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WESTERN ASSET

Webcast Summary

Navigating Risk and Reward at This Stage of the Expansion

As the current credit cycle continues its long run that began in early 2009 and is now in the expansion phase, we wanted to check in on the corporate credit markets. While we don't see this credit cycle ending soon, its longevity does warrant extra scrutiny on valuations and a variety of risks. In general, our assessment of relative value—the intersection of fundamentals and valuations—isn't as compelling as it had been recently. Different risks arise at this stage of the credit cycle, so we're exploring concerns related to a build-up of BBB issues, M&A activity and higher net leverage for bank loans, among others. As a result of these risks and current valuations, we're bringing down some of our exposures. However, even with this current backdrop, we still see very good opportunities in the corporate credit market for select issues and markets.

Insights on the Current Credit Cycle

- For the last several years, Western Asset has continued to stress through various communications that the current credit cycle is one that would likely extend beyond the length of normal credit cycles.
- The longer cycle is due to extraordinary central bank accommodation, increased regulation, more cautious management teams and risk-averse investors still smarting from the great financial crisis.
- As the cycle has grown longer, our favorable view on credit has appeared more out-of-consensus.
- Due to our consistently favorable view of fundamentals relative to valuations, we have been one of the more bullish fixed-income managers with respect to corporate credit.

Investment Returns and Valuations

- We're not saying that as the expansion phase of the credit cycle grows longer, it's about to turn. Rather, the relative value we see isn't as compelling as it was and it's time to tap the brakes and bring down some of our exposures.
- Since the recovery began in early 2009, annualized returns have been impressive; since then annualized returns in bank loans have been close to 10%; high-yield has returned almost 15% while emerging markets (EM) have only returned just over 3%.
- As a consequence of the positive returns, risk premiums have compressed and yields have declined.
- Spreads, while not at their tightest, are relatively tight.
- We believe what matters most is relative value, or the intersection of fundamentals and valuations.

Credit Fundamentals

- One of the metrics we consider is "spread per unit of leverage," which describes how much compensation you get per unit of leverage. This is currently trending lower, below historical averages, and this tells us investors are not being compensated as much for the risk taken.

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- "Late cycle" fear about the longevity of the current cycle is growing. While we don't see the cycle ending soon, it will eventually end—so whatever that end-date, we are always closing in on it and we're keeping this risk in mind.
- While this credit cycle is long in years, its cumulative growth is still below that of previous cycles.
- The build-up of central bank accommodation likely led to tighter spreads though it was certainly not the only factor.
- A prevalent fear now is that the removal of global central bank accommodation could lead to wider spreads. While we are aware of this risk, we feel the process will be very long-tailed, resulting in a smoother transition.
- Major macro headwinds include ongoing trade tensions between the US and China, the perception of an overly hawkish Fed and the strength of the US dollar.

Concerns in Corporate Credit

- We're watching net leverage, which is trending higher for investment-grade, high-yield and bank loans, but is not quite at an alarming level.
- We also look at interest coverage or the amount of EBITA that's covering interest expenses, and lower numbers mean better fundamentals. These have been generally trending upward.
- We like to see cash as a percentage of debt at higher levels, and this has been trending lower too.
- Relatively low yields and relatively tight spreads combined with fundamentals that are trending the wrong way, albeit still supportive, justify lower exposure to corporate credit.
- Beyond fundamental risks, we are also concerned with the growth of BBBs, which are the lowest-grade component of the investment-grade market, increasing from about 30% to 45% of the market since 2008.
- Increased M&A activity has preceded past recessions, so we are keeping an eye on rising M&As, which still appear manageable.
- We recognize the risk of deteriorating underwriting standards in bank loans, and have been paring risk there.

Opportunities in Corporate Credit

- We like European banks with regulation requiring them to improve their investment profiles.
- High-yield credit quality has improved, with the rating agencies' standards making it more difficult to achieve higher ratings.
- While spreads are compressed in high-yield, we think there are opportunities to identify BB rated "rising stars" with a high likelihood of moving to investment-grade in the next four to six quarters.
- Despite some idiosyncratic risks, we see great opportunities in EM high-yield with companies that have conservative balance sheets and increased discipline and are in de-levering mode.
- EM has been a tough trade this year, but we feel that has only made the current opportunity more compelling.

Q&A Highlights

- We've been paring our exposure to CCCs, and harvesting our gains there. We own only a select number of CCC credits in which we have a high degree of conviction.
- Markets have become more intertwined globally, so the pressure we're seeing outside the US could spill over into the US; though we don't see that happening, it is a risk.
- Argentina and Turkey pose risks of contagion on the valuation side with respect to other EM countries, but we don't think that extends to those with solid fundamentals.

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