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# Webcast Summary

## 3Q22 Market & Strategy Update

*The first half of 2022 was extremely difficult for fixed-income investors. Government interest rates are up sharply, global central banks are increasingly hawkish, the outlook in Europe has darkened given the war in Ukraine and fears of energy security, anxiety about global recession is increasing, and downside risks to growth are evident and will likely grow. Inflation is primary among current challenges, and generally all investment themes have become dependent on the inflation outlook and central bank policy. Amid these formidable dynamics, opportunities do exist. Looking forward, we believe supply chains will rectify themselves, commodity price pressures will decline and the inflation rate will moderate, which will reduce the pessimism now driving rates and spreads higher.*

### Market Review

- The pandemic continues to bedevil populations, especially China. Extreme policies in place during the peak of Covid have reversed with spectacular speed. The period of exceptional growth post-Covid has downshifted to a lower level of GDP, with 1H projected to come in near zero.
- Financial conditions have tightened significantly in the US. Mortgage rates have doubled in the last year, real disposable income has declined, though goods prices should fall due to increased inventories and wage growth is decelerating.
- A persistently high US inflation rate and elevated forward expectations led the Federal Reserve (Fed) to abort its forward guidance, hiking rates 75 basis points (bps) and signaling another 75-bp hike at the next meeting. This abrupt change in Fed guidance kickstarted a renewed period of enormous uncertainty and volatility.
- Outside of the US, global fiscal stimulus is set to turn to global fiscal drag; unlike in the US and EU, emerging market (EM) policy flexibility is constrained by potential impact on credit quality and access to funding. 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.

### The Fed and Inflation

- The Fed's confidence in avoiding recession was key in accelerating its path of rate hikes. Forward guidance leading up to the Fed's June meeting implied the economy was resilient and could endure a fast path to tightening, but signs of economic uncertainty accelerated.
- Ultimately the Fed's attack on inflation is an imperfect tool unable to deal with the supply side of the equation. Central banks have decided to focus on reducing demand meaningfully, introducing the prospect of growth falling more than desired, driving market pessimism.
- Fed Chair Jerome Powell has mentioned the elevated University of Michigan Consumer Sentiment Survey catching the Fed's attention. It is concerning to use this single survey as a basis for rapidly shifting policy,

as the survey is highly correlated to the price of oil, and currently stands in sharp contrast to what's happening in the marketplace:
- TIPS breakevens have been in sharp decline for several months.
- Another indicator that inflation is receding is commodity prices—copper is highly correlated with global growth, lumber is tied closely to housing, wheat prices and shipping costs are all in decline.
- Oil futures remain elevated but we're seeing signaling it could move lower soon.
- A strong US dollar is also a powerful headwind for inflation that needs to be considered.

## Global Markets

- Europe is now facing ongoing war in Ukraine, energy insecurity, business uncertainty and weaker real demand. The European Central Bank (ECB) wants to start tightening monetary policy to combat inflation but energy security complicates these plans.

- The UK is facing similar challenges as the EU, including falling real disposable incomes and high inflation cutting into consumers' ability to spend.

- **Japan:** While currently maintaining yield curve control (YCC), elevated rates around the world may make it a challenge to continue the policy. Core Consumer Price Index (CPI) has bounced meaningfully, yet wage pressures remain muted. Reliance on commodities has impacted the inflation rate as prices have risen, but has so far not fed through to the labor market. The country has been slow to come out of Covid; but we are confident that the GDP will continue to improve.

- **China:** China's growth story will not be the same as it was post-GFC. The massive real estate sector has remained on weak footing and will weigh on growth. A sizeable infrastructure proposal recently announced is one of many measures that should help turn growth into positive territory.

## Spread Sector Recap

- All sectors have been crushed year-to-date (YTD) except non-agency residential mortgage-backed securities (NARMBS). The inflation rate has led central banks to attack with aggressive short-term rates, leading to the interpretation that global growth will slow in a meaningful way. This bear market has been painful but one positive is that historically after periods of drawdown like this, sharp positive returns soon follow.

- **Investment-grade credit:** The risk/reward dynamic is strong. Implied default rates are north of double digits, overwhelming historical experience. Pessimism is overwhelming any fundamental analysis and has moved spreads wider. Within investment-grade energy, management teams continue to act conservatively. Elevated prices are improving cash flows; even if oil prices decline past $100, these companies will continue to perform well.

- **High-yield:** Pessimism is again evident in contrast to credit metrics, with the highest implied default probability since 1970.

- **Bank loans:** The asset class has compelling attributes. Credit metrics are strong, and bank loans benefit from a floating-rate component that can take advantage of higher short-term rates.

- **Agency mortgages:** Spreads have widened sharply due to Fed tightening and higher volatility, which work against mortgages. We have reduced our underweight as spreads have moved closer to fair value.

- **Sector recoveries delayed by Covid:**
  - **Residential mortgage credit:** Real estate prices should cool from record increases and elevated risk premiums while lending standards still lean conservative. Collateral value of mortgages is very robust and risk premiums should be taken advantage of.
  - **EM:** Caution is warranted. The sector is challenged by higher central bank rates and not as many fiscal levers to pull versus developed market (DM) countries. Weaker currency makes it difficult to ease policy. EM central banks have actually been tightening much faster than in past cycles. There is a possibility EM

could benefit but needs to be considered on a country-by-country basis.

## Conclusion

- Inflation remains challenging but should ease substantially during 2022; monetary policy is tightening, fiscal policy is tightening, supply bottlenecks are easing and commodity price pressures are easing.
- For fixed-income, the Russia-Ukraine conflict poses massive geopolitical uncertainty. Covid continues to bedevil global populations, the US and global growth are decelerating from high levels, Fed tightening will continue to focus on making inflation a top priority and global fiscal stimulus will be sharply reduced.
- 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 challenge is straightforward. The inflation rate remains elevated and generally all investment themes have become dependent on the outlook for inflation and central bank policy. Can the tide be turned on inflation? This is a critical question, as underlying pessimism has developed and central banks are faced with an unrelenting war as they continue to raise rates; though growth may not be immediately challenged, there is a possibility of it becoming so in a fairly broad-based way over time.

Our key message is that a change in the inflation outlook is needed as an antidote to pessimism, such that the inflation rate will start to ameliorate some of the imbalances such as supply-chain issues and the decline in commodity prices. Our strong expectation is the inflation rate going forward is going to be declining. We think that fading pessimism, both with respect to rates and credit spreads, is justified.

## Q&A Highlights

- The risks in the market are reflective of the weak economic data over the last 4-6 weeks and consistent with surveys on sentiment. We think a recession will be avoided. Services demand and supply are strong. Savings rates will decline but the consumer balance sheet is still strong. Central banks need to take a measured approach, which we expect to happen.
- Lingering inflation and its impact on Fed policy is the key risk to Western Asset's base case and would be an acute challenge for central banks needing to be more aggressive. This challenge does not need to be solved in a quarter's time. Taking on a recession is a high-risk endeavor. We expect policymakers to take the long road in this fight and see signs that inflation is turning downward.
- Supply-chain issues are finally beginning to resolve. Inventories are up, the Baltic Freight Cost Index is coming off sharply, and Capex investment in semiconductors has been spectacular.
- Inflation rising further and growth falling are one and the same challenge. If inflation lingers, central banks will prioritize at the expense of growth. It is difficult to invest amid a poor growth outlook that is tied to inflation (stagflation?). The prospect of battling inflation with extreme confidence in the economy has changed. Front loading hikes to get the funds rate in the US to "neutral" would require close monitoring of all elements to growth.
- At any time the Fed would have to acknowledge a slow growth outlook at the expense of fighting inflation. Fed speakers are out in the media all the time and can front run another 75-bp hike. The BoE and ECB were quick to acknowledge weakening economic conditions, and we expect the Fed to do the same.

- In terms of yield-curve inversion, the market is sending a strong signal that the outlook for long-term growth and inflation is much more muted than at present. The hiking forecast from the Fed is also much higher than market expectations. This implies the Fed may overshoot the neutral rate and be forced to reverse course which would mean a lower terminal rate.

- Our view on currency markets with the US dollar at a 20-year high is that if we are right in that central banks can pull back as inflation recedes, the dollar will decline moderately as that plays out.

- Despite the higher yields in corporate bonds, weaker economic conditions could lead to wider spreads. This is always a risk given the dynamics of tighter financial conditions. Macro risks are driving spreads wider, not deteriorating fundamentals. Credit metrics remain firm. Top-down, a policy error could get us in a gloomy growth scenario that overwhelms fundamentals. At minimum, a mild recession is already priced in. We haven't seen these implied default rates in 50 years. It's an attractive buying opportunity, especially for a long-term buy and hold investor.

- As mortgage rates eclipse 6%, our view on MBS is that repayment risk is very low right now. General market volatility works against mortgages, combined with the Fed's shrinking balance sheet. We have cut our underweight.

- In terms of EM, any pullback we see globally from economic tightening could be a dynamic that leads to improvement in EM. China has a lot of work to do but is moving forward in a pronounced way. It really is a country-by-country assessment.