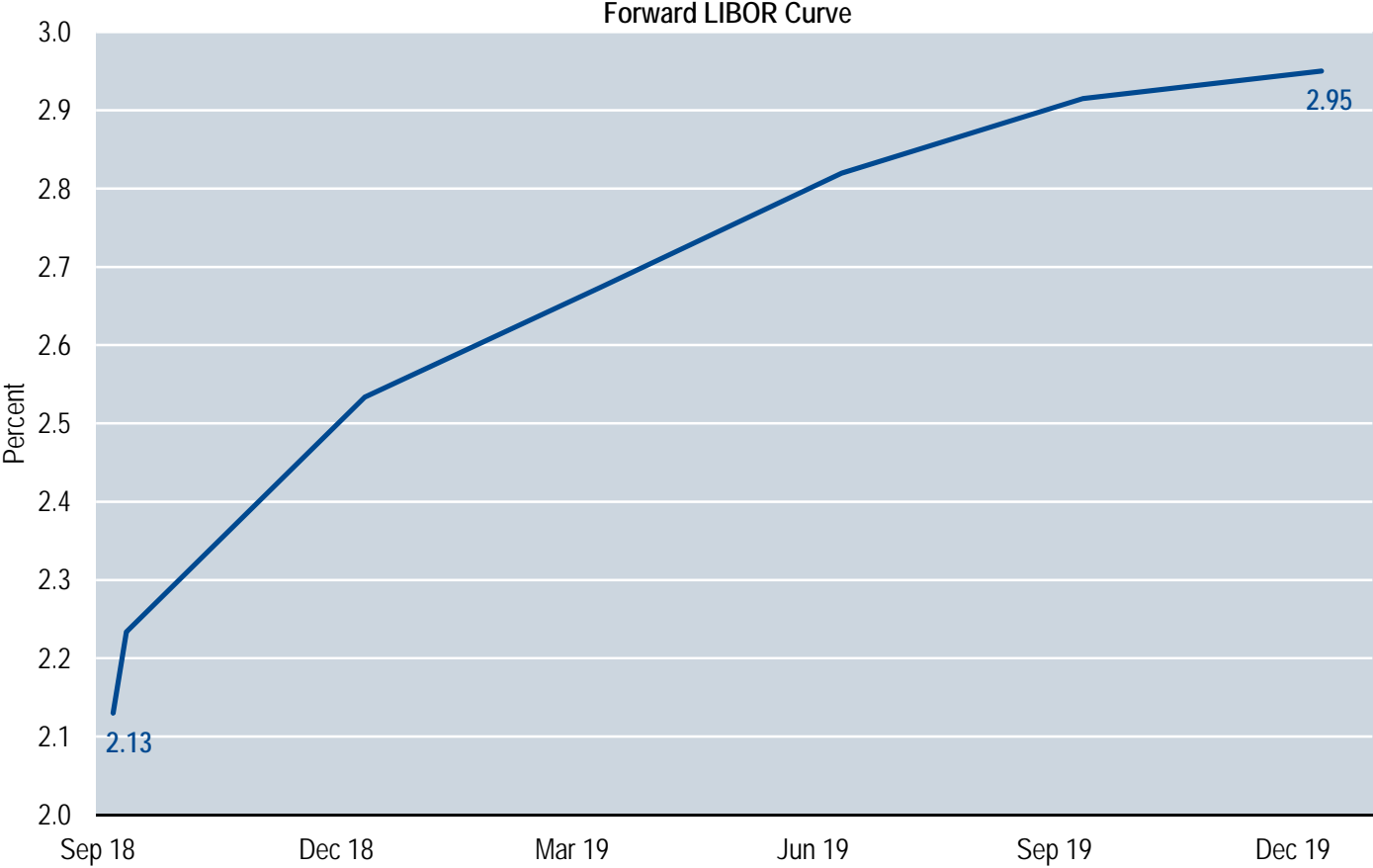
Scores on a Scale of LCQ 1 (strong) to LCQ 5 (weakest)  
 Source: Moody's Investors Services. As of 31 Dec 17

# Easing Loan Covenants Expected to Reduce Recoveries in Next Downturn



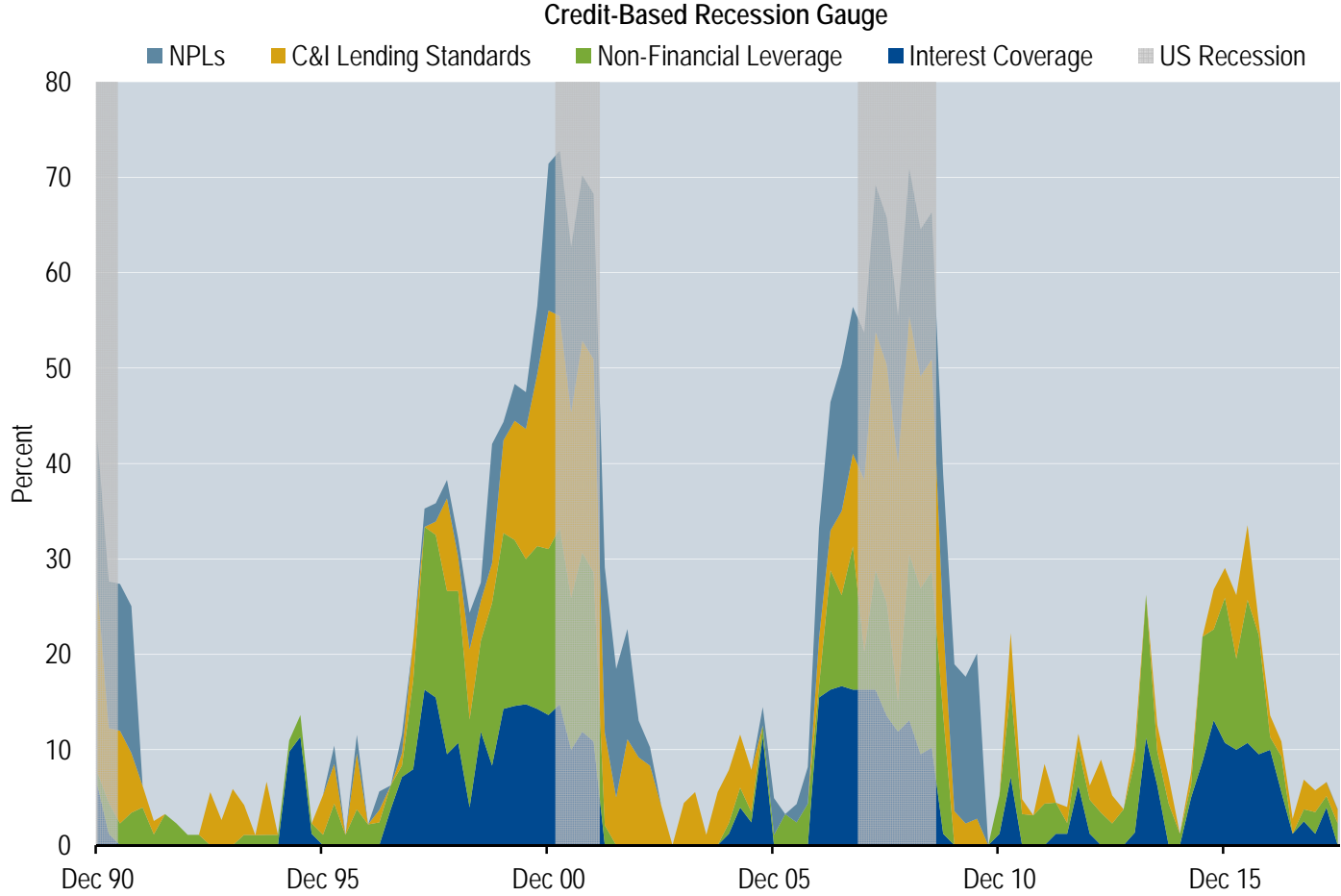
<sup>1</sup>1996-2017  
Source: Moody's Investor Services. As of 31 Jul 18

# The Good News for Leveraged Loans Is That Its Base Rate Is Rising



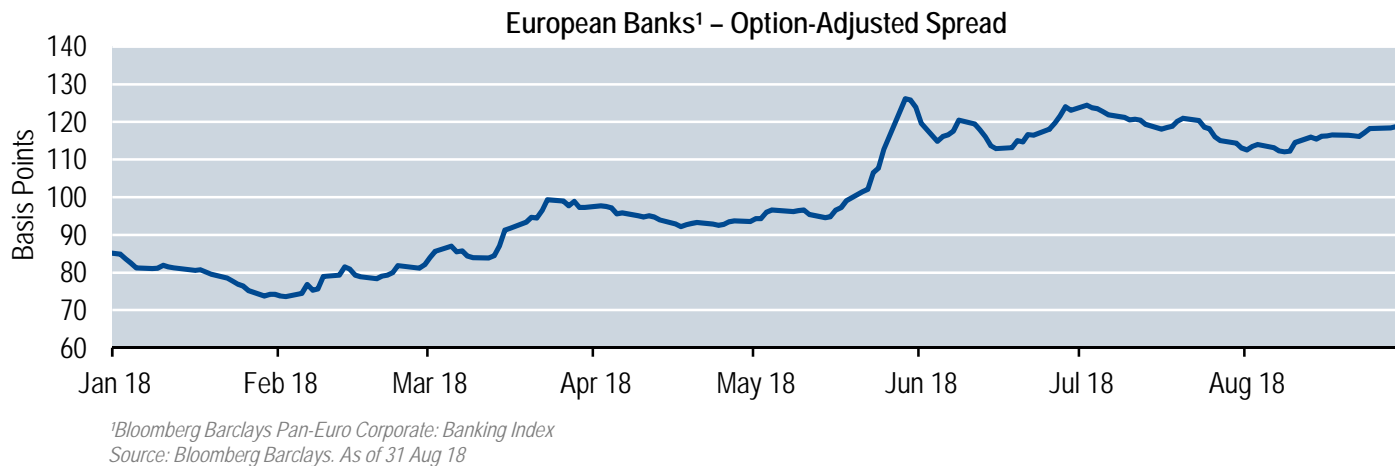
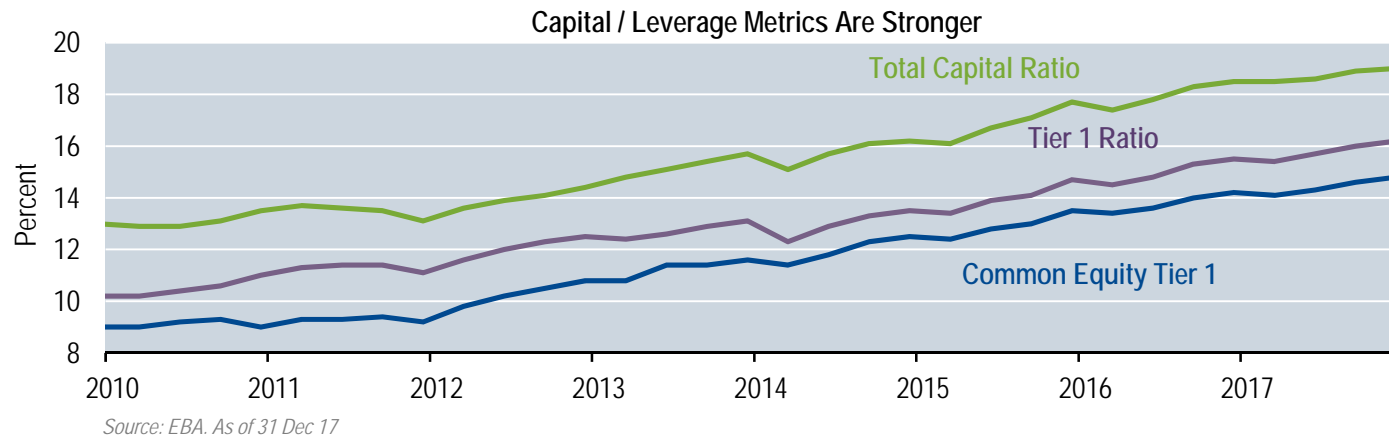
Source: Bloomberg. As of 10 Sep 18

# Recession Not a Near-Term Concern ... Credit Waters Open for Fishing

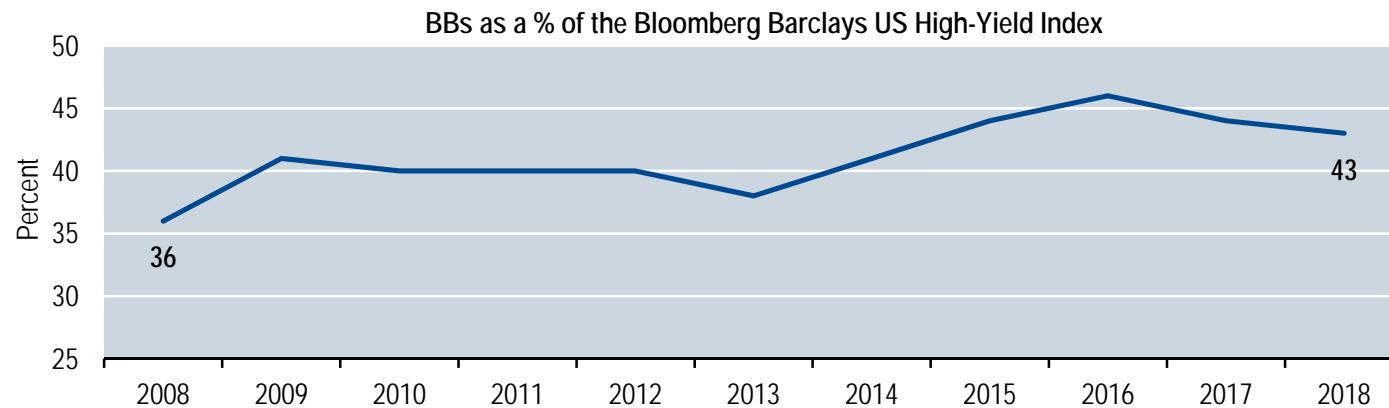


Source: UBS. As of 30 Jun 18

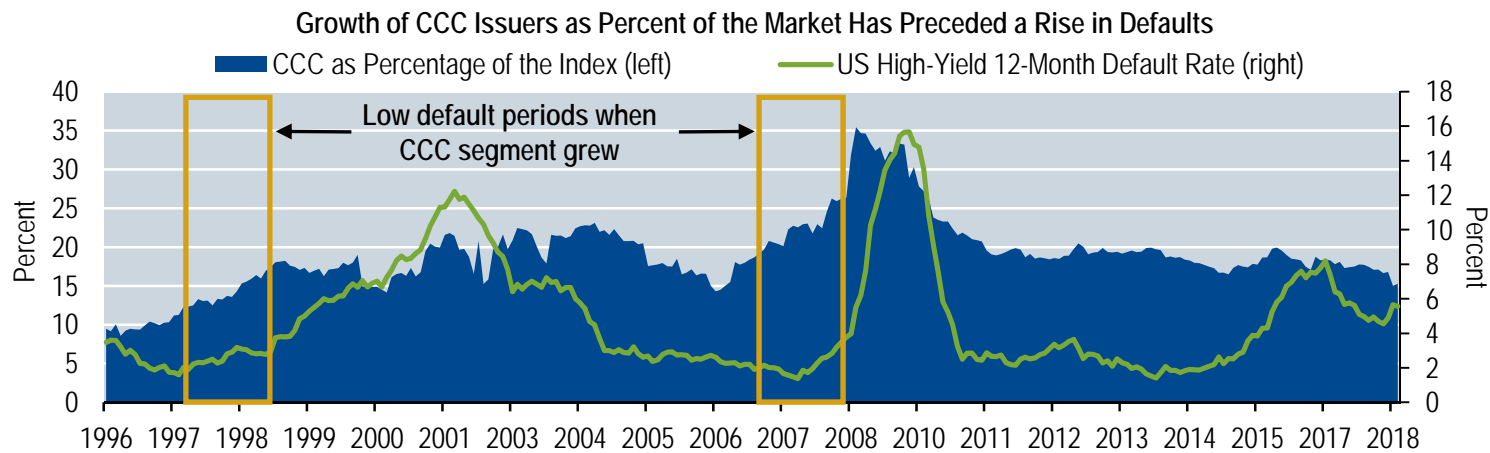
# Opportunities: European Banks



# Opportunities: High-Yield Market Credit Quality Improved

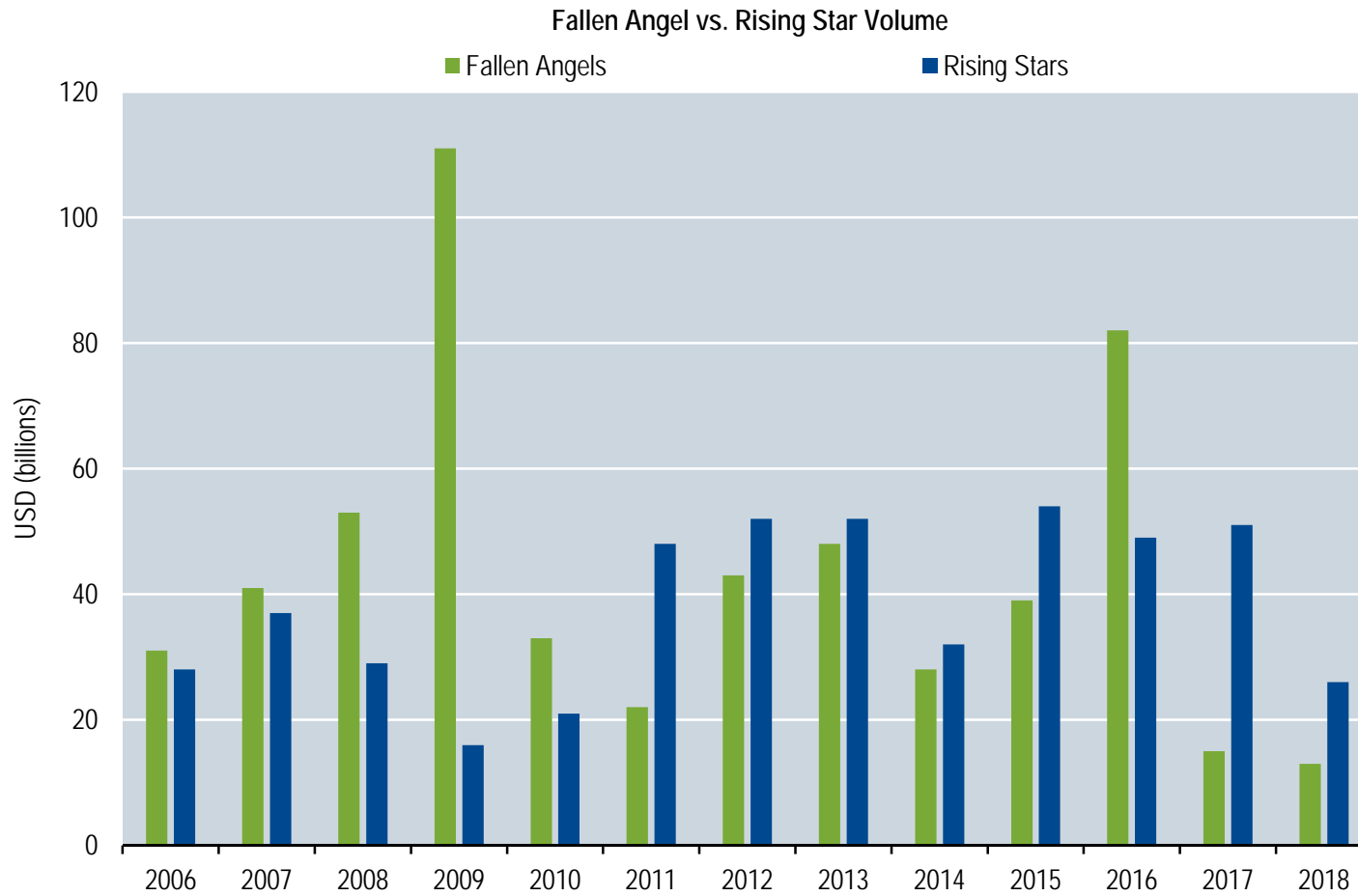


Source: Bloomberg Barclays. As of 31 Aug 18



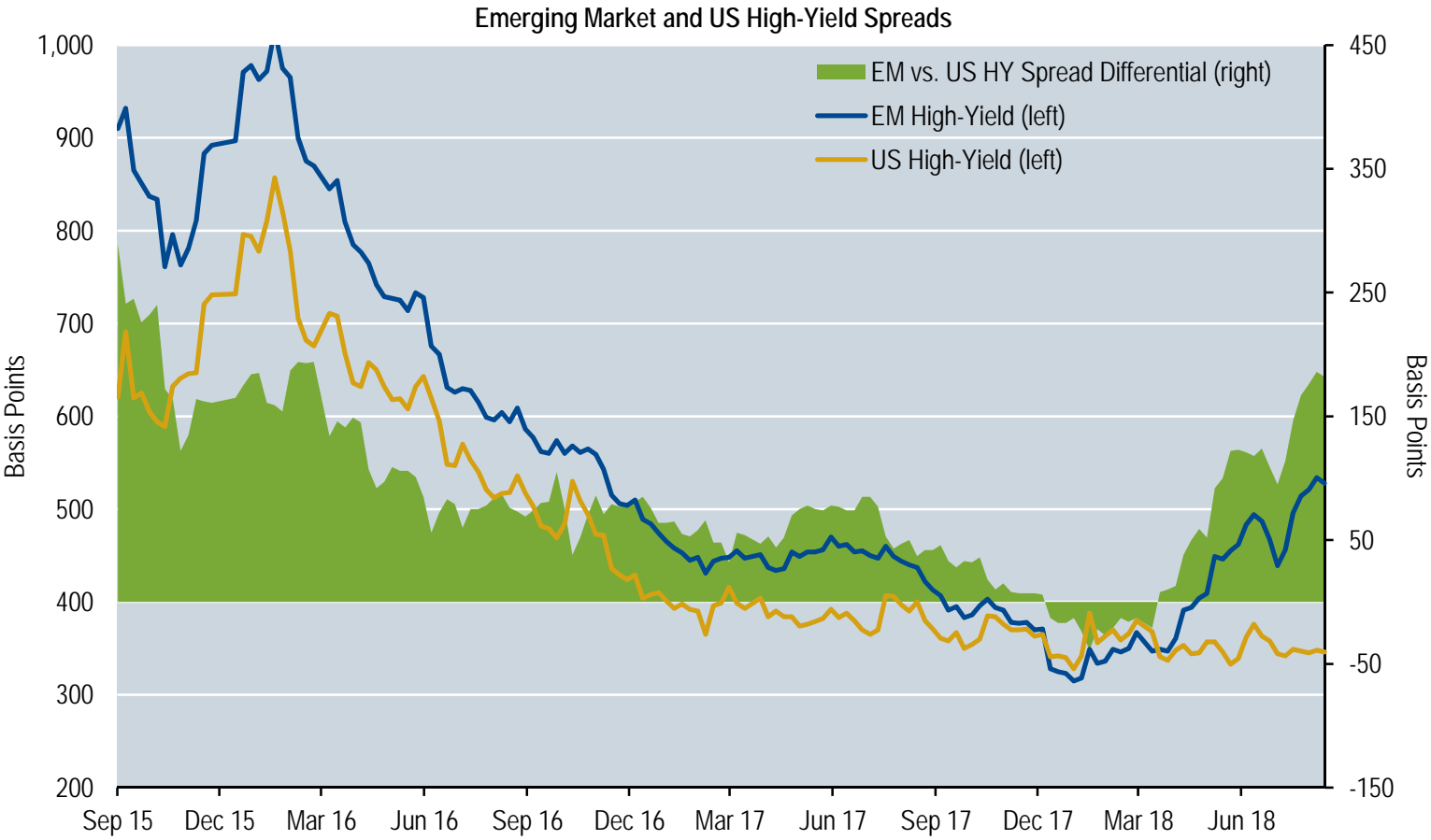
Source: Citibank. As of 30 Apr 18

# Opportunities: Rising Stars



Source: Barclays Research. As of 30 Jun 18

# Opportunities: Dramatic Widening of EM Credit vs. US High-Yield



Source: ICE Data Indices, LLC. BofA Merrill Lynch Global Research. As of 07 Sep 18





## Conclusion

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- Credit cycle endures, but relative value suggests decreased credit exposure
- Fundamentals ... still strong, but experiencing some level of erosion
- Some areas of investor focus/concern: BBB build-up, M&A, bank loans
- Opportunities

## Questions & Answers

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# Thank you

## Risk Disclosure

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