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Webcast Summary

Markets On Edge

Western Asset Deputy CIO Michael Buchanan sat down with Product Specialist Robert Abad for an interactive webcast in a new, free-flowing conversational format. They provide an accessible commentary for investors by connecting the dots between today's market headlines and Western Asset's macro views. Their discussion of the current credit cycle in particular includes more nuance than many investors may have heard before. Of course, the session also covers the Firm's outlook for the year ahead and features an assessment of the current risks facing fixed-income investors that are keeping "markets on edge."

2019 Macro Backdrop

- US growth expectations have shifted from predictions of 3%+ annual growth earlier this year to current fears of recession.
- We acknowledge that this is one of the more complex market backdrops that we've seen.
- Investment performance has been very positive so far this year and fundamentals continue to look relatively good for most fixed-income asset classes.
- The markets are unsettled by a growing number of interconnected risks, including:
  - US recession—not yet supported by fundamental data
  - Fed policy error—unclear/contradictory Fed communication heightens uncertainty
  - Global trade tension—vacillates by the day
  - Inverted yield curve—not entirely inverted; kinked only at certain points
- The buildup of BBB leverage is also a real risk, with nearly 50% of the investment-grade market in BBBs, but there is a promising trend of corporations deleveraging.
- However, regulation since the crisis has been one of the most comprehensive overhauls of the financial system, intended to make our global banking system more resilient than ever to global shocks.

Western Asset's Base Case and Portfolio Positioning

- Given the market's current risk factors, our base case calls for slow but resilient global growth and stubbornly low inflation. These two forces together will require ongoing accommodation from central banks.
- We see generally healthy market fundamentals and believe this environment will continue to support spread product outperformance. As such, we have been overweighting certain spread sectors and underweighting lower-yielding developed market sovereign bonds.
- We continue to focus on diversified, uncorrelated and, in some cases, negatively correlated strategies.
- To better insulate our portfolios during these periods of stress, we are tactically using duration to balance our overweight to spread sectors.

The Credit Cycle

- Many investors, nervous since the great financial crisis in 2008, have been predicting the end of the credit cycle since at least 2012.
- Early in the recovery following the crisis, our Credit Team determined that this credit cycle would be unlike any prior credit cycles. They cited three primary factors: the sheer severity of the crisis, the expected central bank accommodation to address the crisis and new regulations designed to help safeguard the financial system against future shocks.
- "Mini cycles" are helping to extend the lifespan of the current broader credit cycle.
  - The energy sector, for instance, completed a cycle in 2015-2016 wherein weaker companies were pushed out of the market but the companies remaining are now stronger, with greater attention to deleveraging.
  - As other individual sectors experience similar mini cycles, the longevity of the current cycle may continue for much longer than many had expected at its outset.
- In terms of the four segments of the traditional credit cycle—early (recovery), mid (expansion), late (downturn) and recession (repair)—the timing of each can vary significantly. We believe we are currently still in the expansion phase, perhaps toward the later end but not yet to the downturn.
- We think the expansion could continue for another one to two years or more, and we see selective opportunities in investment-grade corporate bonds, bank loans, emerging market debt, high-yield corporate debt and structured products.
- Relative value is key, even in the later stages of the downturn phase.

Q&A Highlights

- Webcast audience polling indicated that more than 80% of attendees expect that we could see a US recession in the next 18 months.
- With respect to investment opportunities in this lower-rate environment, we continue to like bank loans as they produce more income currently than does the high-yield market.
- CLOs have also become more attractive, with AAA or AA tranches providing some of the best yields. Nice demand is underpinning CLOs and we think the collateral protection is very appealing.