Ken Leech
Chief Investment Officer

WESTERN ASSET

Webcast Summary

2Q21 Market & Strategy Update

Market optimism for the global growth recovery has improved significantly given the remarkable progress of vaccinations and economic reopenings after the Covid-driven shutdowns, but we are a bit more cautious than the current consensus. However, we continue to be encouraged by the extremely supportive fiscal and monetary policy, and anticipate a significant pickup in global economic activity in the second half of the year. We expect inflation to rise over the short term but believe that should prove to be transitory. We think the near-term cyclical growth bounce will give way to secular headwinds, and feel it's important for investors to know the difference. In this environment, spread sectors should continue to outperform, with emerging markets particularly benefiting.

COVID-19 Update

- The Covid nightmare persists—but humanity is definitely winning the war.
- While the ongoing threat of COVID-19 has not abated, with the detection of new variants in the UK and South Africa, markets remain forward-looking and are pricing in the triumph over the virus.
- Vaccinations have made incredible advances, with the US on track to vaccinate 75% of its adult population by the end of 2Q, and the potential for 60% global vaccination of adults by year-end.

Market Review

- The V-shaped recovery seen in global economic activity since the depths of the crisis a year ago was extremely encouraging but we still have a long way to go from pre-pandemic levels.
- While it may appear easy to extrapolate the recent short-term growth bounce as the beginning of some kind of a runaway recovery, we think the same headwinds that existed pre-Covid will temper growth.
- US labor markets and small businesses have been severely wounded, with approximately nine million people either unemployed or underemployed. This will take some meaningful time to repair.
- The recent spike in US rates was due in part to Biden's big fiscal surprise—introducing a package worth 10% of GDP to an economy that was already rising. This tremendous amount of fiscal spending will boost growth in 2021 and 2022, but beyond that we think it would be politically challenging for Biden to get more stimulus approved in the order of magnitude that we just saw.

Inflation

- The market is confident in renewed inflation, but we think that optimism may be misplaced.
- The current reopening and base effects from last year will give us a big move up in inflation over the second half of this year, likely above the Federal Reserve's (Fed) 2% target.
- We view the inflation story as one augmented by policy and the supply shortages, which cause price disruptions. We see these as merely temporary forces driving short-term inflation higher.

- As US inflation may be robust in the near term, it is only one component of the global ecosystem that is still dealing with subdued inflation; this gives us less confidence that these inflation pressures will persist in isolation.
- For sustained inflation to be possible, we believe that there would have to be a significant pickup in bank lending, which has yet to appear.
- The market is currently pricing in a Fed tightening timeline, similar to what happened during the 2013 taper tantrum. This conflicts with the Fed's stated direction, and we do not expect this tightening to happen.

Global Economic Outlook

- Europe bungled the initial vaccine rollout and some lockdowns are being reinstated. Western Asset's UK team thinks we are at peak pessimism and a change in tone is coming. 70% of the population is expected to receive the vaccine by the end of July, largely in line with the US.
- Japan's recovery will persist—conditions are not great but will continue in the right direction, with a weak inflation outlook and the expectation of continued monetary and fiscal support.
- China is one of the better stories: one of the largest countries to post positive GDP last year given its "first in, first out" Covid experience. China also has the political means to manage its Covid response, which many countries do not have.

Cyclical vs. Secular Economic Outlook

- We're seeing a short-term move up versus long-term challenges. We need to look past the reopening, as some of these challenges need to be discussed.
- Wage growth remained a challenge pre-Covid; we will likely see some growth over 2021 but need to see an uptrend on a sustained basis.
- Debt burdens globally are much greater today than post-GFC, which is a deflationary force.
- Aging demographics: people tend to become net savers as they age, resulting in less money circulating. The acceleration in technology is displacing the labor force although it brings a lot of benefits.
- We do not see a secular boom, but likely a return to pre-pandemic levels.

Investment Themes

- **Spread sectors:** Western Asset's risk budget is focused on taking advantage of opportunities in spread sectors relative to sovereigns. We see this environment as very favorable for risk assets. The outlook could darken if Covid gets worse and as a result we will hold US Treasuries as an offset should that come to fruition.
- **Investment-grade:** This is the sector we felt most strongly about in terms of a fast recovery 12 months ago and implemented as the cornerstone trade in portfolios. Fortunately, it has played out in our favor as spreads have returned to pre-Covid levels. We are looking to rotate out of investment-grade into other, slower sectors still in recovery mode.
- **Energy:** The energy reopening trade continues and is an area of interest for us. Conservative management teams since the oil price collapse in 2014/2015 have been beneficial. Long-term secular challenges remain with alternative energy sources but reopening has created higher demand and higher prices for energy.
- **European banks:** This is another sector we like, with low volatility due to the ECB's very accommodative purchase program. We are fundamentally positive on banks both in the US and EU. EU banks offer higher yields and are less correlated to moves in interest rates.

- **High-yield:** We saw this as the second responder in the recovery following investment-grade. High-yield is back to fully valued but select opportunities remain. The quality of the sector is improving as the fallen angels are now moving back to rising stars (upgrades outpacing downgrades).
- **Bank loans:** We are rotating into this sector. 2018 loans outpaced high-yield in the face of the Fed raising rates. When the Fed pivoted to accommodative, high-yield outpaced loans. Loans are poised to do well when the Fed gets tighter.
- **Structured product:** Structured product has rallied significantly, but spreads are still wider versus pre-pandemic levels. Housing fundamentals are strong, prices are rising, collateral is looking stronger and we are rotating into this sector.
- **EM debt:** Investment-grade emerging market (EM) debt has been a big theme in our portfolios. Local EM is a laggard in the recovery; it's the cheapest way to play the global recovery but comes with a lot of volatility. EM price return (JPM GBI) versus developed markets (BB Global Agg) has never been wider.
- **China:** Yields on Chinese bonds are attractive, given their low correlation to global markets.

Q&A Highlights

- We are optimistic the Fed will hit its inflation targets eventually. If inflation ran at 3% for 12 months or longer, that would likely get the Fed to begin changing its posture.
- The recent rate spasm was in the context of an improving growth picture. Credit can do well when rates are rising for the right reason (improving economy). Portfolios have been overweight spread sectors and are expected to do well even in a moderately rising-rate environment.
- A US dollar collapse would require runaway inflation. The dollar should naturally weaken as other global economies recover, which is our expectation. Our timeline for the global recovery runs longer than a collapse in the dollar narrative requires.