



# 2Q21 Market and Strategy Update

April 15, 2021

Ken Leech  
Chief Investment Officer

## Economic

- Global economy is recovering
- Fiscal and monetary policy should stay supportive
- Second half should see meaningful pick-up in growth—as economy “reopens”
- Global economic slack, debt burdens, labor market scarring, and SME destruction will take years to absorb
- Central bank policy rates will be very low for very long
- Inflation pick-up will prove transitory—not persistent

## Cyclical vs. Secular

- The near-term cyclical outlook is very strong. Longer-term, the recovery and inflation rates will downshift

## Investment implications

- Reopening spread products should outperform Treasuries and sovereign bonds
- Emerging markets should particularly benefit
- The dollar should weaken only mildly
- Interest rates should be broadly range-bound

## Covid nightmare persists

- New variants first detected in UK and South Africa may be particularly contagious
- Case levels reach record levels in India and Brazil
- Europe re-entering lockdowns

## Humanity is definitely winning this war

- Vaccine efficacy is a little short of miraculous
- Israeli study shows a 94% reduction in infection

## Vaccine supply is set to surge spectacularly

- 2020      31 million doses
- Q1 2021   > 400 million doses predicted
- 2021      9.5 billion doses predicted

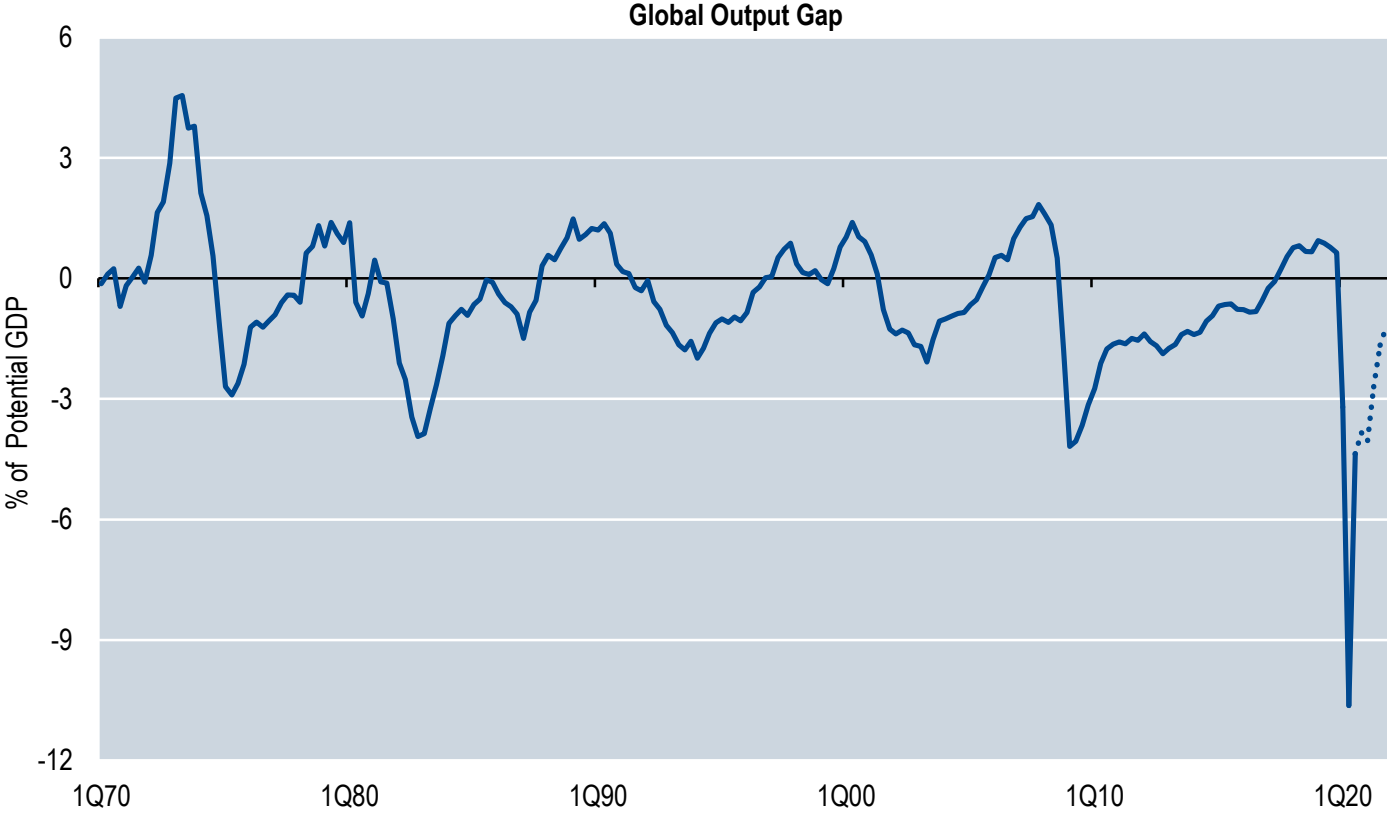
## Vaccine administration is improving

- US will immunize 75% of the adult population by Q2
- Even after slow start, EU may be able to vaccinate 70% of the adult population by July
- Vaccine production could immunize as much as 60% of the global adult population this year

# The Global Economy Is Gaining Traction But Faces a Protracted Period of Output Slack

Resumption of activity to pre-Covid levels could take as long as two years

The fall-off in global aggregate demand is by far the steepest in recent history

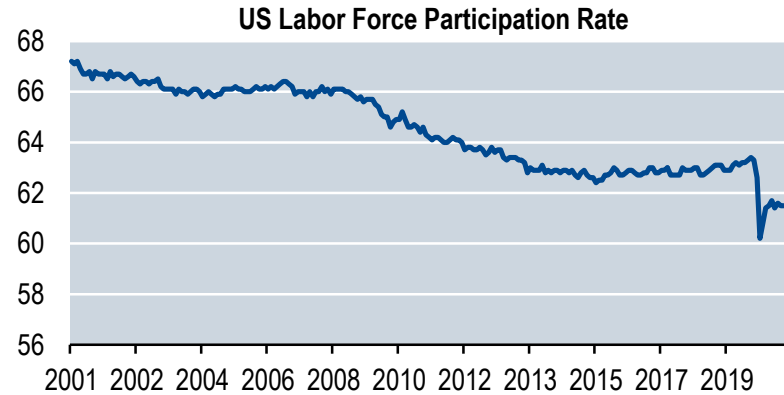


Source: J.P. Morgan. As of 30 Sep 20

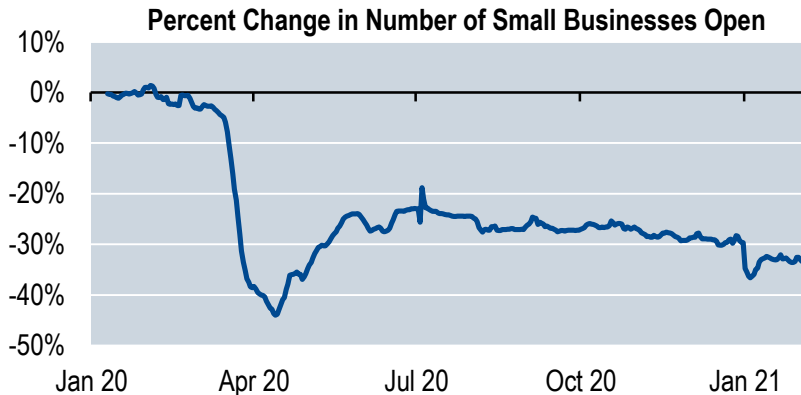
# Labor Markets and Small Businesses Have Been Severely Wounded



Source: Bloomberg. As of 31 Dec 20



Source: Bloomberg. As of 31 Dec 20

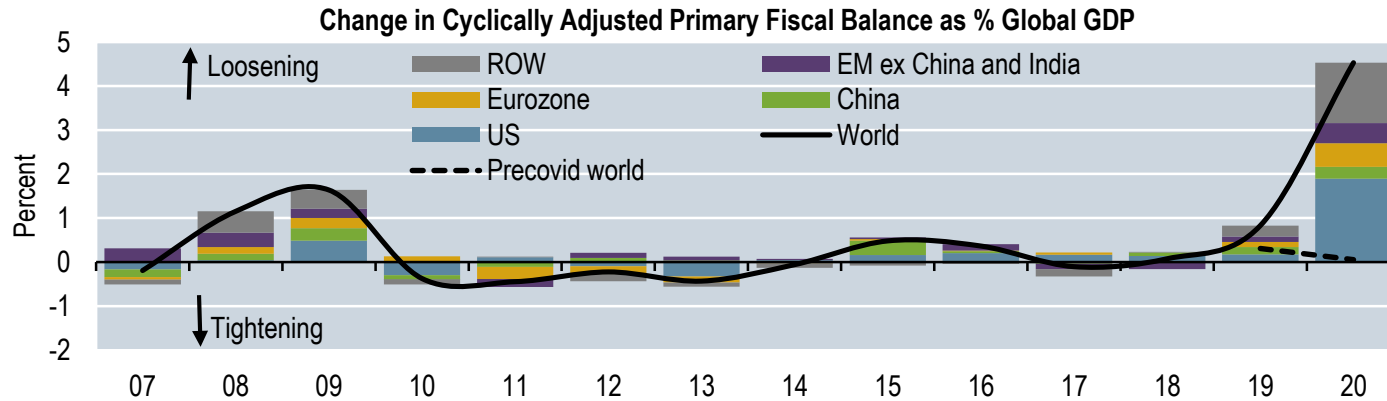


Source: TracktheRecovery.org. As of 04 Feb 21

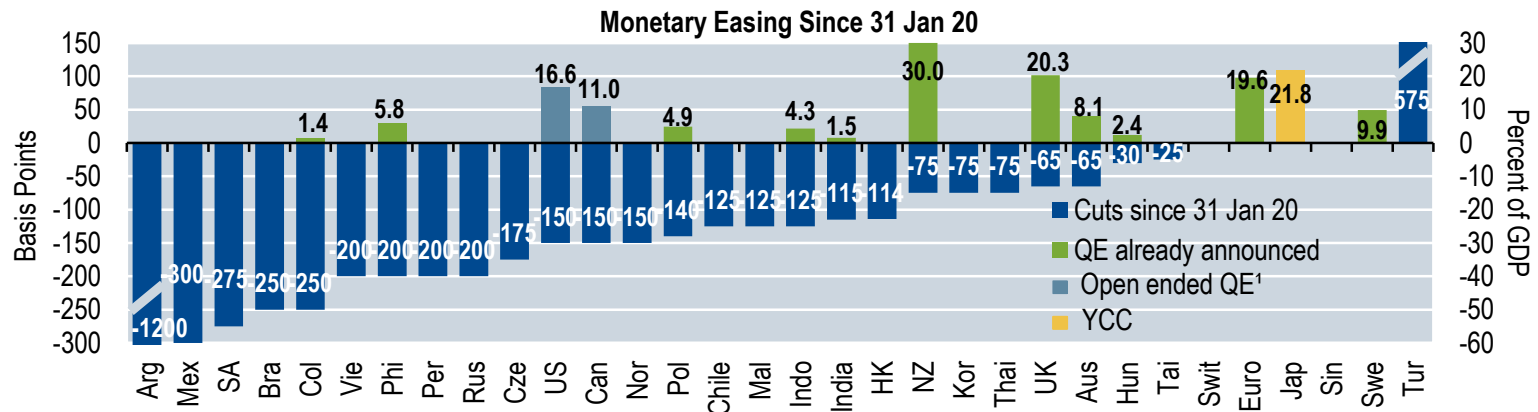
- This does not necessarily mean the small business shut or went bankrupt. In fact, data shows only limited number of bankruptcies. Instead, this means that the business is not currently open
- Small business income is also down, and by a similar magnitude (-35%), although when you add PPP back in, then on aggregate it looks OK
- Presumably many of these small businesses are shut because of Covid restrictions, so could come back

# Global Governments Have Provided Enormous Amounts of Stimulus

While the stimulus to date has been substantial, the question remains whether the current stimulus will be sufficient in mitigating permanent damage to global economies or if more will be required.



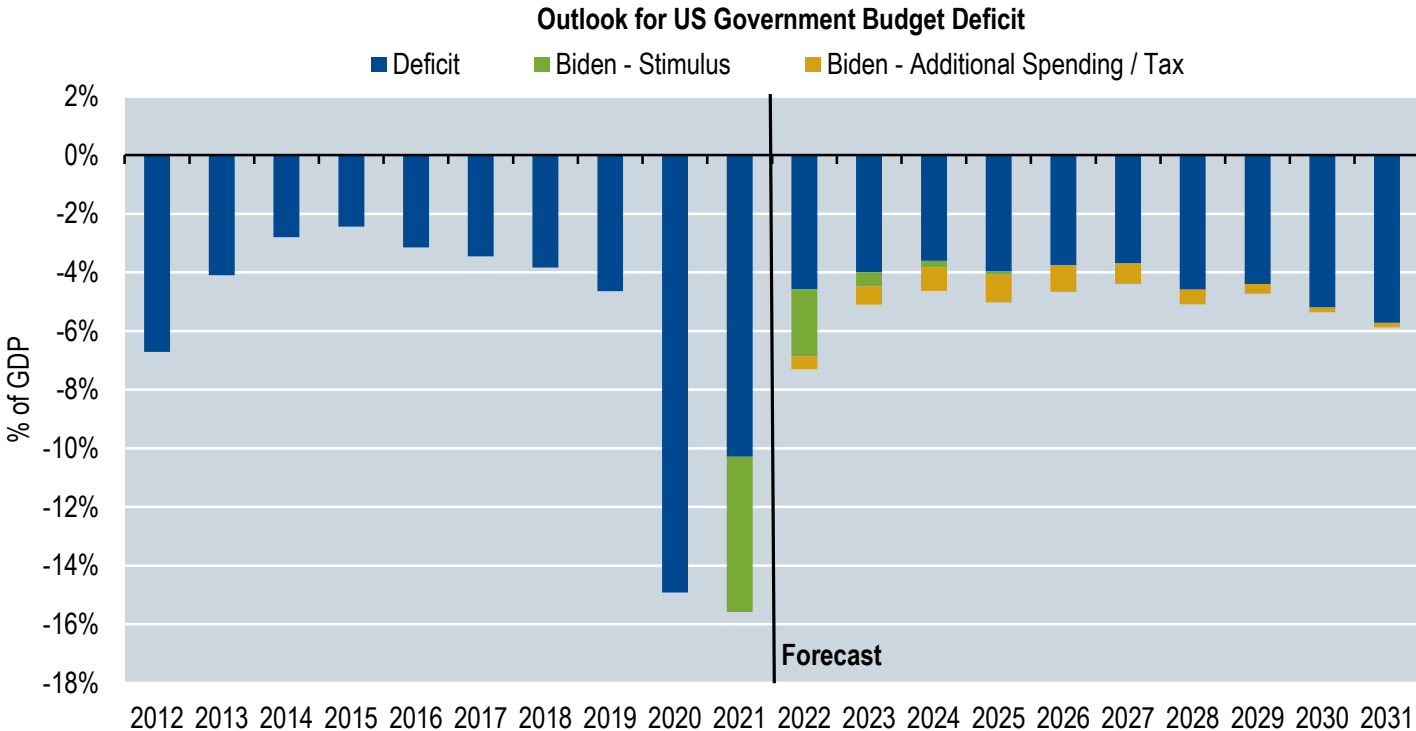
Source: UBS, Haver, European Commission, CBO. As of 06 Apr 21



Source: UBS, Haver. As of 31 Dec 20

<sup>1</sup>Size of bar denotes CB bal sheet increase since January 2020

# Fiscal Impact on GDP Growth: Positive This Year, Negative Next Year (v1)



Source: Bloomberg. As of 09 Apr 21  
 \*Assume additional Biden policies total \$3 tr in spending and \$1.5 tr in taxes over 10 years.

## Increased fiscal thrust may become more politically difficult

“If the filibuster is eliminated or budget reconciliation becomes the norm, a new and dangerous precedent will be set...”

-- Joe Manchin, Washington Post Editorial, April 7, 2021

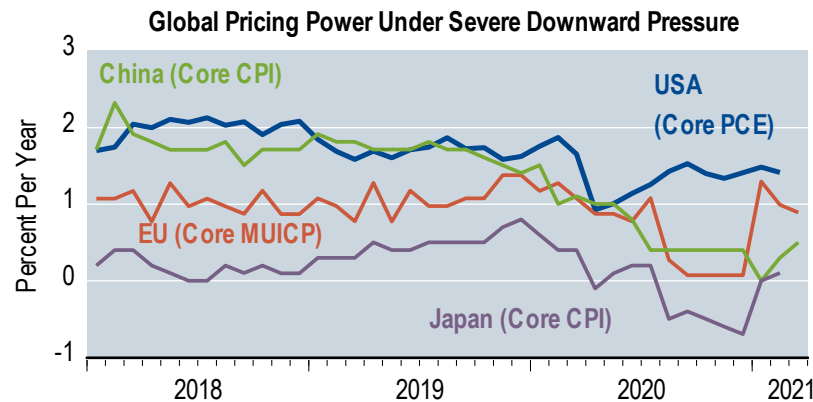


# Market Confidence in Renewed Inflation May Be Misplaced

## Breakeven Inflation Rates Near Beginning of the Year Levels 10-Year Breakeven Inflation (%)

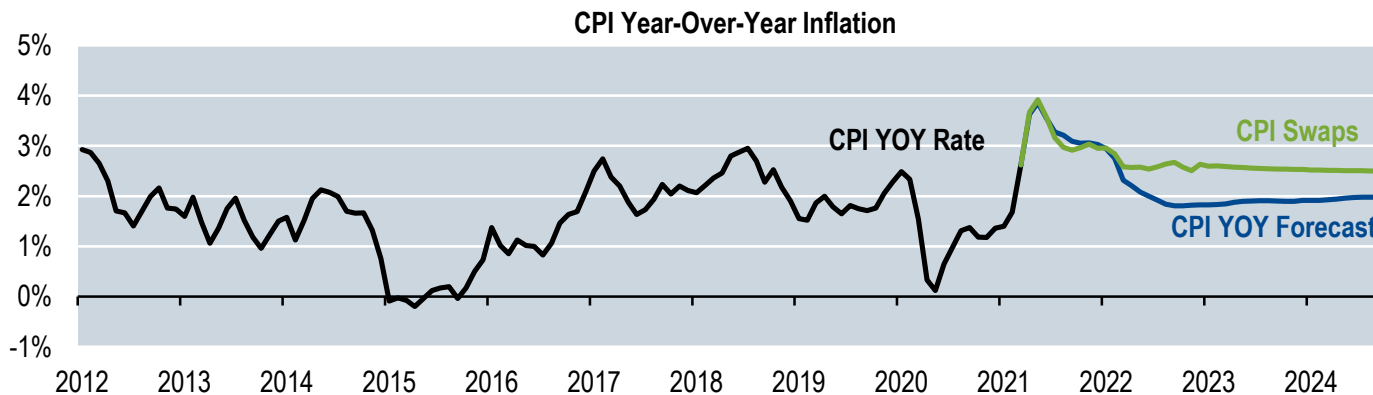
	31 Dec 19	23 Mar 20	14 Apr 21
Australia	1.41	0.09	2.18
Canada	1.39	0.04	1.73
Germany	0.99	0.23	1.34
Japan	0.16	-0.15	0.23
US	1.79	0.81	2.34

Source: Bloomberg. As of 14 Apr 21



Source: US Bureau of Economic Analysis, Bloomberg. As of 31 Mar 21

Year-on-Year (12 Month) Change in Core Consumer Prices



Source: Bloomberg, Western Asset. As of 14 April 21

The market is pricing more than 2.5% of sustained annualized headline CPI inflation over the next 3 years. Western Asset's own optimistic forecast that assumes a robust recovery in COVID-affected categories is a full 50 bps lower at 2.00%. Western Asset uses market-based futures prices to forecast food and energy components of the headline CPI. Therefore, this 50 bps of extra inflation priced into the market is due to expectations of higher Core Inflation that we do not expect.

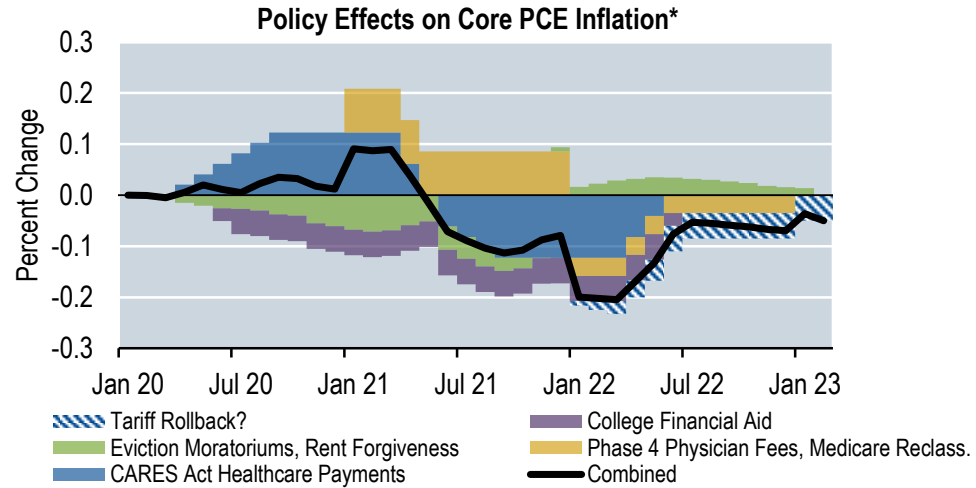


# Covid-Influenced Inflation Spikes

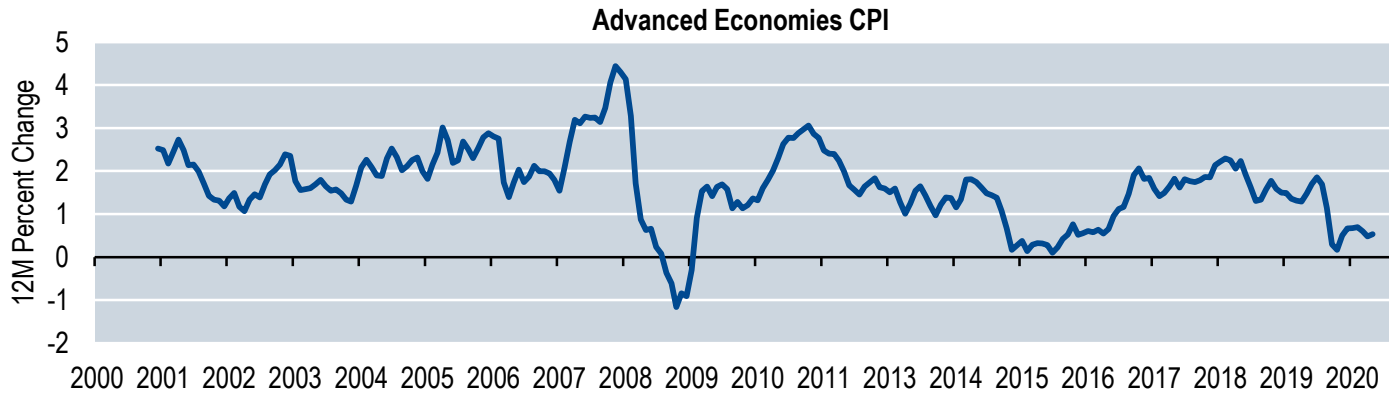
How permanent will they be in a low inflation environment?



Source: Federal Reserve, Nomura Economics. As of 31 Mar 21  
 Note: Words counted are "shortage", "delay", "disruption", "bottleneck", and "backlog".



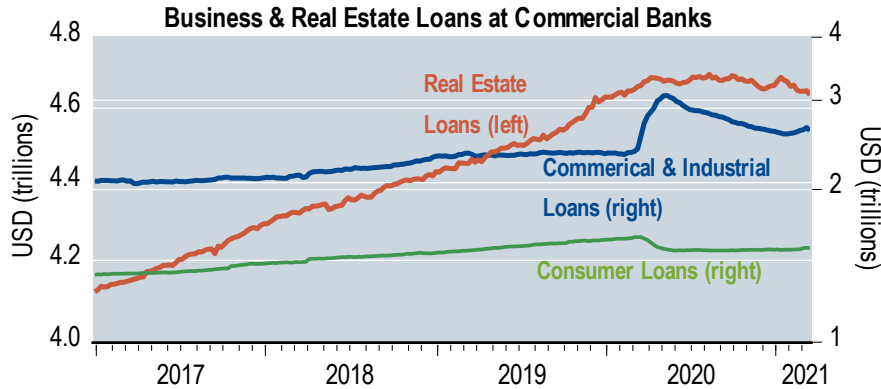
Source: Goldman Sach Global Investment Research. As of 31 Jan 21



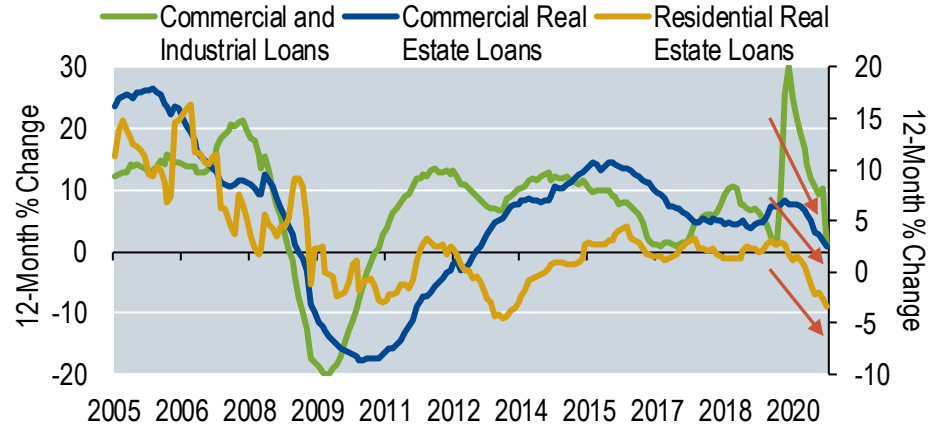
\*Inflation effects reflect GS estimates based on CARES Act and Phase 4 bill text, CBO scores, and BLS and CMS documentation. Assumes CARES Act healthcare payments are not renewed after March 2021, with corresponding drag on healthcare prices in 2Q21. Tariff rollback series illustrates hypothetical impact if one third of the Trump-administration China tariffs are cancelled during 2022-2023

# Bank Lending Remains Very Subdued

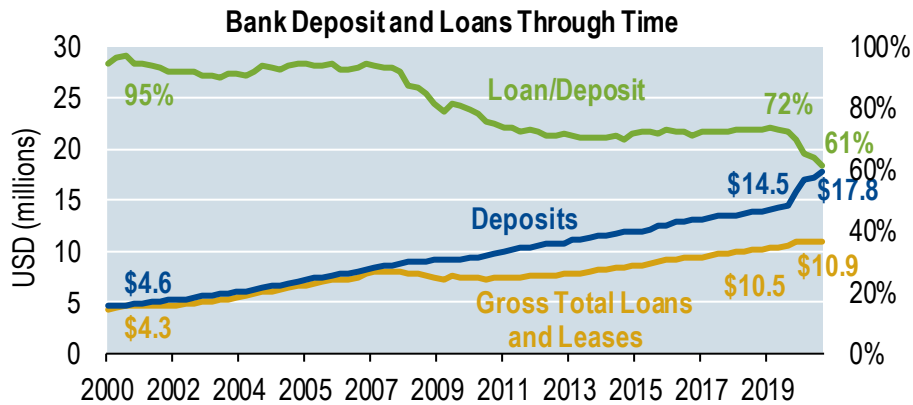
Bank lending would need to pick up strongly if Fed liquidity is to lead to persistent inflation.



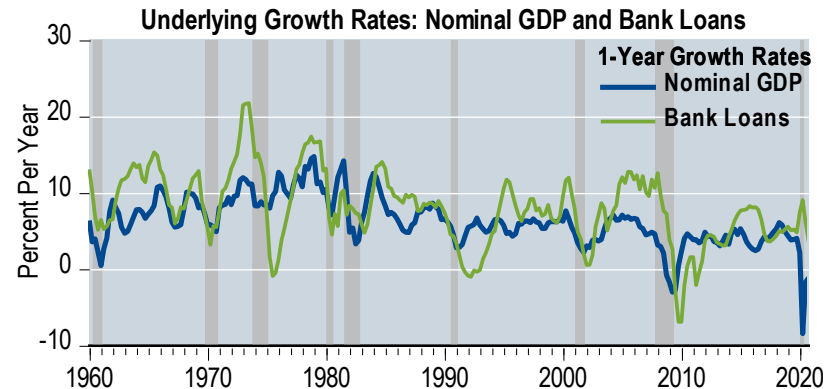
Sources: Federal Reserve. As of 17 Mar 21



Source: Haver Analytics. As of 31 Mar 21

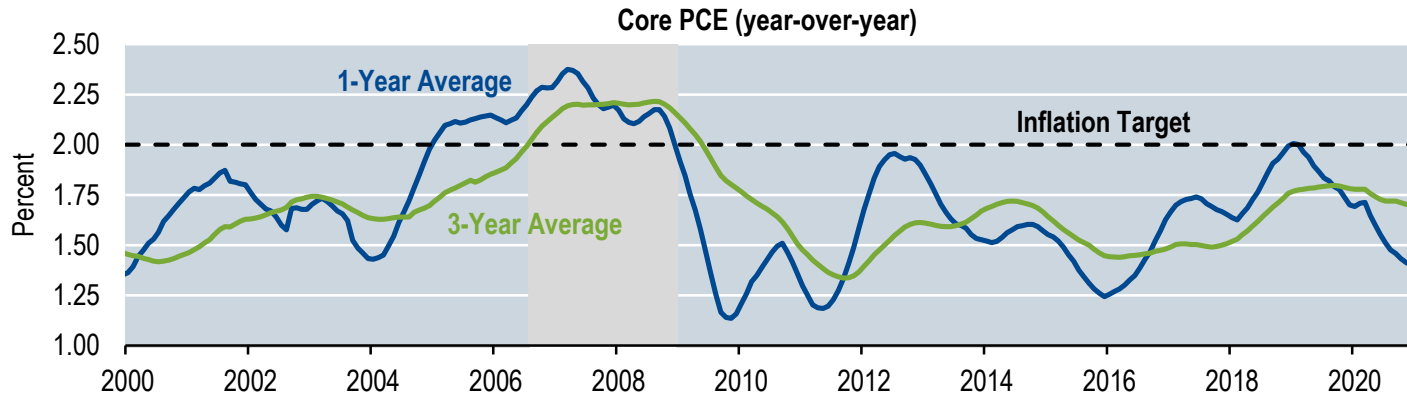


Source: Federal Reserve. As of 31 Dec 20



Source: Federal Reserve

# Fed Expects Only a Gradual Rise in Inflation



Source: Bloomberg. As of 21 Jan 31

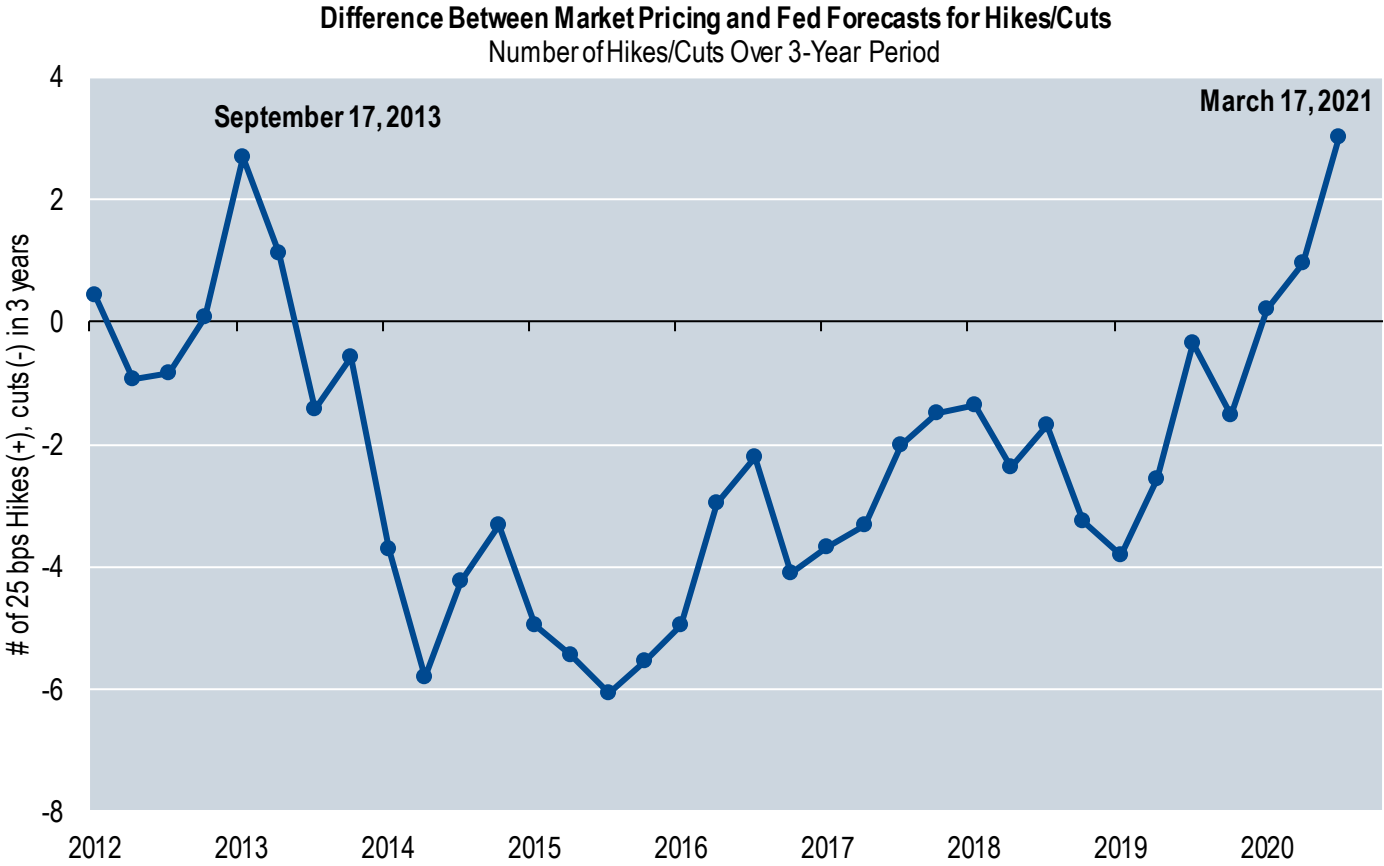
“...inflation has averaged slightly below 2 percent for over a quarter-century.”

“In the nine years [since the FOMC announced a 2 percent inflation objective]... 12-month PCE inflation has averaged under 1-1/2 percent.”

“...at the end of 2019, with unemployment at a multidecade low...PCE inflation was 1.6 percent for the year.”

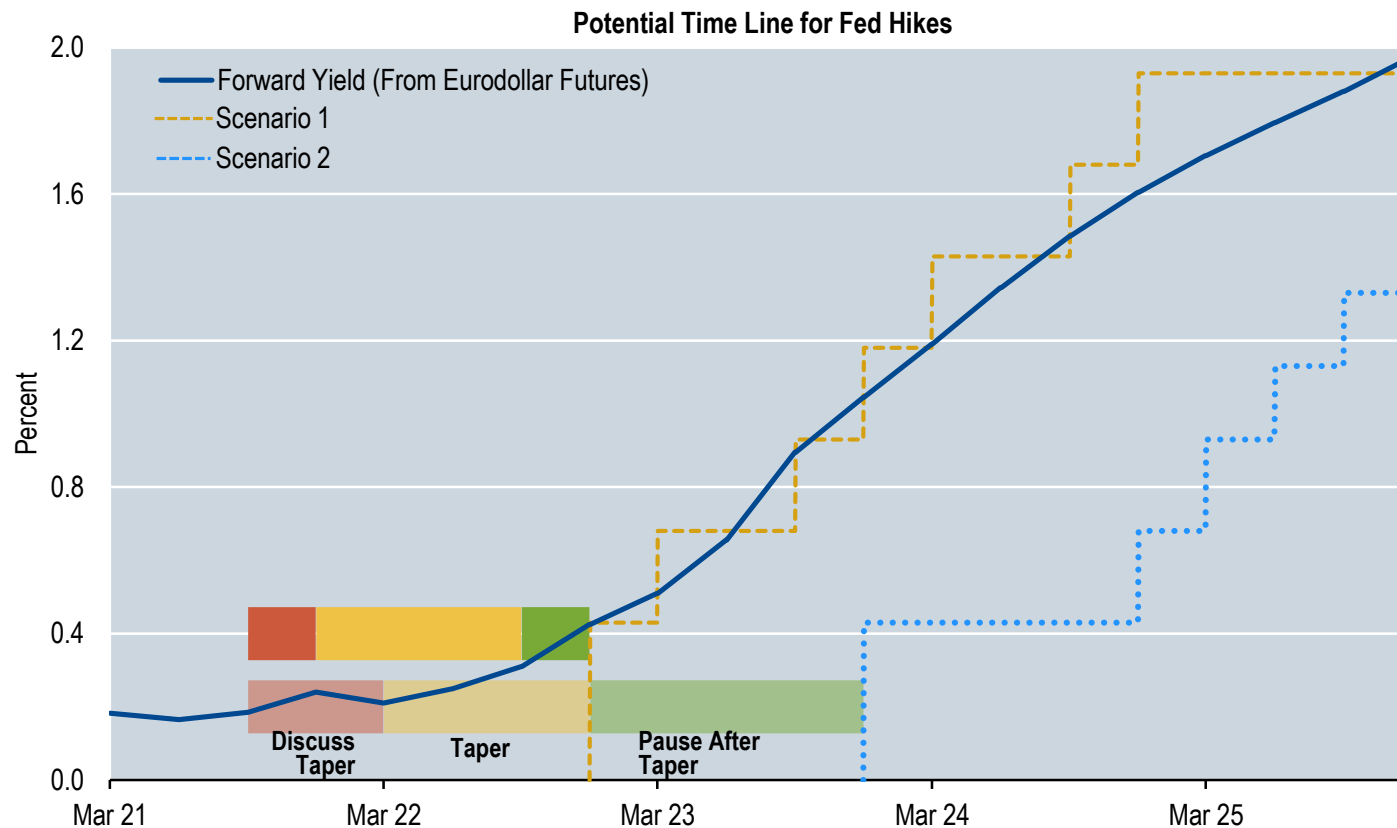
– Governor Lael Brainard, March 2, 2021

# Market Pricing v. Fed Forecasts for Rate Hikes



Source: Morgan Stanley, Western Asset, and Bloomberg. As of 17 Mar 21  
 Notes: FOMC projections for future hikes/cuts are based on the quarterly Statement of Economic Projections. The forecasts are interpolated for March, June, and September quarters, using the long term dot for March and June. Market pricing is based on Eurodollar futures and an adjustment for the LIBOR/OIS spread, as of the close before each FOMC meeting.

# Potential Timeline for Fed Hikes



## Scenario 1: Consistent with Current Market Pricing:

- Powell discusses taper in Sep 2021
- Taper to Start in Dec 2021 (+3 months)
- Taper to End in Sep 2022 (+12 months)
- First Rate Hike in Dec 2022 (+15 months)
- Funds Rate reaches 1% in Dec 2023 (+27 months)
- Funds Rates reaches 2% in Dec 2024 (+39 months)

## Scenario 2: Consistent with Previous Cycle:

- Bernanke mentioned taper in May 2013
- Taper Started in Jan 2014 (+8 months)
- Taper Ended in October 2014 (+18 months)
- First hike was in Dec 2015 (+31 months);
- Funds Rate reached 1% in June 2017 (+50 months)
- Funds Rate reaches 2% in June 2018 (+62 months)

Source: Bloomberg. As of 10 Mar 21

# How High Will US Yields Rise?

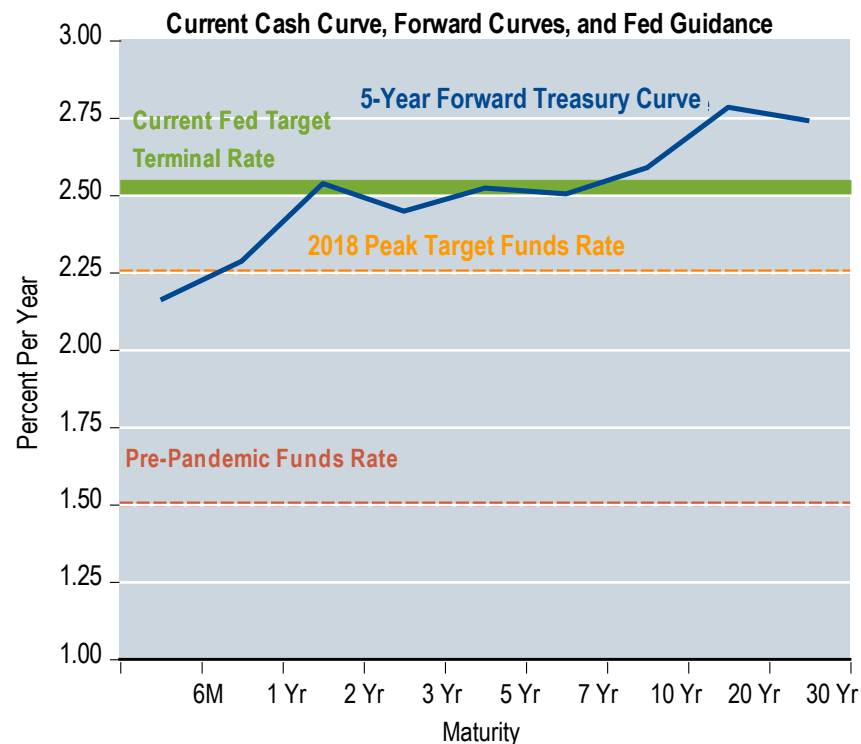
There have been 11 major Fed hiking cycles since the early-1960s. In all cases over the past 60 years except two, the yield curve was inverted when the Fed finished hiking rates.

**Bonds vs. Funds At Peak of Fed Hiking Episodes**

Date of FF Peak	Peak FF Level*	30 Yr Tbond at FF Peak**	Difference – 30s over FF
November 1, 1966	6.00%	4.74%	-1.26%
October 15, 1969	9.75%	6.27%	-3.48%
July 24, 1974	14.19%	7.18%	-7.01%
March 30, 1981	15.23%	12.80%	-2.43%
July 22, 1981	22.36%	13.87%	-8.49%
June 20, 1984	12.31%	13.49%	1.18%
March 20, 1989	10.50%	9.05%	-1.45%
July 5, 1995	7.41%	6.61%	-0.80%
July 3, 2000	7.03%	5.87%	-1.16%
August 1, 2006	5.27%	5.07%	-0.20%
December 20, 2018	2.40%	3.02%	0.62%

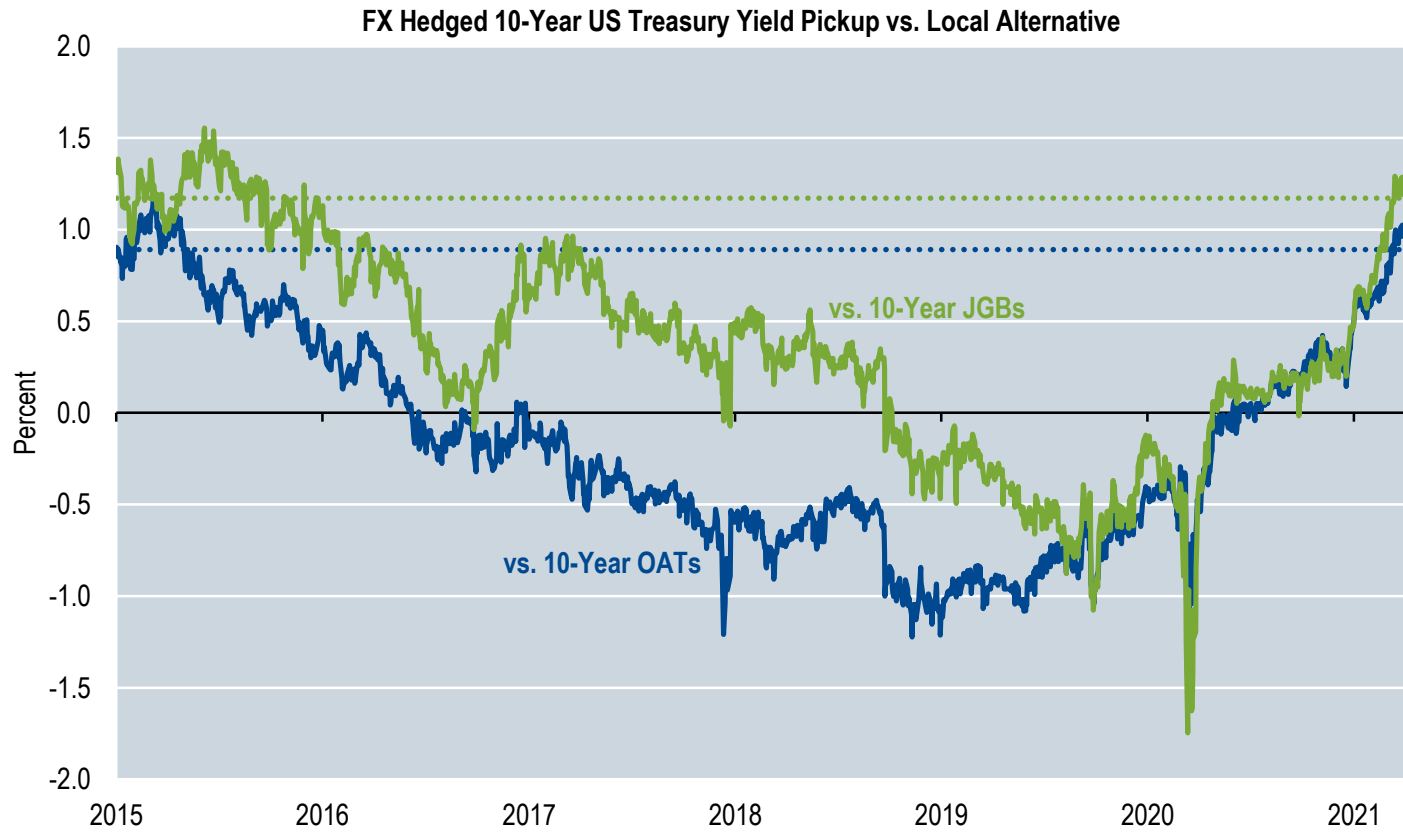
Source: Federal Reserve Board. \*For dates prior to 1970 and after 2000, date of peak is taken as first date the Federal Reserve peak target rate was achieved. \*\*For dates prior to 1977, yields are for an index of all Tbonds with more than 10 years maturity.

If the Fed could get the funds rate to 2.50% in five years....what do you think the 30-Year Treasury bond yield would be?



Source: Federal Reserve, Western Asset. As of 25 Mar 21

# Treasury Bonds Are Attractive Globally on a Hedged Basis



Source: Goldman Sachs Global Investment Research. As of 13 Apr 21

**Despite renewed Covid lockdowns, 70% of European adult population is still expected to be vaccinated by end of July**

**Second half GDP growth should be very strong**

**We expect Europe to recover to pre-crisis activity levels, but not before the end of 2022**

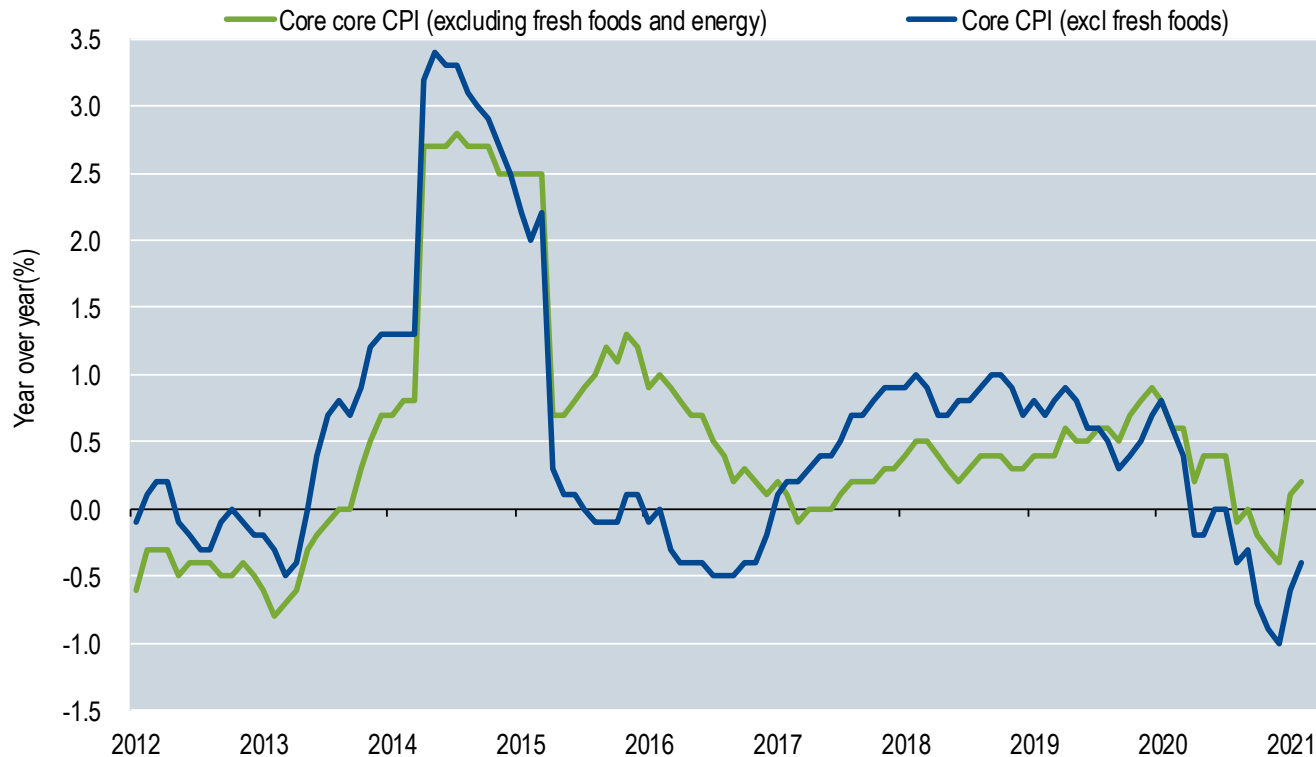
**Inflation in the eurozone is likely to remain muted for an extended period, abstracting from significant base effects in 2021 due to tax changes**

**This will allow the ECB to focus its interventions on ensuring favorable financing conditions, in line with its commitment last December**



# Japan Outlook and Strategies

- We believe that the recovery of Japanese economy will persist as the global economy recovers, considering that the unprecedented scales of fiscal and monetary package globally are in place.
- Developments in inflation will remain weak and slow.
- BOJ's commitment to the current monetary policy and the expected fiscal stimulus package will be supportive.
- Downside risk and uncertainty are greater due to the threat of COVID-19.



Source: Datastream, Western Asset. As of 28 Feb 21

- Core CPI (excluding fresh food) decreased by 0.4% Y/Y in February, up from a 0.6% decline in January. Core core CPI (excluding fresh food and energy) increased by 0.2% Y/Y in February, improved from a 0.1% Y/Y increase in January.

# China Outlook: Firm Signs of Economic Normalization

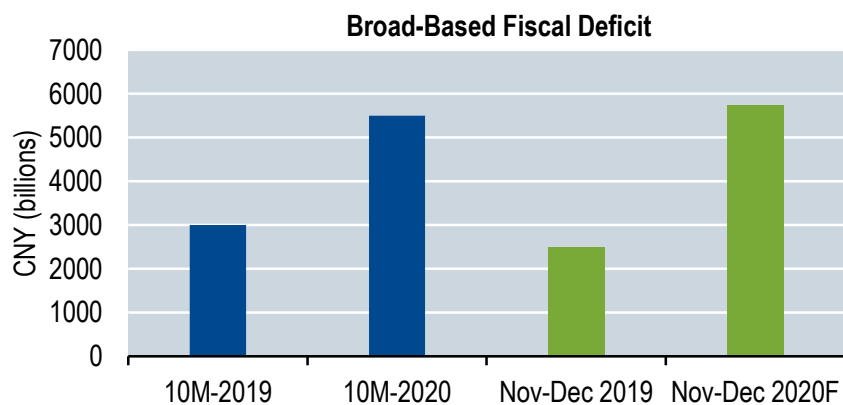
- Despite abating coronavirus outbreak, China maintains systematic control
- March leading indicators are encouraging, especially services PMI
- Macro policy stance will remain growth-supportive for some time



Source: Bloomberg. As of 31 Dec 20

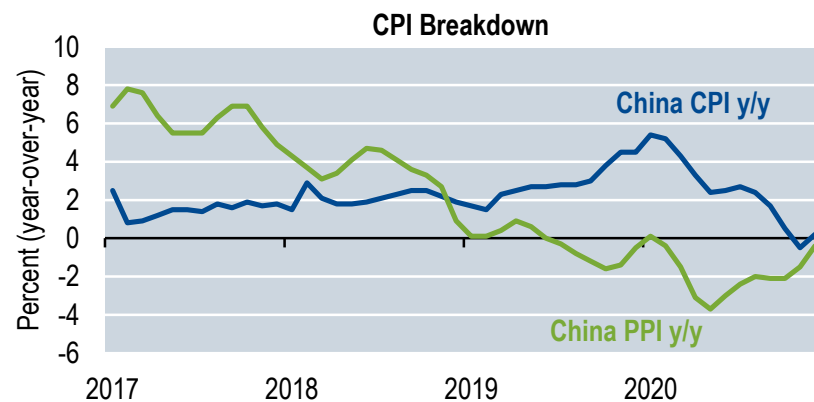


Source: Bloomberg. As of 30 Nov 20



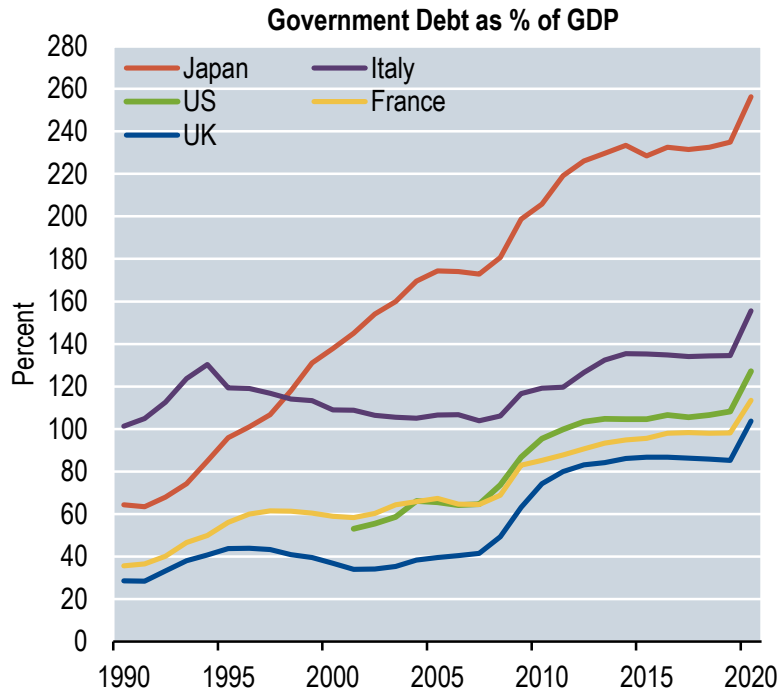
Source: Standard Chartered

Based on calculation following widely accepted fiscal accounting, covering general public and government budget; assumes full implementation of budget

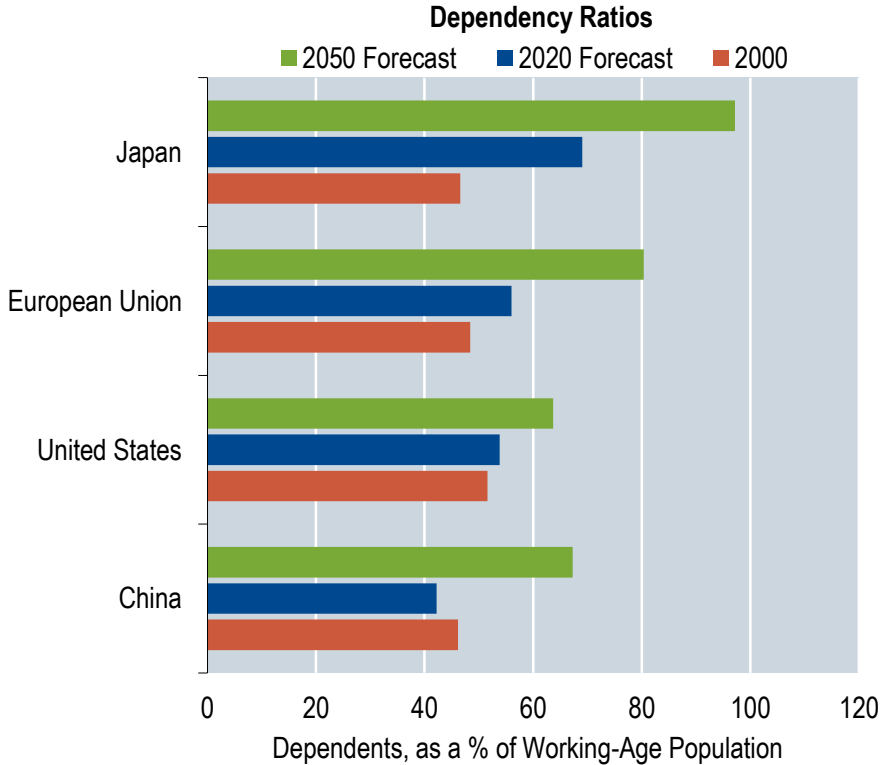


Source: Bloomberg. As of 31 Dec 20

# The Challenges of Global Slack & Debt Burdens Will Retard Future Growth

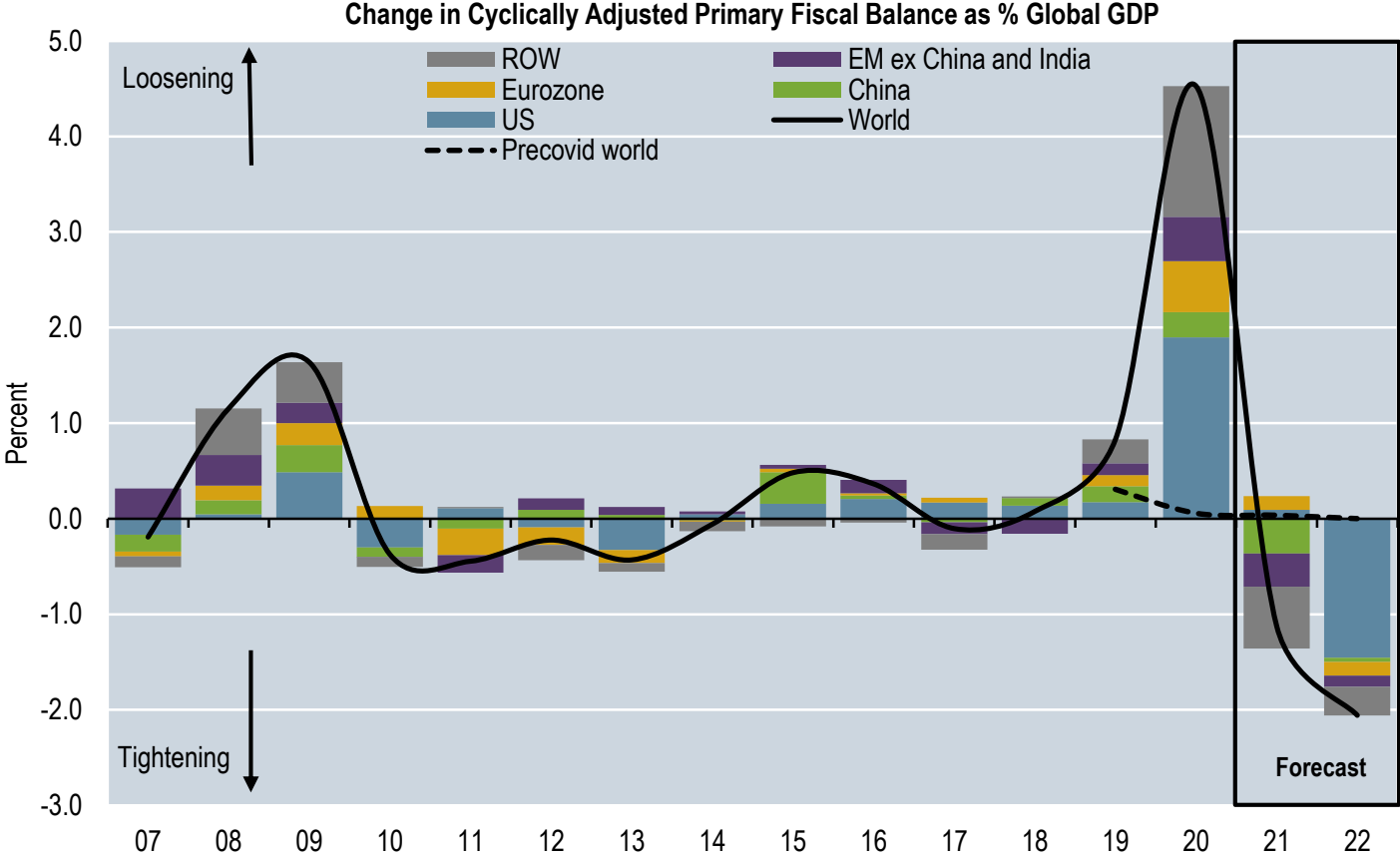


Source: IMF. As of 31 Dec 20



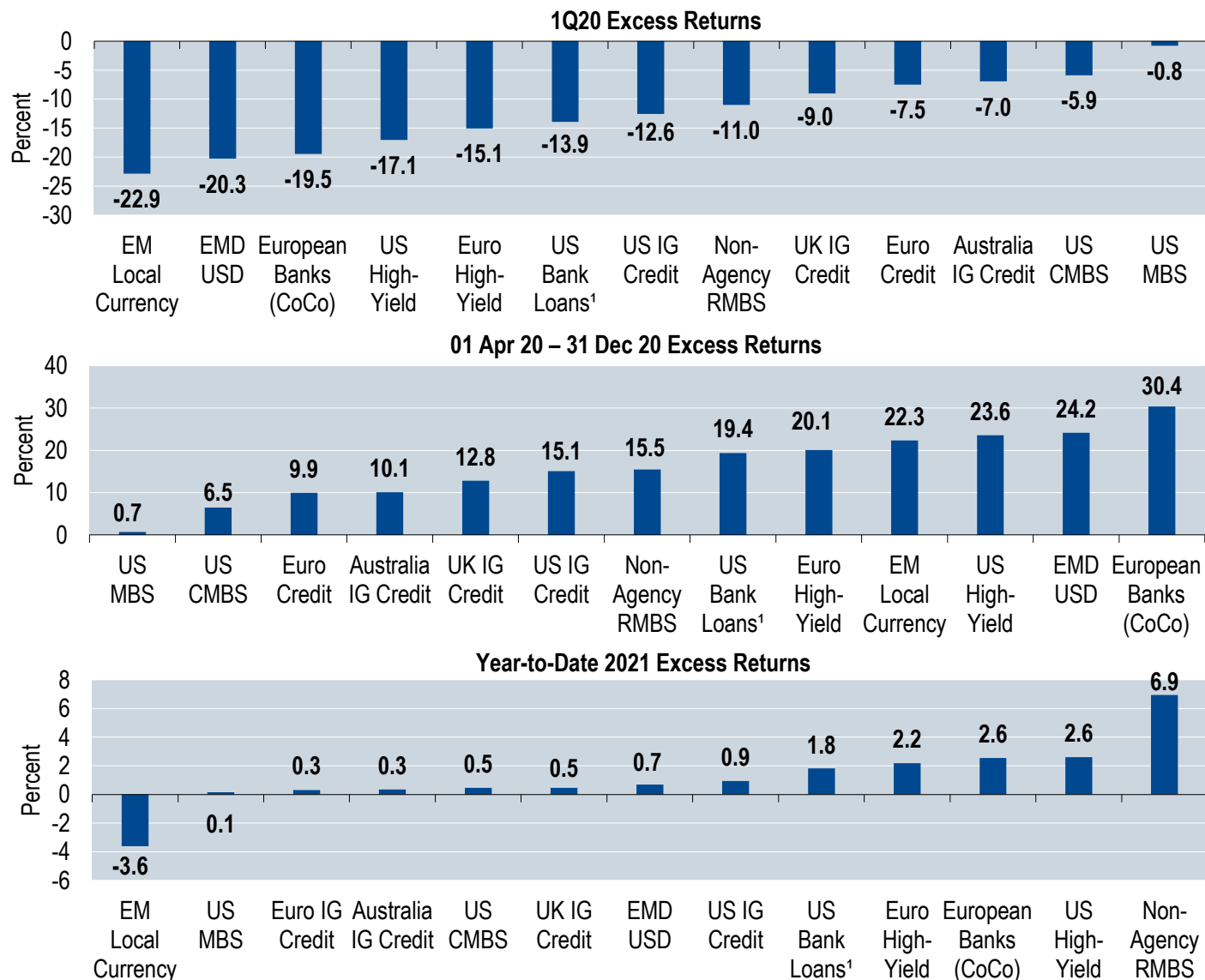
Source: World Bank. As of 09 Sep 20

# Global Fiscal Stimulus Is Set to Turn to Global Fiscal Drag



Source: UBS, Haver, European Commission, CBO. As of 06 April 21

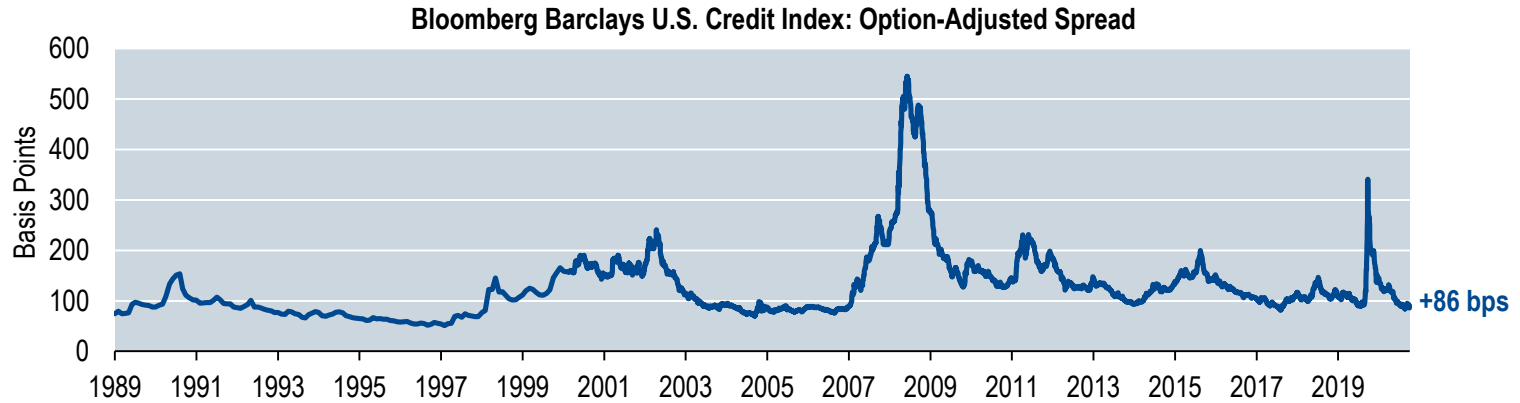
# Spread Sector Excess Returns



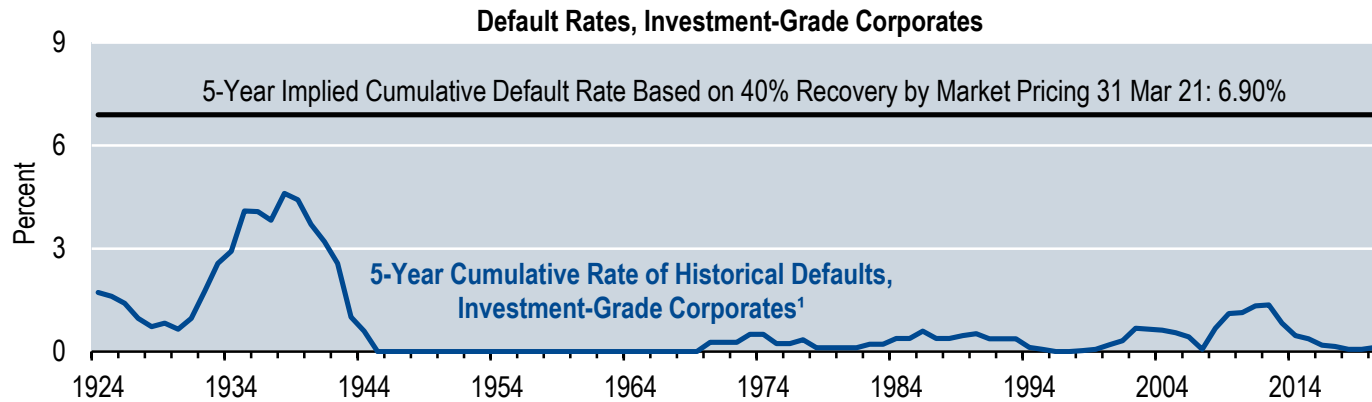
Source: Bloomberg Barclays, J.P. Morgan, S&P Global Market Intelligence, a division of S&P Global Inc, Western Asset. <sup>1</sup>S&P/LSTA Performing Loans Index excess return vs. 3-Month LIBOR. As of 31 Mar 21  
 Past performance is not a reliable indicator of future results.

# US Investment-Grade Credit

## Spreads and Default Rates



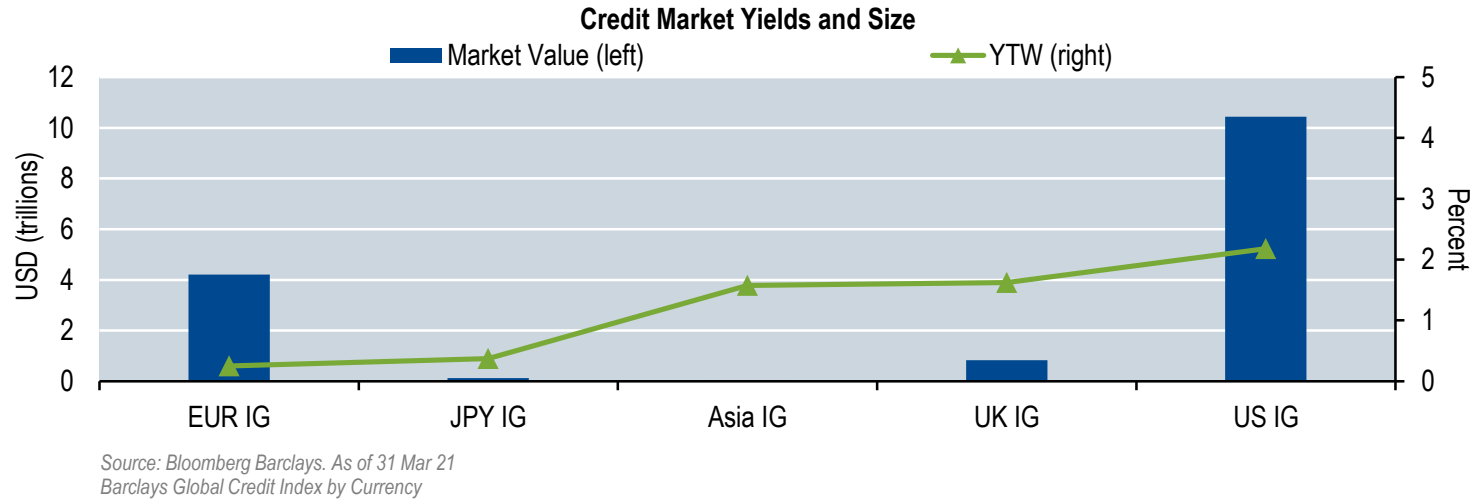
Source: Bloomberg Barclays. As of 31 Mar 21



Source: Bloomberg Barclays, Moody's. As of 31 Mar 21  
\*As of 31 Dec 20

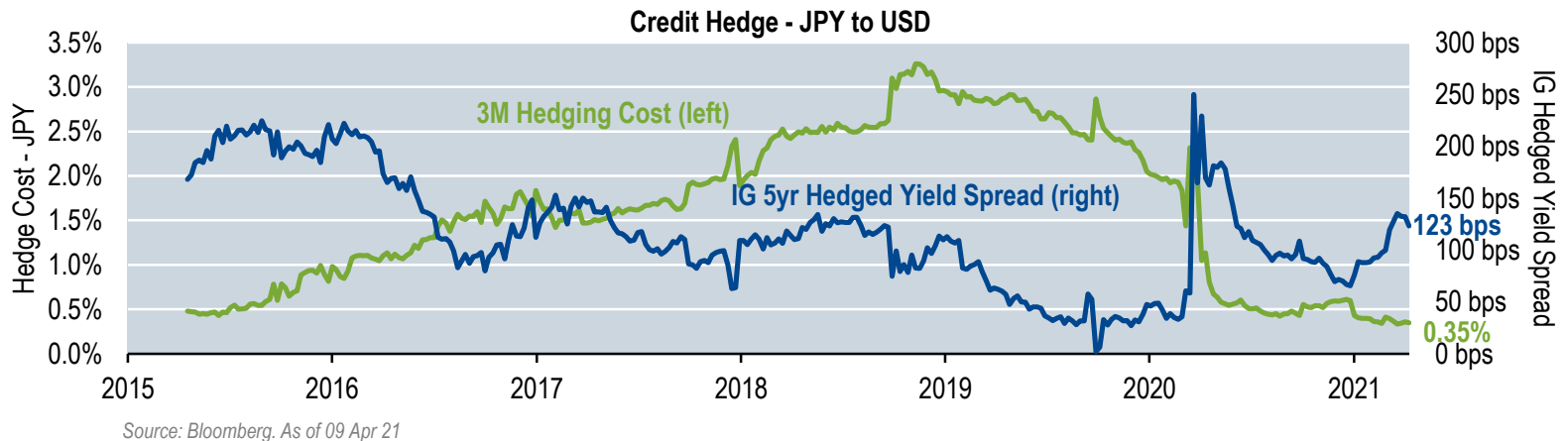
# US Credit Markets Offer Both Attractive Yield and Size

Relative to other mature markets, US credit markets are attractive to a global investor.



# US Credit Markets Are Attractive to Global Investors

Higher Yields and Low Hedging Costs Have Increased Global Demand for US IG Credit



# Investment-Grade Energy – Further Improvement in Q1 2021

## Since 2016, IG managements have

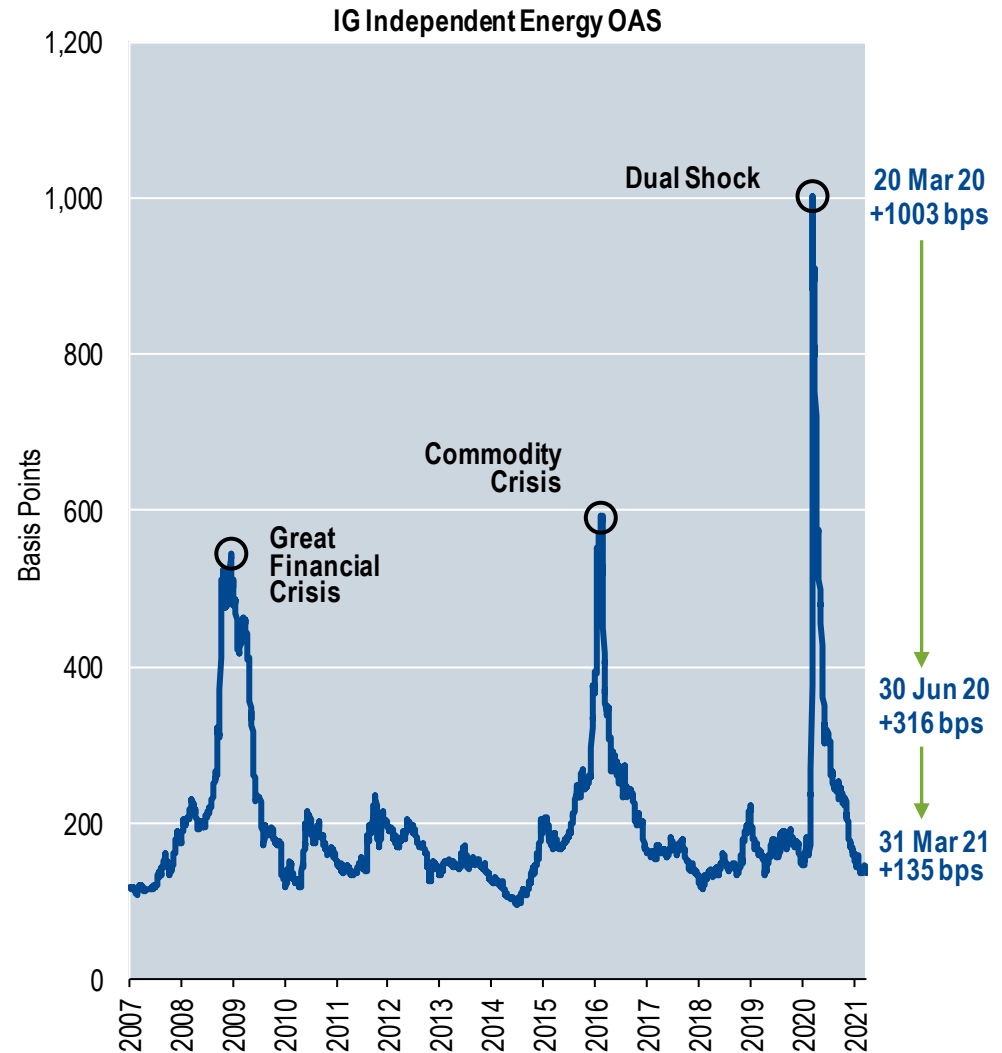
- Acted conservatively
- Lowered cost structures
- Improved cash flow
- Delevered balance sheets
- Extended maturity runways
- Improved liquidity
- Implemented hedges

## Have additional levers

- Cut capital budgets
- Cut dividends

## Conclusion:

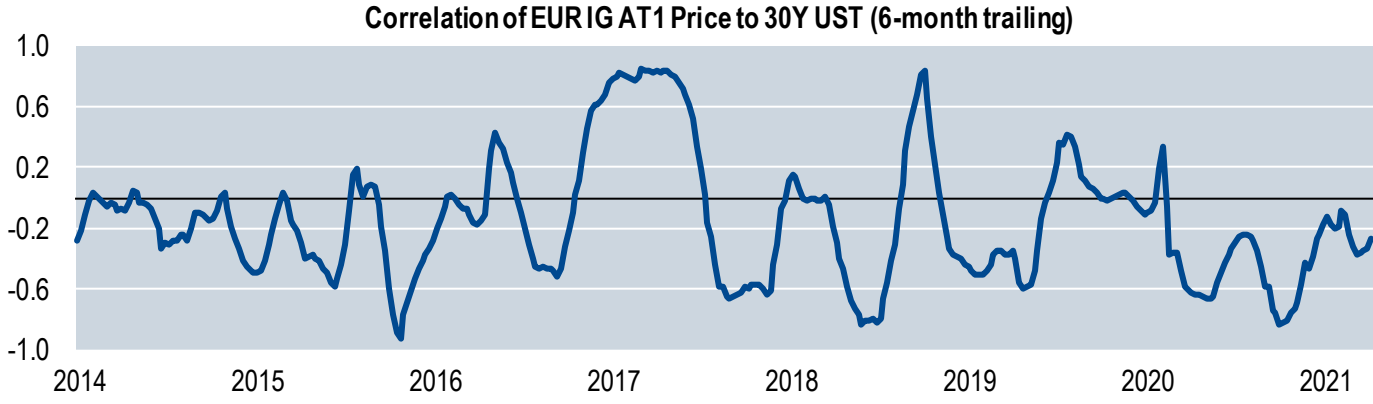
- Energy sector “still healing” – Capital preservation in focus
- Global recovery provide tailwind for energy prices
- Secular challenges remain



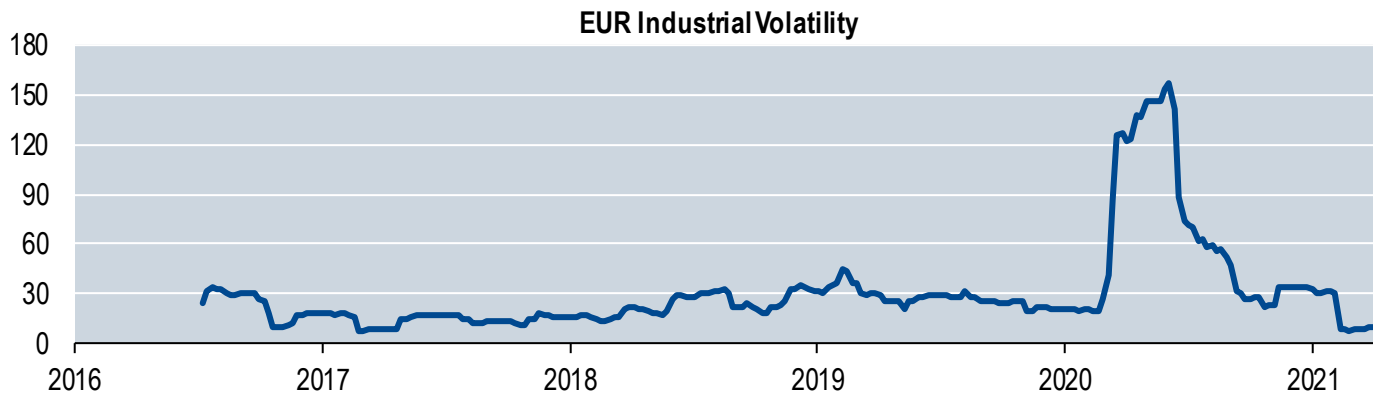
Source: Bloomberg Barclays. As of 31 Mar 21



# European Banks Remain Attractive in a Low Volatility Corporate Market

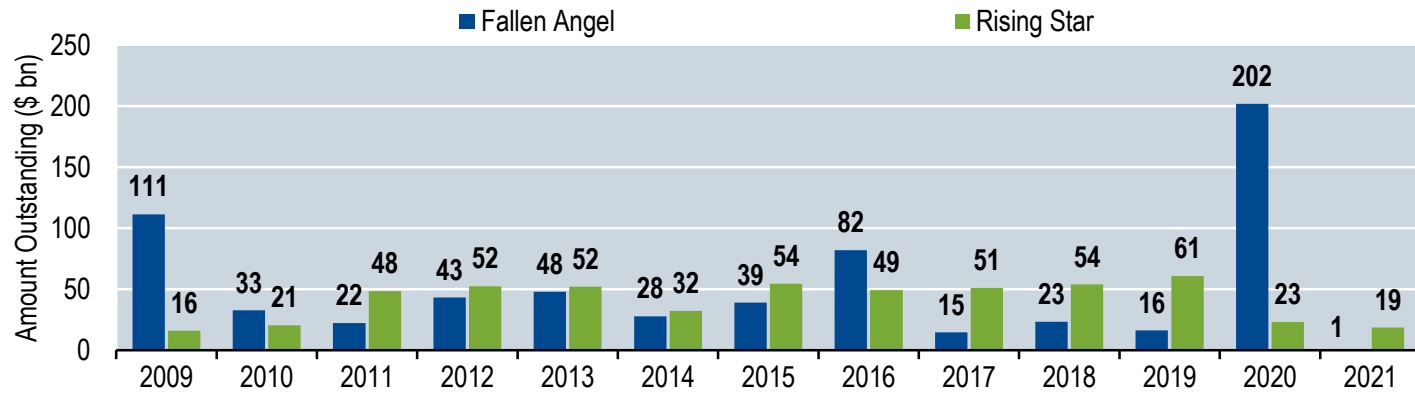


Source: ICE BofA, Western Asset. As of 26 Mar 21



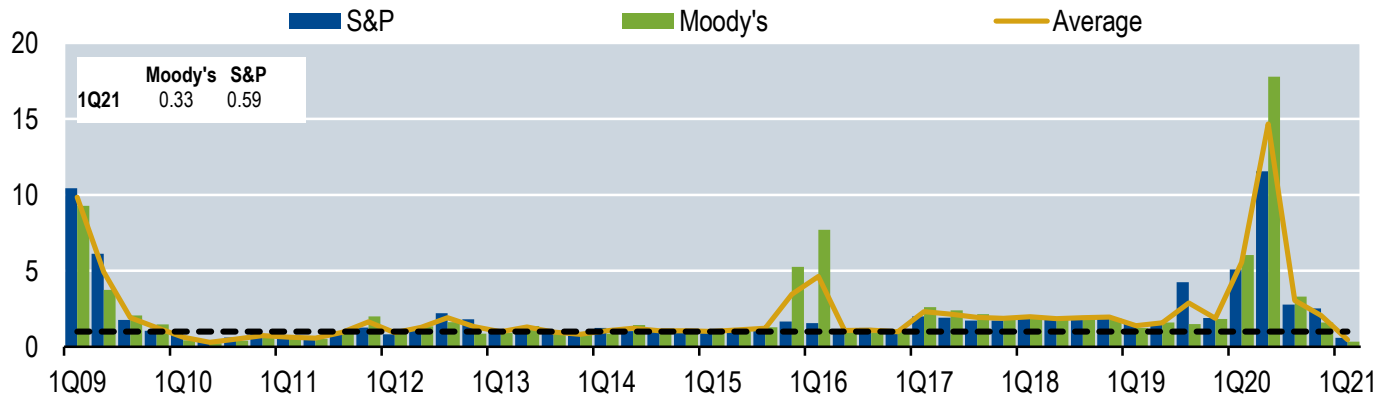
Source: ICE BoAML, Western Asset. As of 01 Apr 21  
\*Annualised spread volatility of EUR industrial index, 13 week rolling

# US Corporate Fallen Angels and Rising Stars



Source: Bloomberg, Barclays Research. As of 31 Mar 21

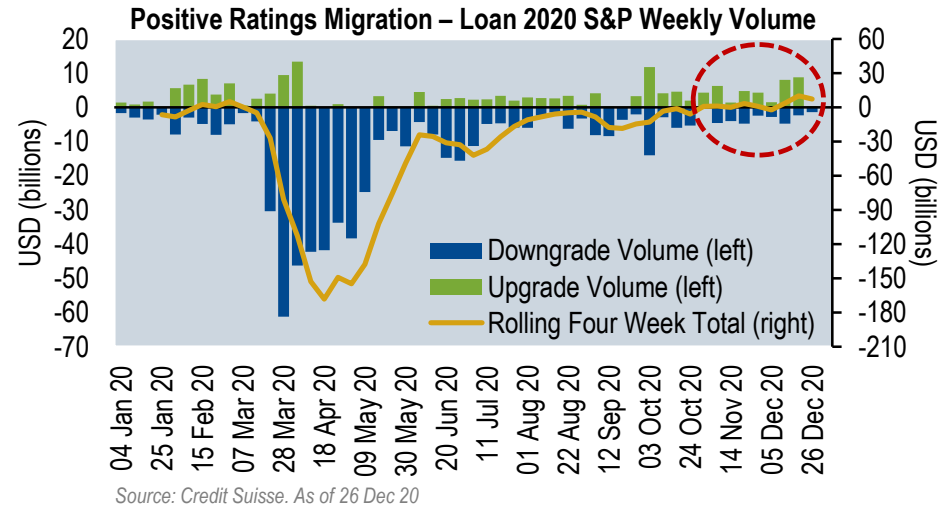
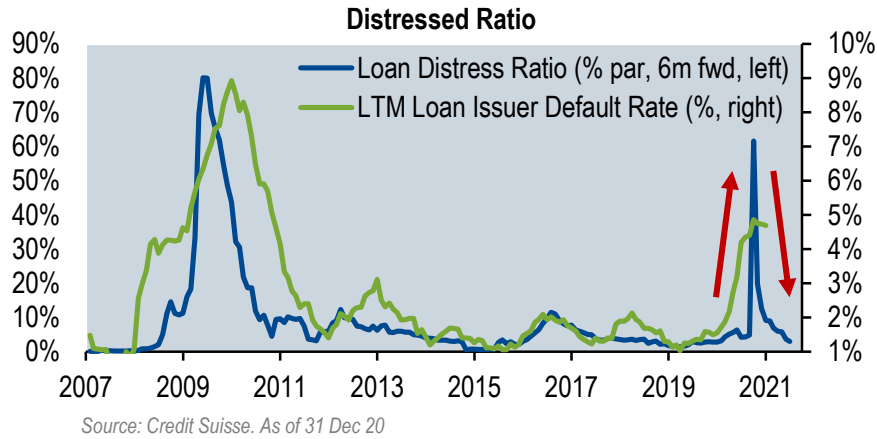
## Moody's & S&P High Yield Quarterly Downgrade/Upgrade Ratios



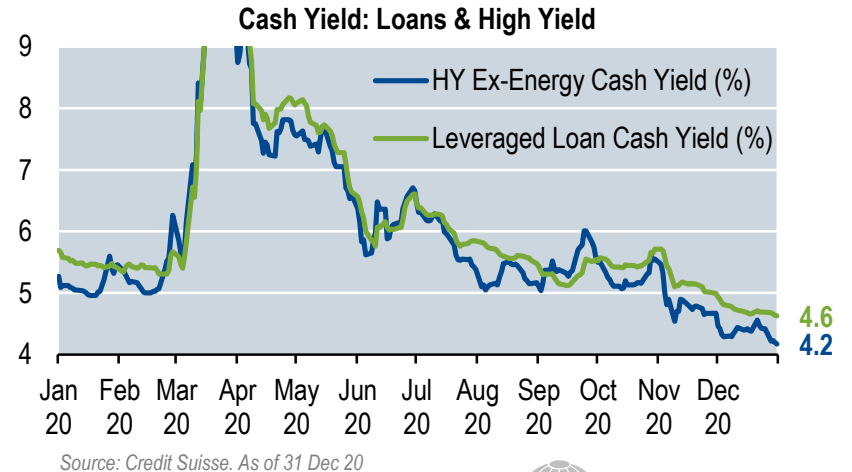
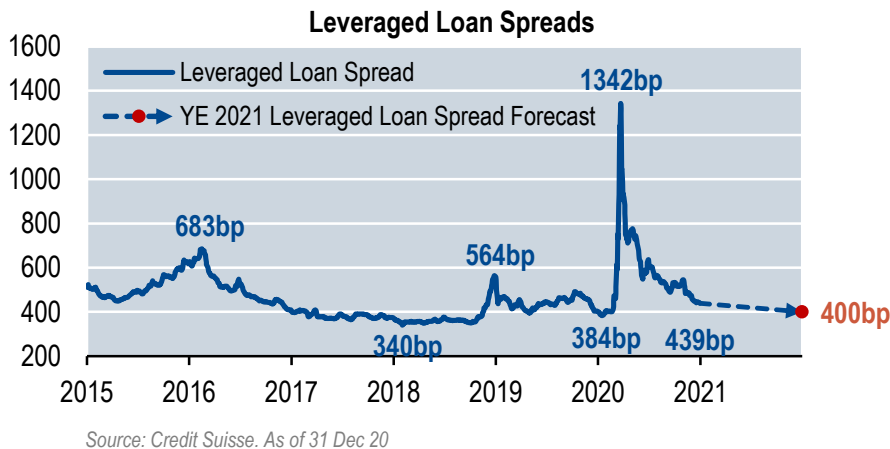
Source: Bloomberg, Barclays Research, Moody's. As of 31 Mar 21

# Loan Fundamentals Remain Intact and Improving While Yields Remain Attractive

Loan asset class distress ratio below pre-Covid levels with improving fundamental profiles and positive outlook



Loan yields are attractive and remain wide of pre-Covid levels as the asset class has lagged high yield and investment grade recovery

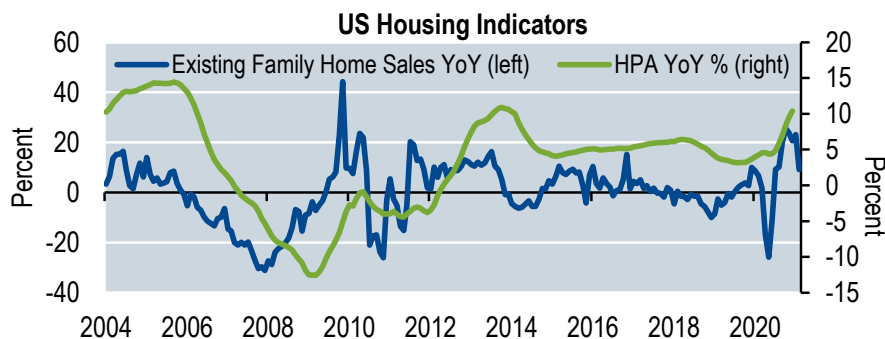


# Mortgage Credit Offers Attractive Relative Value

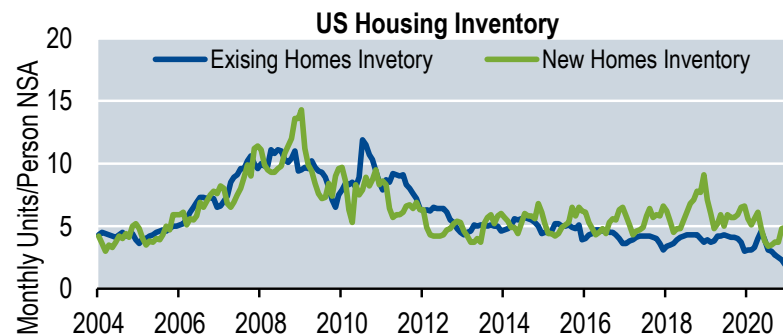
Mortgage credit has lagged corporate credit in the post-COVID recovery as there has not been explicit stimulus from the US Federal Reserve and there are uncertainties impacting certain sub-sectors' collateral performance.

Spreads	JP Morgan Non-Agency RMBS CRT	JP Morgan Non-Agency RMBS Legacy	Bloomberg Barclays Non-Agency CMBS BBB	Bloomberg Barclays US IG Credit	Bloomberg Barclays US High Yield
31 Jan 20	201	170	331	98	390
<b>31 Mar 21</b>	<b>430</b>	<b>229</b>	<b>494</b>	<b>86</b>	<b>310</b>
Difference Since 31 Jan 20	229	59	163	-12	-80

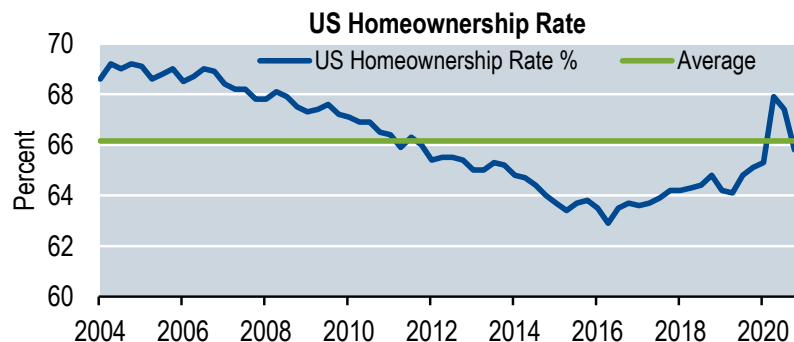
Source: J.P. Morgan, Bloomberg Barclays. As of 31 Mar 21. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situations or needs of investors. Past performance is not a reliable indicator of future results.



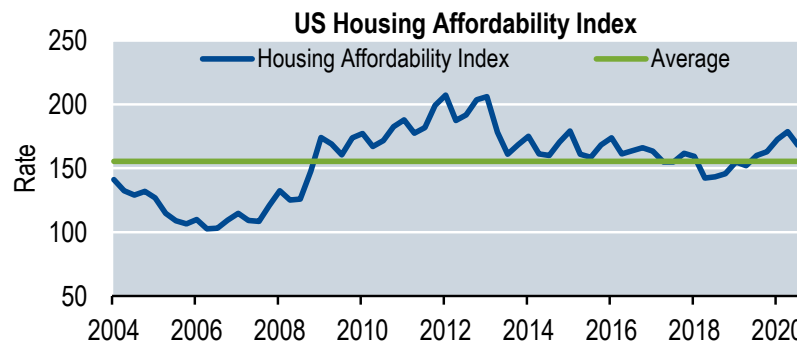
Source: Case Shiller and National Association of Realtors (NAR). As of 28 Feb 21



Source: NAR U.S. Census Bureau. As of 28 Feb 21



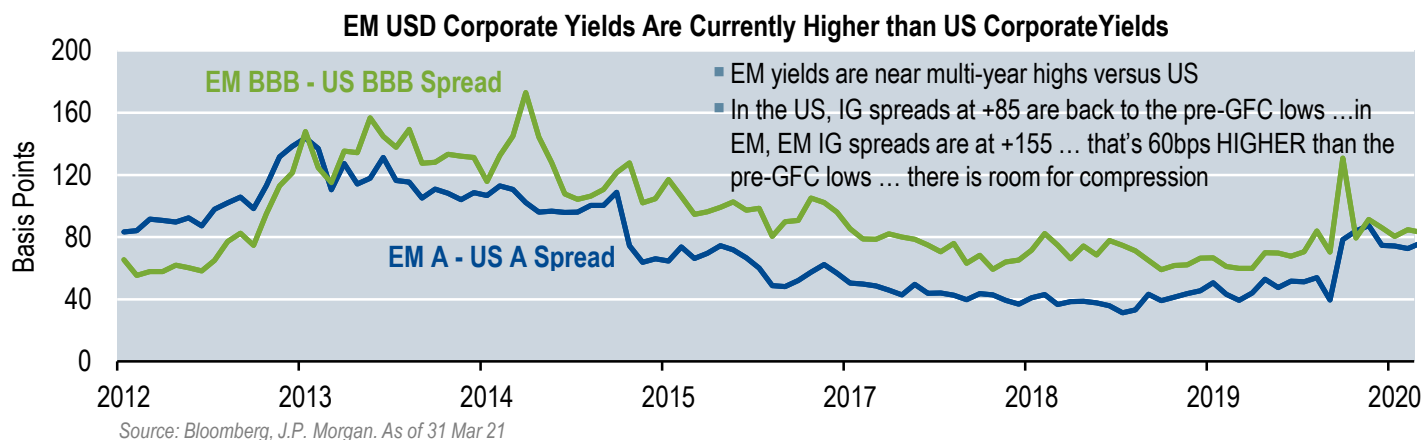
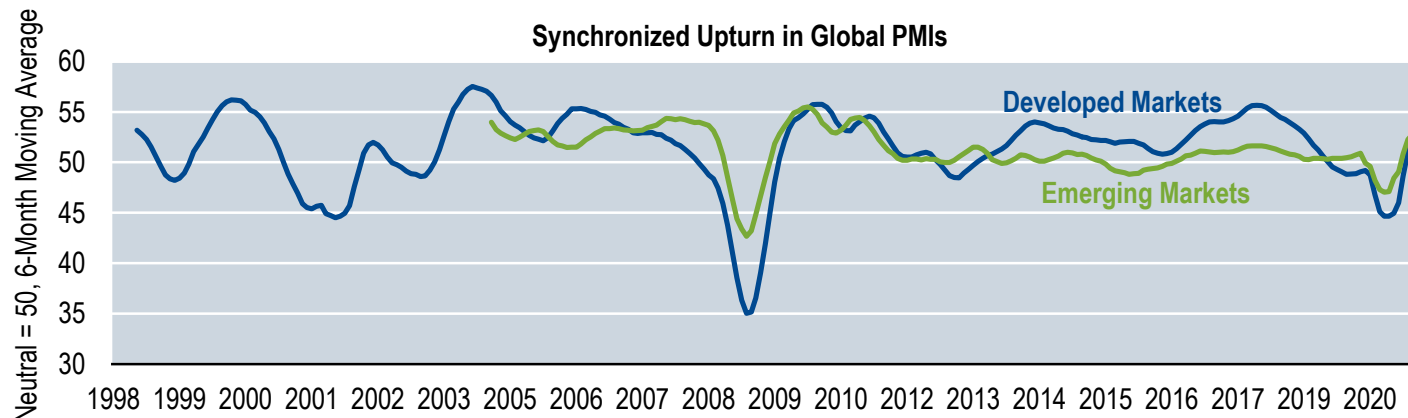
Source: U.S. Census Bureau. As of 31 Dec 20



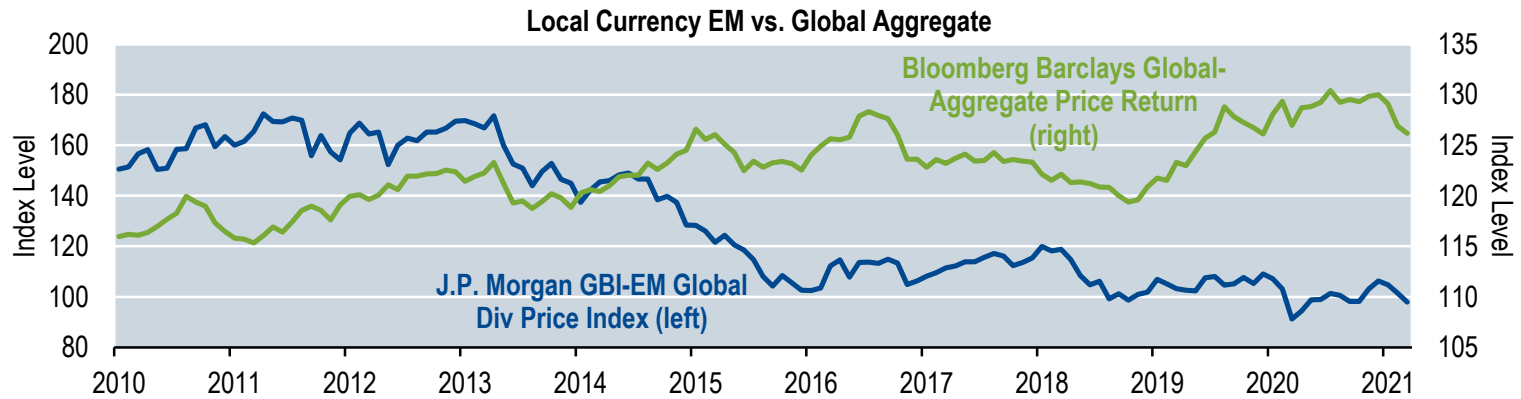
Source: National Assoc. of Realtors. As of 31 Dec 20

# Post-Pandemic EM Rebound on Track, Albeit Unevenly Across Countries

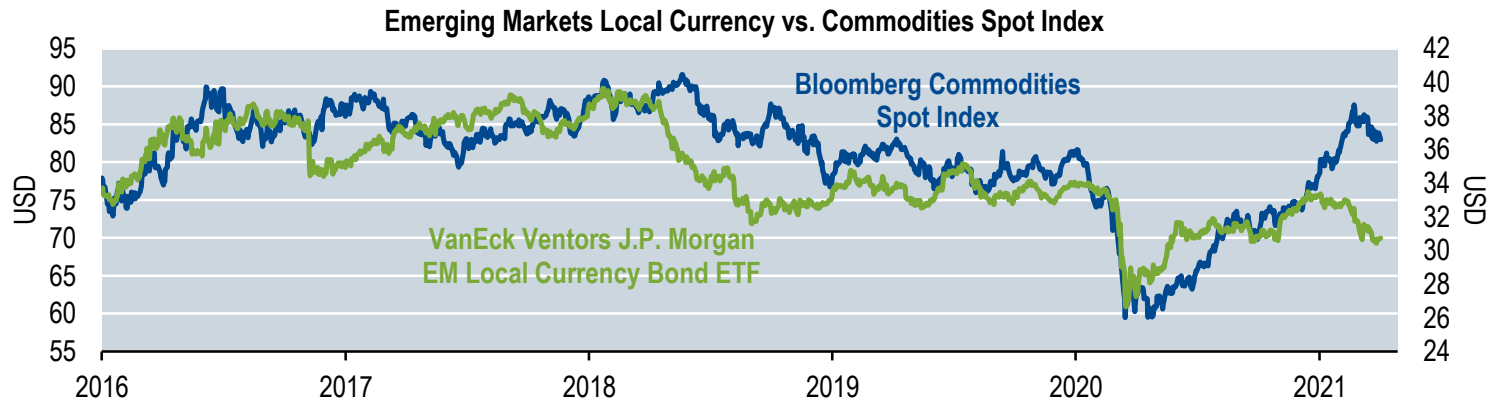
- EM PMIs point to activity expansion, buoyed by export demand
- By region, economic upturn continues to be led by North Asia



# Local Currency Emerging Market Debt Prices Are Very Distressed

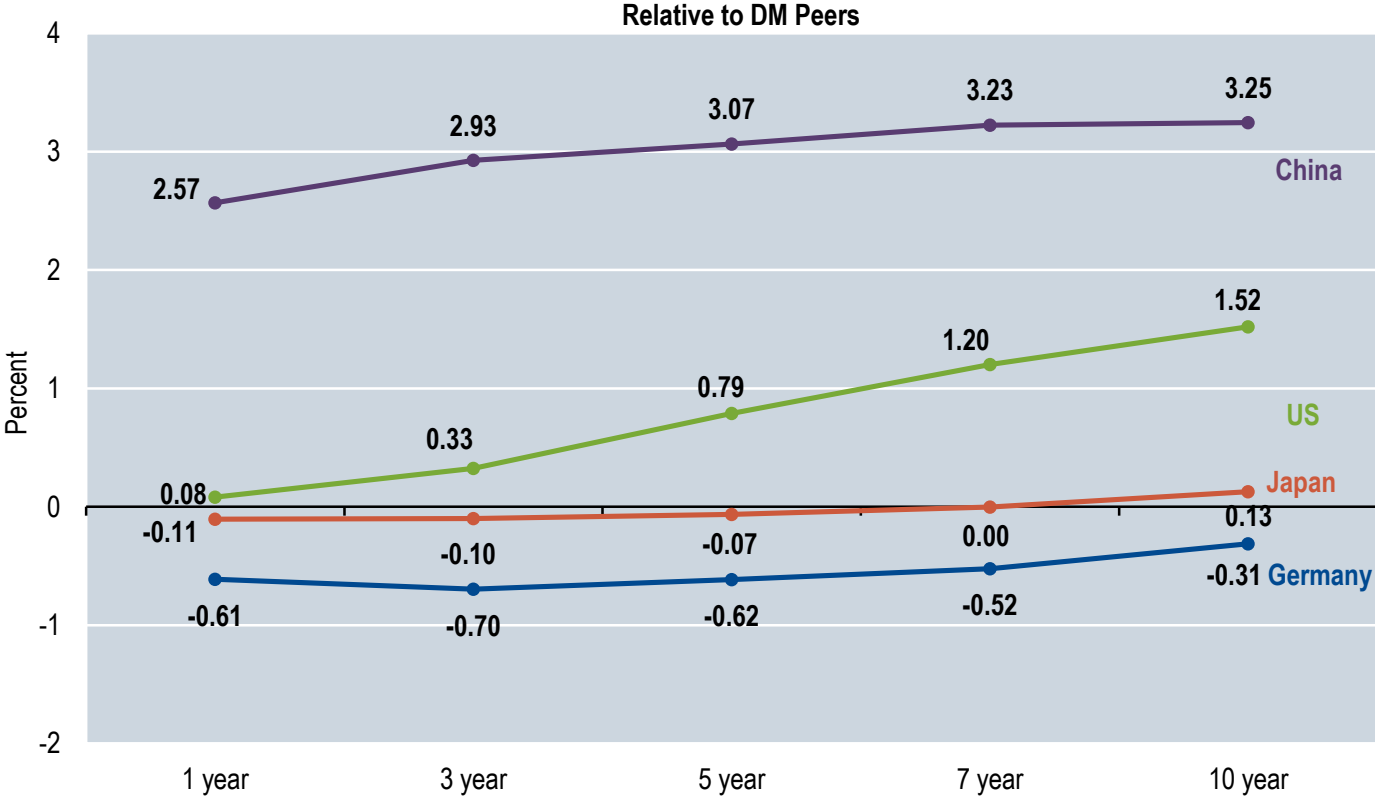


Source: Bloomberg Barclays, J.P. Morgan. As of 31 Mar 21



Source: Bloomberg. As of 31 Mar 21

# China Local Onshore Bonds Offer Attractive Valuations



Source: Bloomberg. As of 09 Mar 21

## Economic

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- Fiscal and monetary policy should stay supportive
- Second half should see meaningful pick-up in growth—as economy “reopens”
- Global economic slack, debt burdens, labor market scarring, and SME destruction will take years to absorb
- Central bank policy rates will be very low for very long
- Inflation pick-up will prove transitory—not persistent

## Cyclical vs. Secular

- The near-term cyclical outlook is very strong. Longer-term, the recovery and inflation rates will downshift

## Investment implications

- Reopening spread products should outperform Treasuries and sovereign bonds
- Emerging markets should particularly benefit
- The dollar should weaken only mildly
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**Thank you.**

# Risk Disclosure

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