



April 6, 2022

Thank you for joining Western Asset's  
2Q22 *Market & Strategy Update* webcast  
featuring CIO Ken Leech.

*The presentation will begin shortly.*



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# 2Q22 Market and Strategy Update

April 6, 2022

Ken Leech

Chief Investment Officer

## Russia-Ukraine conflict poses massive geopolitical uncertainty

- Elevates both inflation and downside growth risks

## Inflation remains challenging but should ease substantially during 2022

### Fixed-Income Outlook

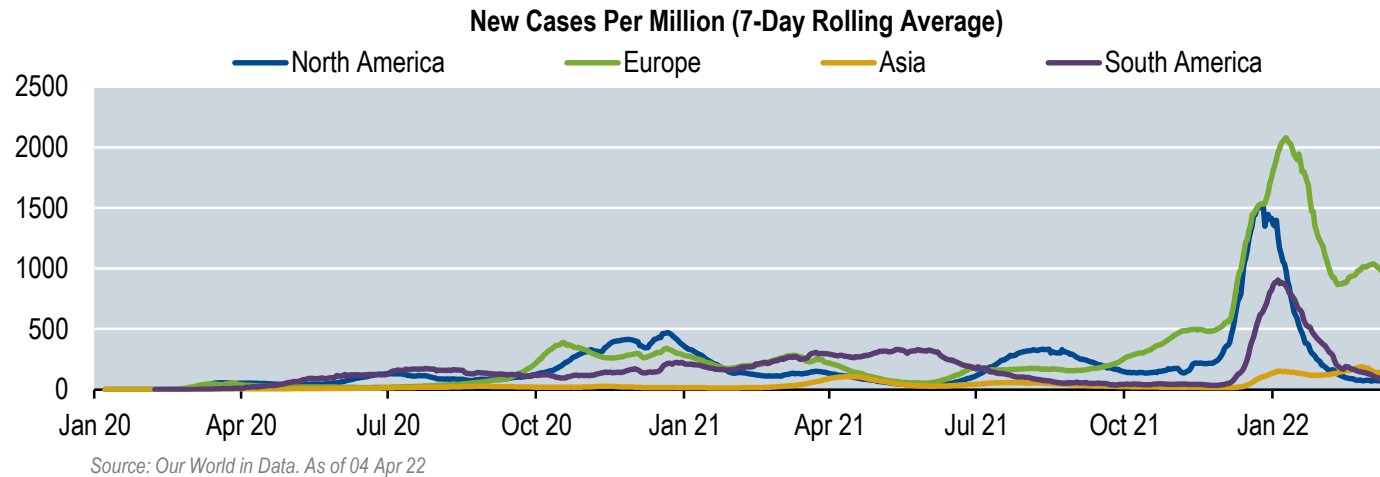
- Covid continues to bedevil global populations
- US and global growth are decelerating from high levels
- Fed tightening will focus on making inflation a top priority
- Global fiscal stimulus will be sharply reduced

### Investment Implications

- Global growth has recently downshifted but should remain resilient, which continues to support the overweight of spread products
- The recovery of “reopening” sectors has been delayed, not derailed
- With the Fed committed to tightening, risk asset volatility should increase
- Longer term rates, while currently elevated, should subside

# COVID-19 Outlook

## Transitioning from pandemic to endemic



## COVID-19

- A once-in-a-century pandemic which has killed over 5 million people so far
- Vaccines are key to fighting the disease

## Omicron

- BA.2 is the latest subvariant
- Most transmissible variety to date
- Targets upper airways rather than lungs; therefore, disease is less severe
- Hospitalization and death rates for all omicron subvariants are muted

## Vaccines

- Existing vaccines protect against severe disease
- Unvaccinated individuals are 8 times more likely to be hospitalized vs vaccinated
- A booster dose of existing vaccines enhances immunity
- New Omicron-specific mRNA vaccines anticipated by August 2022

## Tailwinds



- Fiscal thrust
- Monetary accommodation
- Covid reopening demand

## Headwinds



- Debt
- Demographics
- Technological displacement

## Ukraine – Russia conflict

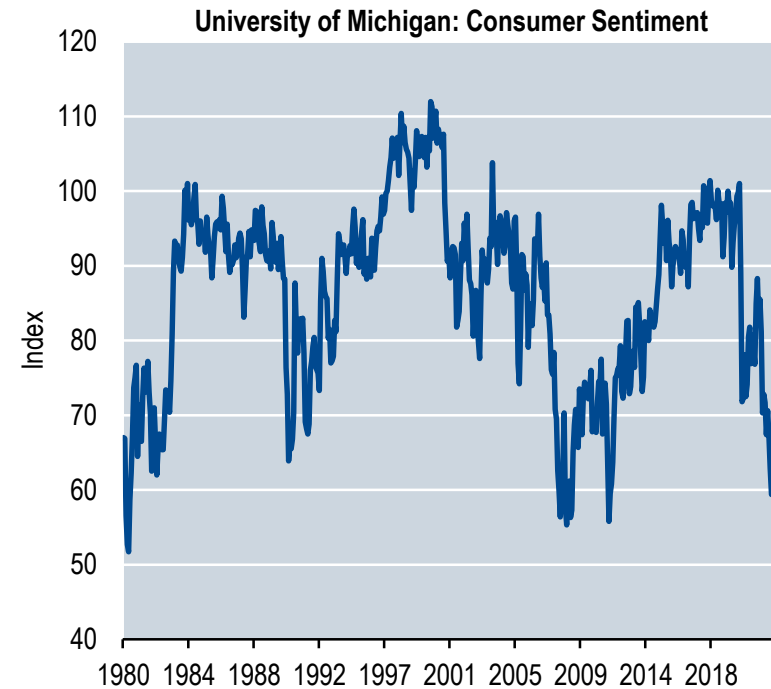
- Higher commodity prices
- Additional supply side disruption
- Additional monetary tightening
- Increased pressure on real incomes and further downside risks to global growth

# Declining Real Income a Headwind for Demand

Real incomes are declining to start 2022, due to fading fiscal stimulus and higher inflation

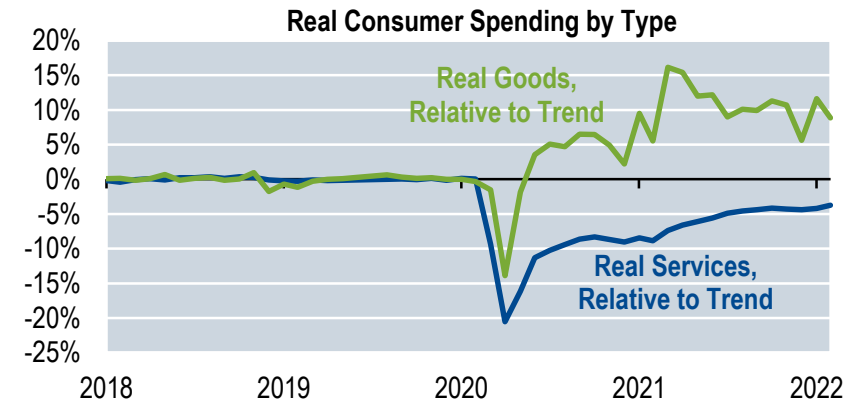


Source: Bureau of Economic Analysis. As of 31 Mar 22

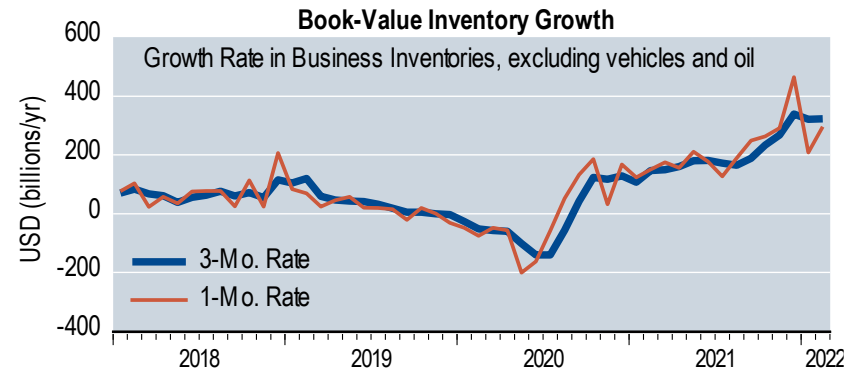


Source: University of Michigan, Haver. As of 31 Mar 21

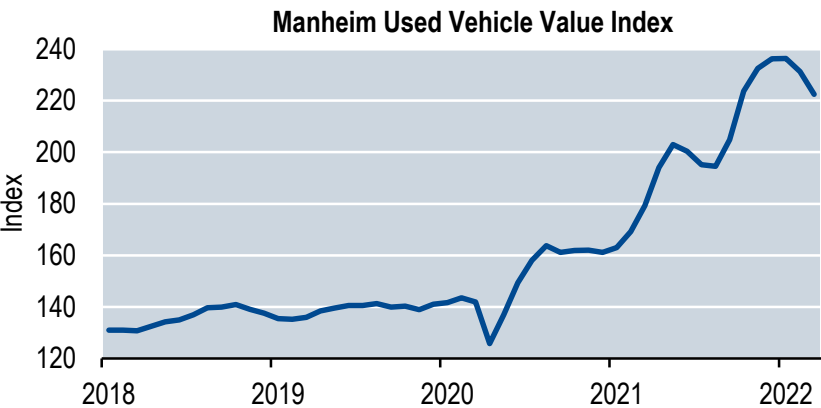
# Rebalancing Supply and Demand for Goods



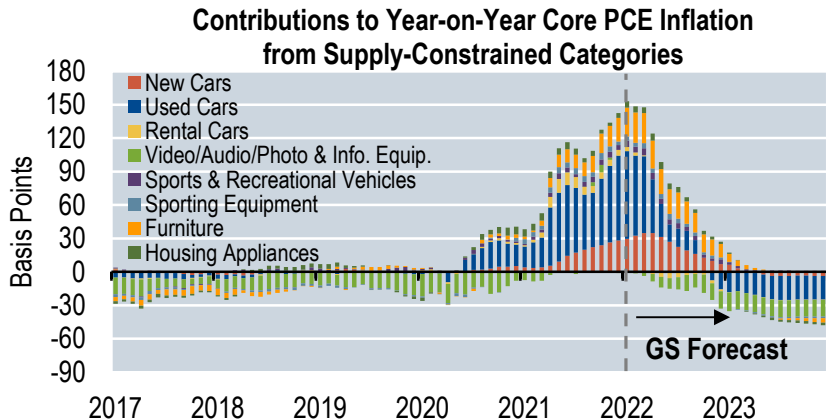
Source: Bureau of Economic Analysis. As of 31 Mar 22



Source: Census Bureau. As of 28 Feb 22

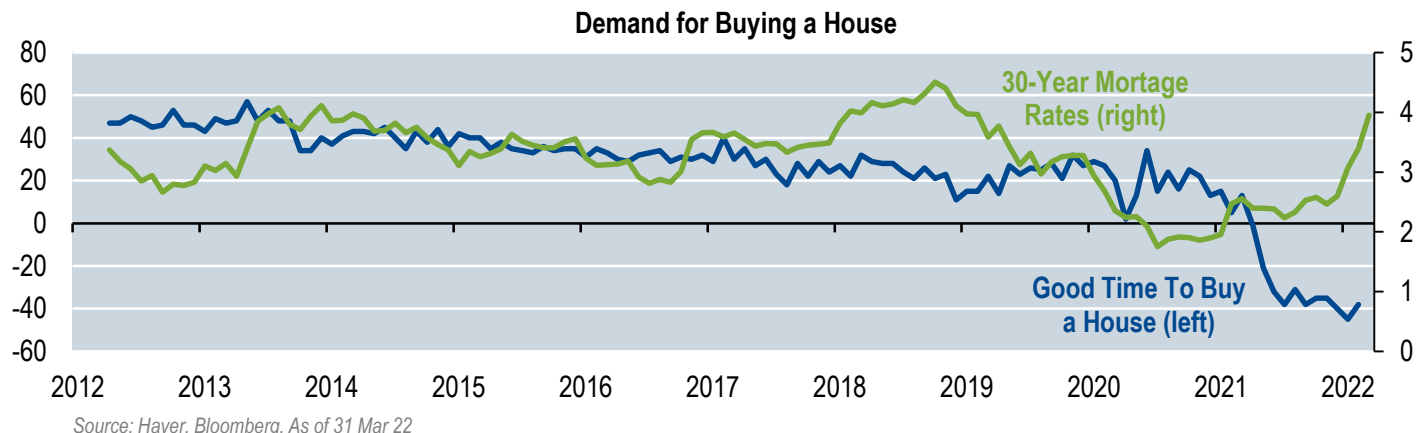
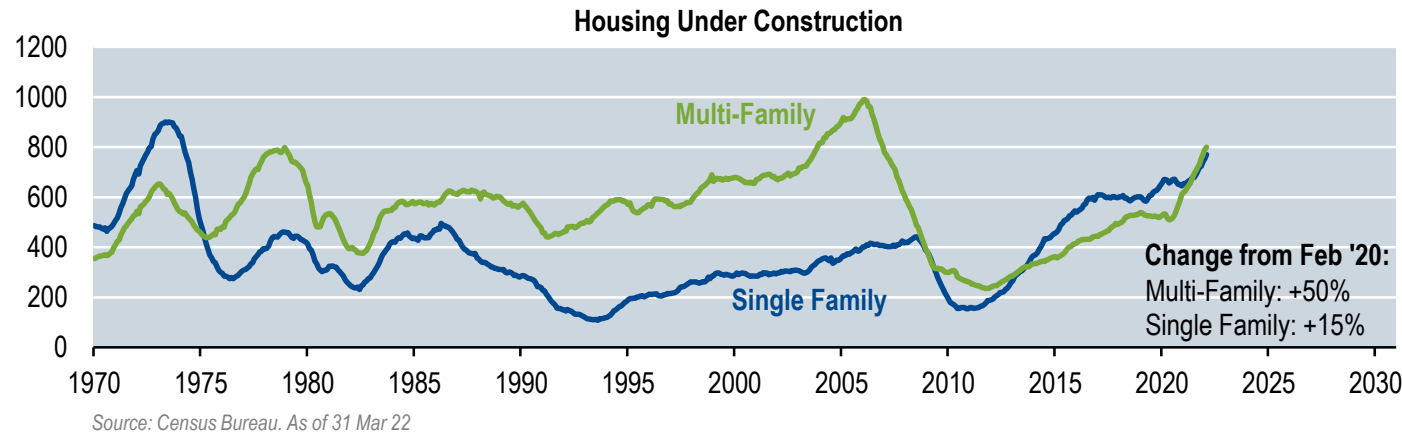


Source: Manheim, Haver. As of 31 Mar 22



Source: Goldman Sachs. As of 31 Jan 22

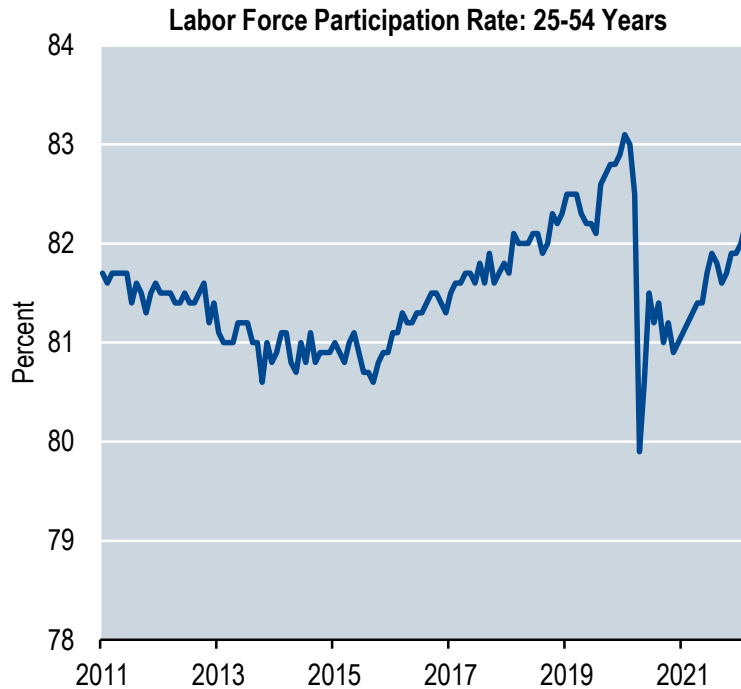
# Rebalancing Supply and Demand for Housing



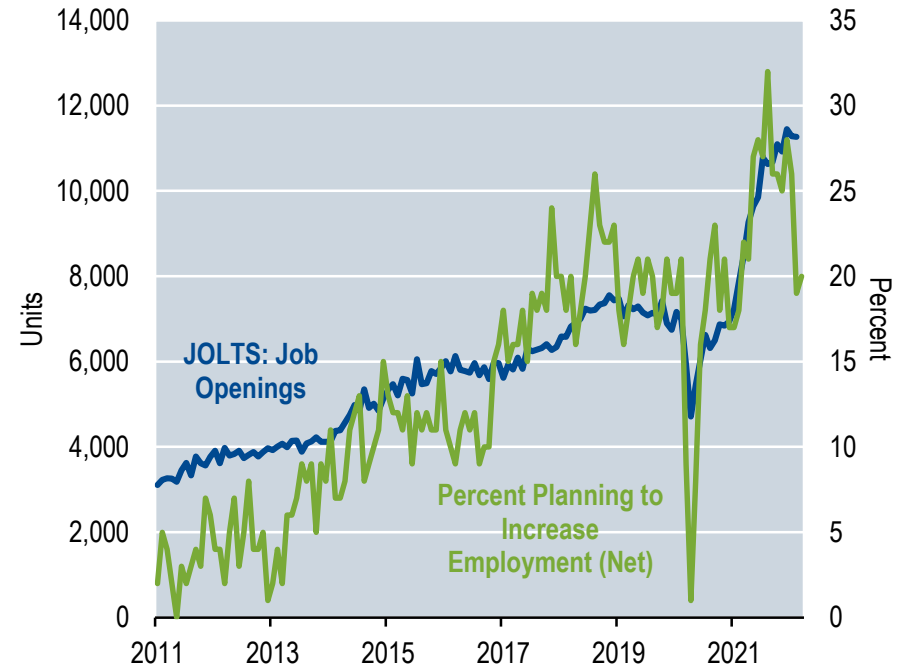


# Rebalancing Supply and Demand for Labor

Labor supply improvement can continue in 2022. Job openings have peaked, albeit at high levels. Are hiring plans turning?

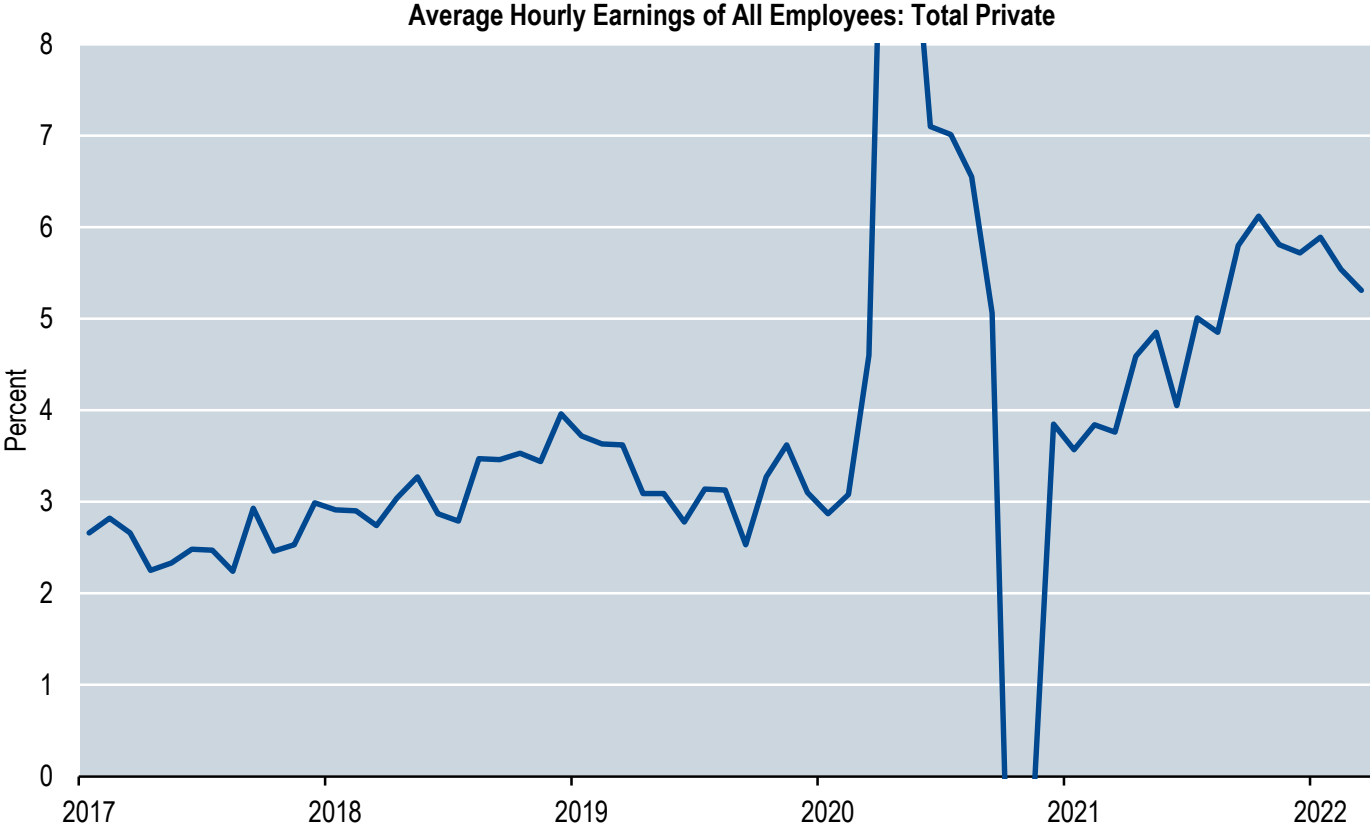


Source: Bureau of Labor Statistics. As of 31 Mar 22  
Note: Seasonally adjusted



Source: NFIB, Bureau of Labor Statistics, Haver. As of 31 Mar 22  
Note: Seasonally adjusted

# Average Hourly Earnings Acceleration May Be Over



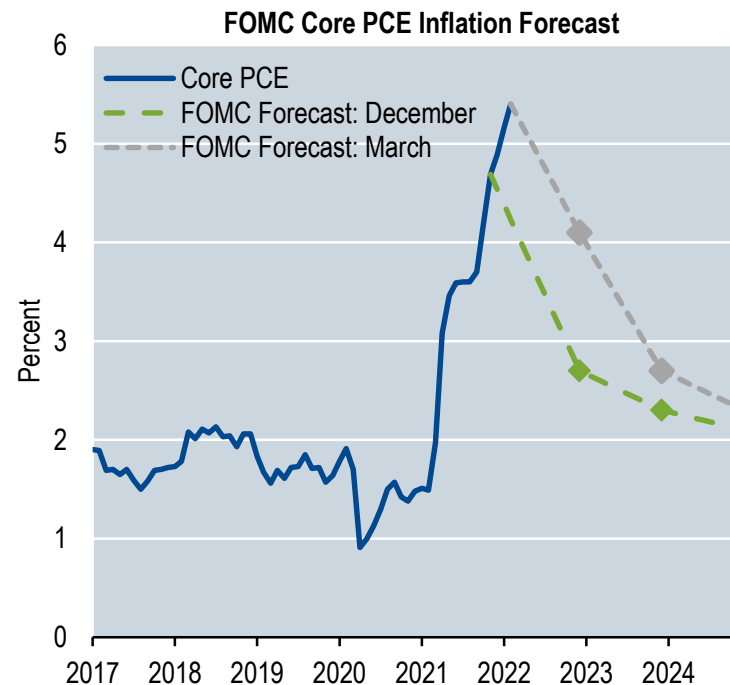
Source: Bureau of Labor Statistics, Haver. As of 31 Mar 22  
6-Month percent change annually, seasonally adjusted, USD per hour

# The Fed's Hawkish Pivot Accelerated in March

Did the Fed overreact with changes to inflation outlook?

## In March, the Fed significantly increased its forecast for inflation in 2022

- January – increased by ‘a few tenths’
  - “I would say that the inflation situation is about the same but probably slightly worse. I’d be inclined to raise my own estimate of 2022 core PCE inflation by a few tenths today”  
– Chair Powell, January 26, 2022
- March – increased by 1.7%
  - “Inflation is likely to take longer to return to our price stability goal than previously expected. The median inflation projection of FOMC participants is 4.3 percent this year [increased from 2.6 percent in December]...participants continue to see risks as weighted to the upside.”  
– Chair Powell, March 16, 2022



Source: Federal Reserve, Bloomberg. As of 16 Mar 22

Note: Market pricing is from Federal Funds Futures.

# Fedspeak Following the FOMC Meeting Was Hawkish, on Net

Powell's comments in particular led to a further repricing of 2022 hikes, now 50 bps above SEP<sup>1</sup> projections

## Chair Powell

- "The labor market is very strong and extremely tight"
- "The inflation outlook has deteriorated significantly"
- "There is an obvious need to move *expeditiously* to return the stance of monetary policy to a more neutral level." (emphasis added)

## Doves

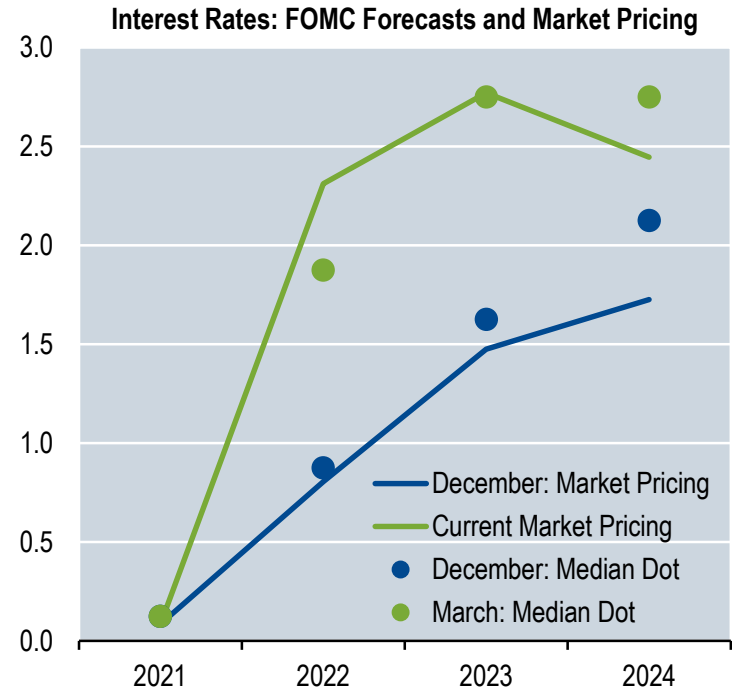
- "Market forces should help to temper the recent inflation surge" – Pres. Evans
- "If some imbalances are resolved, we may not need as many rate hikes...there is a risk of overdoing it..." – Pres. Kashkari

## Hawks

- "My greatest concern is continued elevated inflation. Inflation is too high, and I think concerted action is needed to rein it in" – Gov. Waller

## Moderates

- "Elevated levels of uncertainty are front forward in my mind and have tempered my confidence that an extremely aggressive rate path is appropriate today" – Pres. Bostic
- "These geopolitical events also pose downside risks to growth." – Gov. Brainard

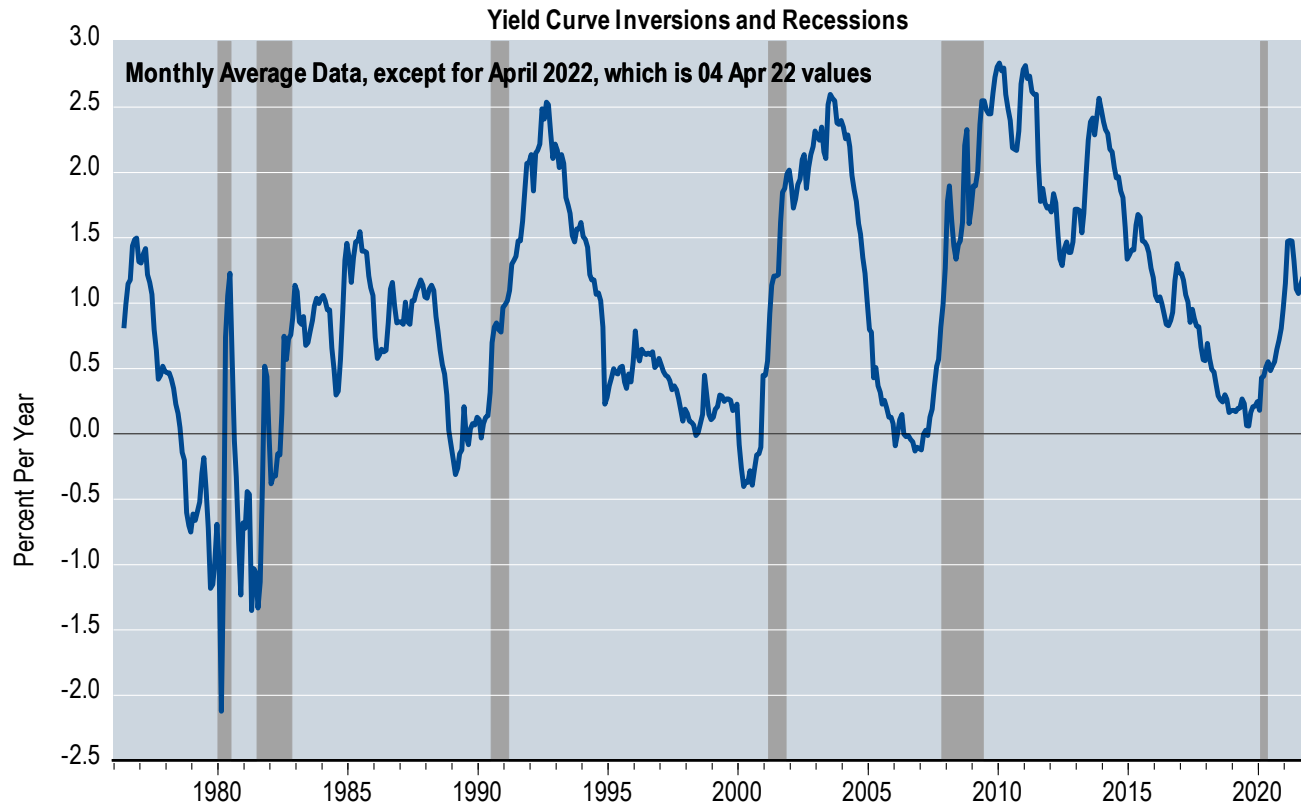


Source: Federal Reserve, Bloomberg. As of 31 Mar 22

<sup>1</sup>FOMC summary of economic projections

# Yield Curve Inversion

**“research by staff at the Fed says to look at the first 18 months of the yield curve ... because if it's inverted that means the Fed's going to cut because the economy is weak.” – Chair Powell, March 21, 2022**



Source: Federal Reserve. As of 04 Apr 22

Note: Shaded areas are recessions

**“I am attentive to signals from the yield curve at different horizons and from other data that might suggest increased downside risks to activity.” – Gov. Brainard, April 5, 2022**

Source: Bloomberg, As of 31 Mar 22

# Not So Fast, Global Economy!

After a rapid bounce, growth is slowing due to lower real disposable income. Downside risks are higher in Europe.

Global Growth (% Change in GDP year-on-year)									
	IMF World Economic Outlook (Jan 2022 Update)						Western Asset		IMF Long-Run
	Actual		Projections		Difference from Oct 2021 WEO Edition		Projections*		Potential
	2020	2021	2022	2023	2022	2023	2022	2023	Growth
<b>World Output</b>	<b>-3.1</b>	<b>5.9</b>	<b>4.4</b>	<b>3.8</b>	<b>-0.5</b>	<b>0.2</b>	<b>4.0</b>	<b>3.9</b>	<b>3.3</b>
<b>Advanced Economies</b>	<b>-4.5</b>	<b>5.2</b>	<b>3.9</b>	<b>2.6</b>	<b>-0.6</b>	<b>0.4</b>	<b>2.8</b>	<b>2.6</b>	<b>1.6</b>
United States	-3.4	5.6	4.0	2.6	-1.2	0.4	2.3	3.0	1.7
Euro Area	-6.4	5.2	3.9	2.5	-0.4	0.5	3.2	2.7	1.4
Germany	-4.6	2.7	3.8	2.5	-0.8	0.9	3.0	3.2	1.1
France	-8.0	6.7	3.5	1.8	-0.4	0.0	3.3	2.1	1.4
Italy	-8.9	6.2	3.8	2.2	-0.4	0.6	3.3	2.4	1.0
United Kingdom	-9.4	7.2	4.7	2.3	-0.3	0.4	4.2	1.3	1.5
Japan	-4.5	1.6	3.3	1.8	0.1	0.4	3.0	1.5	0.5
<b>Emerging &amp; Developing Markets</b>	<b>-2.0</b>	<b>6.5</b>	<b>4.8</b>	<b>4.7</b>	<b>-0.3</b>	<b>0.1</b>	<b>4.8</b>	<b>4.8</b>	<b>4.4</b>
China	2.3	8.1	4.8	5.2	-0.8	-0.1	4.9	5.4	4.9

Source: IMF, Western Asset. As of 31 Jan 21. Western Asset Projections as of 10 Mar 22.

\*The above reflects current opinions of Western Asset.

# ECB: Faster Tapering, But Need for Rate Hikes Less Clear (For Now)

- A stagflationary shock does not mean stagflation
- The ECB is more worried about the inflation profile drifting higher than the growth profile drifting lower ... for now
- Survey-based inflation expectations have essentially converged to target
- Asset Purchase tapering accelerated, likely to end in Q3
- Rate hikes no longer linked to end of asset purchases, but possible in 2022
- As macro picture keeps deteriorating compared to the ECB's baseline, policy uncertainty increases – but strong bias to end asset purchases

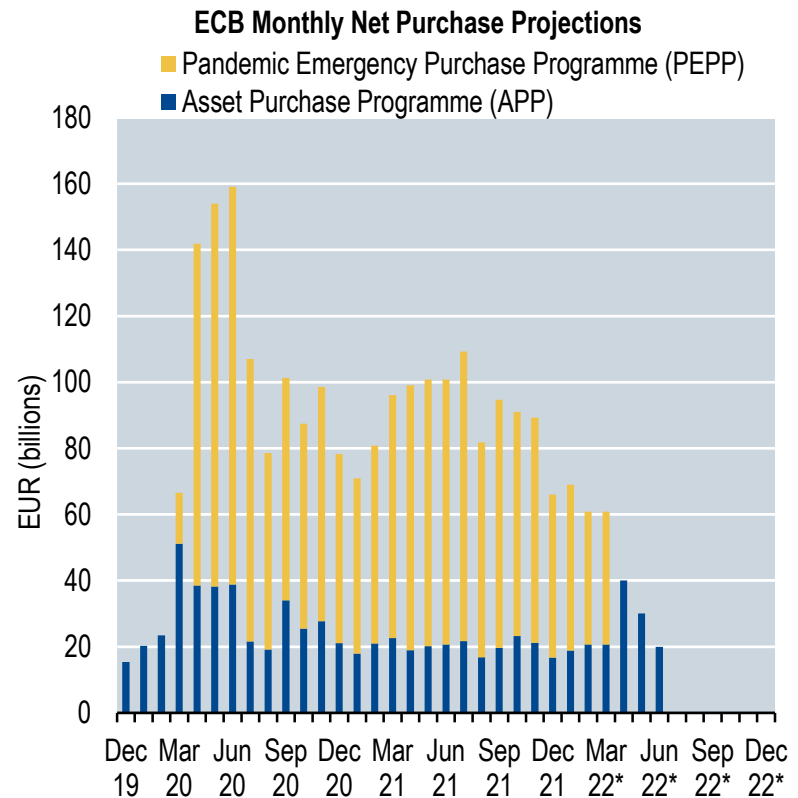


Source: ECB, Haver, Bloomberg. As of 28 Feb 22.

Long-Term is defined by the ECB as "four calendar years ahead in the Q1 and Q2 rounds and five calendar years ahead in the Q3 and Q4 rounds"

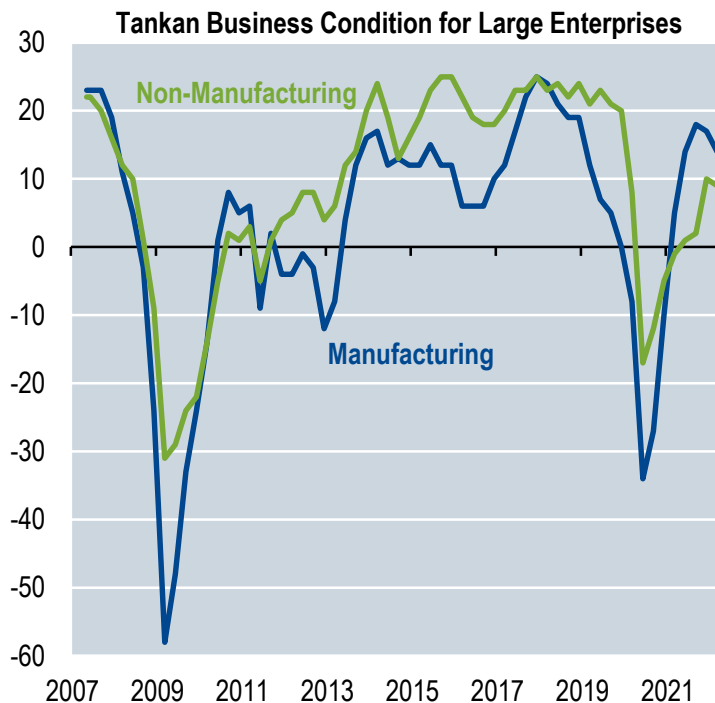
5Y-5Y inflation swap is latest observations from 31 Dec 21.

SPF = ECB Survey of Professional Forecasters



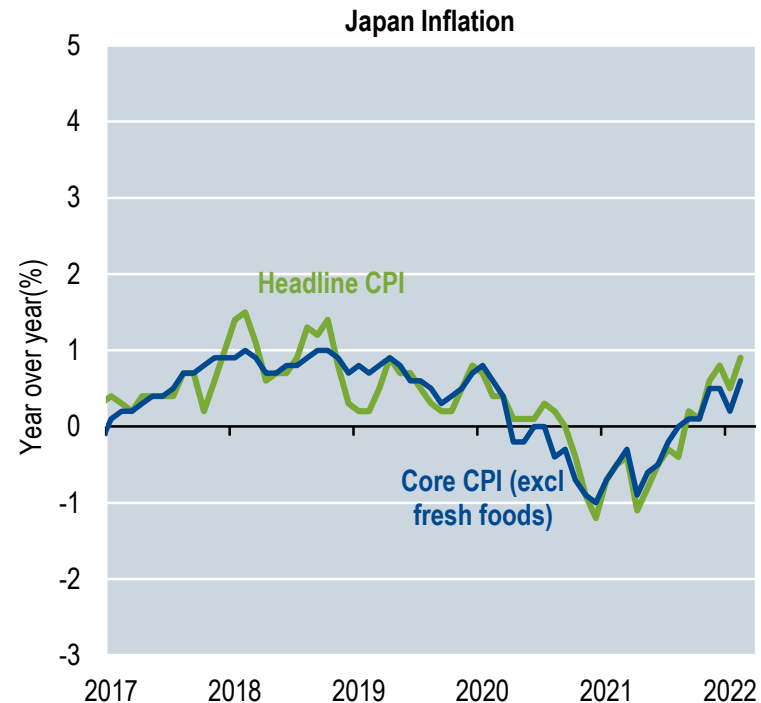
\*Western Asset projections which are based on the ECB forward guidance and Western Asset's assumed APP purchase rate in 2H22.

Source: ECB, Western Asset. As of 28 Feb 22



Source: Bloomberg, Western Asset. As of 31 Mar 22

- BoJ Tankan survey: corporations' sentiment moderated in March while it remained elevated.



Source: Datastream, Western Asset. As of 28 Feb 22

- The Bank of Japan will likely maintain the current monetary accommodation unlike other central banks in developed markets. The Bank will continue to place more focus on growth as long as inflationary pressures remain relatively low with the Japanese economy negatively impacted from worsening terms of trade due to higher energy prices on top of the recently weaker Japanese yen



## Zero Covid policy

## Regulatory crackdown

- Mitigate systemic risks (property sector)
- Align private sector party goals

## US position

- Biden administration similar to Trump – Friction a permanent feature of relationship

## Russia connection

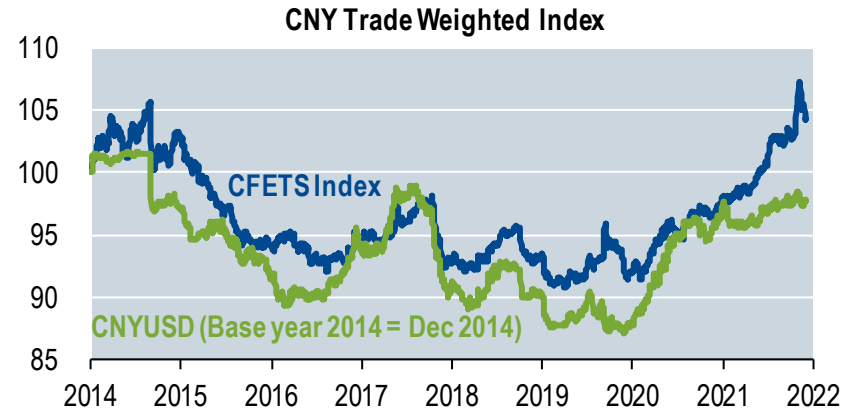
- Xi + Putin, abstained on vote to condemn invasion, willingness to help Russia economically/militarily

# China Outlook: Policy Loosening Amidst Cyclical Soft Patch

Leading indicators have moderated from elevated levels, but policy stimulus are in place to mitigate the fallout from omicron variant and regulatory crackdowns. Underpinned by resilience in its external accounts, China maintains systemic control.



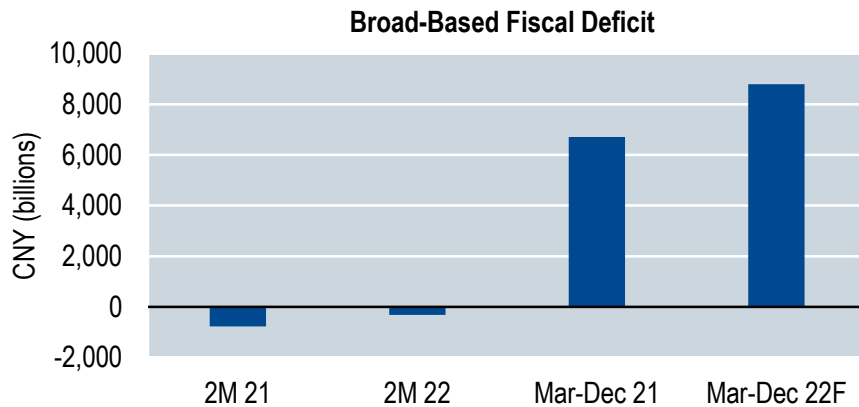
Source: Bloomberg. As of 31 Mar 22



Source: Bloomberg. As of 31 Mar 22

Past performance is not indicative of future results.

CNY: Chinese Yuan Renminbi; CFETS: China Foreign Exchange Trading System



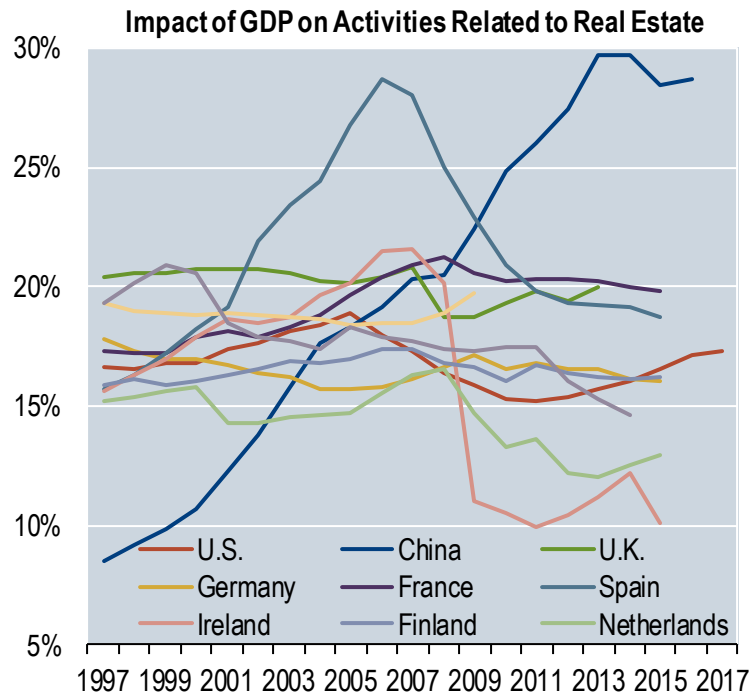
Source: Standard Chartered

Based on our calculation following widely accepted fiscal accounting, covering general public and government funds budget; negative value = budget surplus. 2021 numbers are based on actual implementation, 2022F assumes budget.



Source: Bloomberg, As of 31 Mar 22

# A Slowing in Real Estate Activity Will Weigh on Chinese Growth



Source: Rogoff, K, and Y Yang (2021), "Has China's Housing Production Peaked?"

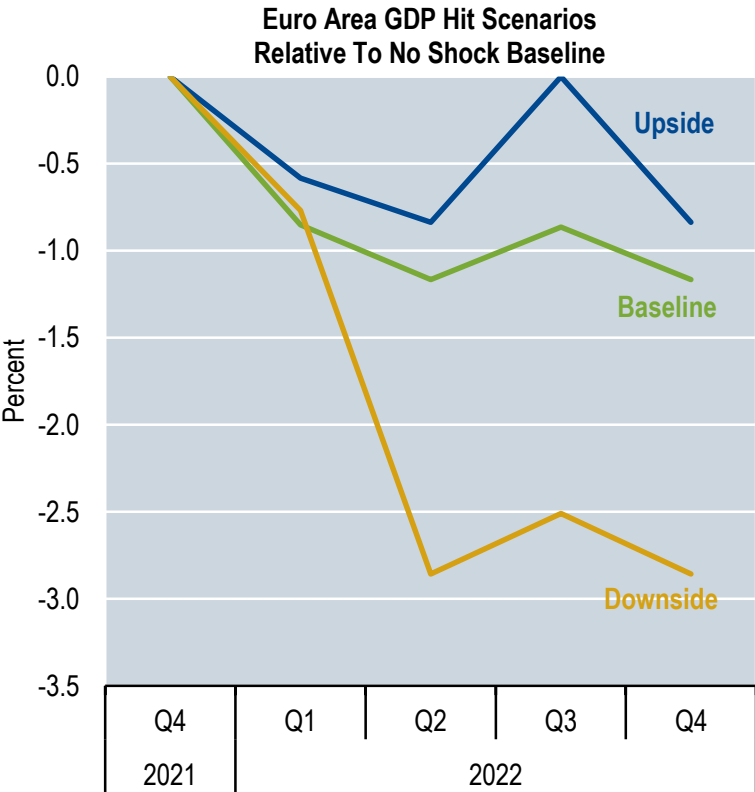


Source: CEIC, Morgan Stanley. As of 28 Sep 21  
<sup>1</sup>As of 31 Dec 19

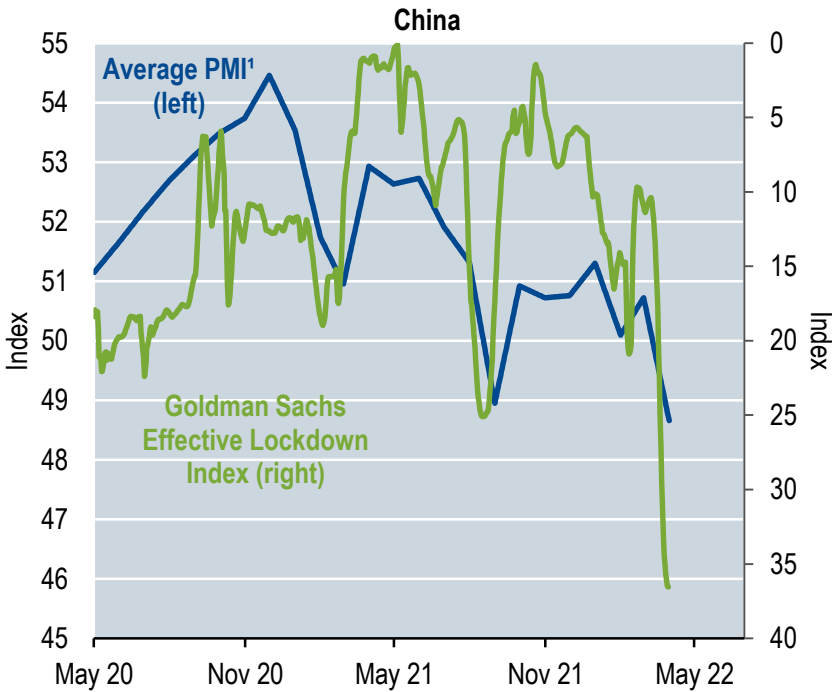
Real estate volatility and lingering pandemic vagaries pose cyclical growth risks...

... But significant scope for policy accommodation to cushion the downdraft

# European and Chinese Growth May Be Vulnerable to Downside Risks



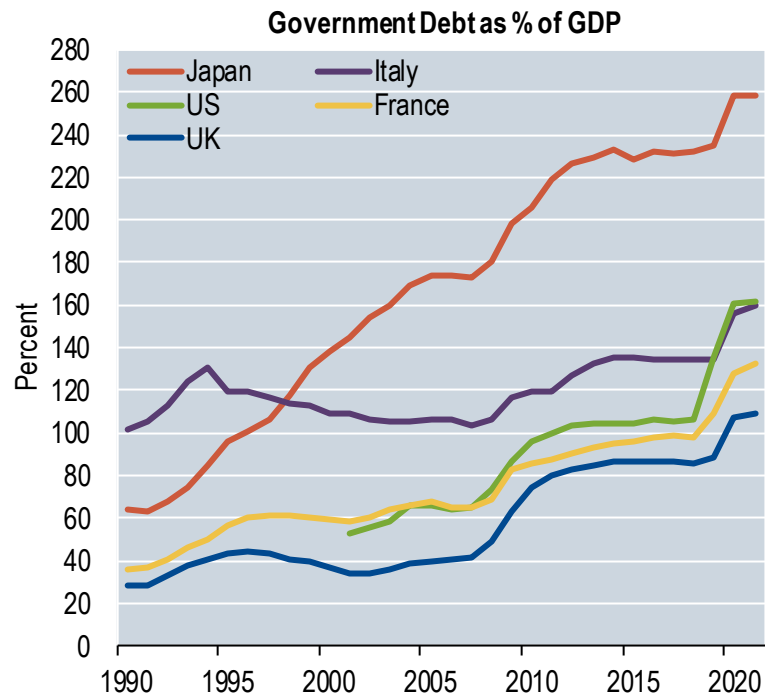
Source: Goldman Sachs Global Investment Research



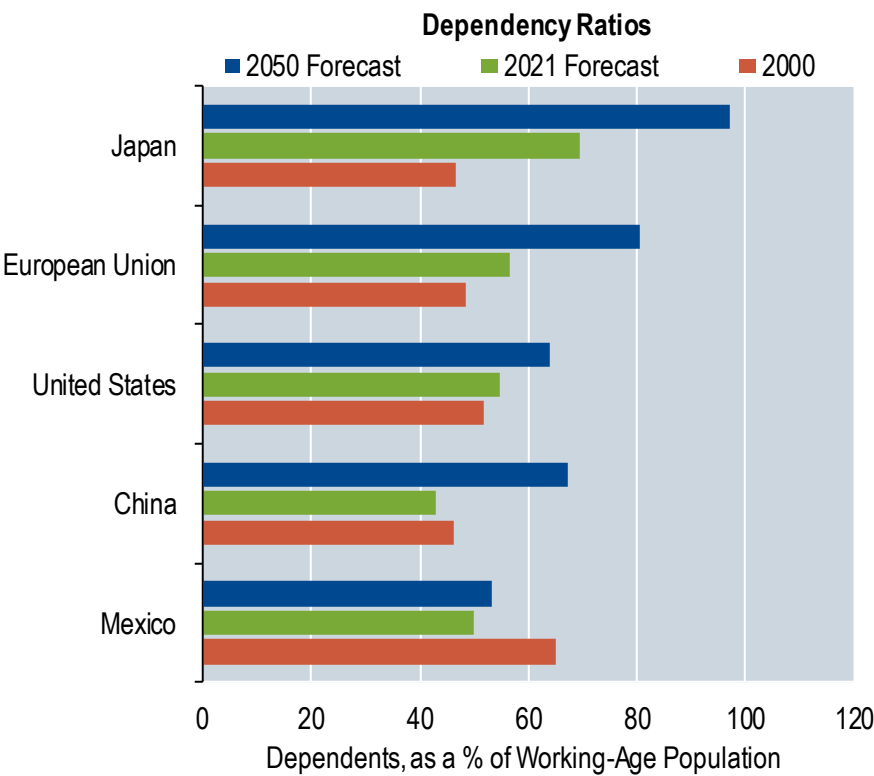
Source: Haver Analytics, Goldman Sachs Global Investment Research. As of 31 Mar 22

<sup>1</sup>Average of NBS Services, NBS Manufacturing, and Markit/Caixin Manufacturing PMI surveys.

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

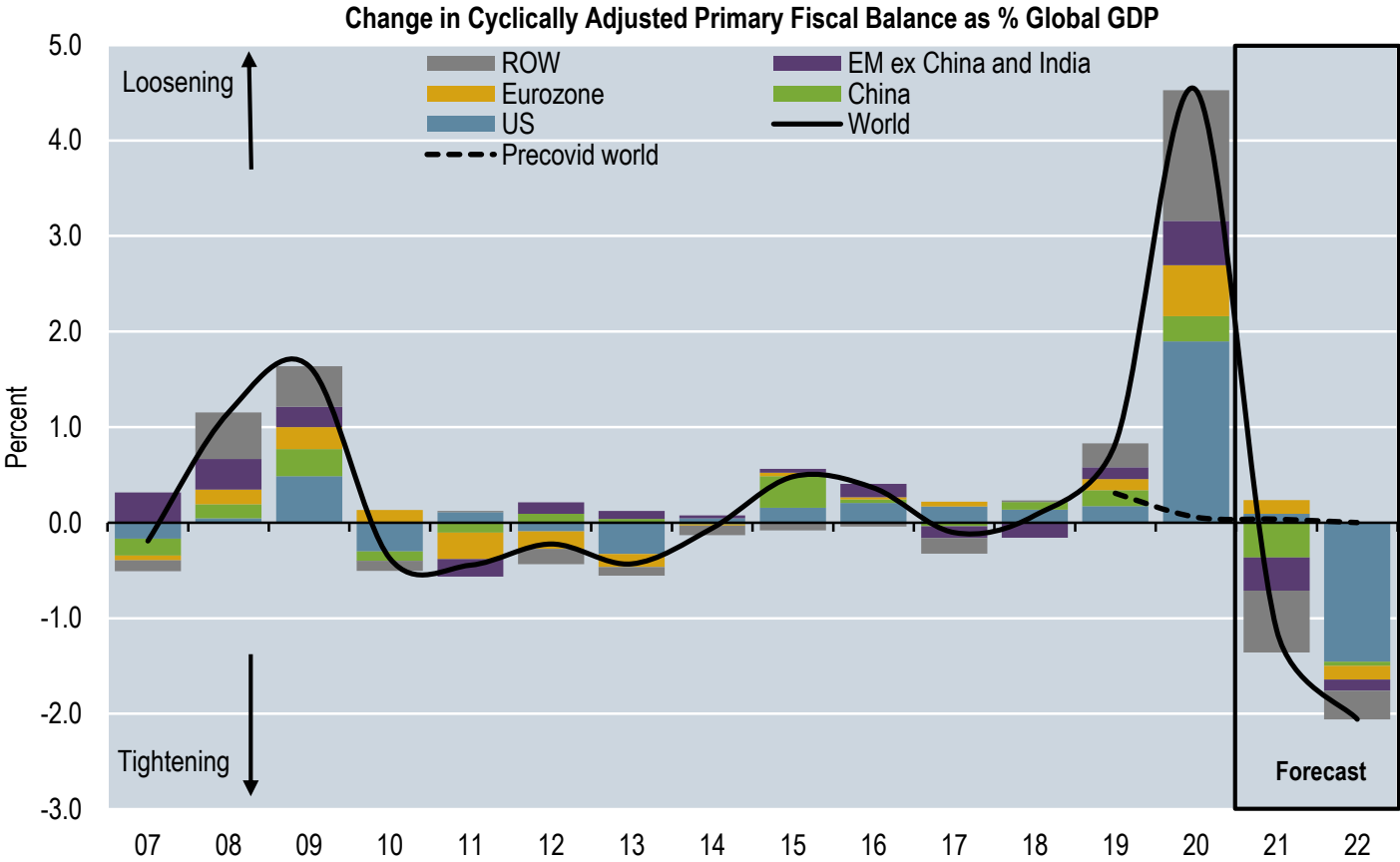


Source: IMF, Organisation for Economic Co-operation and Development (OECD).  
As of 31 Mar 21



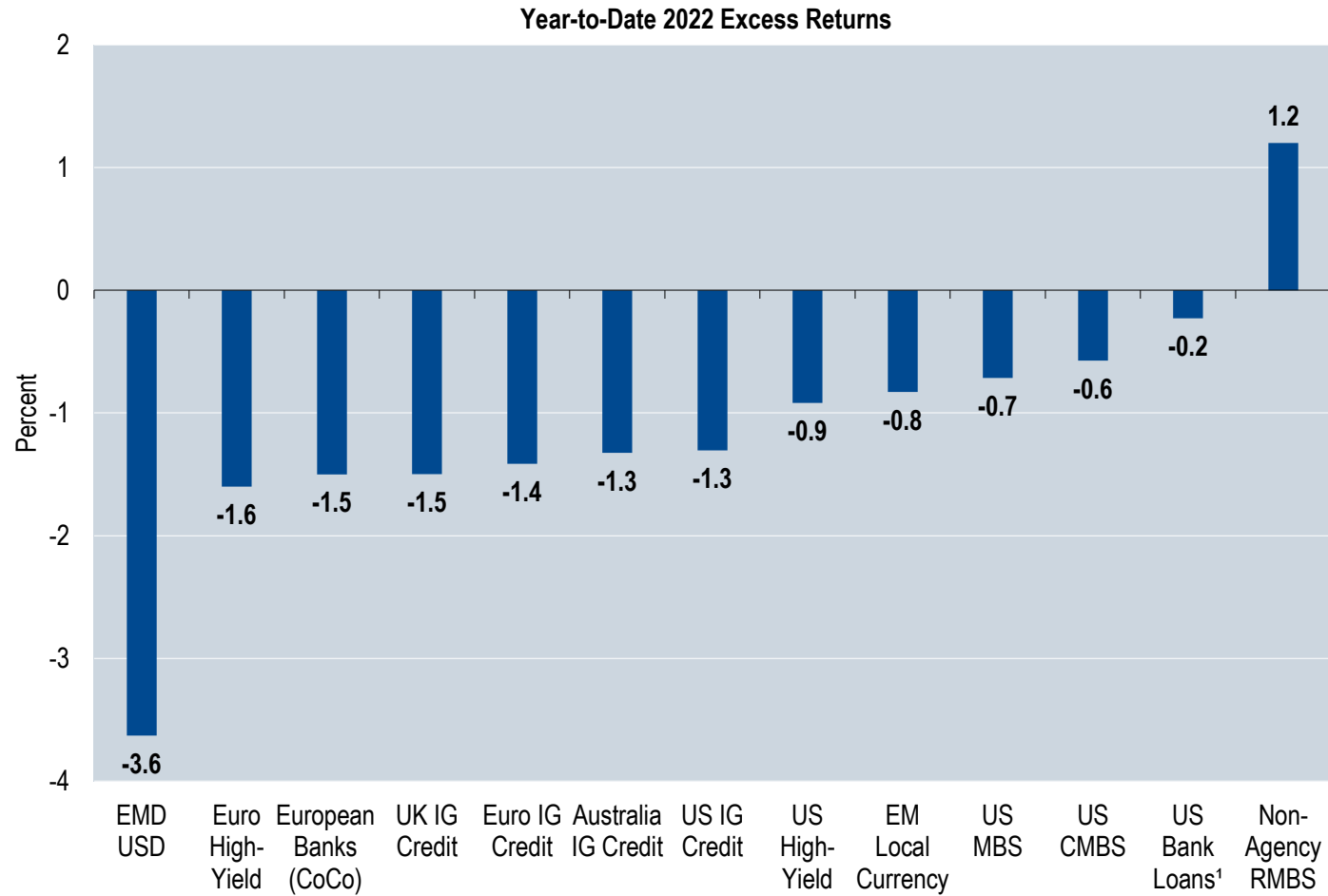
Source: World Bank. As of 15 Sep 21

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



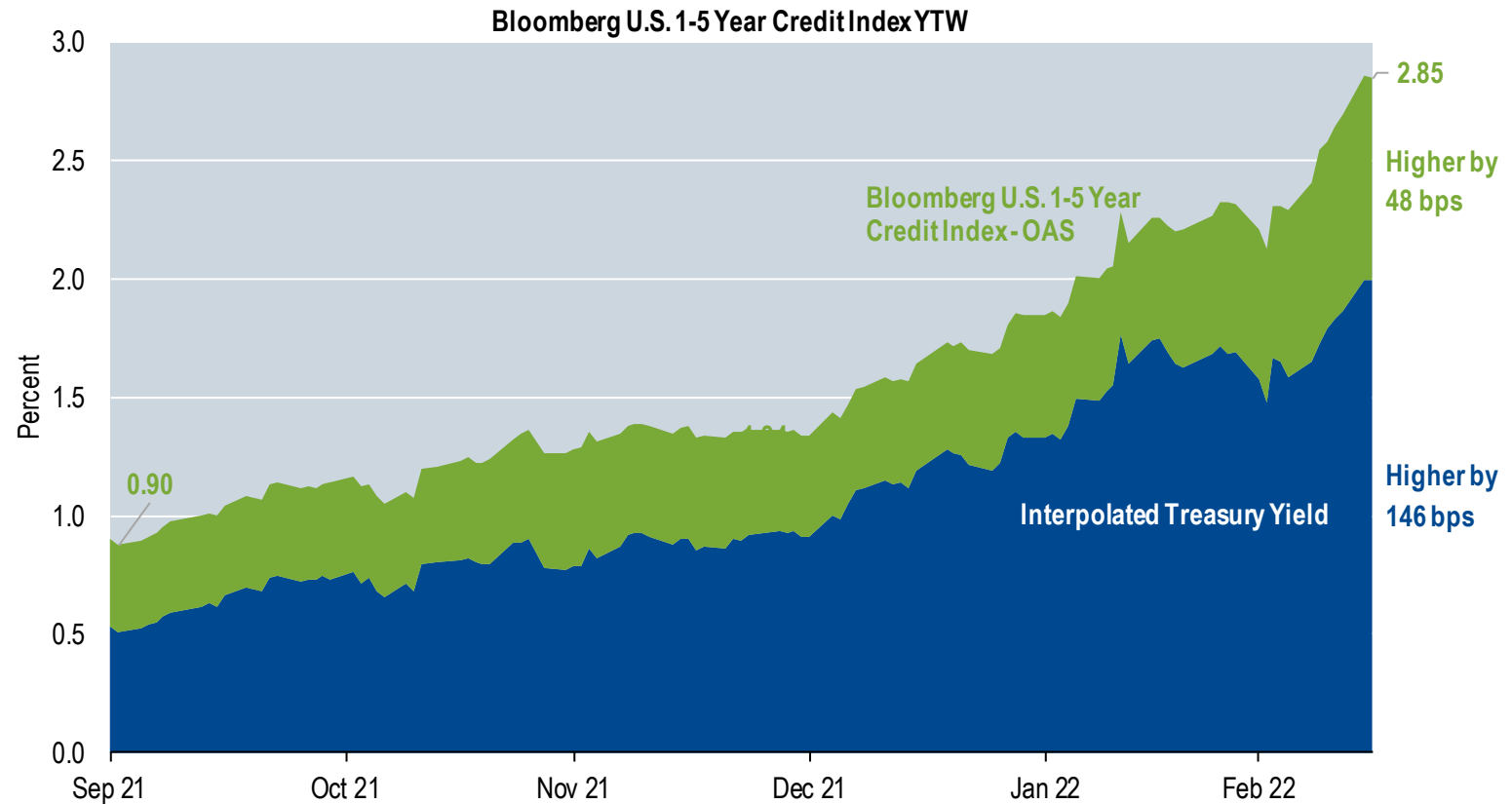
Source: UBS, Haver, European Commission, CBO. As of 06 April 21

# Spread Sector Excess Returns



Source: Bloomberg, Citi, J.P. Morgan, S&P Global Market Intelligence, a division of S&P Global Inc, Western Asset. <sup>1</sup>S&P/LSTA Leveraged Loan Total Return Index excess return vs. 3-Month LIBOR. As of 31 Mar 22  
Past performance is not a reliable indicator of future results.

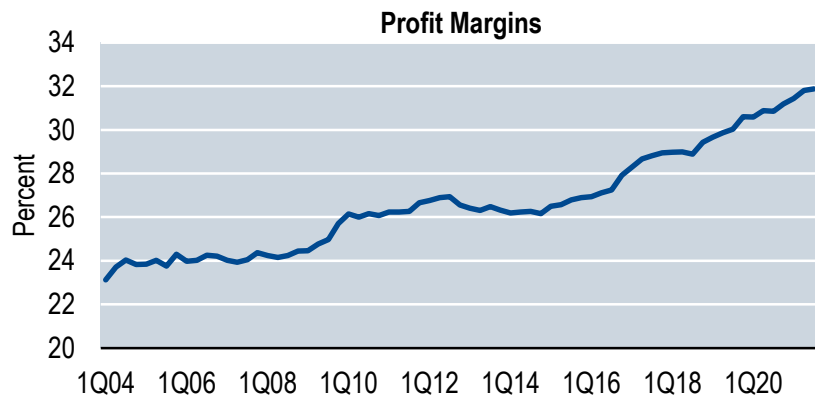
# Valuations Improved - Significant Increase In Both Treasury Yields and Credit Spreads



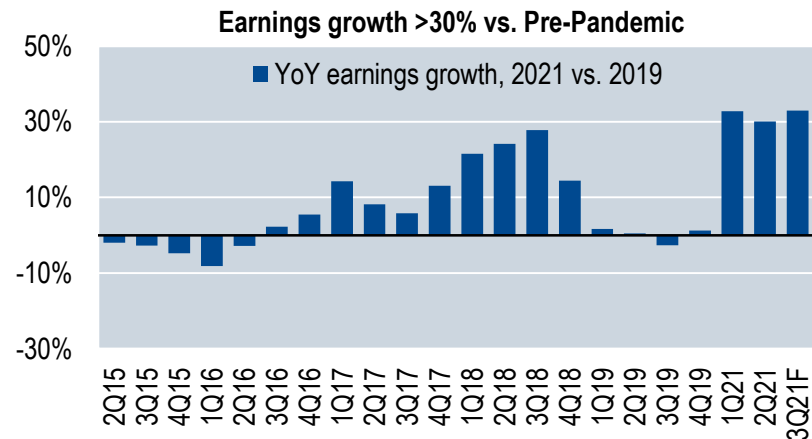
Source: Bloomberg. As of 15 Mar 22



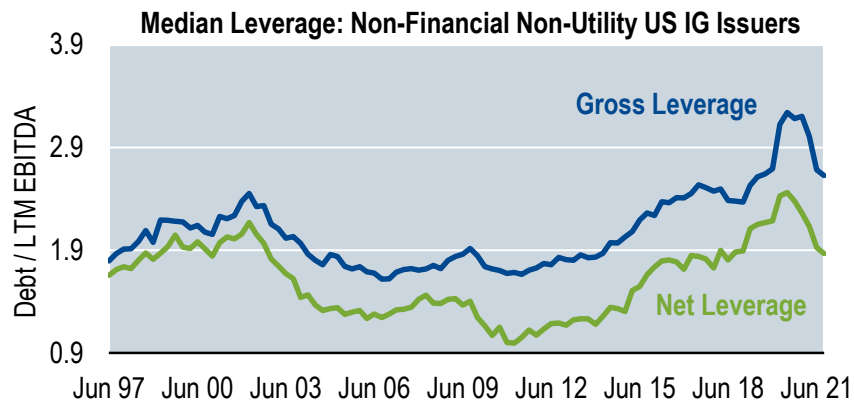
# Cash Flow and Debt Metrics Support Investment-Grade Credit



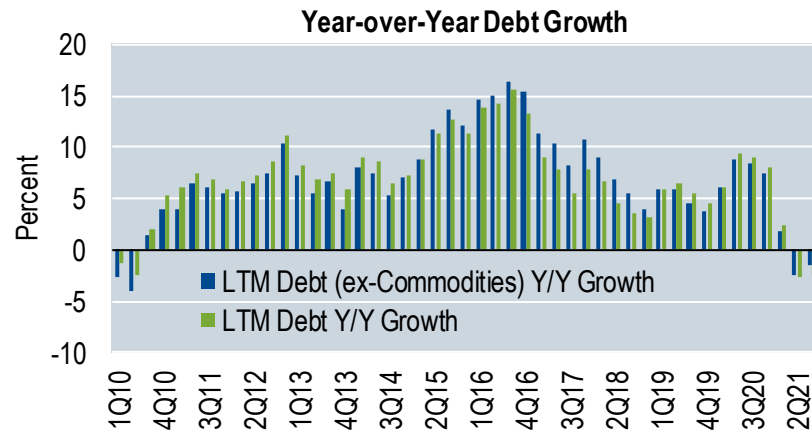
~180 Non-Financial Companies (JULI Based)  
Weighting based on amount of debt in the benchmark  
Source: J.P. Morgan. As of 30 Sep 21



Source: Factset, BofA Global Research\*. As of 31 Dec 21  
Note: based on medians for US investment grade non-financial non-utility issuers. Net debt is gross debt minus cash and marketable securities.



Source: BofA Global Research\*. As of 30 Sep 21



Source: J.P. Morgan. As of 30 Sep 21

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# Investment-Grade Energy – Strong Relative Performance So Far in 2022

## Since 2016, IG managements have

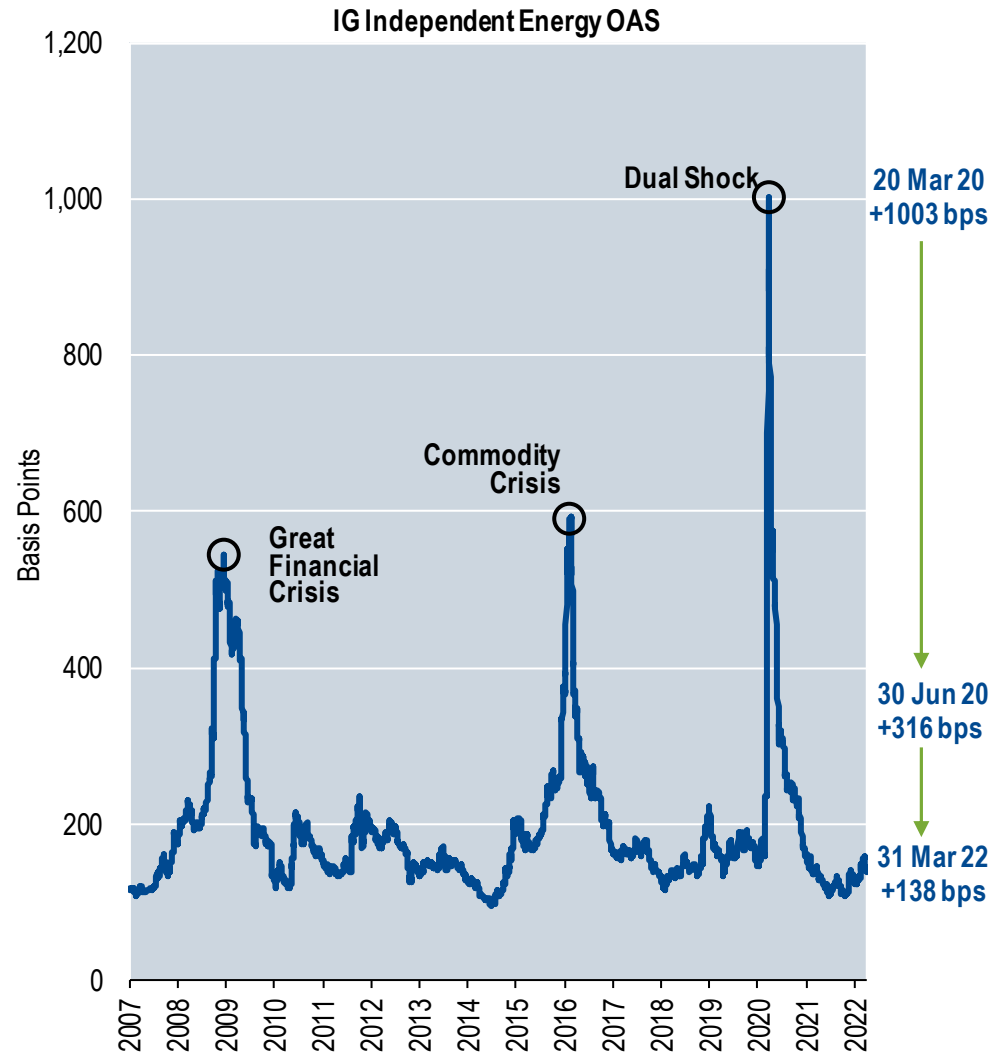
- Acted conservatively
- Lowered cost structures
- Improved cash flow
- Delevered balance sheets
- Extended maturity runways
- Improved liquidity

## Conservatism Prevails

- Capital budgets remain conservative
- Shareholder returns from excess free cash flow

## Conclusion

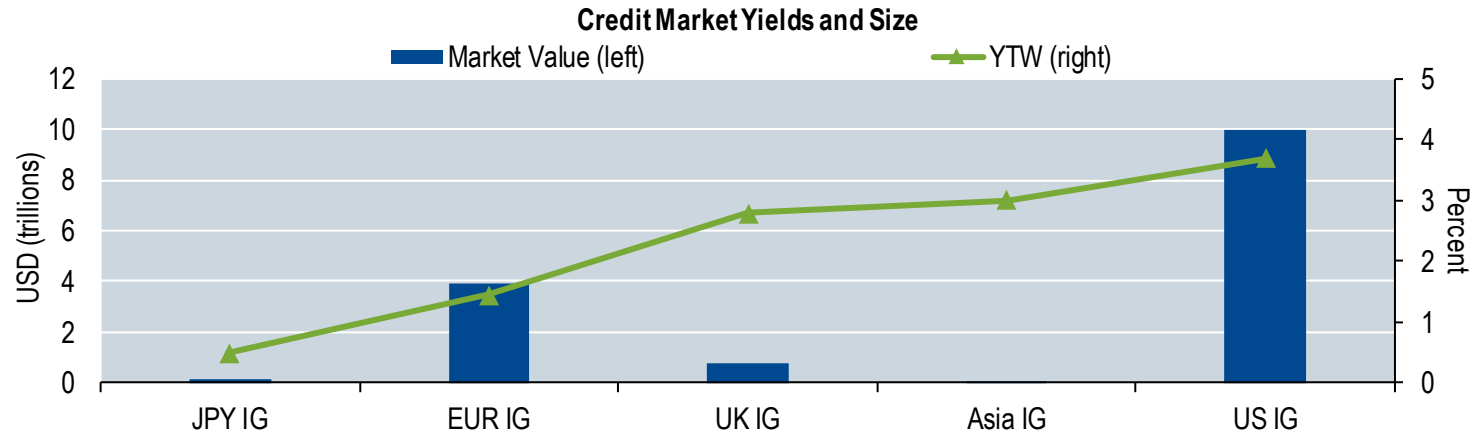
- Focus continues to be on cost reduction and greater capital discipline even in the face of higher commodity prices
- Seeing ‘bottlenecks’ in the energy space also
- Under-owned sector
- Continue to hold our overweight



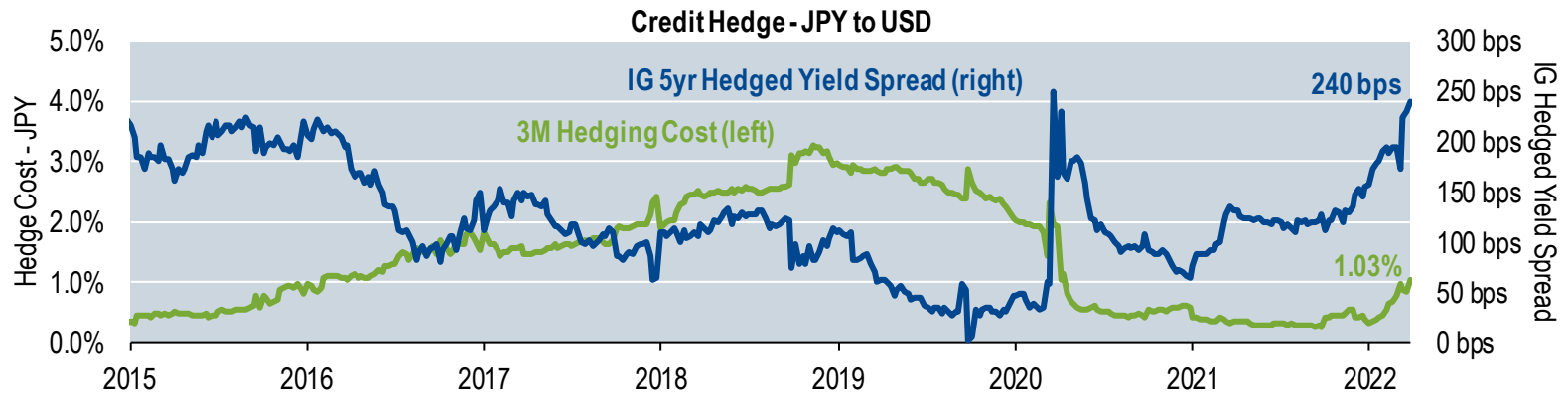
Source: Bloomberg. As of 31 Mar 22

# US Credit Markets Are Attractive to Global Investors

Good liquidity, higher yields and low hedging costs have increased global demand for US IG credit

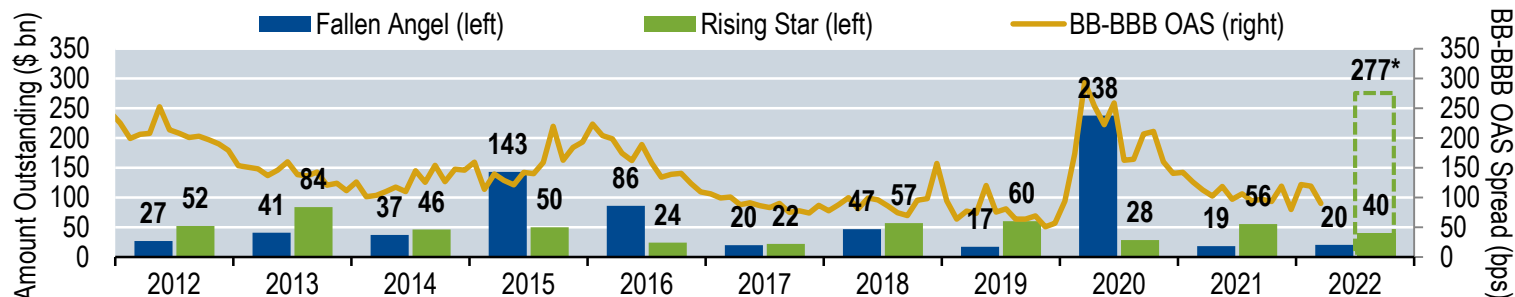


Source: Bloomberg. As of 28 Mar 22  
Bloomberg Global Credit Index by Currency



Source: Bloomberg. As of 25 Mar 22

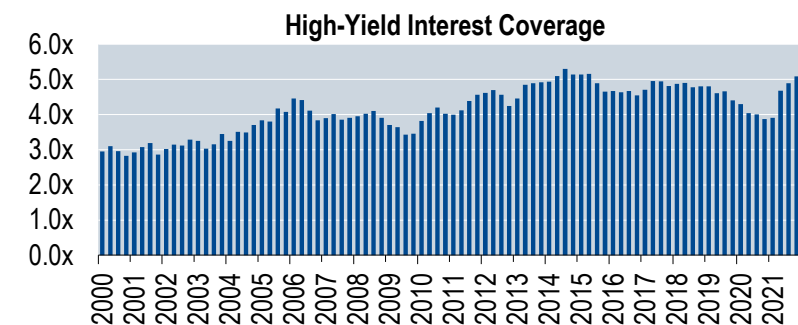
# US High-Yield Fallen Angels/Rising Stars and Credit Quality Improvement



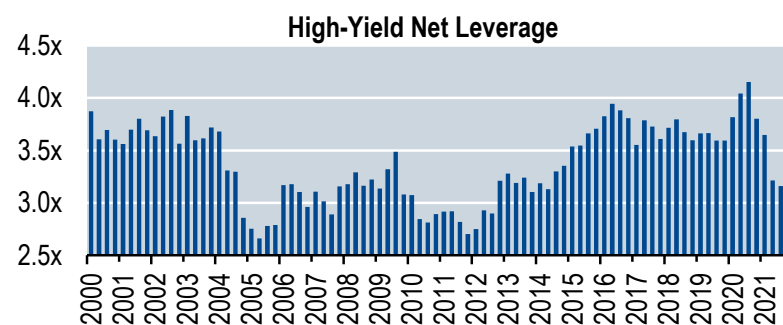
Source: J.P. Morgan, Moody's Investors Service; S&P. As of 31 Mar 22

\*12-18 month estimate

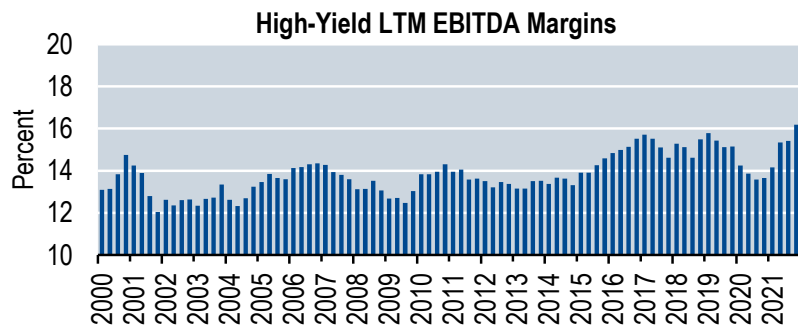
## High-Yield Financial Metrics Remain Strong Given US-Centric Nature



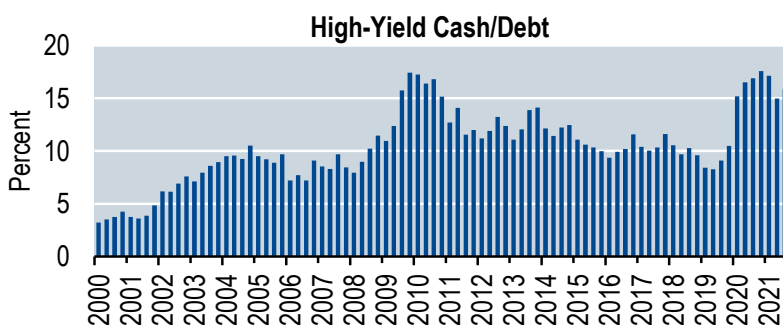
Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Dec 21



Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Dec 21

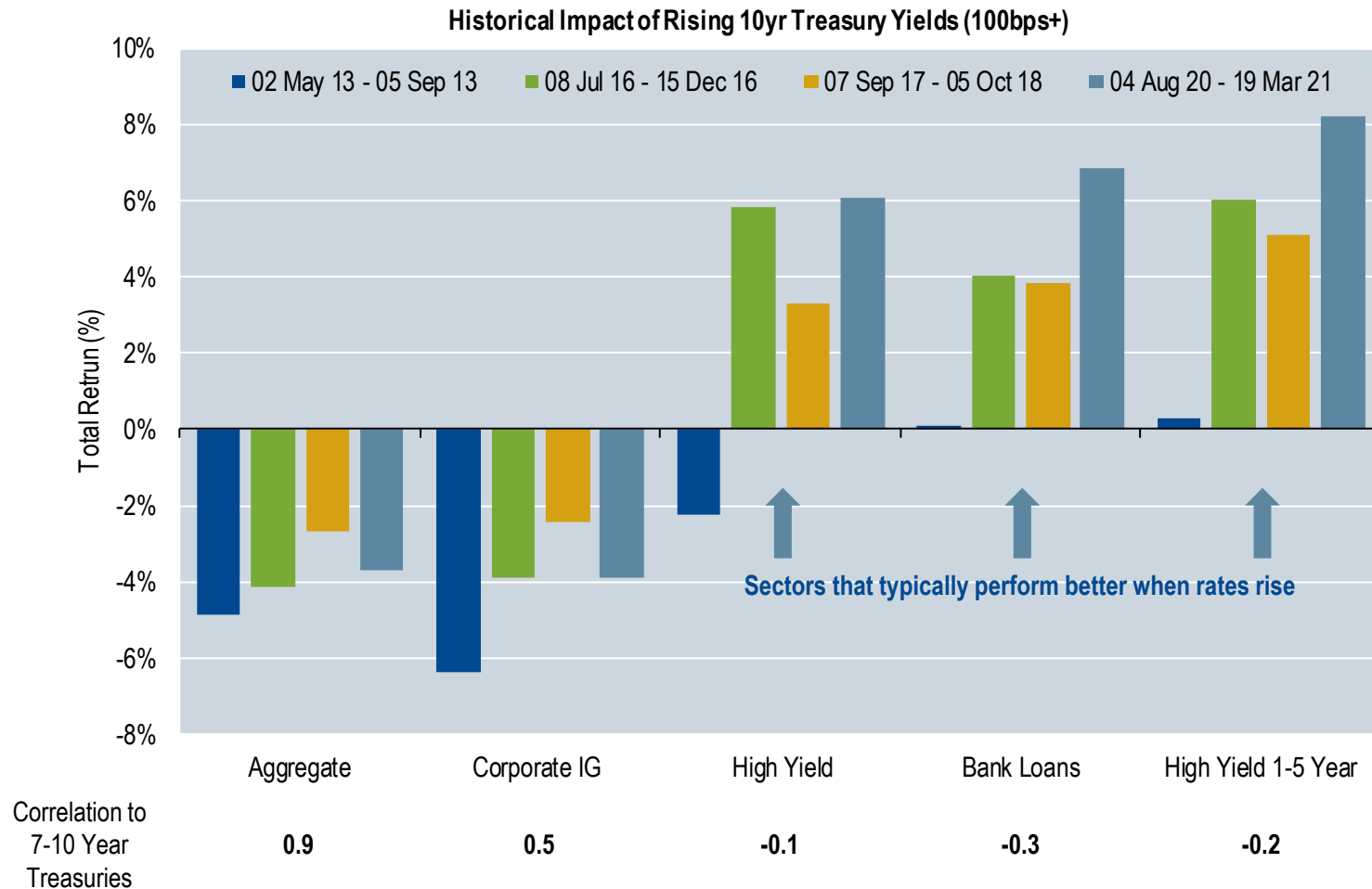


Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Dec 21



Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Dec 21

# Fed Hiking Cycles Historically a Supportive Environment for Shorter Duration Credit Asset Classes



Source: Bloomberg, S&P

Past performance not indicative of future results

Correlation measured monthly over 10 years as of 31 Dec 21

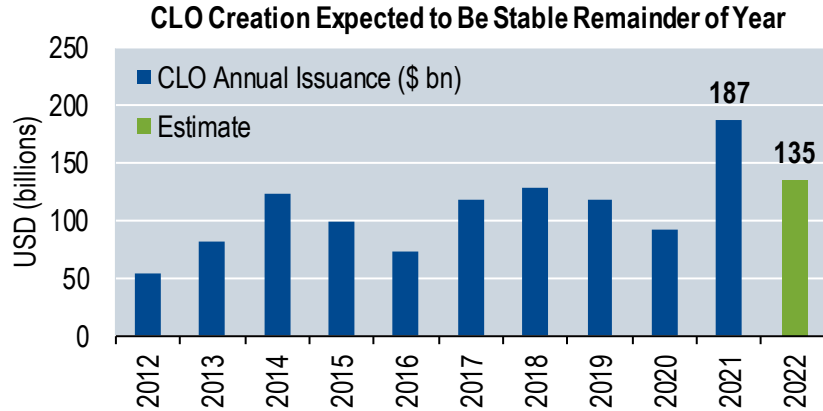
Over rising rate periods: 10yr US Treasury yield rose 1.37%, 1.24%, 1.19% and 1.17% in the 2013, 2016, 2017 and 2021 periods respectively

Aggregate: Bloomberg US Aggregate Index, Corporate IG: Bloomberg US Corporate IG Index, High Yield: Bloomberg US Corporate High Yield Index

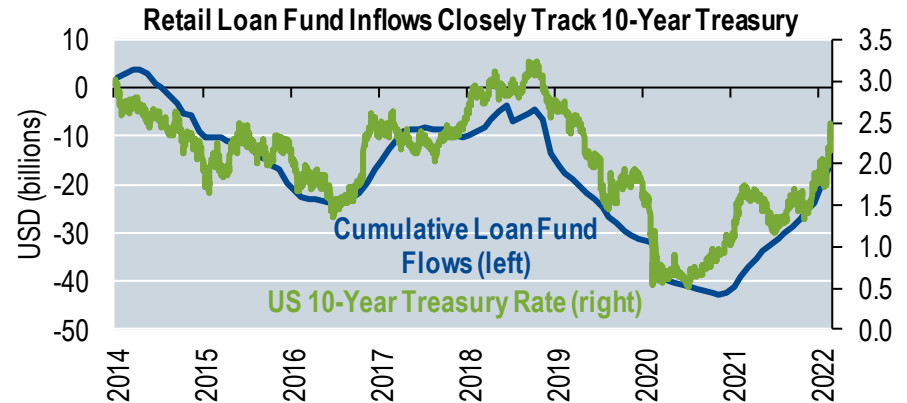
Bank Loans: S&P/LSTA Leveraged Loan Index, High Yield 1-5 Year: Bloomberg US High Yield 1-5 Year Cash Pay 2% Index

# Floating Rate Corporate Loans Remain Attractive in Current Market Conditions

Floating rate corporate loans will continue to see demand from retail investors looking for rising rate protection and a stable base of CLO investors

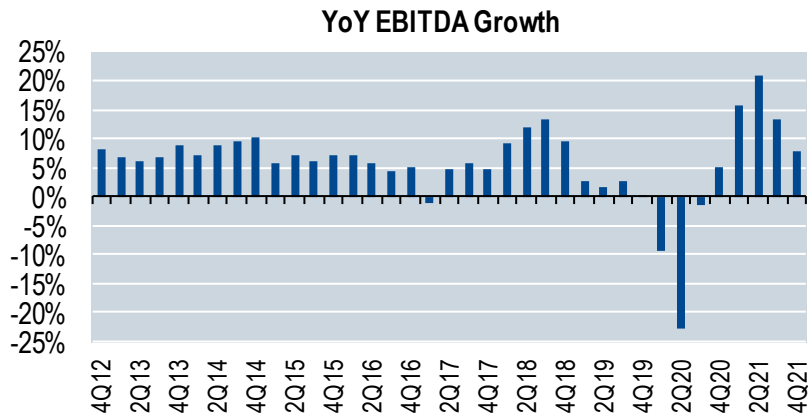


Source: Credit Suisse. As of 31 Mar 22

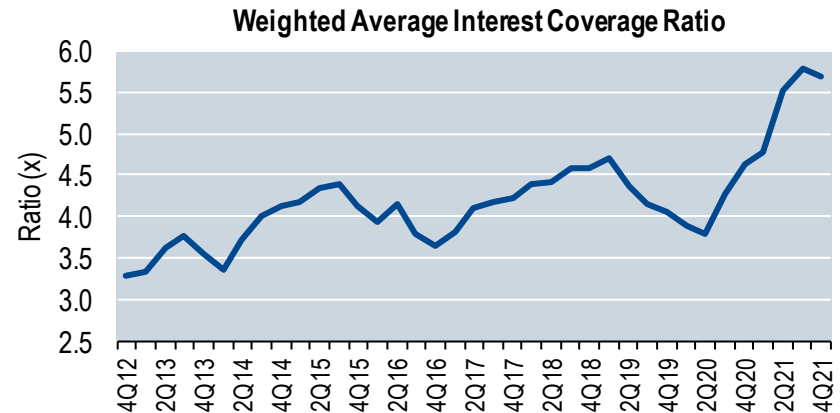


Source: Bloomberg, Lipper. As of 28 Feb 22

Underlying company fundamentals of loan issuers remain strong with ample cash flow cushion to sustain increased interest burden from higher rates



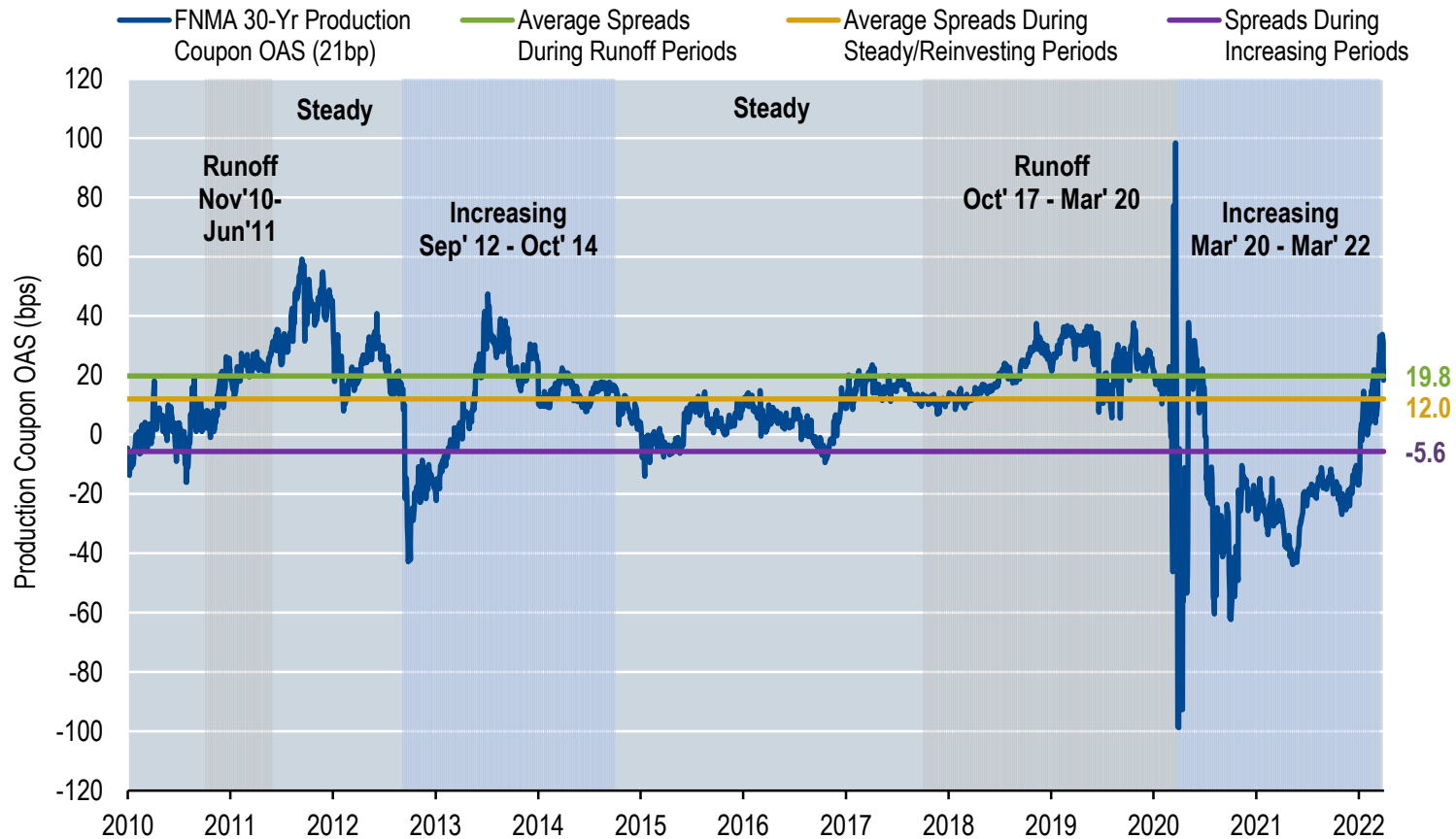
Source: S&P/LSTA, LCD. As of 31 Dec 21



Source: S&P/LSTA, LCD. As of 31 Dec 21

# Agency Mortgage Spreads During QE/QT Cycles Since 2010

- Mortgage spreads have widened significantly year to date as Fed support diminished
- Expect continued headwinds in the sector depending on the timing and pace of runoff (QT) as Fed shifts to Reinvesting and Runoff Mode



Source: MS Research, Western Asset As of 31 Mar 22

# Mortgage Credit Offers Attractive Relative Value

- In spite of expectations for real estate prices to cool from record increases in 2021, market spreads are elevated with increased risk premiums
- Reemerging from COVID, lending stayed conservative and real estate markets remain well supported by long term fundamentals
- The mortgage team favors taking credit risk versus prepayment risk, favoring non-agency mortgage over agency mortgages

Spreads	Representative RMBS CRT Below IG	BAML RMBS Legacy Below IG	JP Morgan Non-Agency CMBS BBB	Bloomberg US IG Corporate	Bloomberg US High Yield
31 Jan 20	178	123	250	102	390
<b>25 Mar 22</b>	<b>387</b>	<b>160</b>	<b>335</b>	<b>121</b>	<b>342</b>
Difference Since 31 Jan 20	209	37	85	19	-48

Source: Bloomberg, J.P. Morgan, Bank of America., Western Asset. As of 25 Mar 22

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Past performance is not a reliable indicator of future results.



# Russia-Ukraine

## Assessing Risk and Contagion

### Big picture views

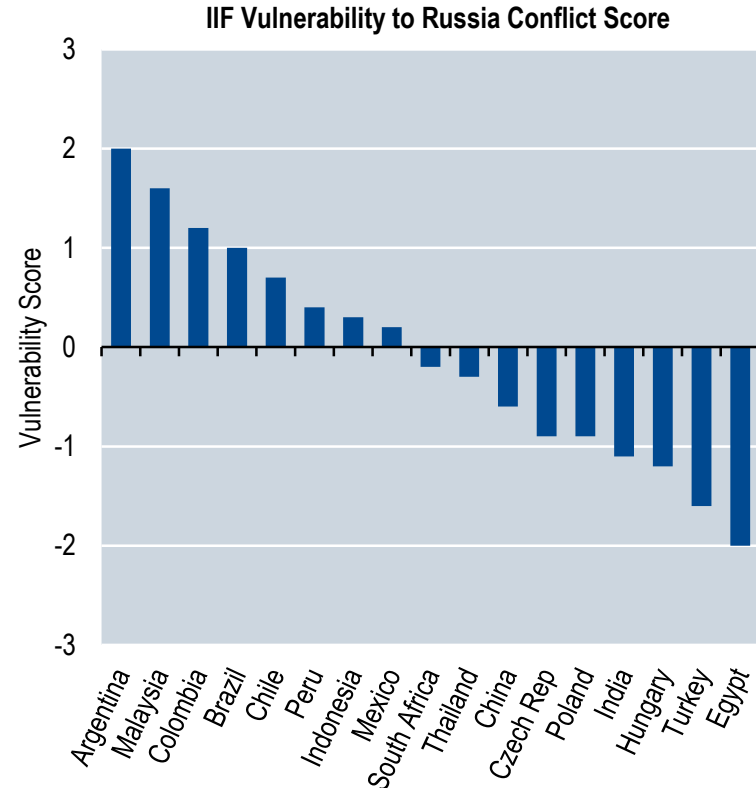
- Structural break between Russia and West
- West sanctions are further and faster than expected
- Slower global growth and higher inflation

### Contagion channels

- Higher commodity prices and confidence shock
- Financial contagion limited despite the size of Russia's economy

### Countries and credits to watch

- First-order impact low
- Eastern Europe - Growth hit due to energy and confidence shock
- Kazakhstan - Guilt by association / Lower growth but higher revenues and positive terms of trade shock
- Winners and losers - Commodity importers vs. exporters



Source: IIF. As of 10 Mar 22

## Russia-Ukraine conflict poses massive geopolitical uncertainty

- Elevates both inflation and downside growth risks

## Inflation remains challenging but should ease substantially during 2022

### Fixed-Income Outlook

- Covid continues to bedevil global populations
- US and global growth are decelerating from high levels
- Fed tightening will focus on making inflation a top priority
- Global fiscal stimulus will be sharply reduced

### Investment Implications

- Global growth has recently downshifted but should remain resilient, which continues to support the overweight of spread products
- The recovery of “reopening” sectors has been delayed, not derailed
- With the Fed committed to tightening, risk asset volatility should increase
- Longer term rates, while currently elevated, should subside



**Thank you.**

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