Western Asset

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July 7, 2022

Thank you for joining Western Asset's *3Q22 Market & Strategy Update* webcast featuring CIO Ken Leech.

The presentation will begin shortly.

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3Q22 Market & Strategy Update

July 7, 2022

Ken Leech
Chief Investment Officer

Second Half 2022 Outlook

Inflation remains challenging but should ease substantially during 2022

- Monetary policy tightening
- Fiscal policy tightening
- Supply bottlenecks easing
- Commodity price pressures easing

Fixed-Income Outlook

- Russia-Ukraine conflict poses massive geopolitical uncertainty
- 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

The above reflects current opinions of Western Asset and are subject to change with market conditions. As of 06 Jul 22

Western Asset Base Case

Inflation to moderate in H2 in most countries

Growth to weaken in H2 but no recession

Central banks won’t tighten policy by more than currently implied

What we need to see

- Survey and market-based inflation has moved lower and actual inflation should follow
- Hard data to decline but remain in expansion territory
- Policymakers to signal more measured tightening

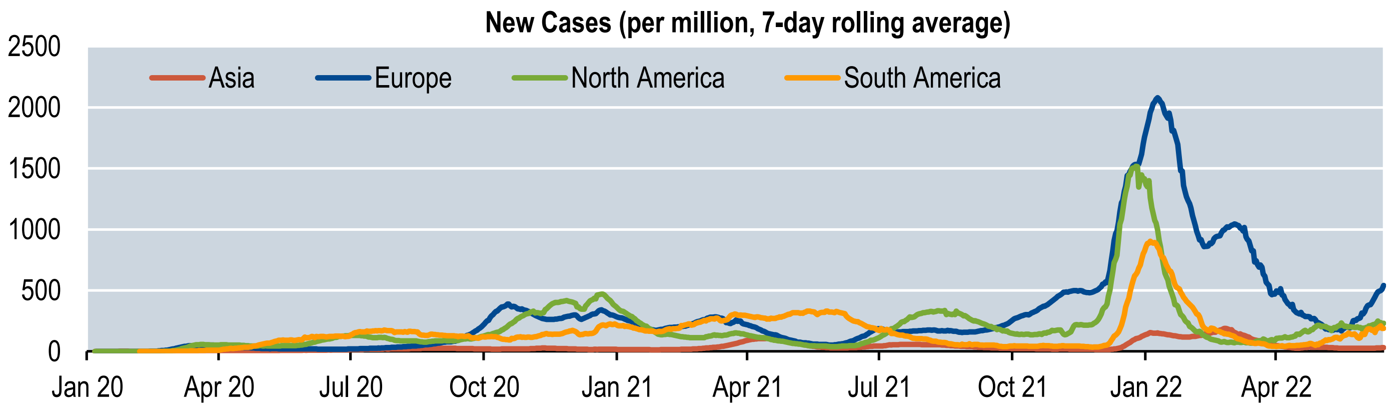
Risks

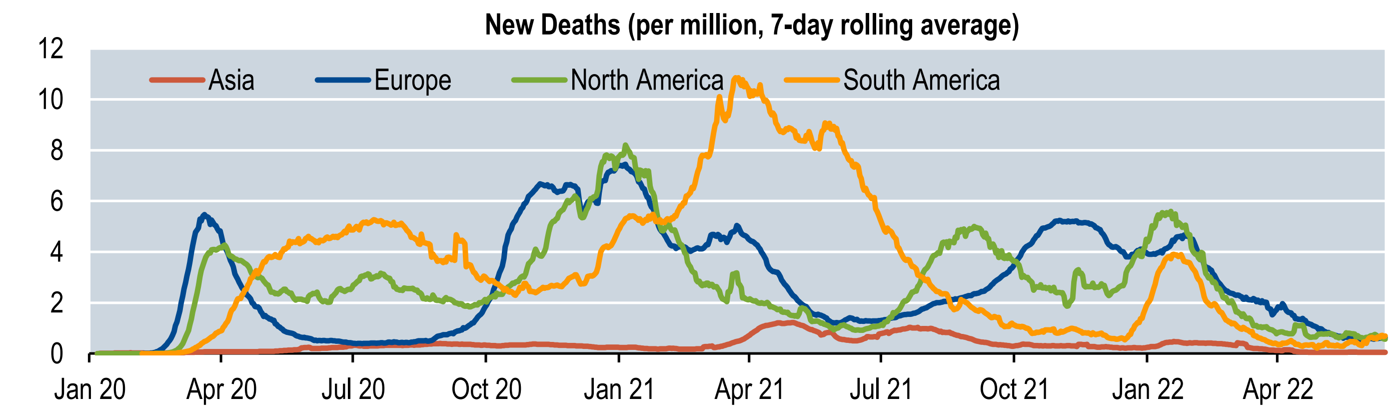
- Inflation to remain higher and stickier than we expect
- Too much tightening from central banks could lead to a contraction in growth

Market implications under WA base case

- DM yields to remain at or below current levels
- Credit spreads to tighten to reflect growth moderation

A One-in-a-Century Pandemic That Has Killed Over 6 Million People So Far





Source: Our World in Data. As of 05 Jul 22

Vaccinations have driven a decline in the death rates versus case rates over time

COVID-19 is transitioning from pandemic to endemic

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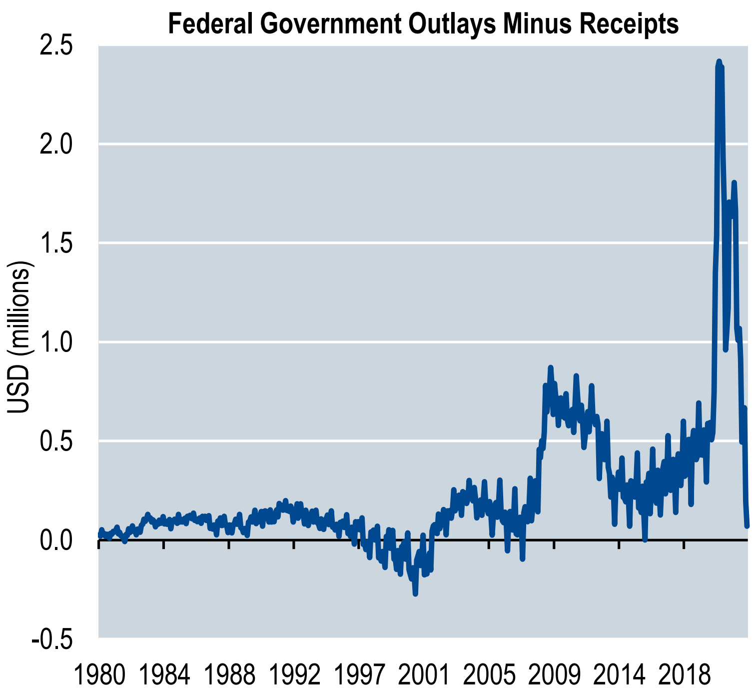
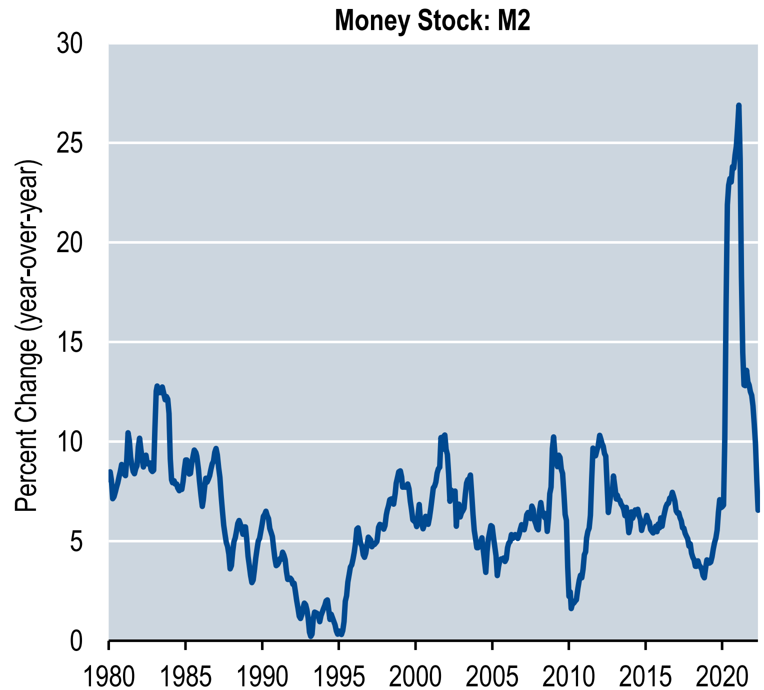
Pandemic Policy Extremes Have Ended

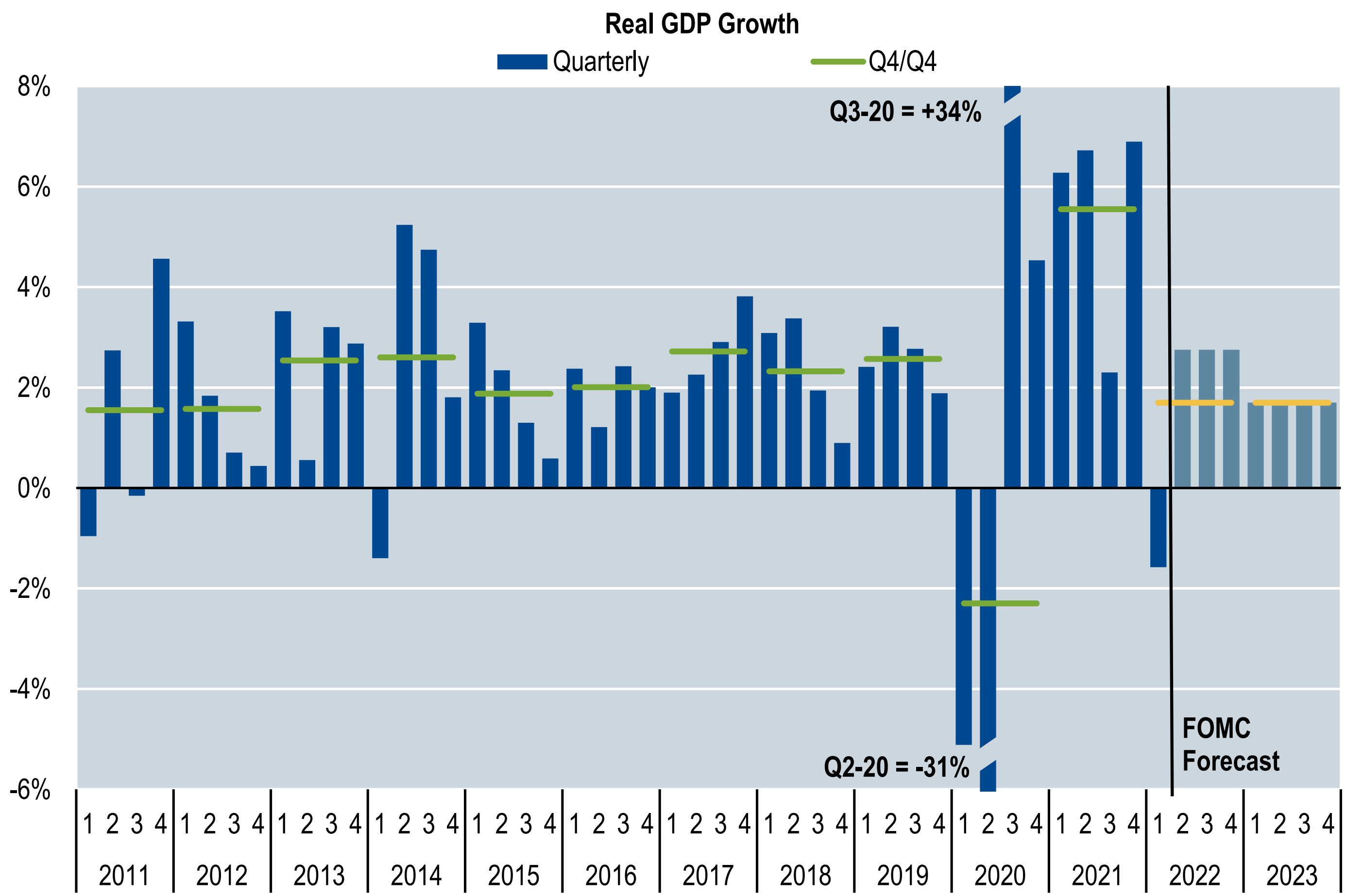


Source: Federal Reserve, Haver Analytics. As of 31 May 22
6-month trailing sum



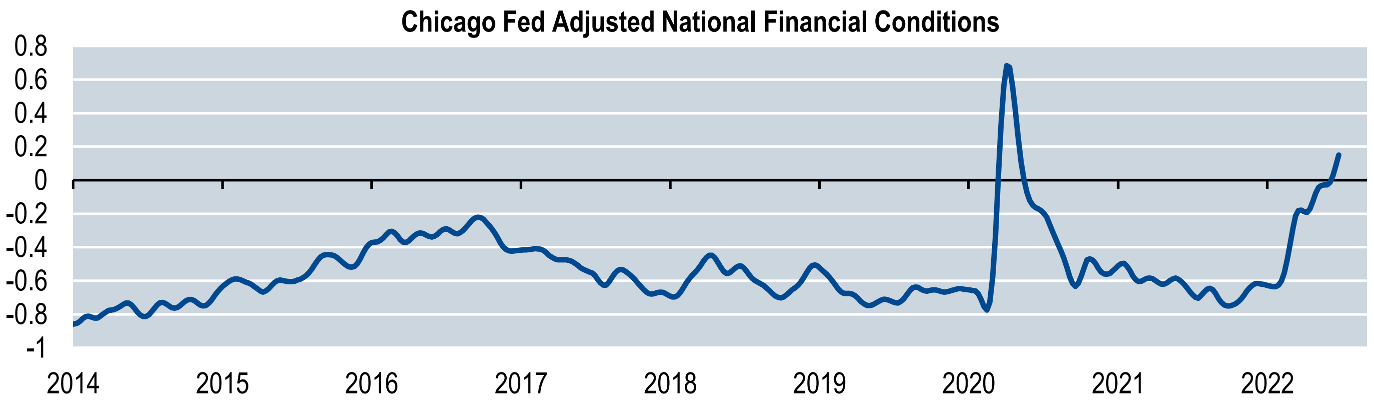
Source: US Treasury, Haver Analytics. As of 31 May 22
Seasonally adjusted

Period of Exceptional Growth Has Ended

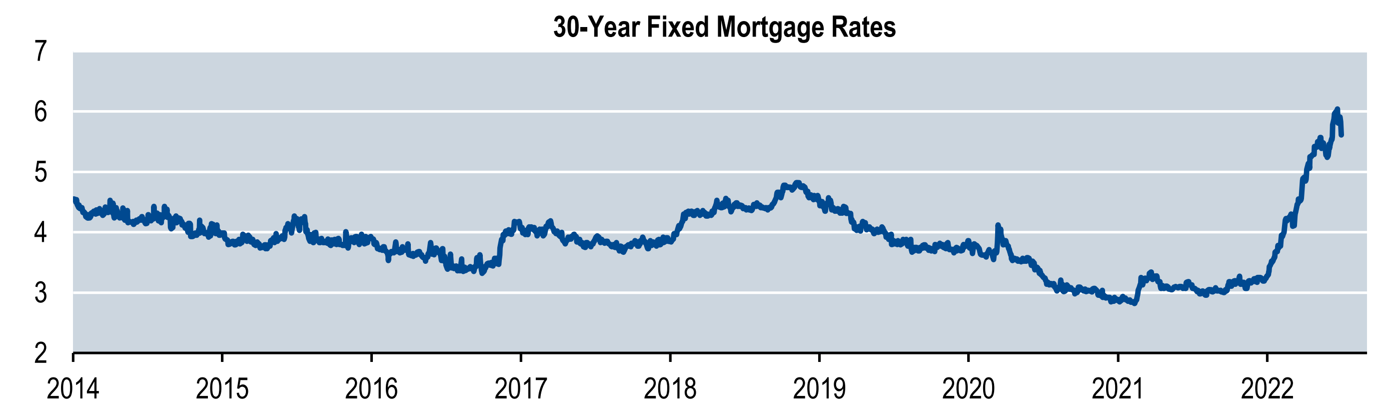


Source: Bureau of Economic Analysis, Federal Reserve. As of 16 Jun 22

Financial Conditions Have Tightened

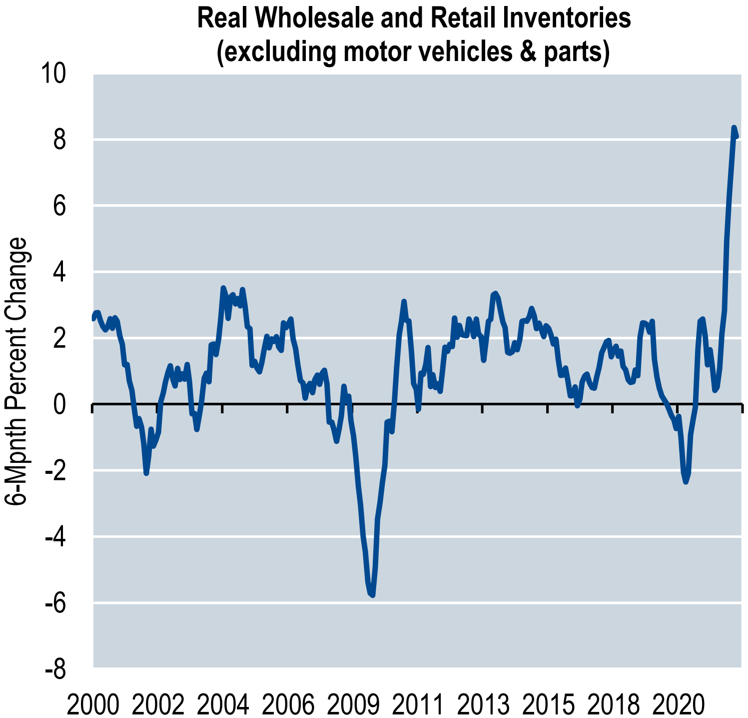


Source: Federal Reserve Bank of Chicago, Bloomberg. As of 29 Jun 22

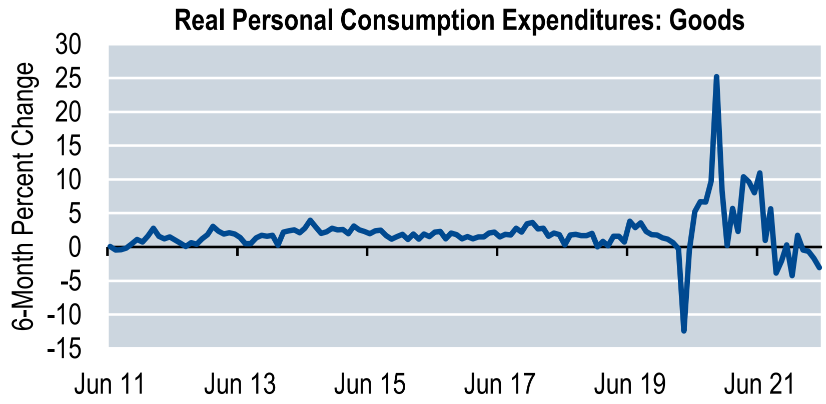


Source: Federal Reserve Bank of Chicago, Bloomberg. As of 29 Jun 22

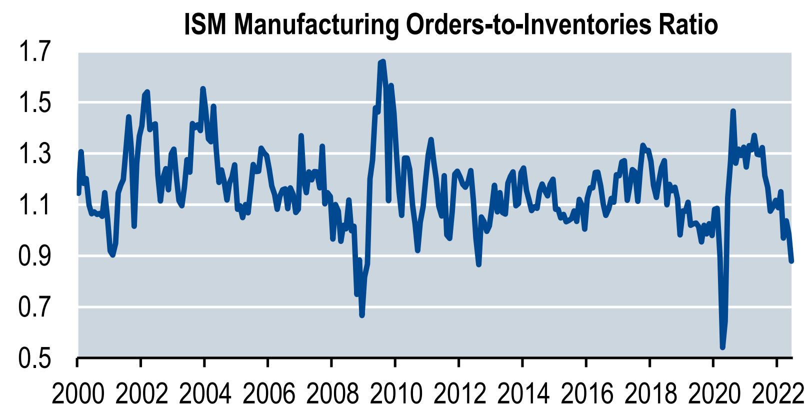
Rising Inventories: Softening Sales and Improving Supply Chains



Source: Haver Analytics, Bloomberg. As of 16 Jun 22



Source: Bureau of Economic Analysis, Haver Analytics. As of 31 May 22



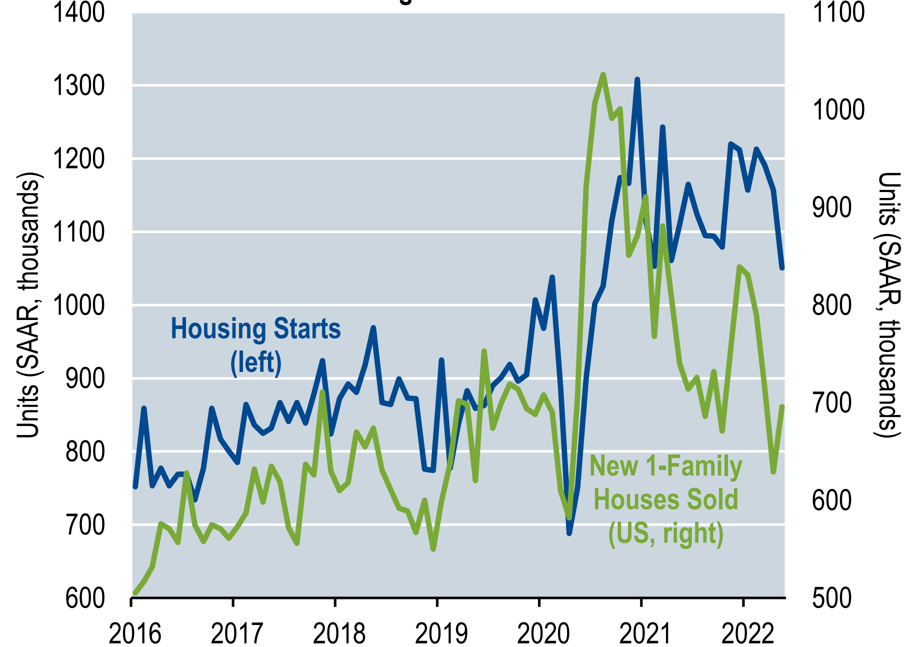
Source: Bloomberg. As of 30 Jun 22

Housing Market Turning

NAR Housing Affordability Index, Fixed-Rate Mortgages

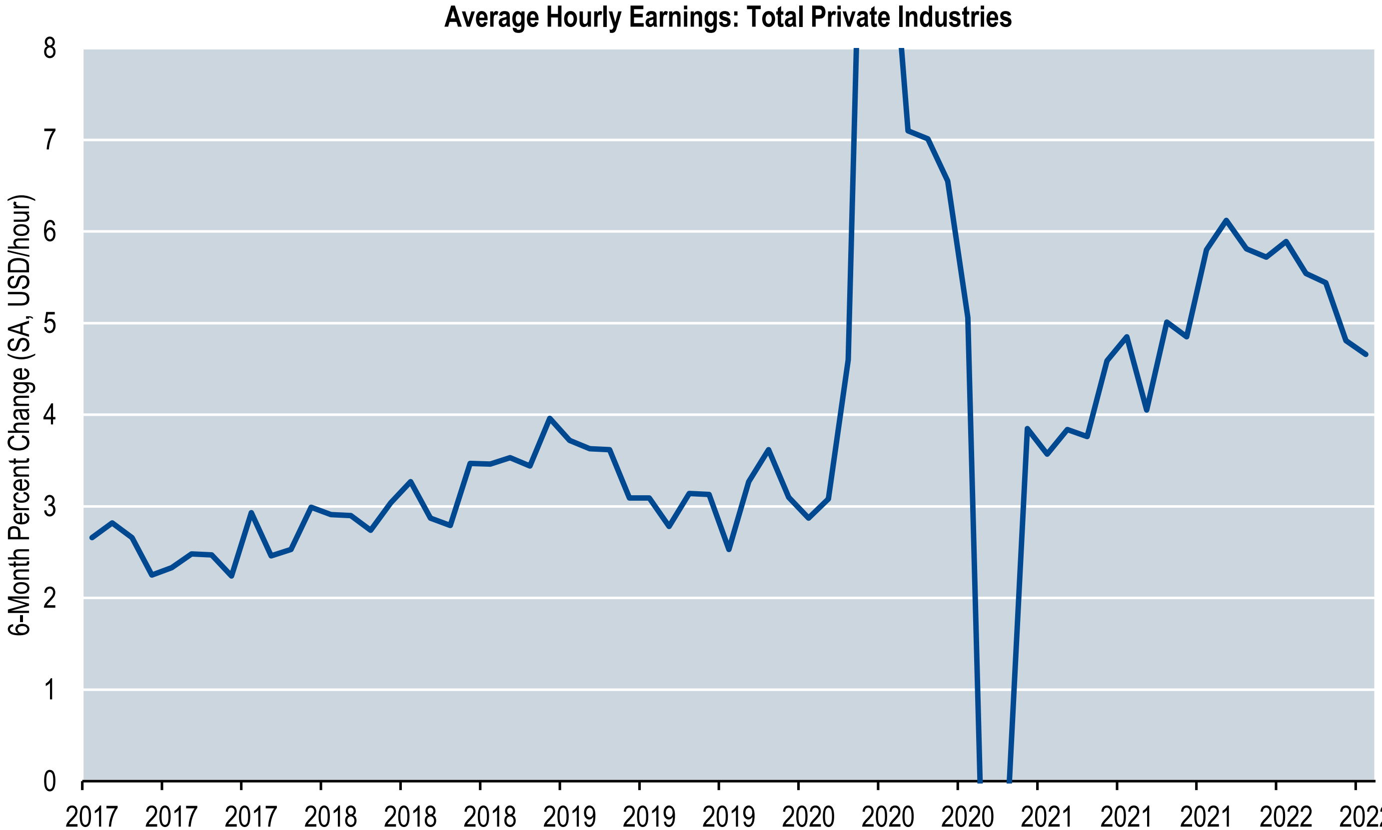
Source: National Association of Realtors, Haver Analytics. As of 30 Jun 22

Housing Starts and Sales



Source: Census Bureau, Haver Analytics. As of 31 May 22

Wage Growth Decelerating



Source: Bureau of Labor Statistics, Haver Analytics. As of 31 May 22

US Growth Risks to the Downside?

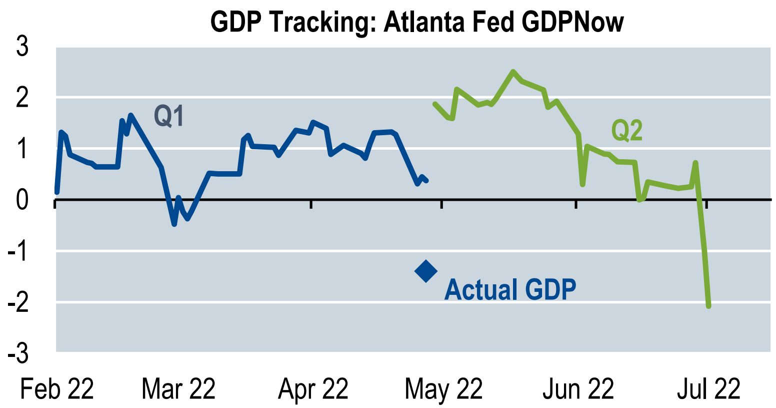
Fed remains confident on growth

- "There's <u>no sign</u> of a broader slowdown that I can see in the economy"

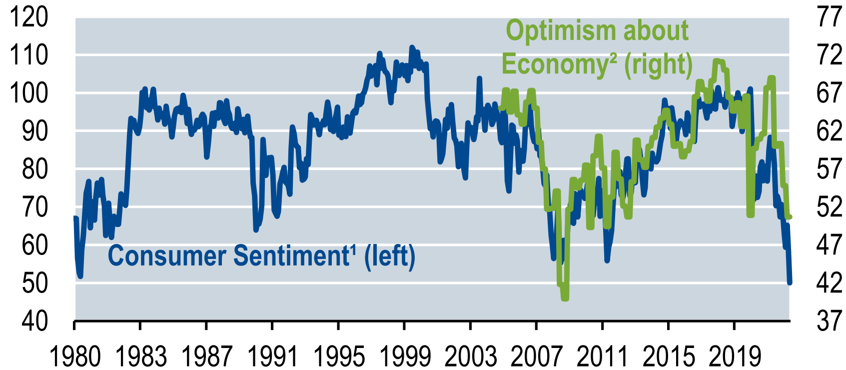
  – Chair Powell, June 17, 2022

Meanwhile, US economic data decelerating

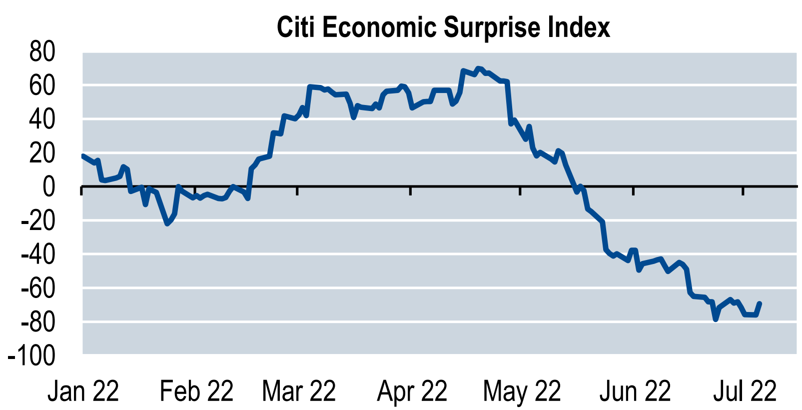
- GDP tracking for a negative Q2
- Economic Surprise Indices have turned negative
- Sentiment surveys have turned down (consumer and CFO)



Source: Federal Reserve Bank of Atlanta, Bloomberg. As of 29 Jun 22



Source: University of Michigan, Duke, Haver Analytics. As of 29 Jun 22
[1]University of Michigan: Consumer Sentiment (NSA, Q1-66=100)
[2]CFO Survey: Optimism about Economy: Mean (0-100, 100=Most Optimistic)



Source: Bloomberg. As of 29 Jun 22

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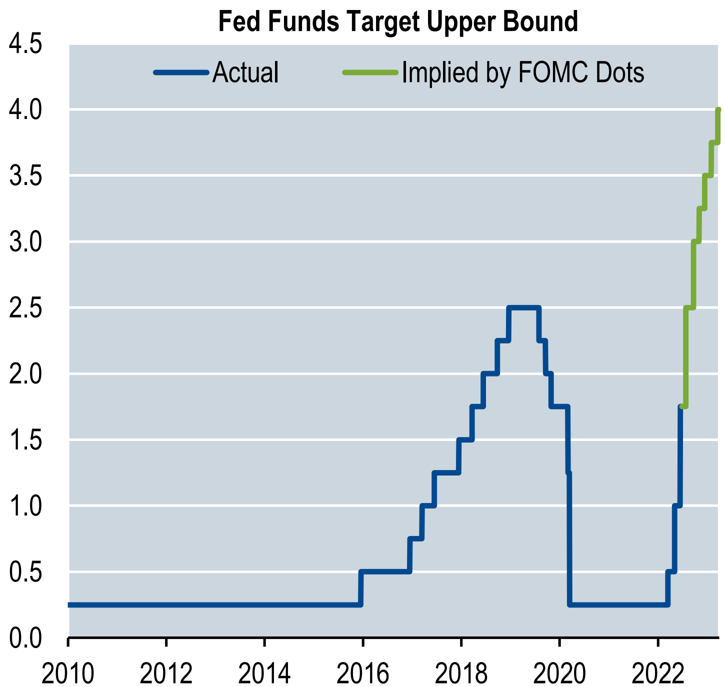
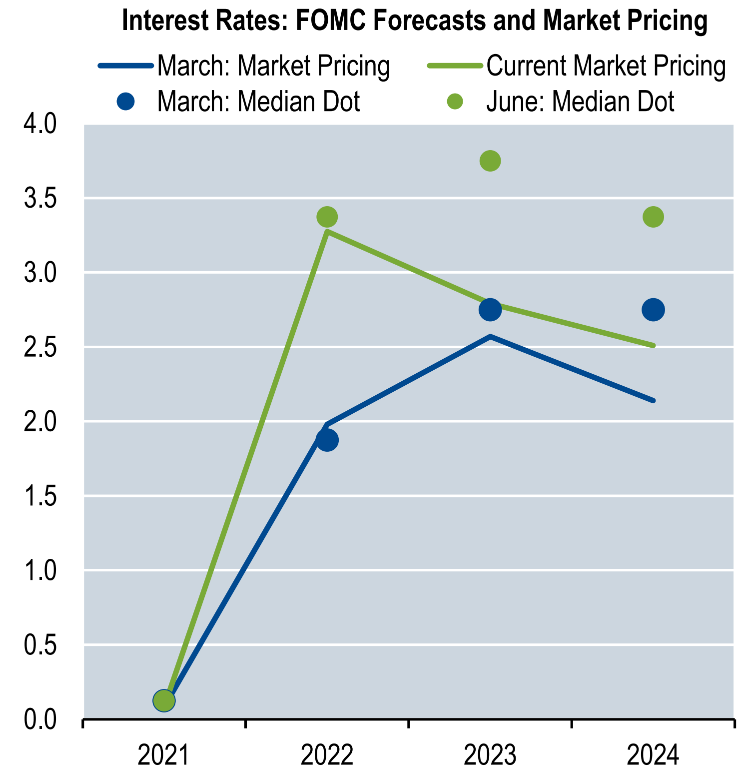
June FOMC: Another Hawkish Surprise



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

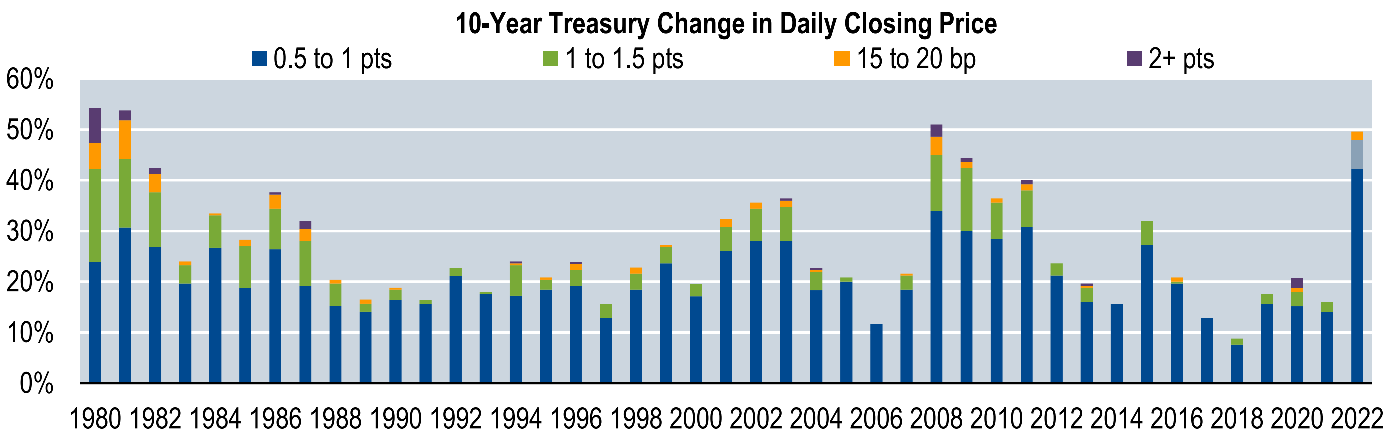


Source: Federal Reserve, Bloomberg. As of 06 Jul 22

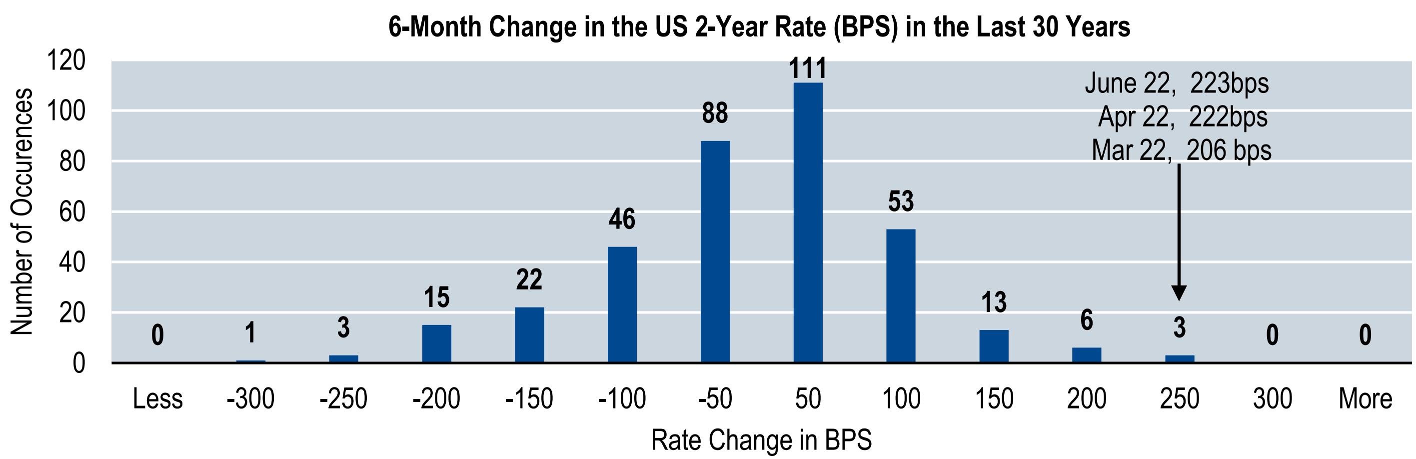
"I dissented at this week's FOMC meeting against a 75 basis point increase in the target range for the federal funds rate because <u>I viewed that move as adding to policy uncertainty</u> … Policy changes affect the economy with a lag, and significant and abrupt changes can be unsettling to households and small businesses as they make necessary adjustments."

– Esther George, June 17, 2022

A Volatile Repricing: Uncertainty and Market Structure



Source: Bloomberg. As of 30 Jun 22



Source: Bloomberg. As 30 Jun 22

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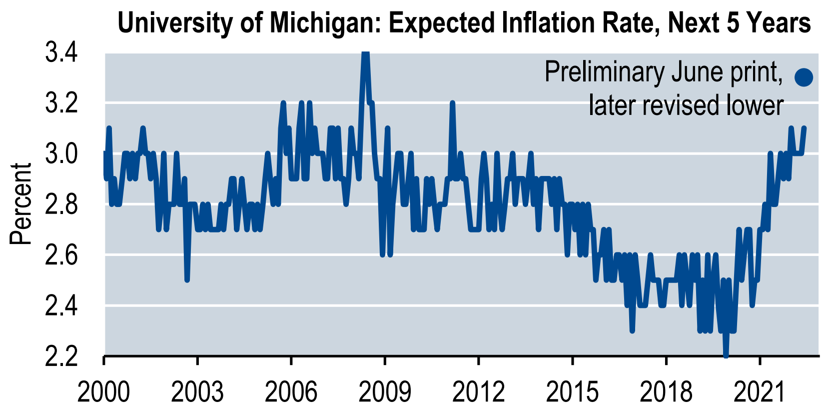
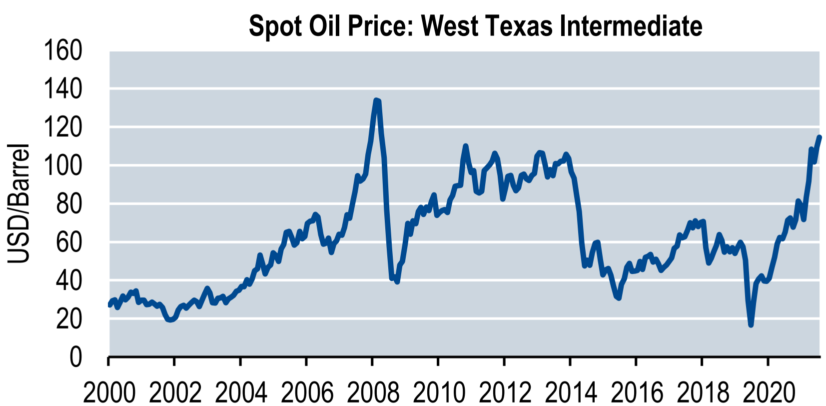
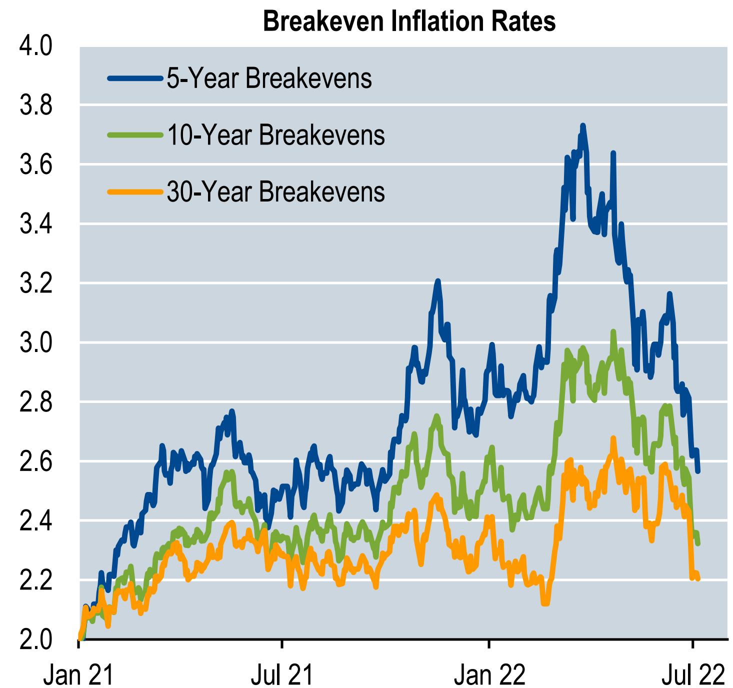
Inflation Expectations – Rising or Falling?



Source: University of Michigan, Haver Analytics. As of 16 Jun 22

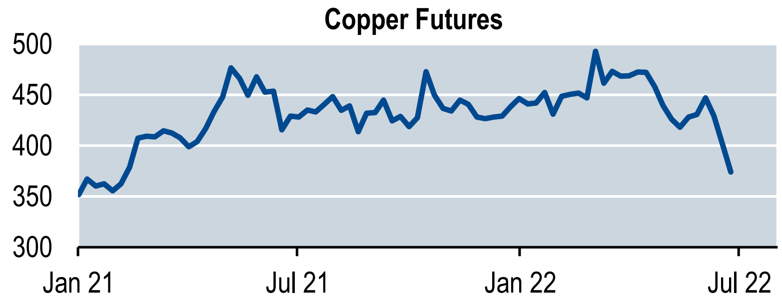


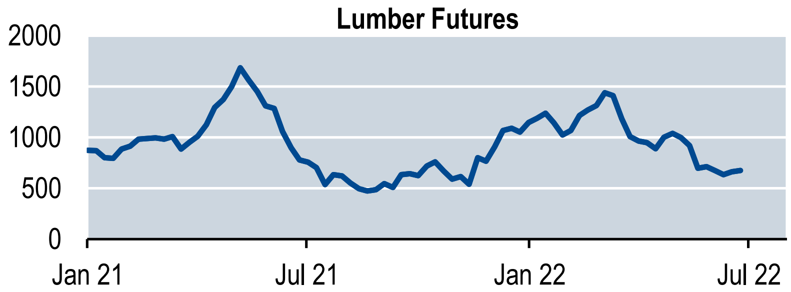
Source: Energy Information Admin/Chicago Mercantile Exchange, Haver Analytics. As of 16 Jun 22

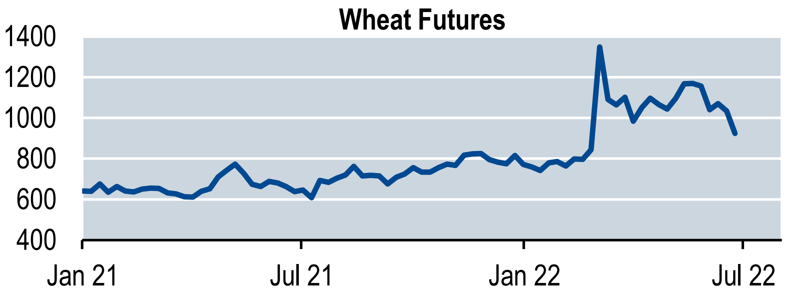


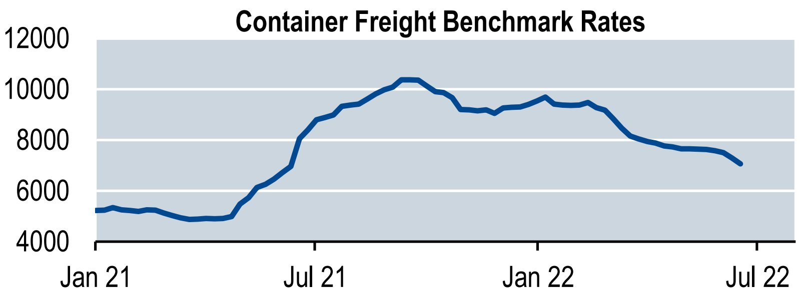
Source: Bloomberg. As of 05 Jul 22

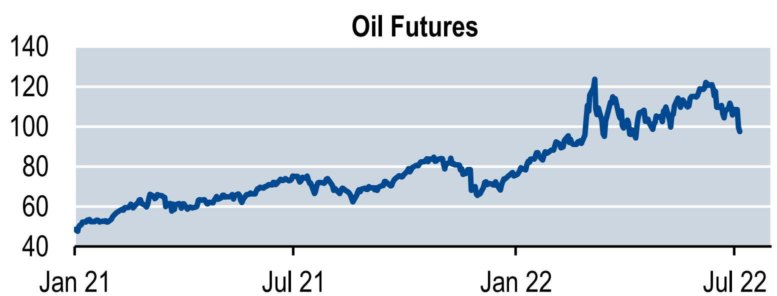
Commodity Price Weakness

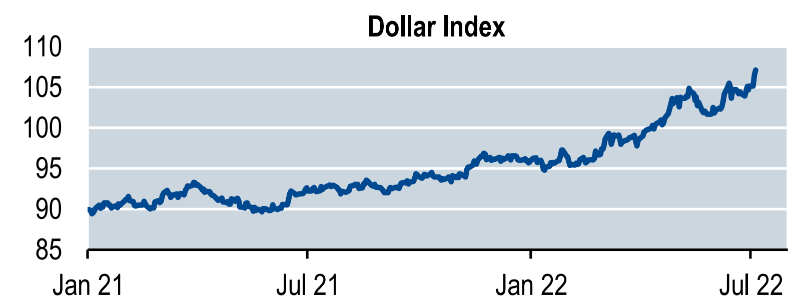










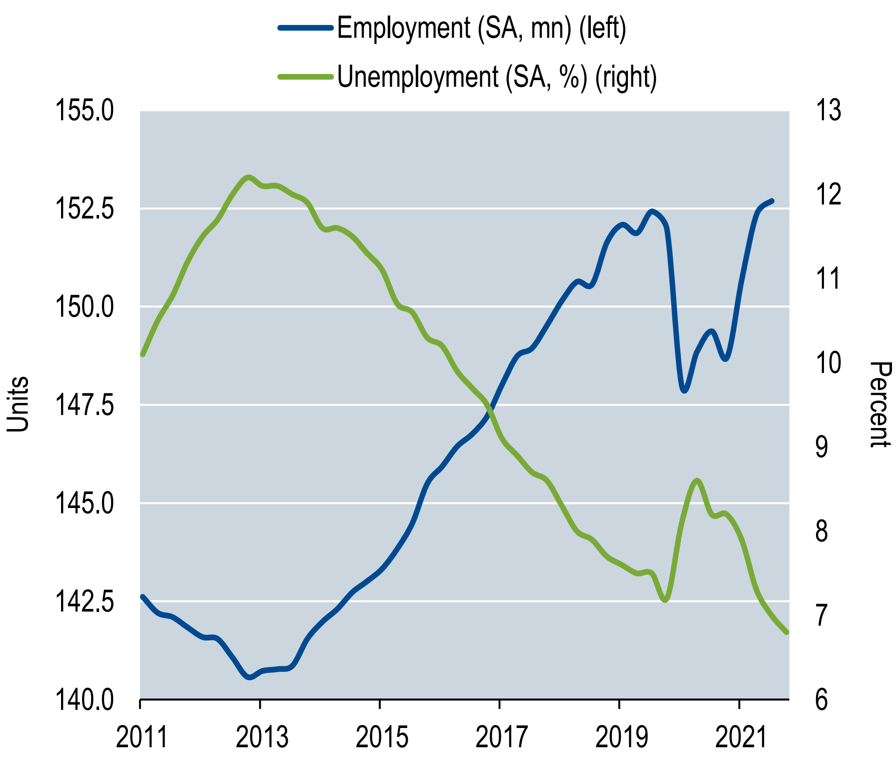


Source: Bloomberg. As of 29 Jun 22

Europe's Rebound Slowed by Higher Inflation and Energy Security Risks

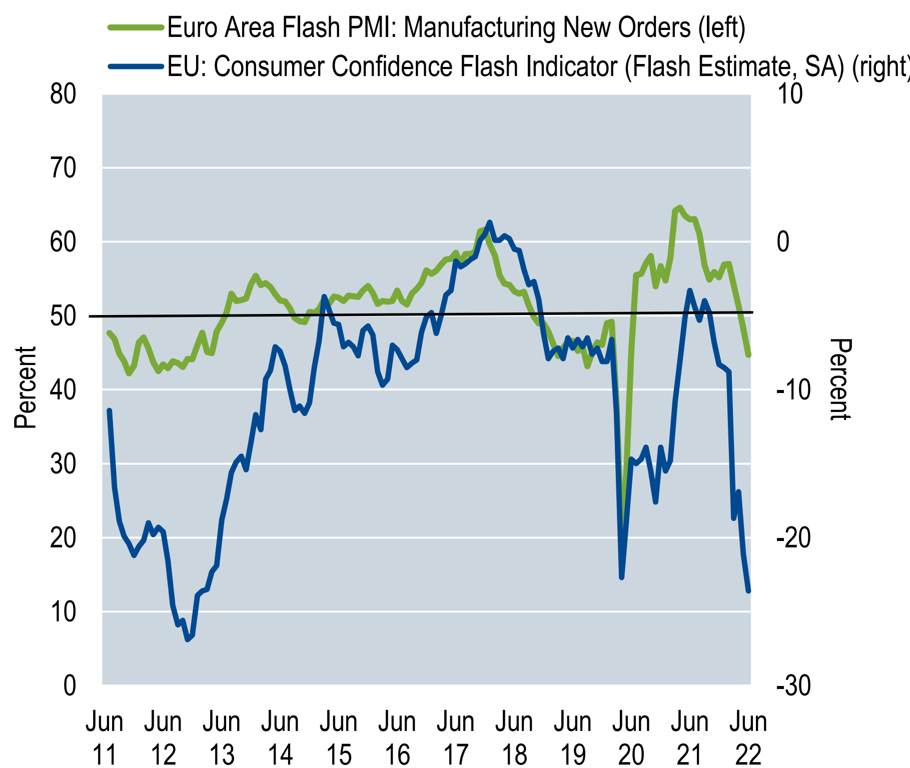
The reopening of the economy still provides positive growth impulses over the short term. Over the medium term, however, the darkening outlook is characterized by weaker real demand, business uncertainty hampering investment, and the more prominent risk of energy rationing in key eurozone economies.

European labor markets have fully recovered from the Covid pandemic



Source: Statistical Office of the European Communities/Haver Analytics. As of 30 Apr 22

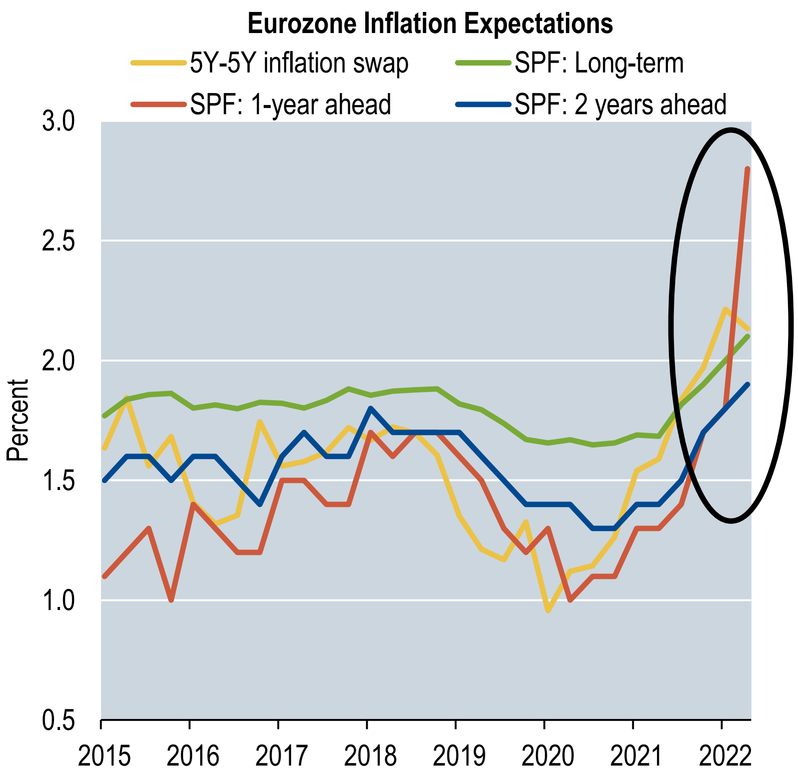
Consumer confidence and New Order expectations dropping sharply in the eurozone



Source: Haver Analytics. As of 30 Jun 22

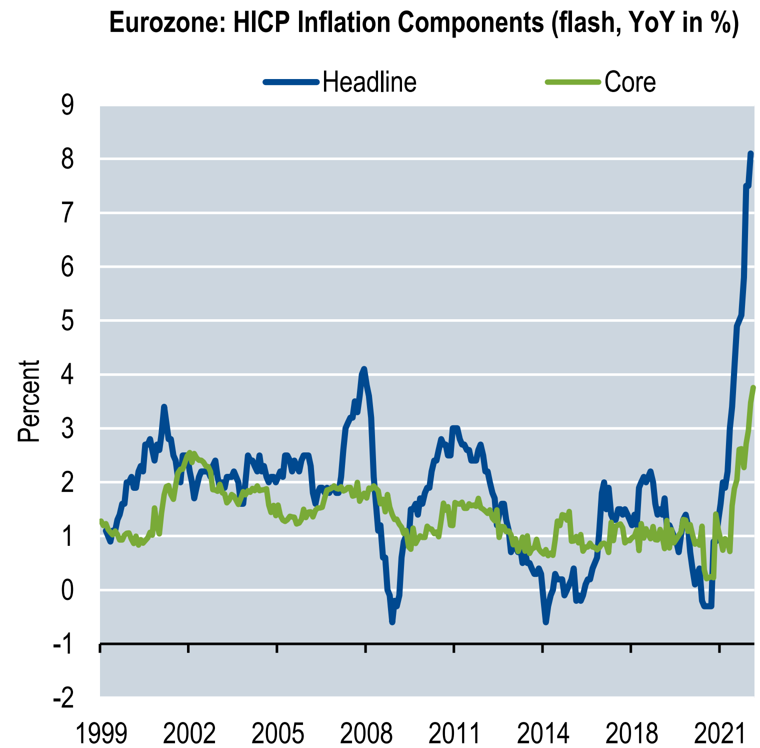
ECB: Stepping on the Brakes Hard, but for How Long?

- The ECB has stopped buying assets (for now) and is committed to interest rate hikes in July and September to end negative rates.
- Beyond September, the economic and inflation outlook is highly uncertain.
- In the baseline, the ECB continues to hike gradually as the inflation outlook, including survey-based expectations, remains above target.
- If growth takes a significant hit due to potential energy shortages, the inflation outlook might normalize, causing (at least) a pause in its hiking cycle and the ECB may not be able to fulfill hawkish market expectations of 200 bps in hikes by mid-2023.
- In addition to a more flexible reinvestment policy, the ECB is likely to propose, at its July meeting, a new tool to deal with market fragmentation.



Source: ECB, Haver, Bloomberg. As of 29 Jun 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 29 Jun 22.

SPF = ECB Survey of Professional Forecasters



Source: Statistical Office of the European Communities, Haver. As of 31 May 22

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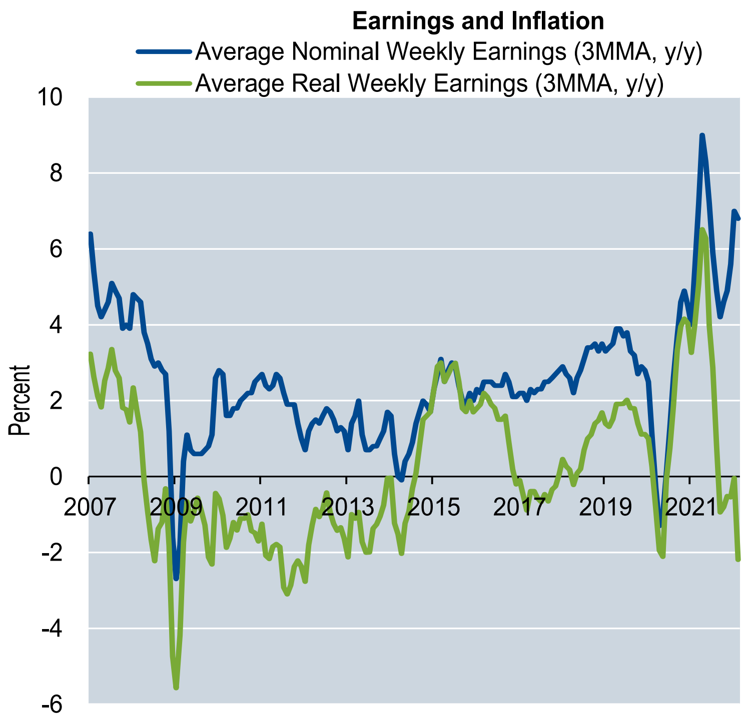
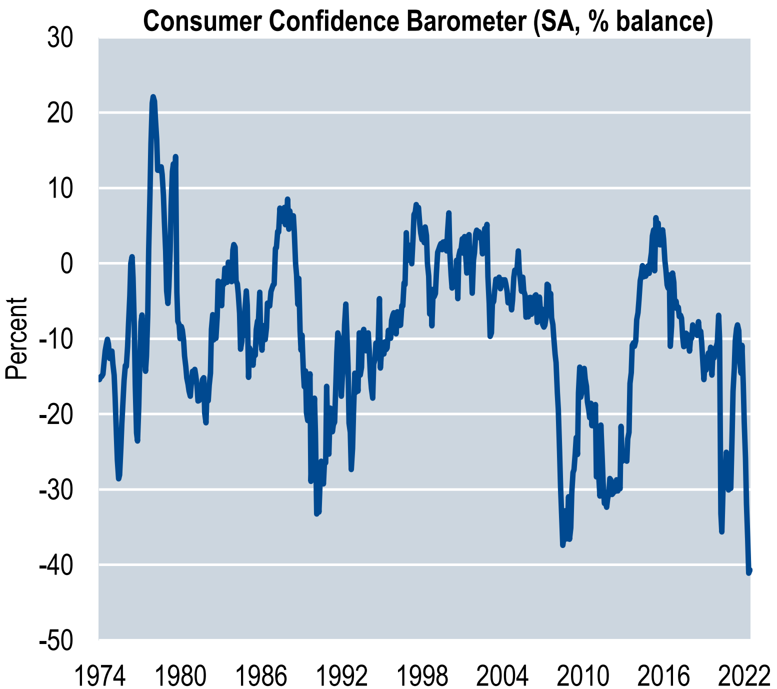
United Kingdom: Rebound Under Threat

- UK macro narrative similar to the eurozone: falling real disposable incomes/higher cost of living (energy and food inflation, National Insurance contribution hikes)
- Consumer sentiment close to all-time lows, comparable to Covid pandemic and GFC
- Less downside risk as UK economy does not rely on Russian energy imports (but also less inclination for fiscal support)
- Bank of England ended asset purchases last year, hiked the policy rate at consecutive meetings and began (passive) quantitative tightening
- At recent meetings, the central bank softened its stance on the need for further hikes, indicating that current market pricing would lead to an undershoot of the inflation target



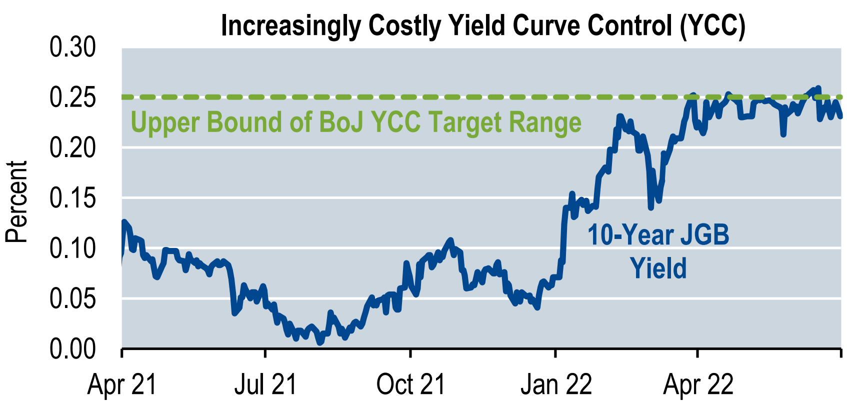
Source: Office for National Statistics/ Haver Analytics. As of 30 Apr 22



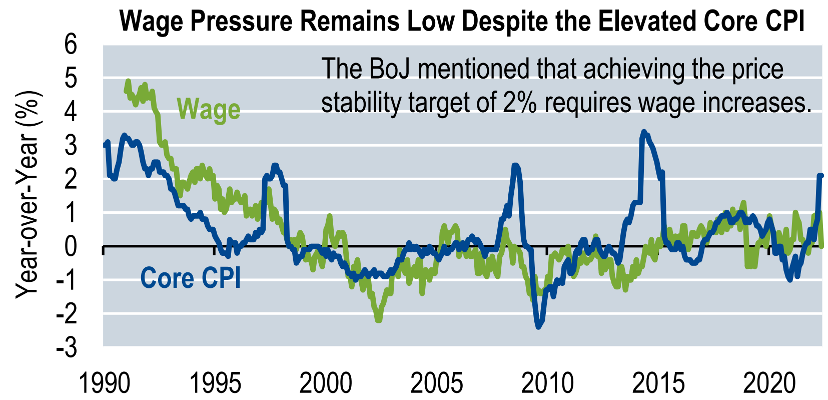
Source: GfK NOP/ European Commission/ Haver Analytics
As of 29 Jun 22

The above reflects current opinions of Western Asset and are subject to change with market conditions.

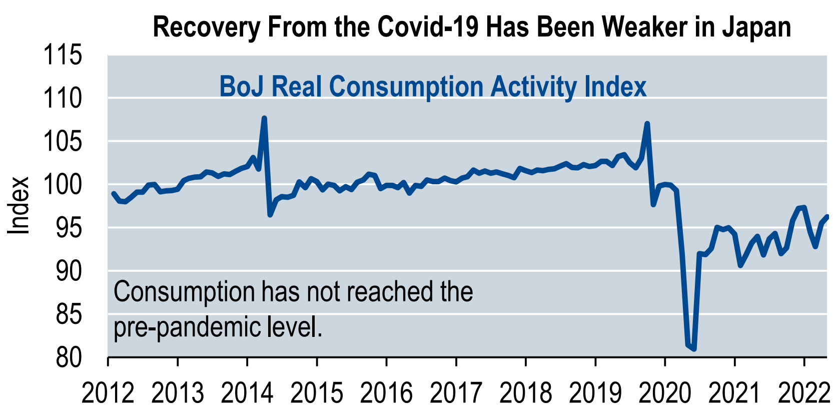
YCC Is Challenged by the Markets Where Interest Rates & Inflation Increase Globally



Source: Bloomberg. As of 31 May 22

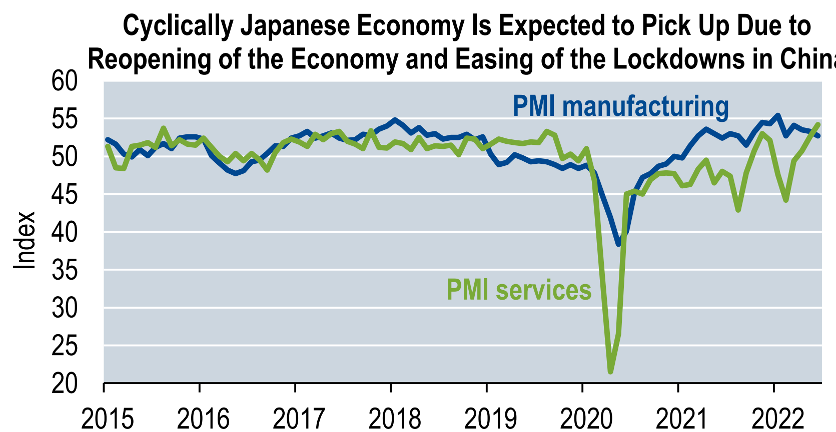


Source: Bloomberg. As of 31 May 22



Source: Bloomberg, Western Asset. As of 30 Apr 22

- BoJ's real consumption activity index rose by 0.8% M/M in April following a 2.9% increase in March. Consumption proved resilient after lifting the quasi-state of emergency measures in March.



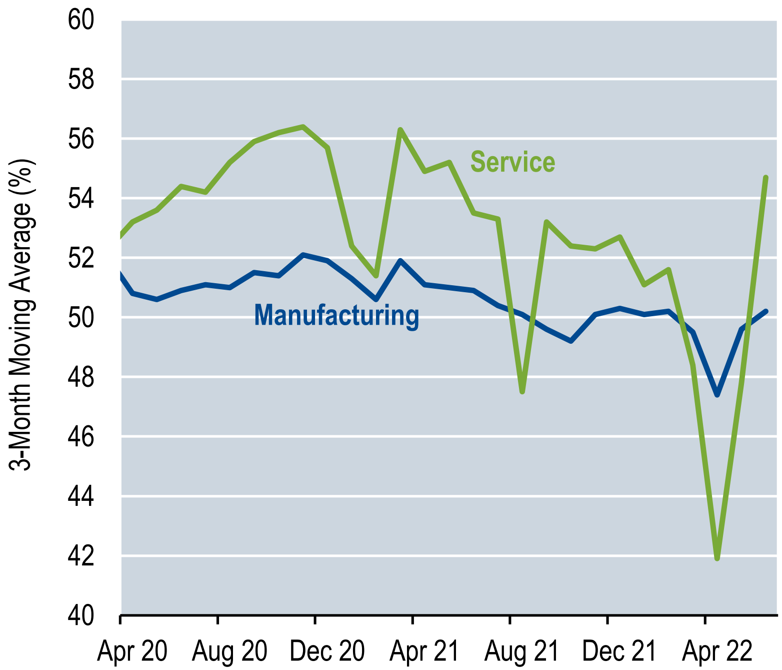
Source: Bloomberg, Western Asset. As of 30 Jun 22

- PMI manufacturing was slightly down to 52.7 in June from 53.3 in May while it remained above the pre-pandemic level. PMI services nicely increased and reached to the highest level for the past nine years due to the reopening of the economy.

China Outlook

Policy Priority to Stabilize Growth

China PMI

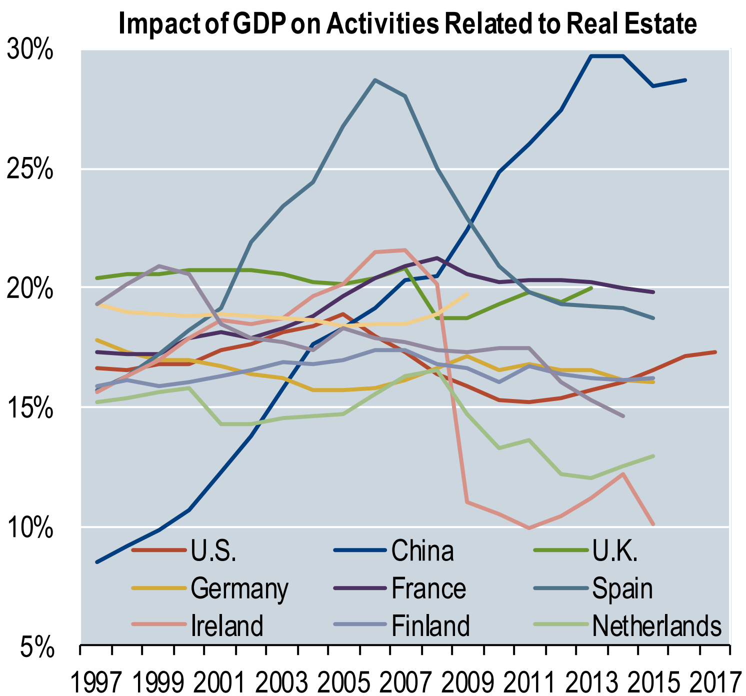


Source: Bloomberg. As of 30 Jun 22

Central Government

- **Infrastructure**
  - To issue 3.65 trillion CNY in LGFV bonds for infrastructure investment by the end of June and utilize by the end of August.
  - State Council pledged 300 billion CNY in financial bonds to provide bridge financing for key infra projects, in addition to directing policy banks to provide 800 billion CNY in loans for infra.
- **Monetary**
  - RRR cut from 11.5% to 11.25% for major banks. RRR cut on FX deposits to 8% from 9%.
  - Voiced strong support and availability but also reiterated commitment to FX stability (no major benchmark rate cuts)
- **Fiscal**
  - State council added 140 billion CNY to the 2.5 trillion CNY in tax and fee cuts already planned for this year
- **Regulation Easing**
  - Easing regulatory restrictions on Ant and Didi, the high-profile cases in the past
  - Signaling regulatory easing in fin-tech
  - Starting to approve video game publishing licenses again
- **Local**
  - Infrastructure
  - Encouraging foreign investments with incentives
  - Increase sales and local consumption

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: Source: CEIC, Morgan Stanley. As of 28 Sep 21
[1]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

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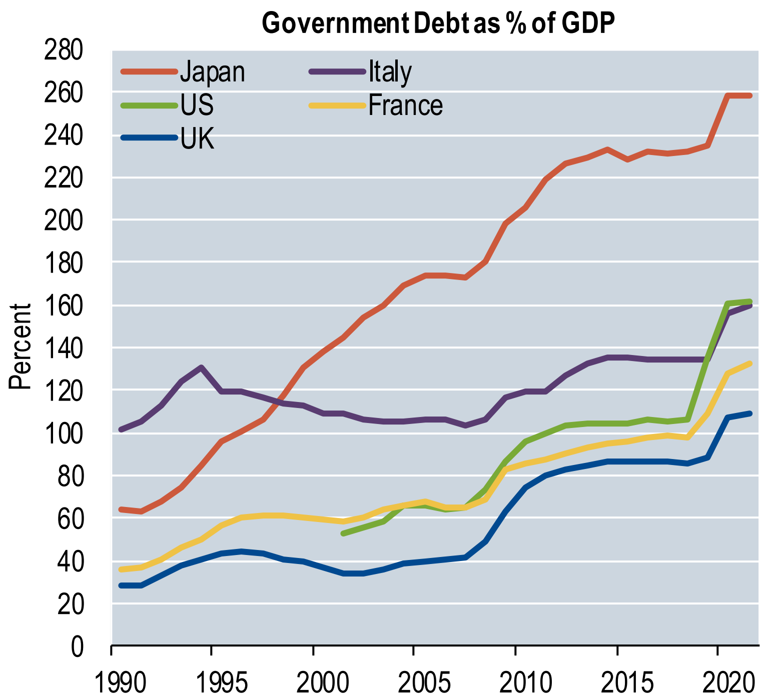
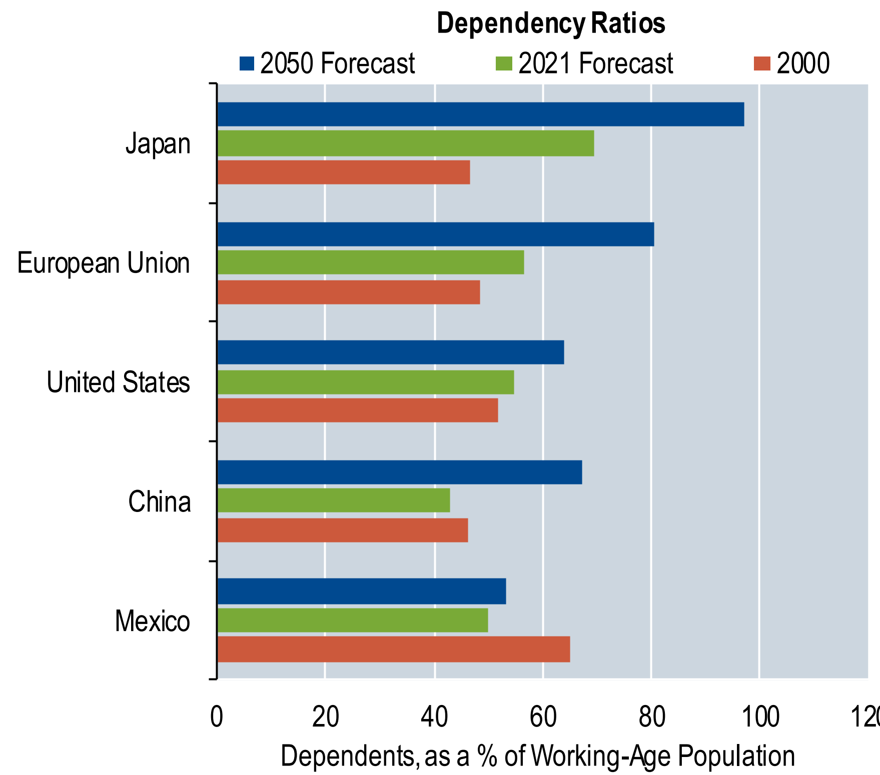
The Challenges of Global Slack and Debt Burdens Will Retard Future Growth



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



Source: World Bank. As of 15 Sep 21

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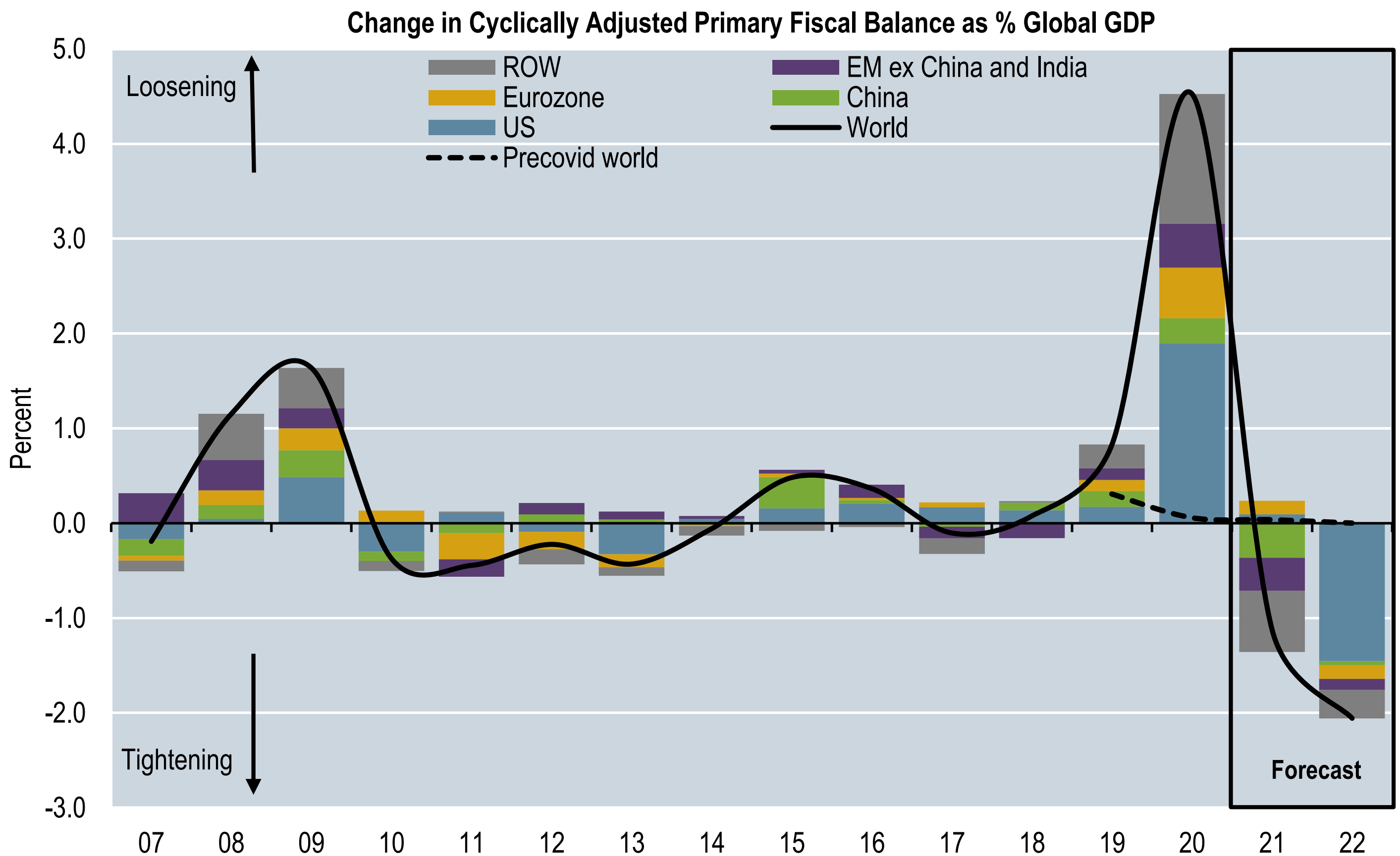
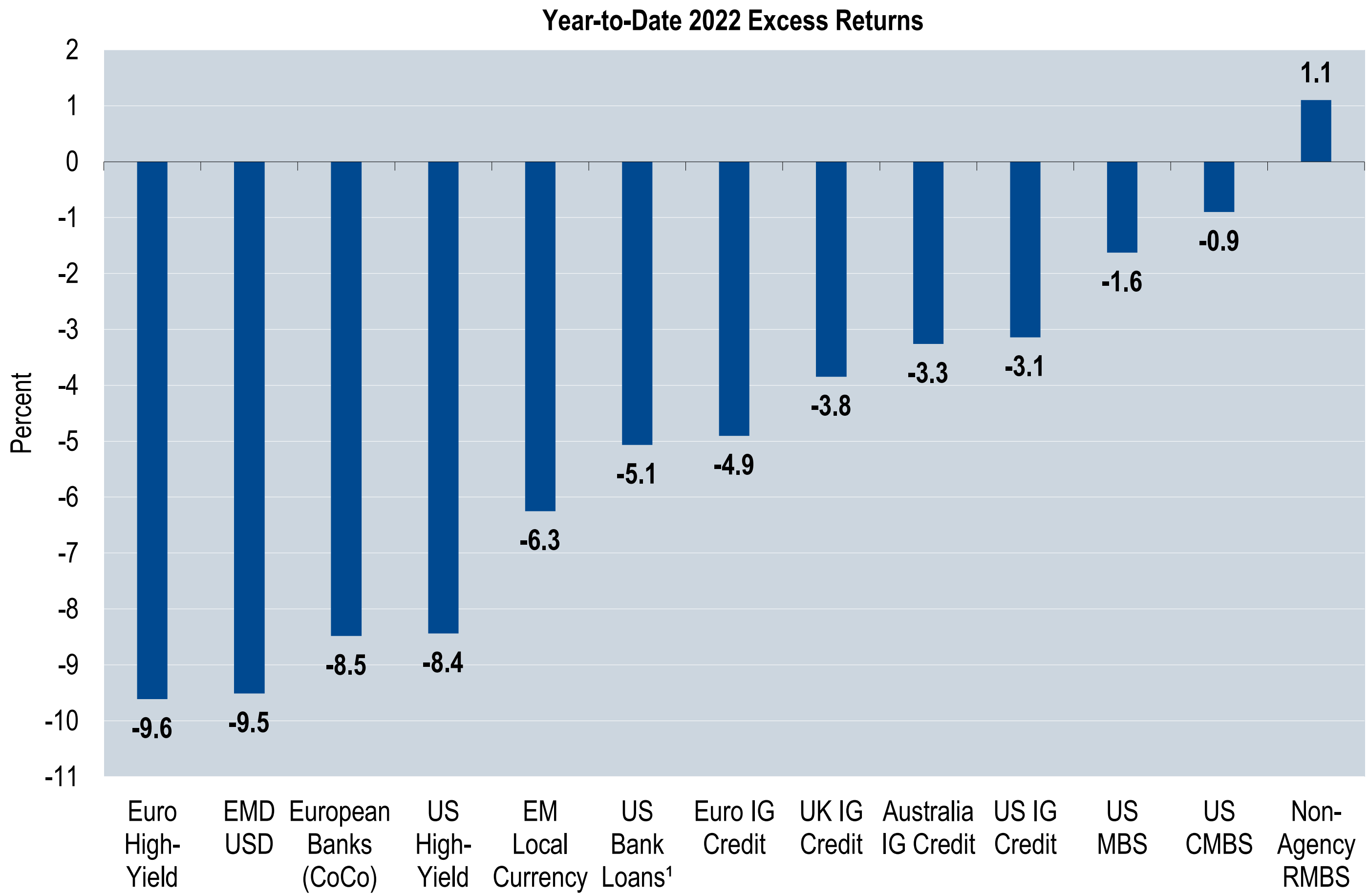
Global Fiscal Stimulus Is Set to Turn to Global Fiscal Drag



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

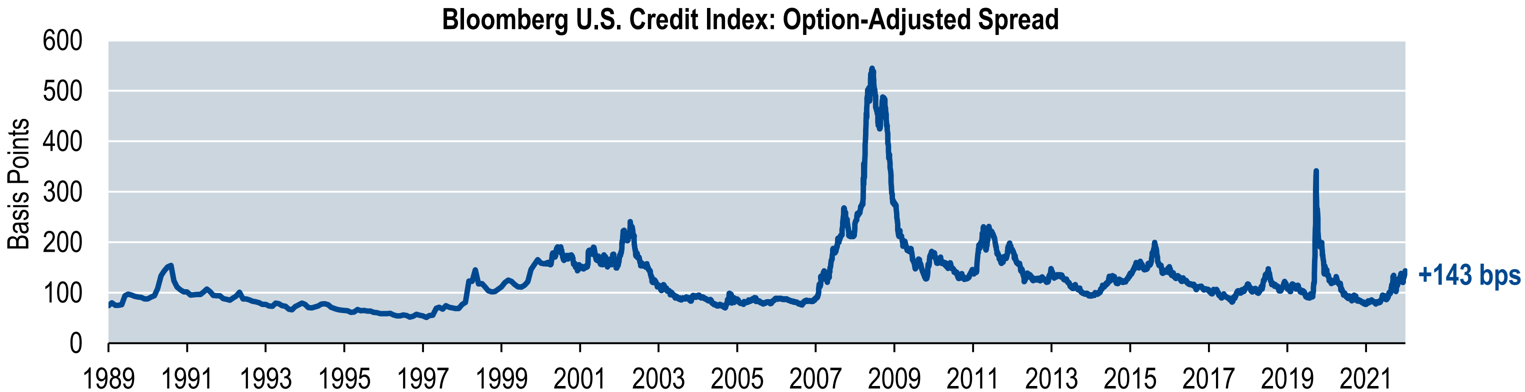
Spread Sector Excess Returns



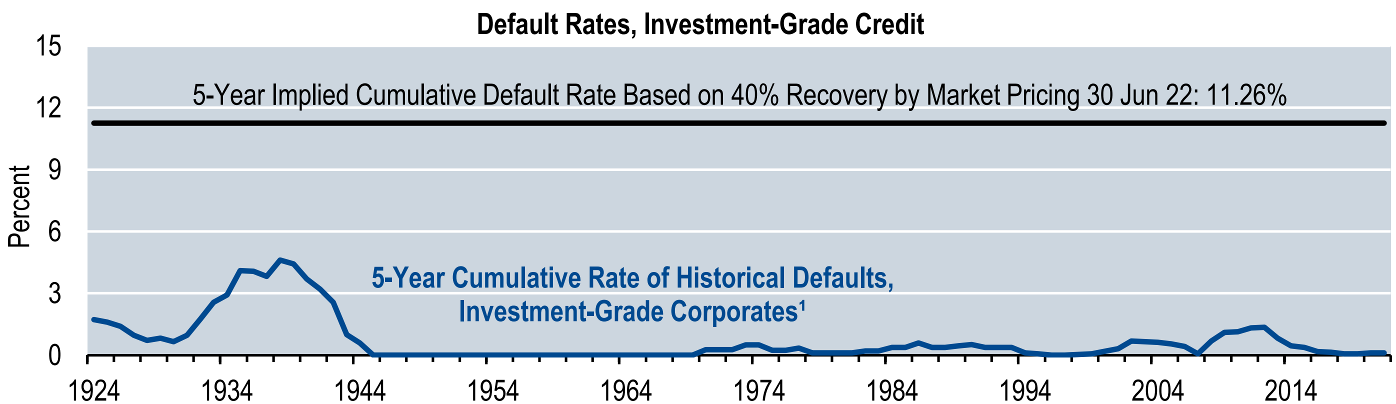
Source: Bloomberg, Citi, J.P. Morgan, S&P Global Market Intelligence, a division of S&P Global Inc, Western Asset. [1]S&P/LSTA Leveraged Loan Total Return Index excess return vs. 3-Month LIBOR. As of 30 Jun 22
Past performance is not a reliable indicator of future results.

US Investment-Grade Credit

Spreads and Default Rates



Source: Bloomberg. As of 30 Jun 22



Source: Bloomberg, Moody's. As of 30 Jun 22
[1]As of 31 Dec 21

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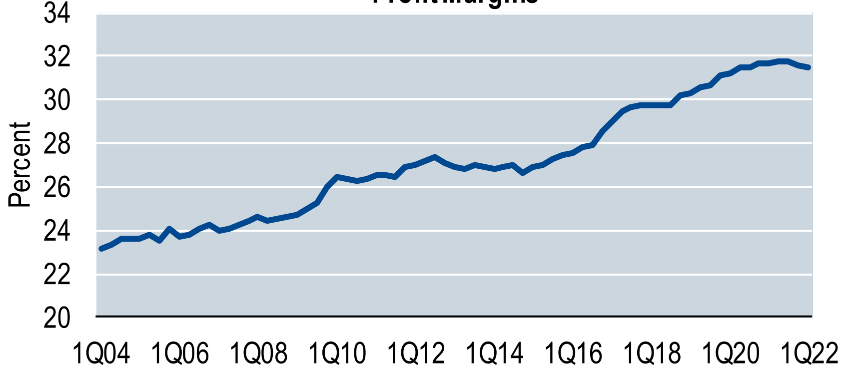
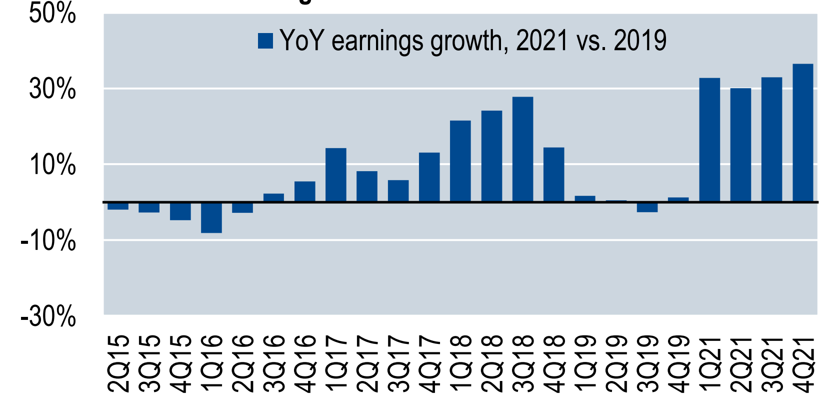
Cash Flow and Debt Metrics Support Investment-Grade Credit

Profit Margins



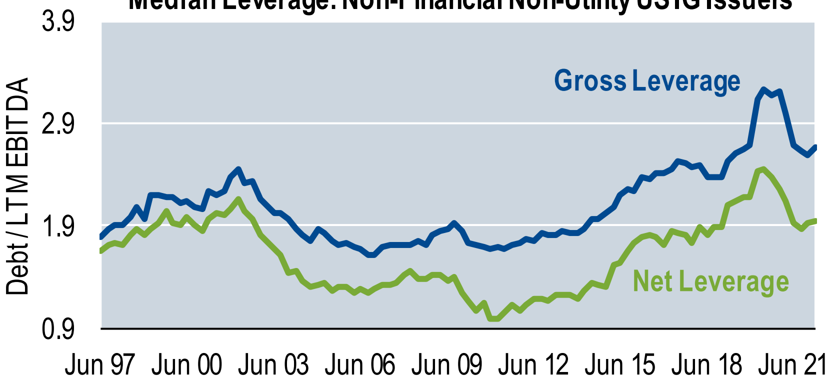
~180 Non-Financial Companies (JULI Based)
Weighting based on amount of debt in the benchmark
Source: J.P. Morgan. As of 31 Mar 22

Earnings Growth >30% vs. Pre-Pandemic



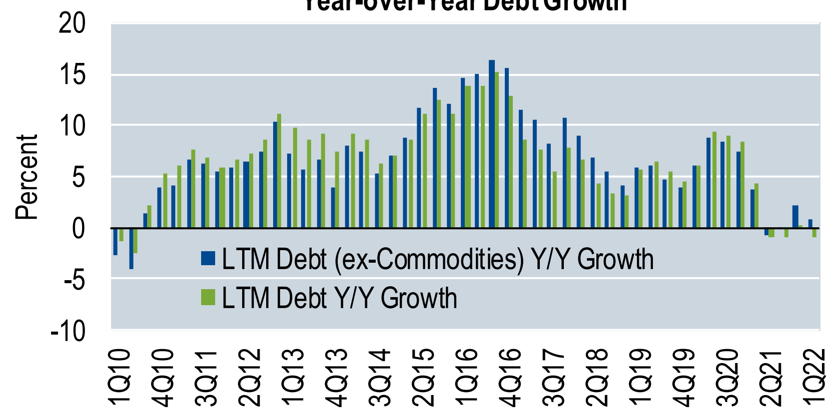
Source: Factset, BofA Global Research. As of 31 Dec 21*
Note: based on medians for US investment grade non-financial non-utility issuers. Net debt is gross debt minus cash and marketable securities.

Median Leverage: Non-Financial Non-Utility US IG Issuers



Source: BofA Global Research. As of 31 Mar 22*

Year-over-Year Debt Growth



Source: J.P Morgan. As of 31 Mar 22

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

Since 2016, IG managements have

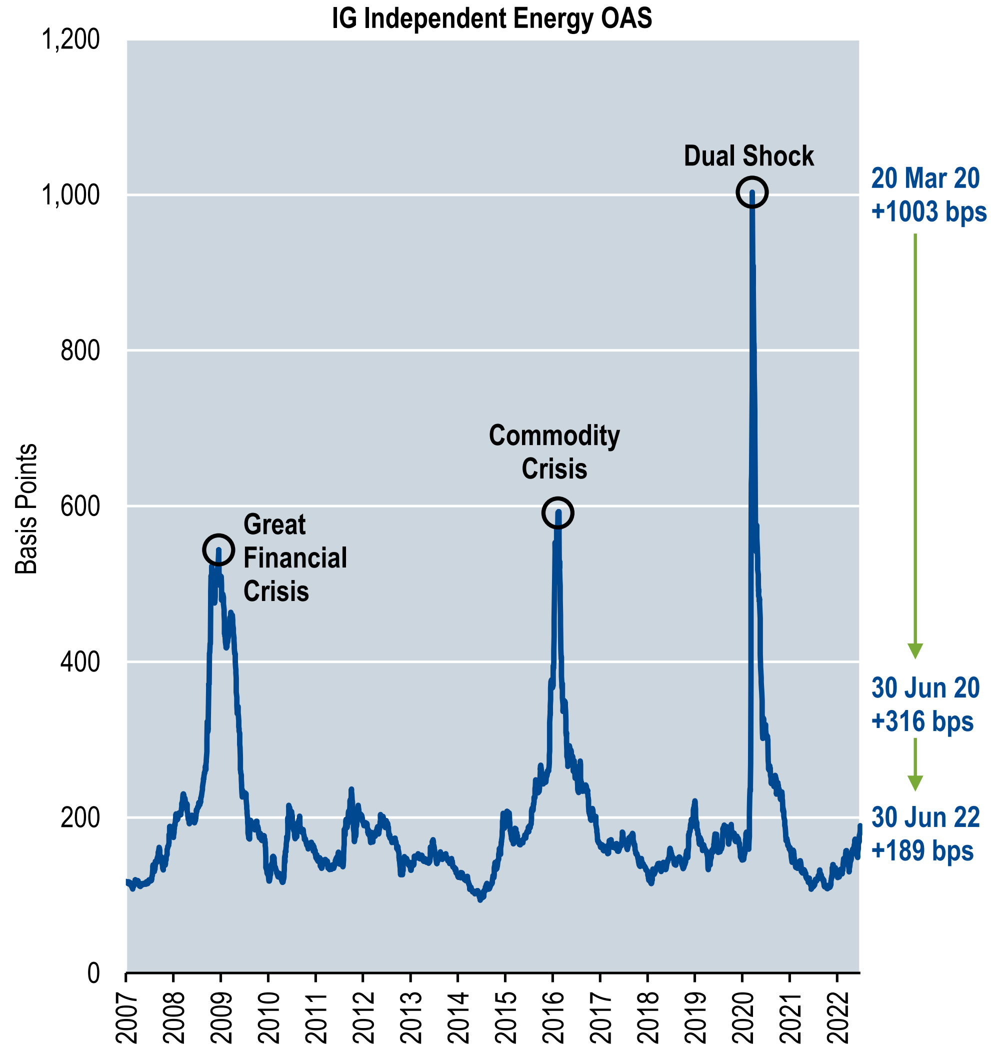
- Acted conservatively
- Lowered cost structures
- Improved cash flow
- Delevered balance sheets
- Extended maturity runways
- Improved liquidity

Conservatism Prevails

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

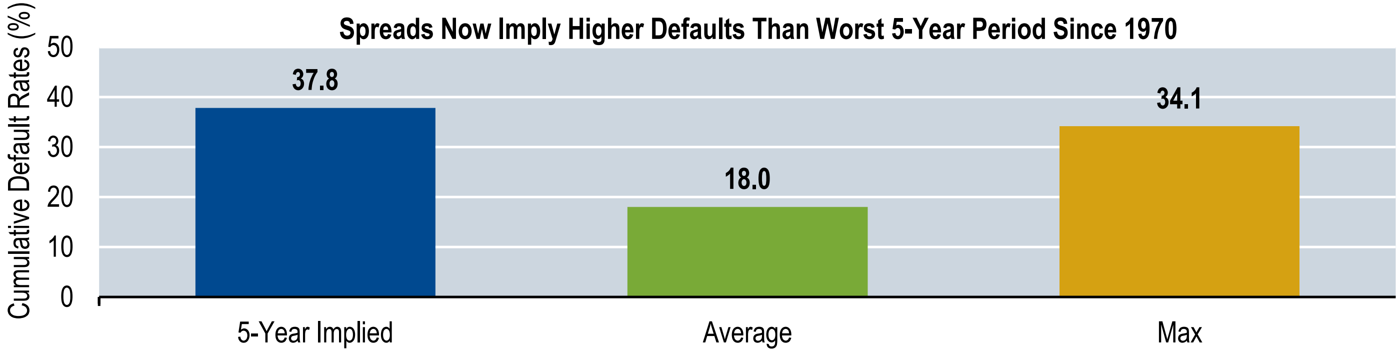
Conclusion

- 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

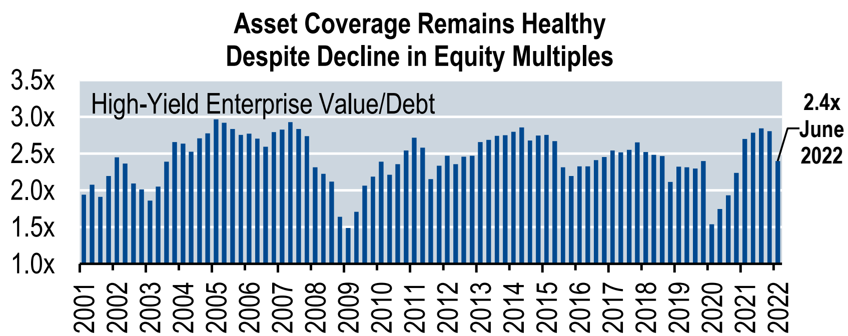


Source: Bloomberg. As of 30 Jun 22

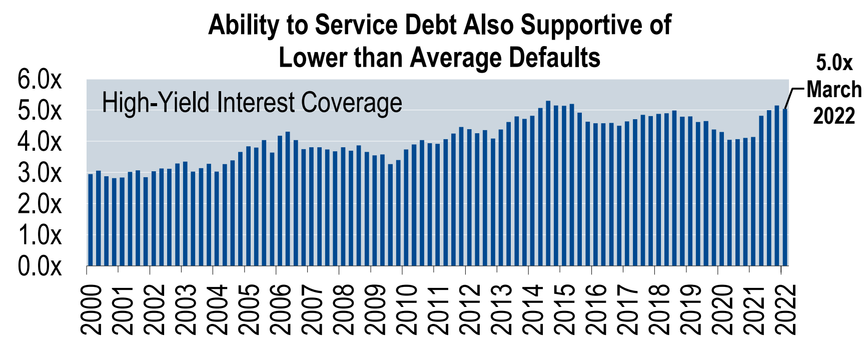
High-Yield Valuations Are More Compelling



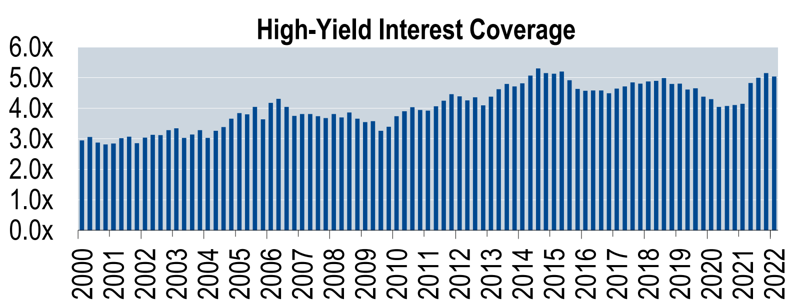
Source: Moody's, Western Asset. As of 30 Jun 22. 40% recovery assumption was used and spread used to imply cumulative defaults over 5 years. Worst cumulative 5-year default period since 1970 was 1992



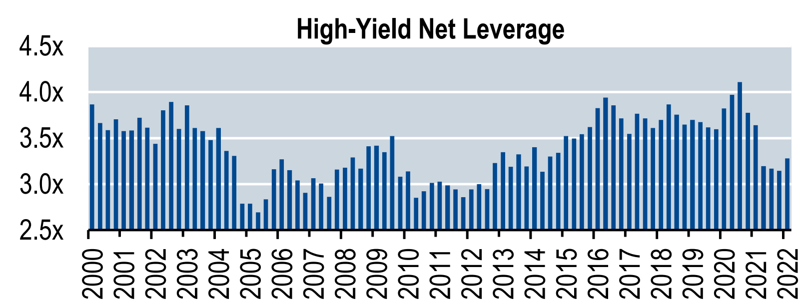
Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 28 Jun 22



Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Mar 22



Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Mar 22

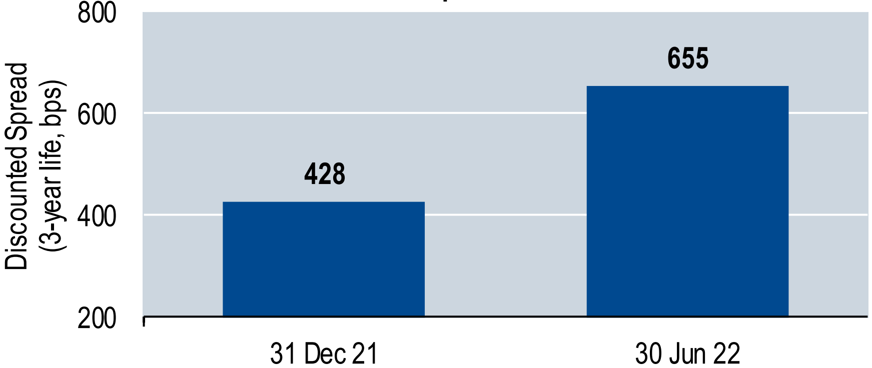


Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Mar 22

Western Asset

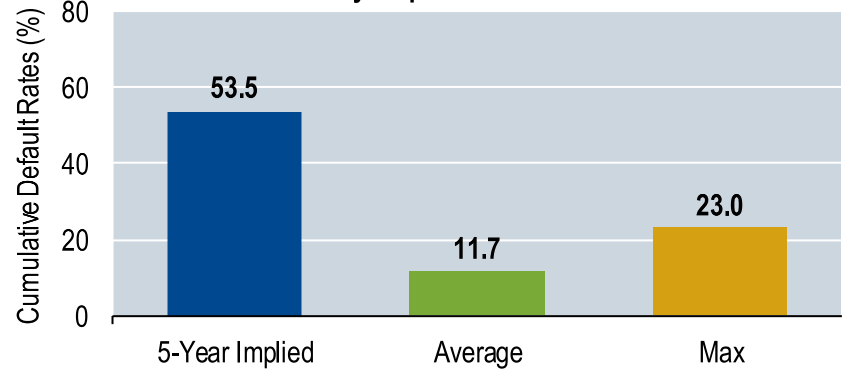
Bank Loan Valuations Are More Compelling

Spreads rose by more than 200 bps this year as rates rose and spreads widened



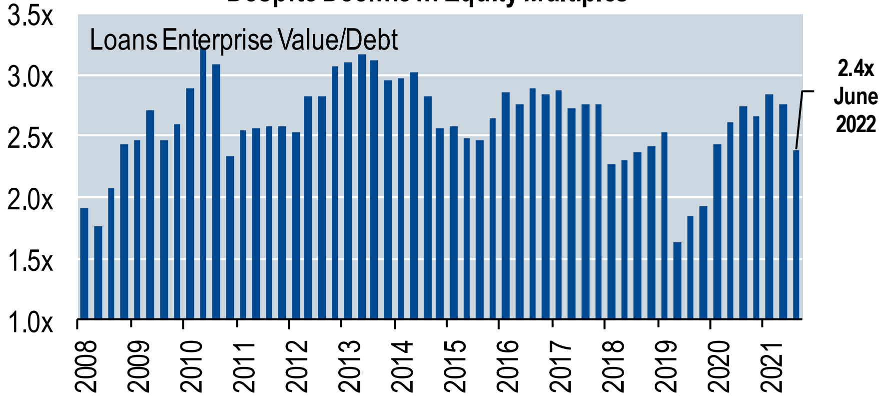
Source: PitchBook Data, Inc. As of 30 Jun 22

Spreads now imply higher defaults than worst 5-year period since 1999



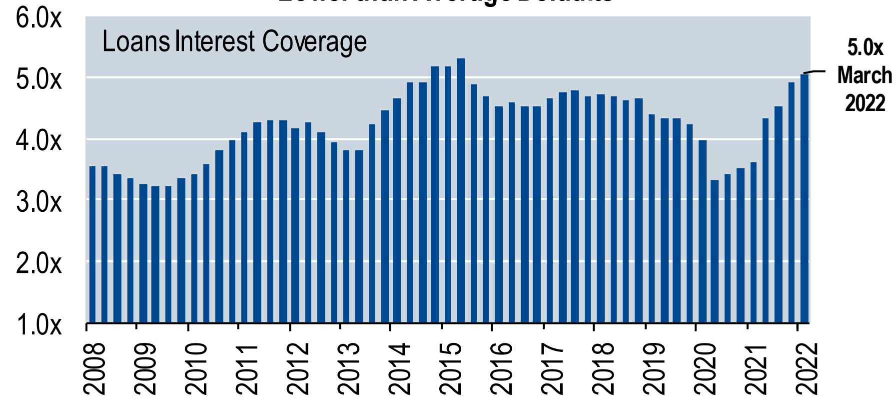
Source: PitchBook Data, Inc., Western Asset. As of 31 May 22
60% recovery assumption was used and spread used to imply cumulative defaults over 5 years.
Worst cumulative 5-year default period since 1999 was 2003

Asset Coverage Remains Healthy Despite Decline in Equity Multiples



Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 28 Jun 22

Ability to Service Debt Also Supportive of Lower than Average Defaults

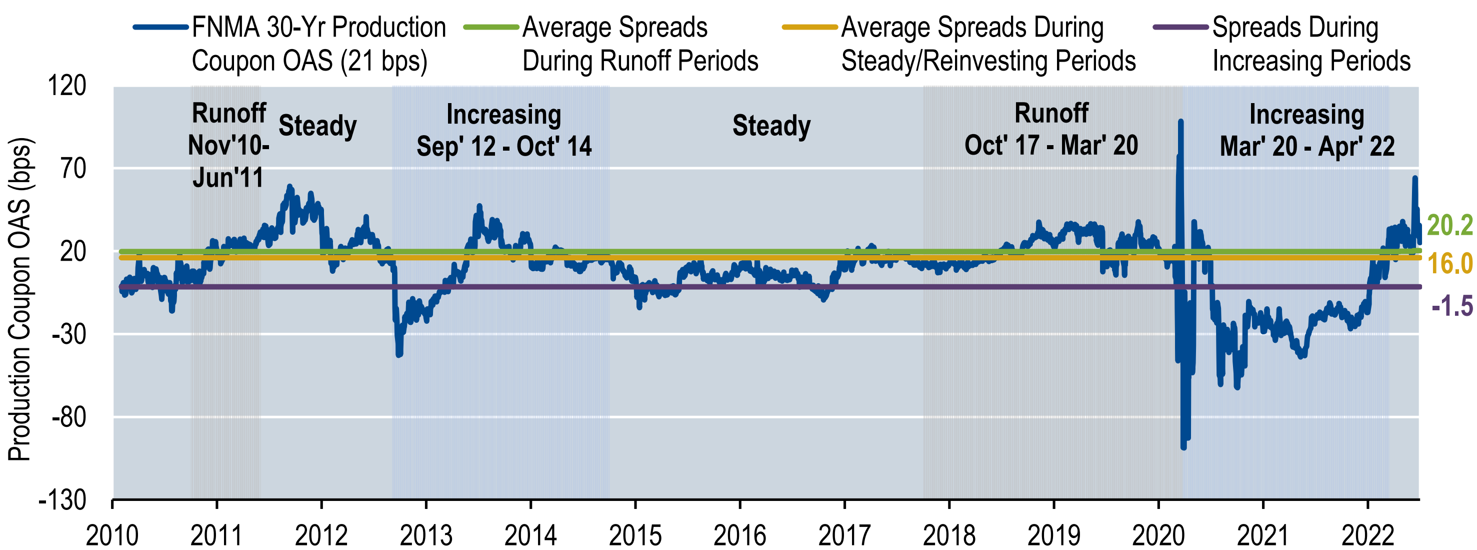


Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Mar 22

Western Asset

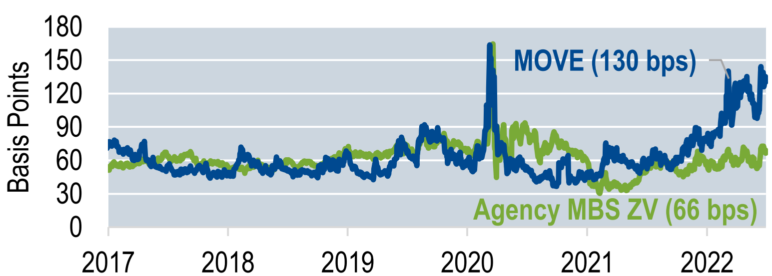
Agency Mortgage Spreads During QE/QT Cycles Since 2010

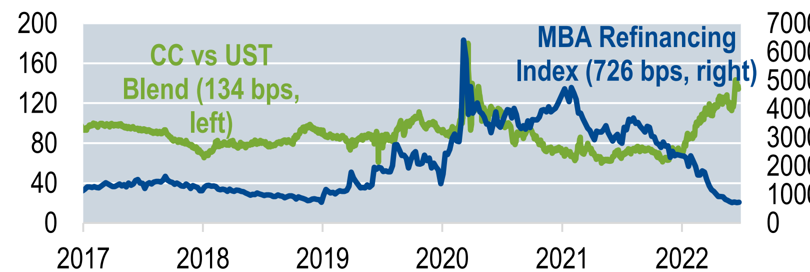
- Mortgage spreads have widened significantly year to date as Fed support diminished
- Expect continued headwinds in the sector depending on the timing and pace of runoff (QT) as Fed shifts to Reinvesting and Runoff Mode



Agency MBS Fundamentals and Valuations Have Improved

- Agency MBS spreads have widened with elevated volatility, potential Fed selling
- Prepayment risk reduced as mortgage borrowers have little refinancing incentive





Source: Bloomberg, MS Research, Western Asset As of 01 Jul 22

WESTERN ASSET

Mortgage Credit Offers Attractive Relative Value

- While real estate prices are expected to cool from the record increases, 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

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
30 Jun 22	**481**	**275**	**442**	**155**	**570**
Difference Since 31 Jan 20	303	152	192	53	180

Source: Bloomberg, J.P. Morgan, Bank of America, Western Asset. As of 30 Jun 22
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.

WESTERN ASSET

Policy Response in EM versus Developed Markets

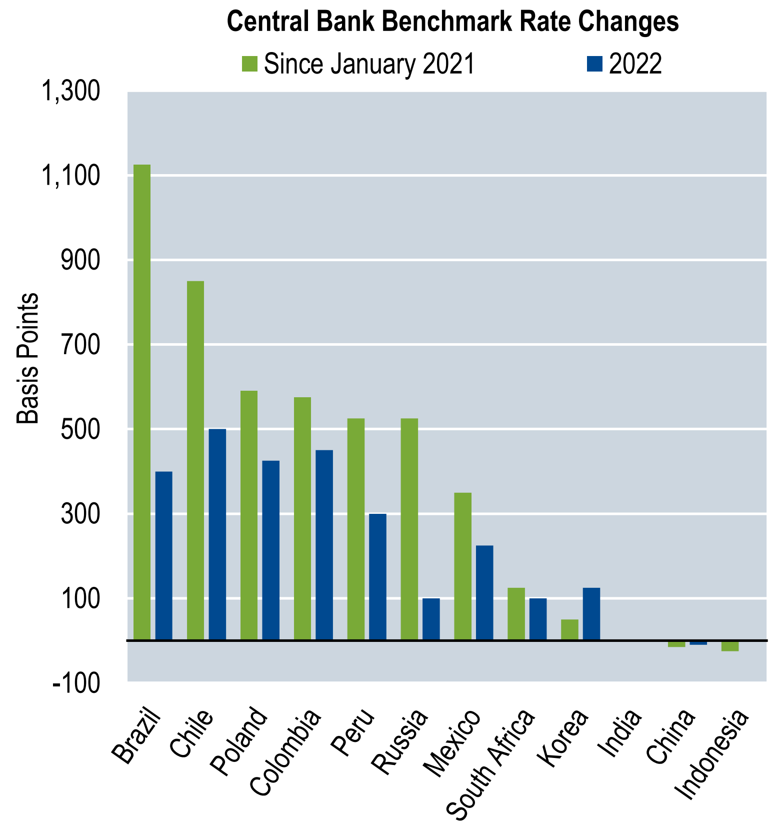
Unlike the US and EU, EM policy flexibility is constrained by potential impact on credit quality and access to funding

Fiscal Policy

- Fiscal stimulus in EM will be constrained by existing buffers, with some countries having more flexibility and willingness than others
- Policy responses so far differ across countries, ranging from aggressive (Chile) to stoic (Mexico)
- Countries with significant fiscal revenues from oil are faced with a double whammy of lower receipts and greater needs for stimulus

Monetary Policy

- Historically, EM central banks have not been able to cut rates during periods of FX depreciation
- In the face of inflation challenges, EM central banks have progressively begun the tightening cycle



Source: Bloomberg. As of 30 Jun 22

Second Half 2022 Outlook

Inflation remains challenging but should ease substantially during 2022

- Monetary policy tightening
- Fiscal policy tightening
- Supply bottlenecks easing
- Commodity price pressures easing

Fixed-Income Outlook

- Russia-Ukraine conflict poses massive geopolitical uncertainty
- 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

The above reflects current opinions of Western Asset and are subject to change with market conditions. As of 06 Jul 22

Questions & Answers

Thank you.

Risk Disclosure

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