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January 12, 2023

Thank you for joining Western Asset's  
*1Q23 Market & Strategy Update* webcast  
featuring CIO Ken Leech.

*The presentation will begin shortly.*



### **When Diversification Fails ... and Recovers**

This blog post discusses why we expect to see the correlations between bonds and equities revert to their historical relationship in 2023.

[www.westernasset.com/DiversificationRecovers](http://www.westernasset.com/DiversificationRecovers)



# 1Q23 Market & Strategy Update

January 12, 2023

Ken Leech

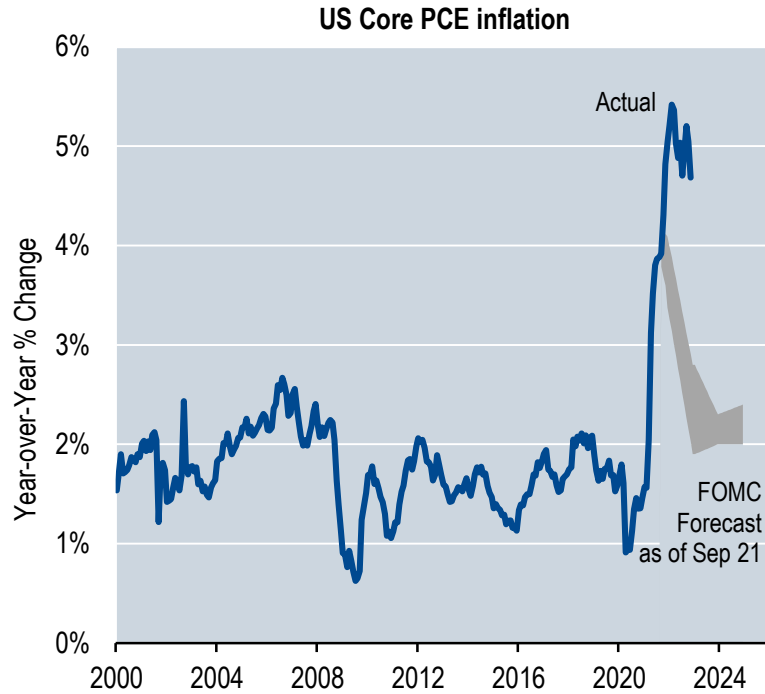
Chief Investment Officer

# 2022 – Year in Review

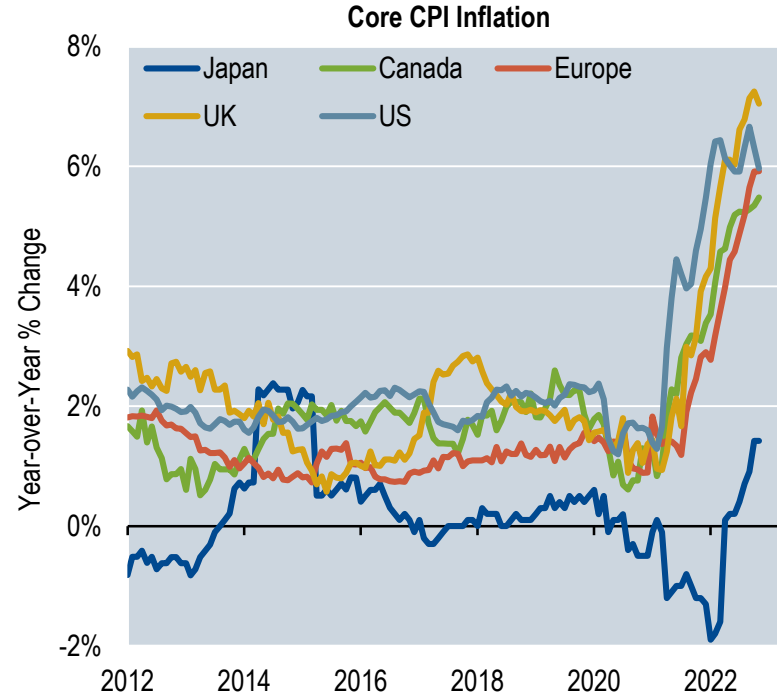
## Inflation Surprised Higher

"We understand better how little we understood about inflation."

– Chair Powell, June 22



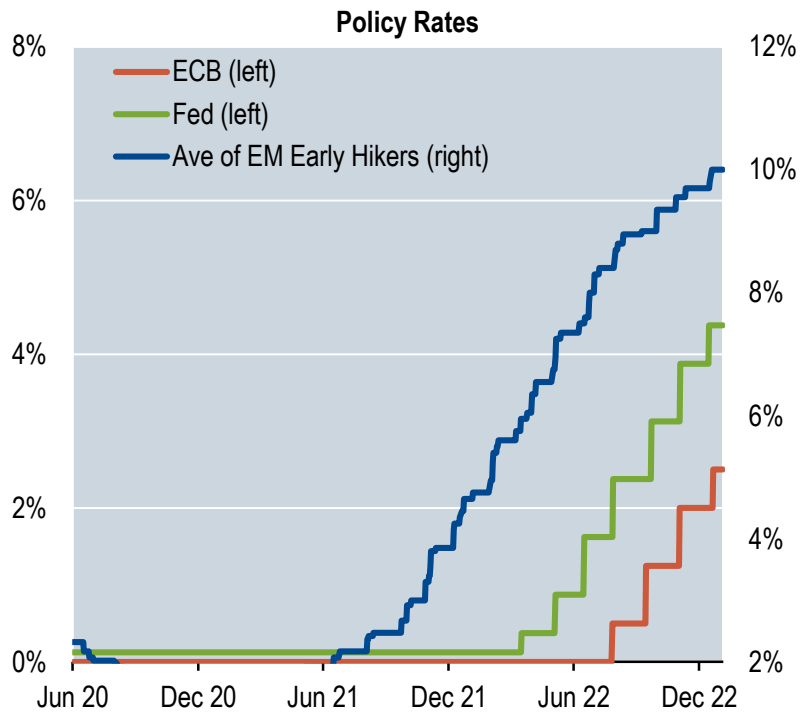
Source: Haver Analytics. As of 30 Nov 22



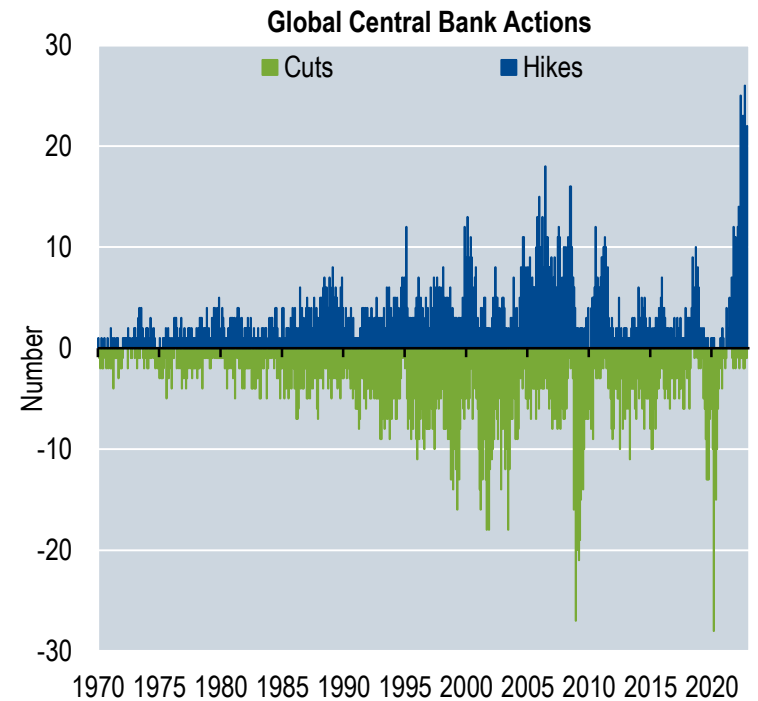
Source: Haver Analytics, Federal Reserve, As of 30 Nov 22

# 2022 – Year in Review

## Central Banks Tightened



Source: Haver Analytics, Bank of International Settlements. As of 31 Dec 22

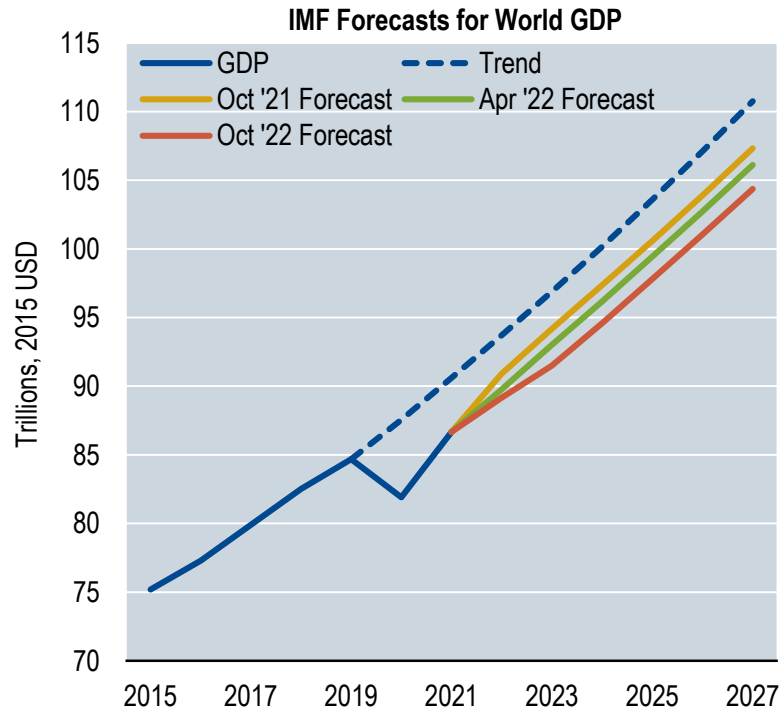


Source: Haver Analytics, Bank of International Settlements. As of 31 Dec 22

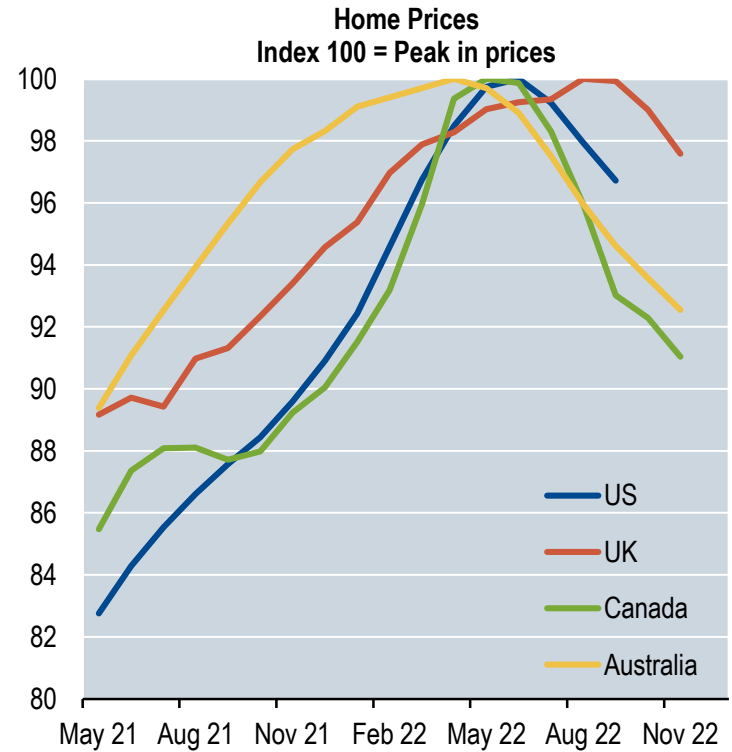
# 2022 – Year in Review

## Expected Effects of Tightening

Downgraded growth forecasts, housing prices falling, etc.



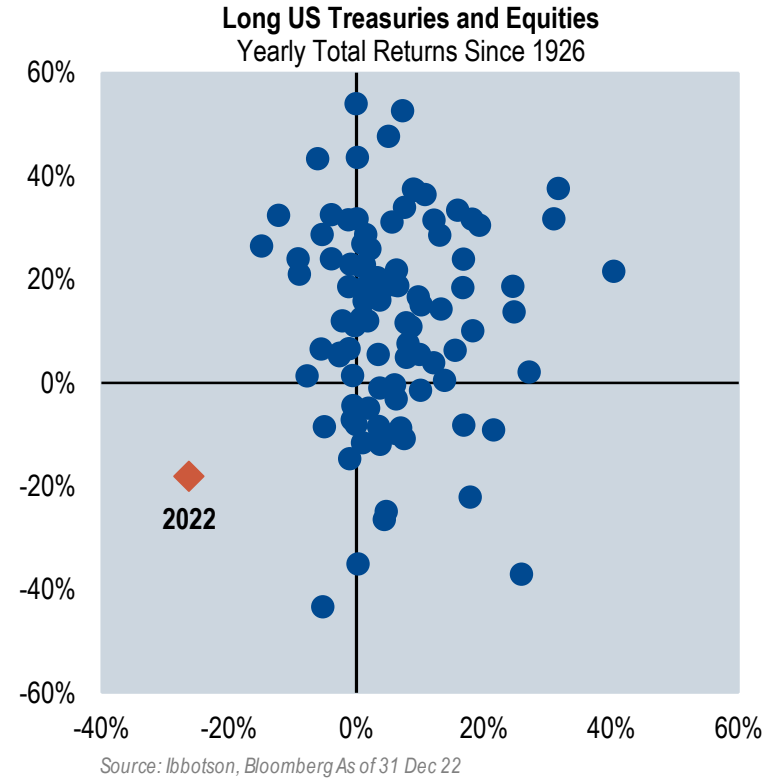
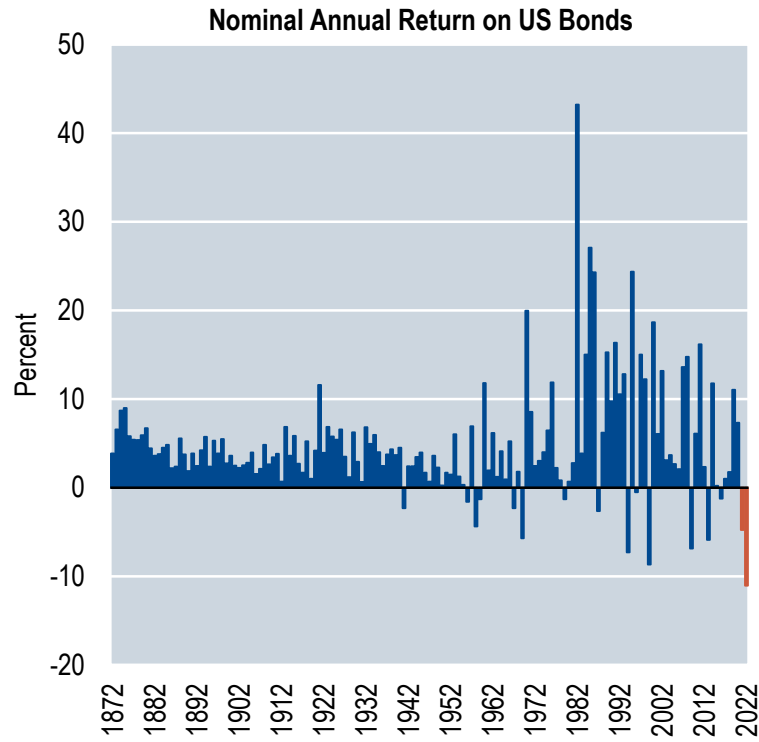
Source: IMF. As of 30 Nov 22



Source: Haver Analytics and Terra Net. As of 30 Nov 22

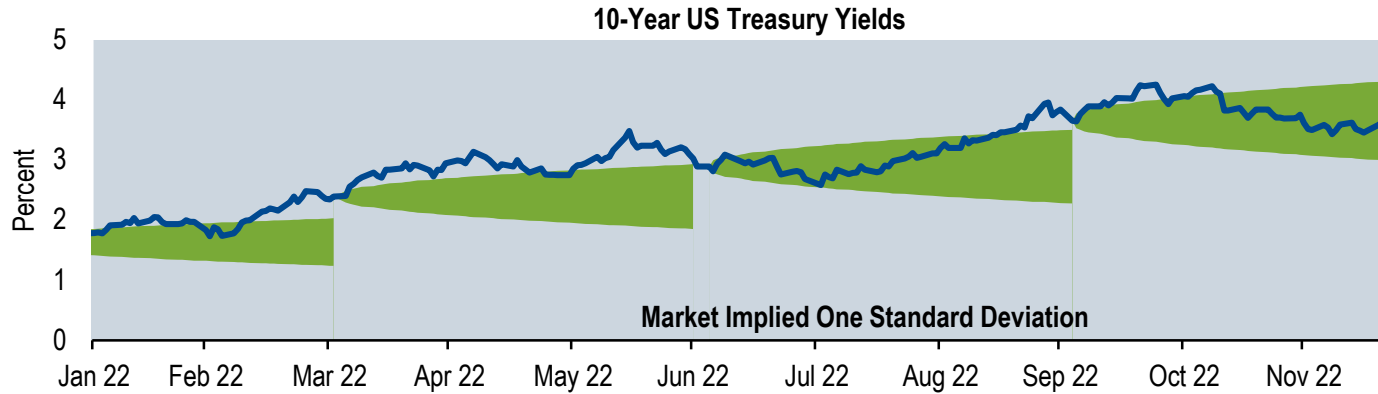
# 2022 – Year in Review

## Worst Year on Record for US Treasury Bonds

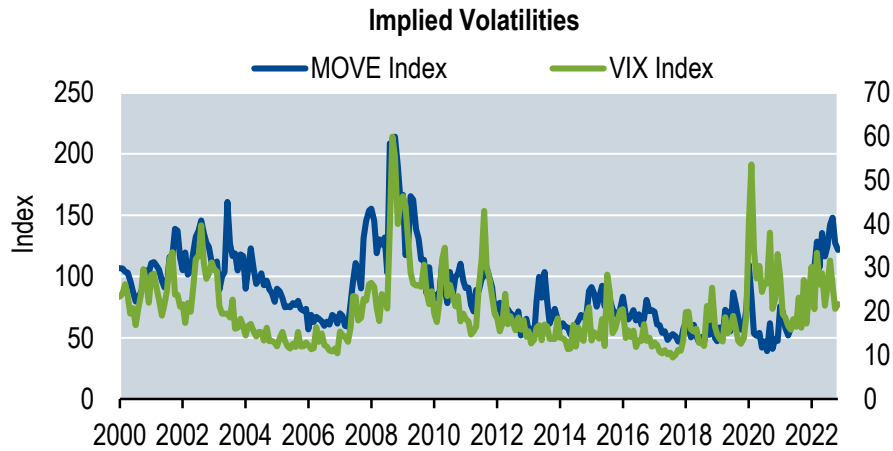


# 2022 – Year in Review

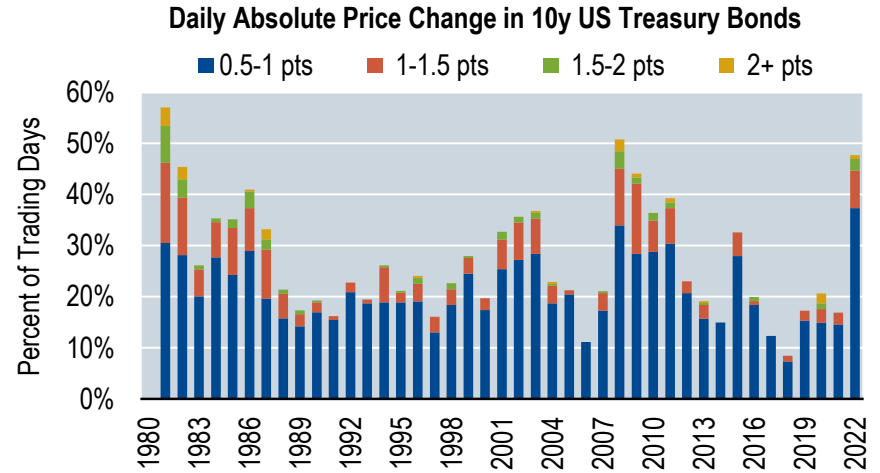
Bond volatility was high.



Source: Bloomberg As of 31 Dec 22



Source: Bloomberg As of 31 Dec 22

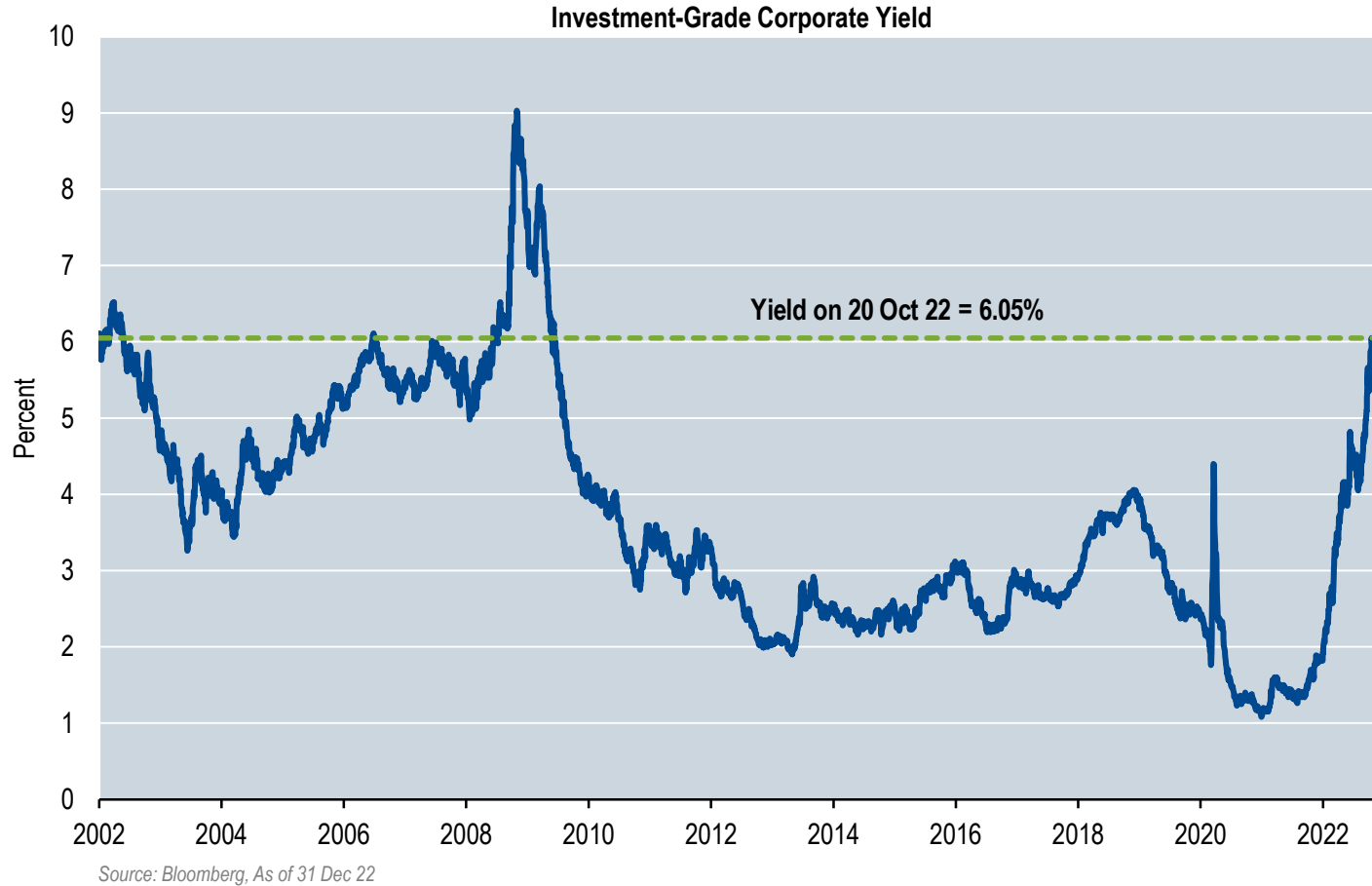


Source: Bloomberg As of 31 Dec 22

# 2022 – Year in Review

## Elevated Yields

In Q4 yields reached their highest level in 20 years (except GFC)





## Inflation should ease substantially during 2023

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

## Federal Reserve Policy Outlook

- Stickiness of lagging inflation measures has postponed the pause and elevated the peak rate
- Forward inflation indicators display substantial progress
- Fed's policy goal is to pause at restrictive rate and allow inflation to fall
- We expect the Fed to pause in Q1 2023

## Fixed-Income Outlook

- US growth will slow but will avoid recession
- Global growth has downshifted, but with China's reopening will remain resilient
- Global inflation will continue to recede
- The dollar will weaken moderately
- Emerging markets will shine
- Central bank overtightening is a meaningful risk
- Spread sectors are extremely attractive but the outlook is clouded by macro risk
- Geopolitical uncertainty continues to add to volatility

# Fed Policy: Focus on Real Interest Rates

“ ... We also know that there are long variable lags, particularly as they relate to inflation.”

“ ... You want to be at a place where real rates are positive across the entire yield curve ...”

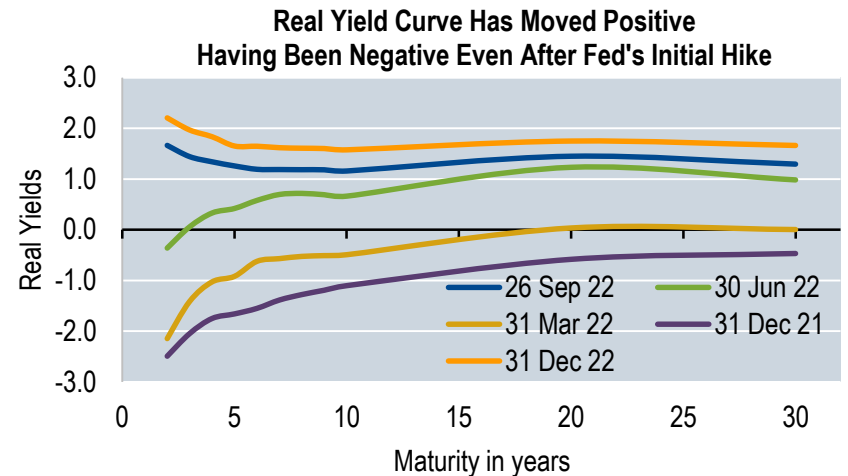
– Chair Powell, 21 Sep 22

“ ... the entire real curve will soon move into positive territory.”

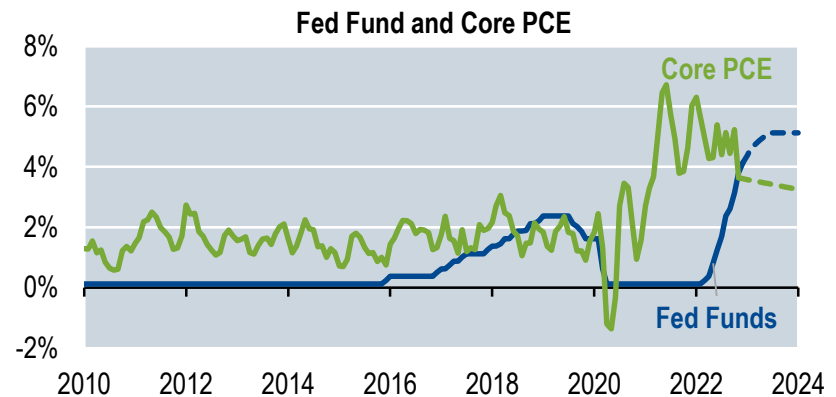
– Vice Chair Brainard, 30 Sep 22

“The combined effect of concurrent global tightening is larger than the sum of its parts ...”

– Vice Chair Brainard, 10 Oct 22

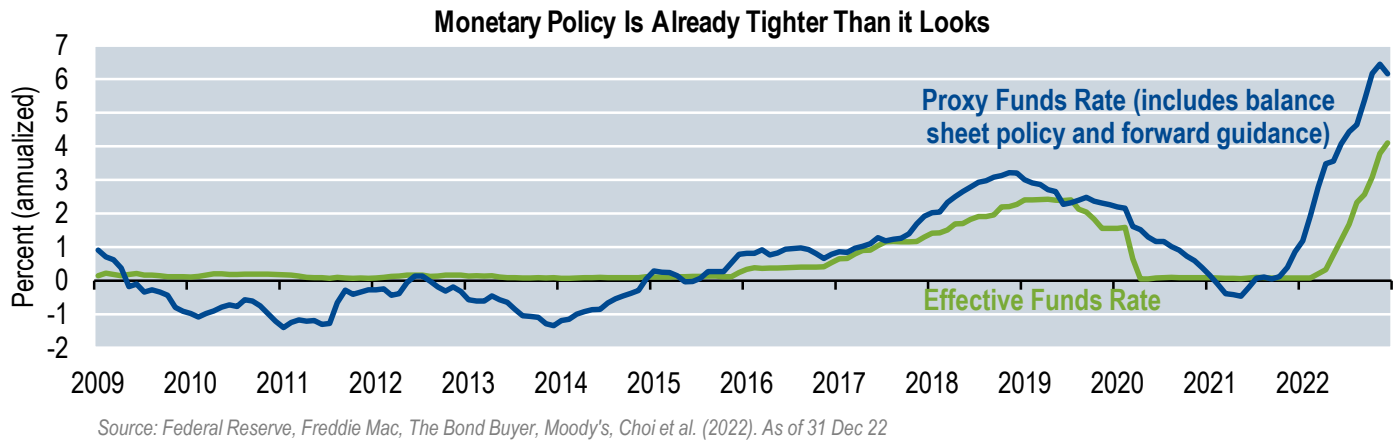
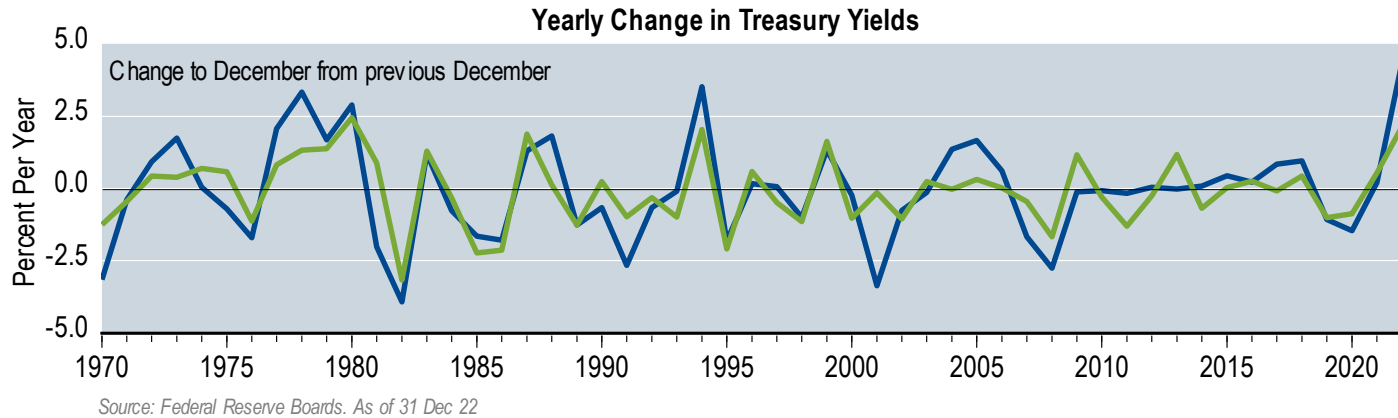


Source: Bloomberg

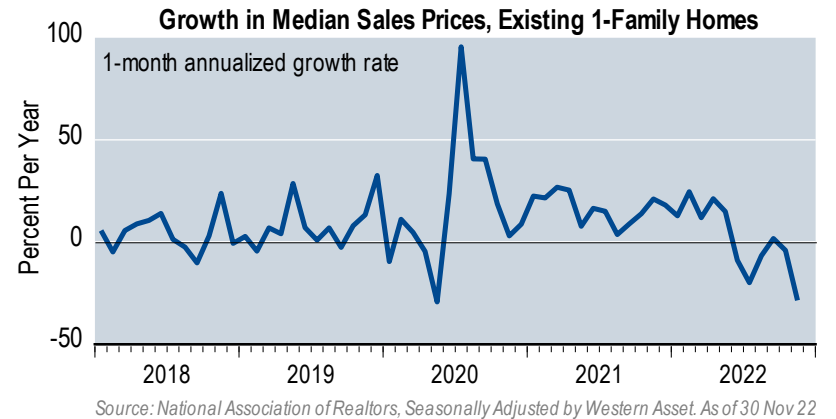
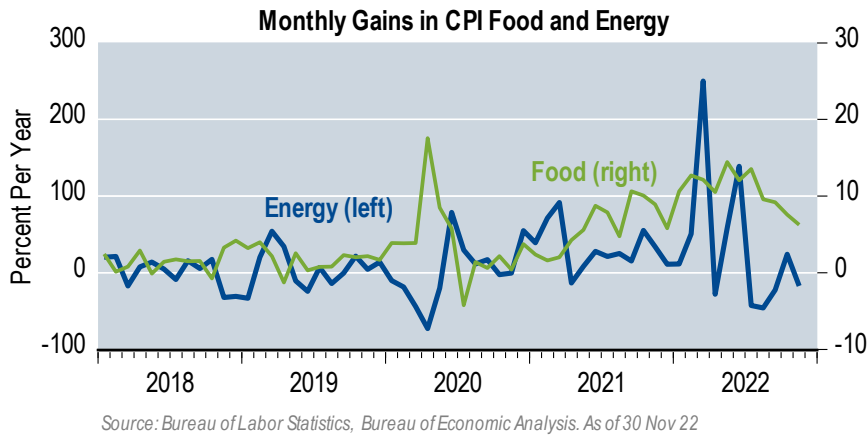
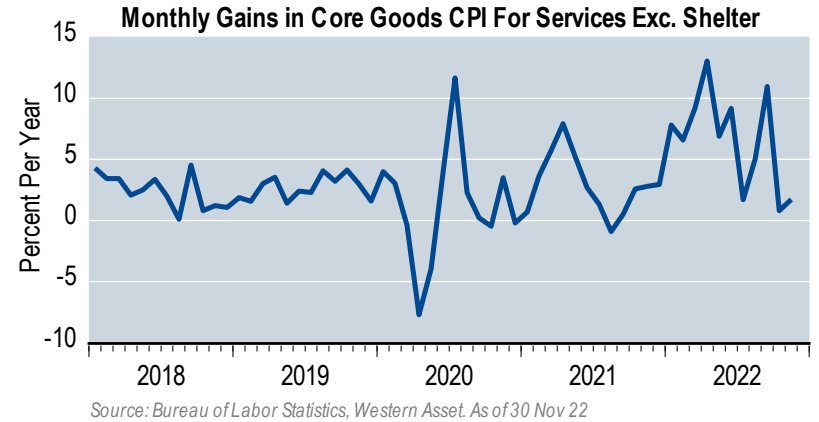
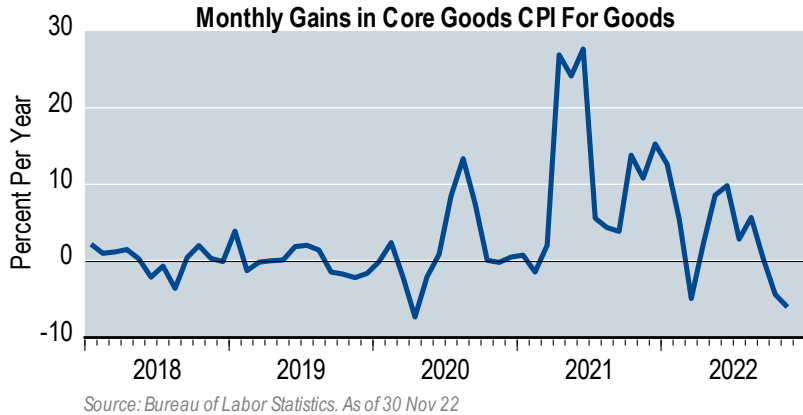


Source: Haver Analytics, Federal Reserve. As of 31 Dec 22

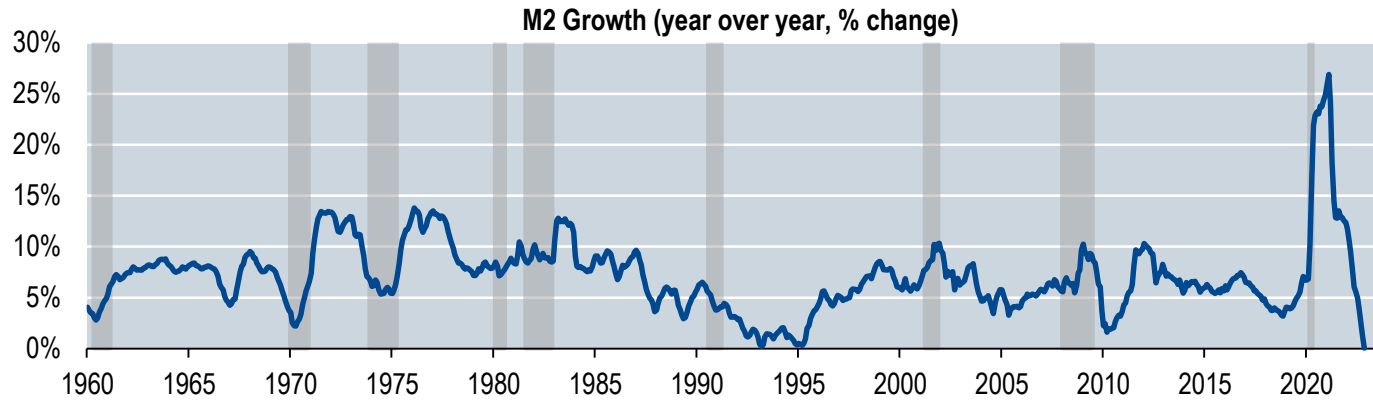
# Yearly Change in Treasury Yields Largest on Record



# Inflation War Is Being Won



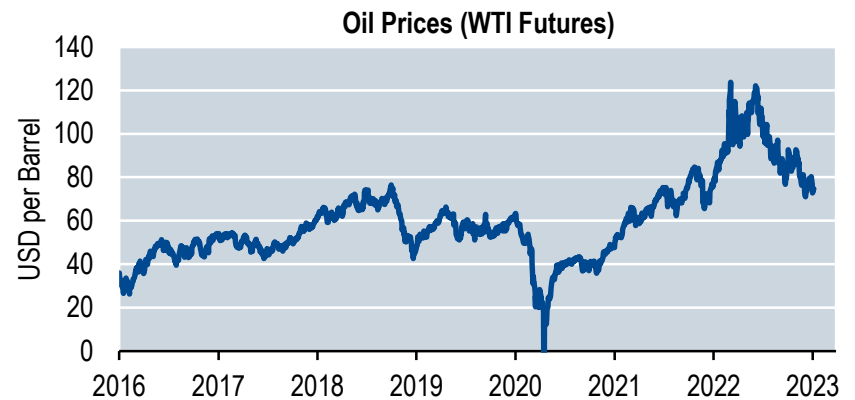
# Shocks Dissipating



Source: Haver Analytics. As of 30 Nov 22

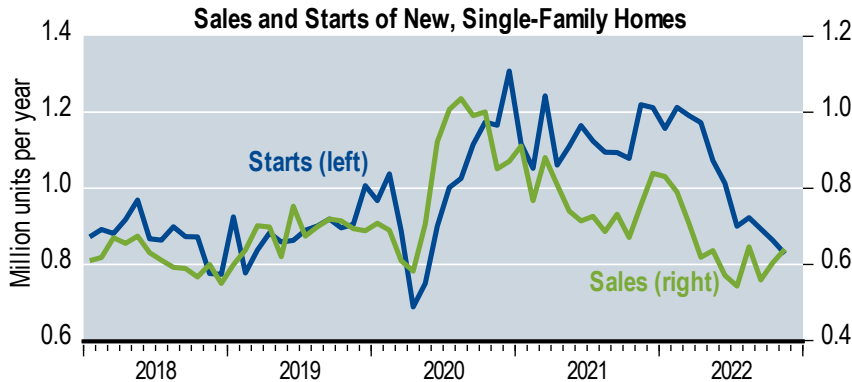


Source: New York Federal Reserve. As of 31 Dec 22

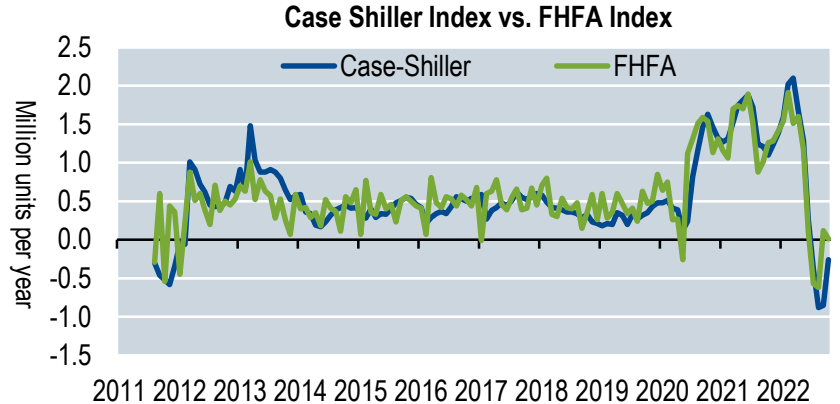


Source: Bloomberg. As of 31 Dec 22

# Housing Market Turning



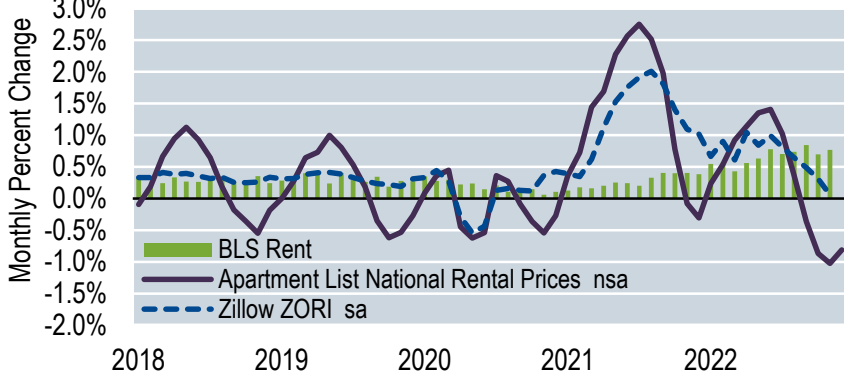
Source: Census Bureau. As of 30 Nov 22



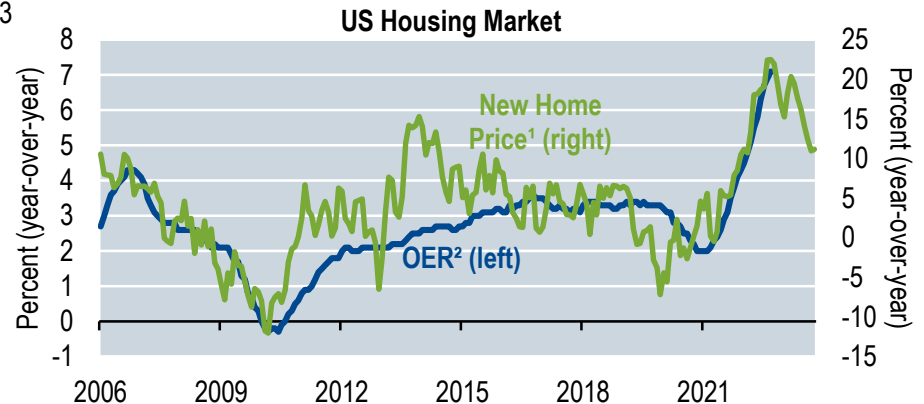
Source: Haver Analytics. As of 31 Oct 22

## Asking Rents Decelerating Sharply From 2021 Highs

BLS Rents Lag But Increases Should Begin Sustainably (Slowly) Declining Jan-2023



Source: ApartmentList.com, Zillow, BLS. As of Nov 22

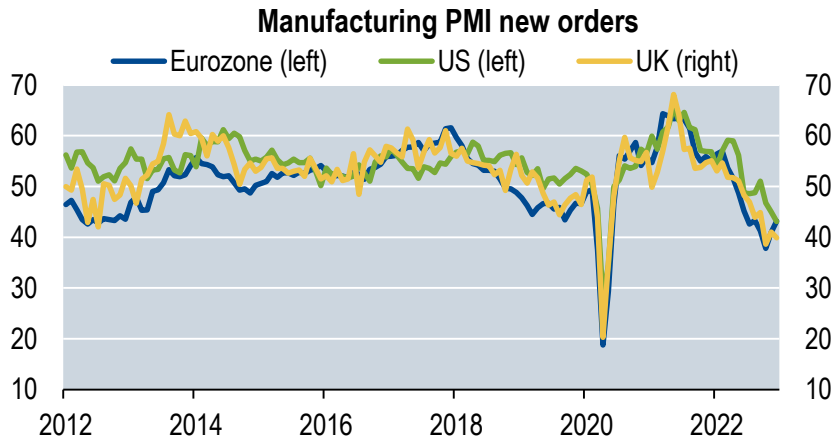


As of 30 Nov 22

<sup>1</sup>Shown as 3-month moving average and advanced by 14 months

<sup>2</sup>Owners' Equivalent Rent

# Softening Sales, High Inventories and Improving Supply Chains



Source: Haver Analytics. As of 31 Dec 22



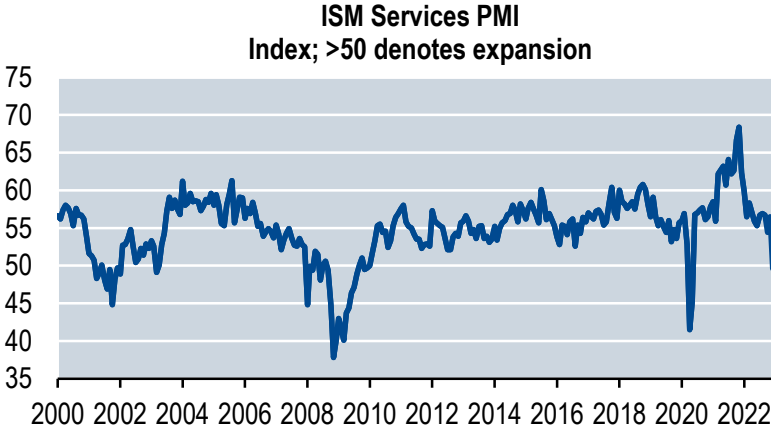
Source: JP Morgan, Haver Analytics. As of 31 Dec 22

# Supply-Chain Improvement Has Led to Lower Manufacturing Inflation

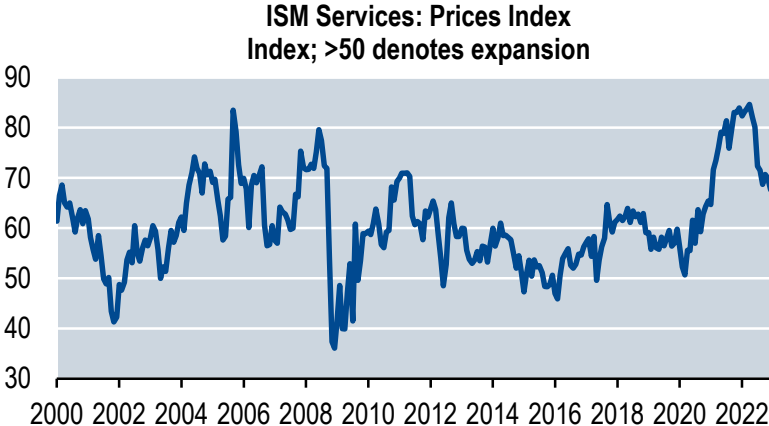


Source: Haver Analytics. As of 31 Dec 22

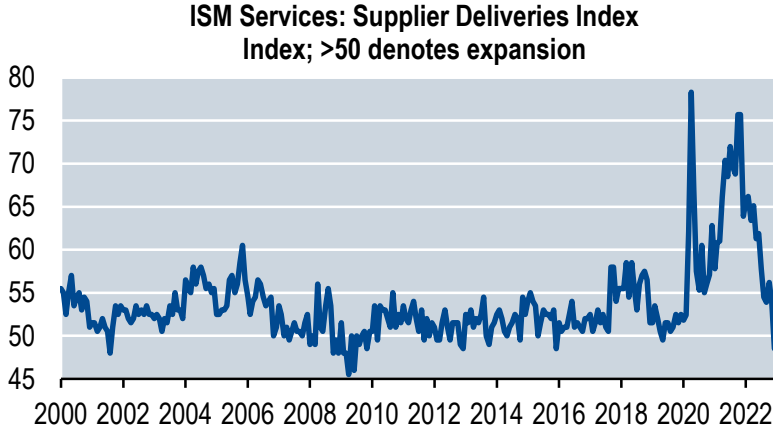
# Signs of a Turn in the Service Sector?



Source: Bloomberg. As of 31 Dec 22



Source: Bloomberg. As of 31 Dec 22

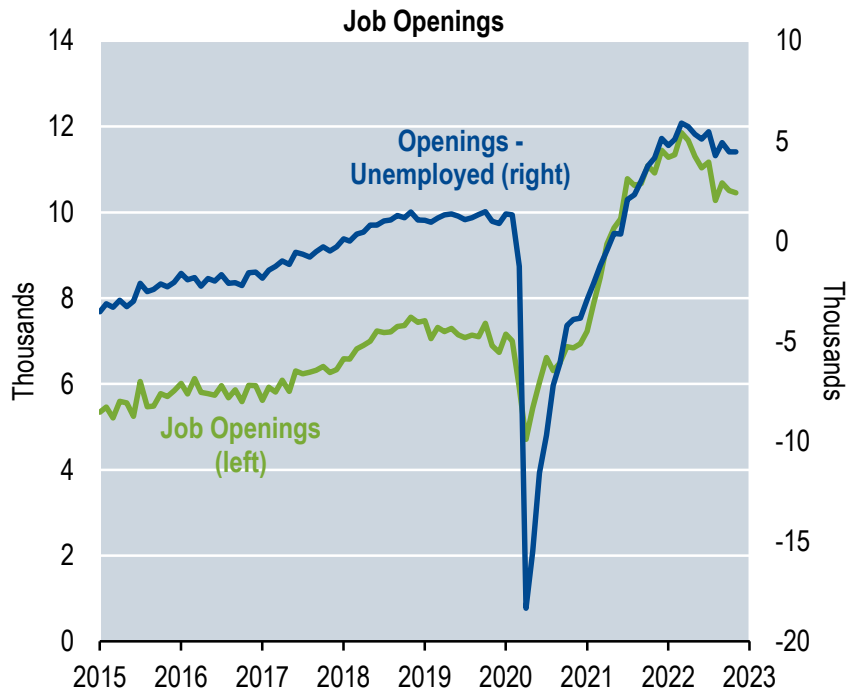


Source: Bloomberg. As of 31 Dec 22

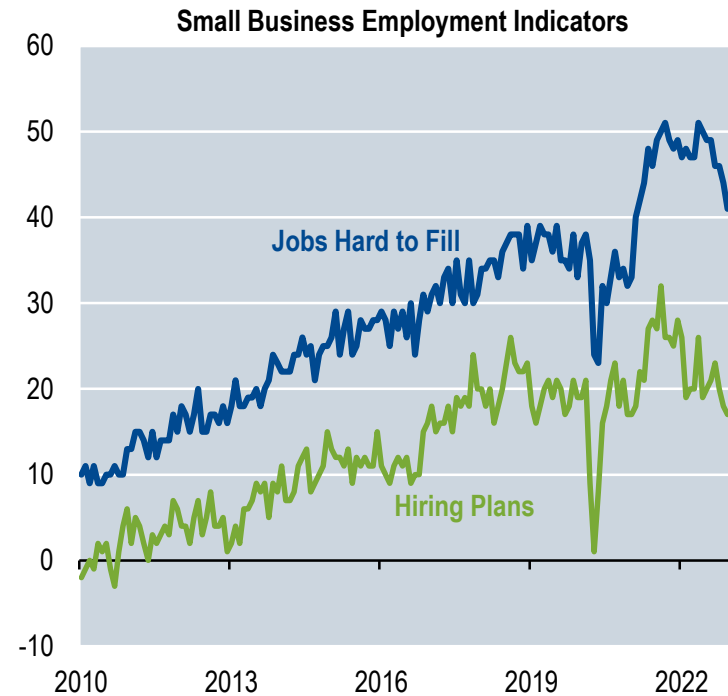


# Job Openings

Openings still elevated; there is potential for additional declines without large scale layoffs.

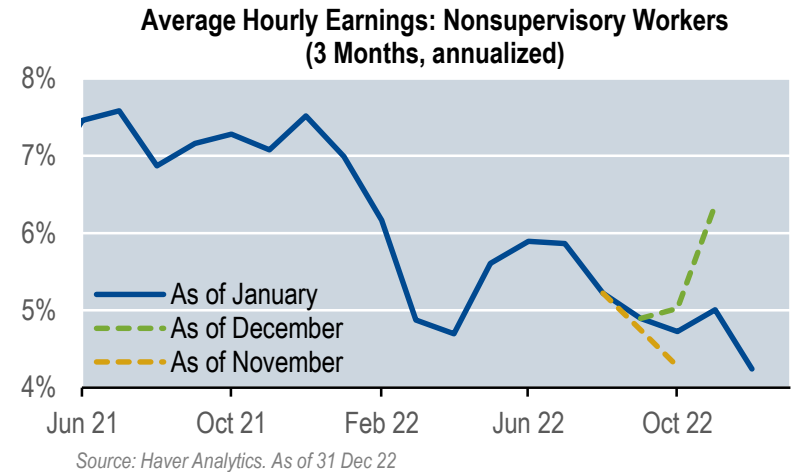
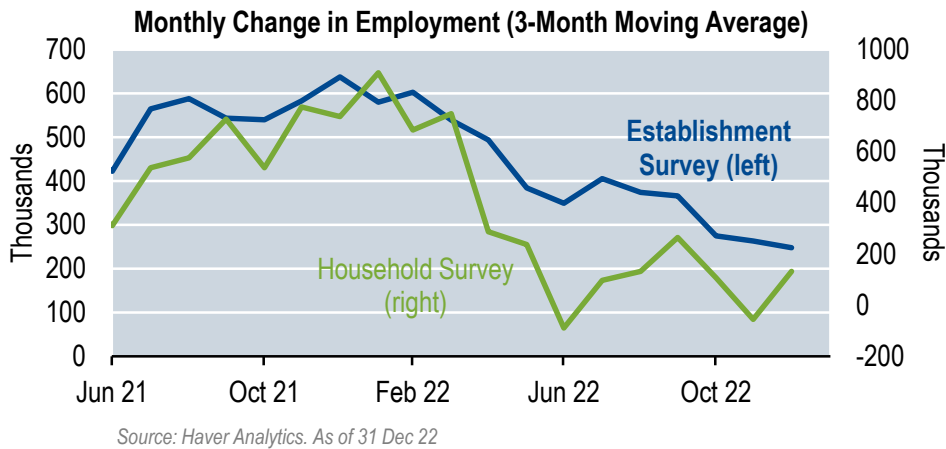
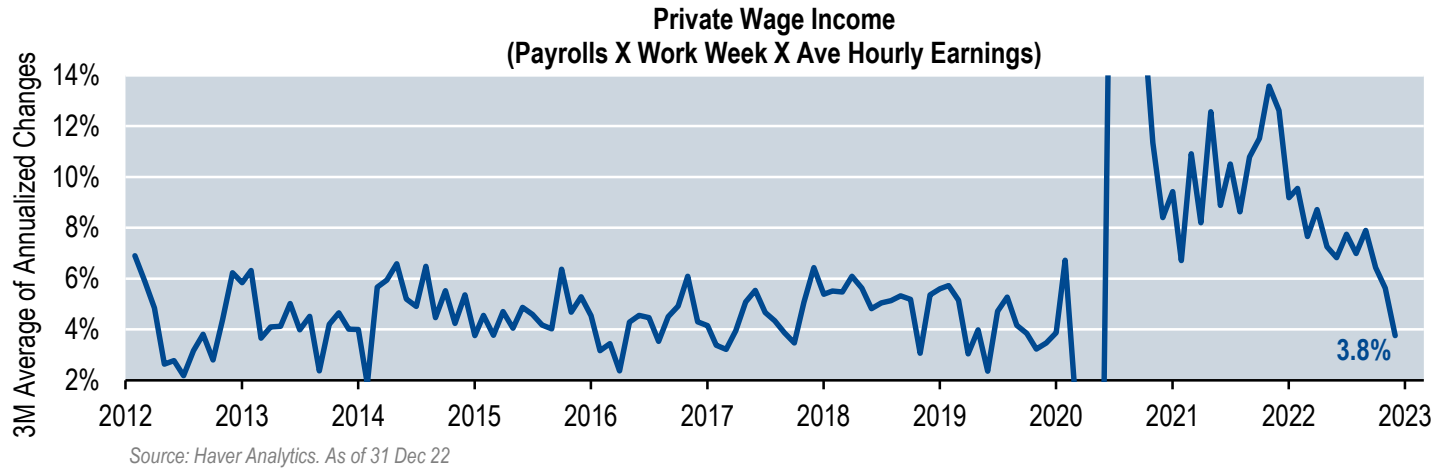


Source: Haver Analytics. As of 31 Dec 22



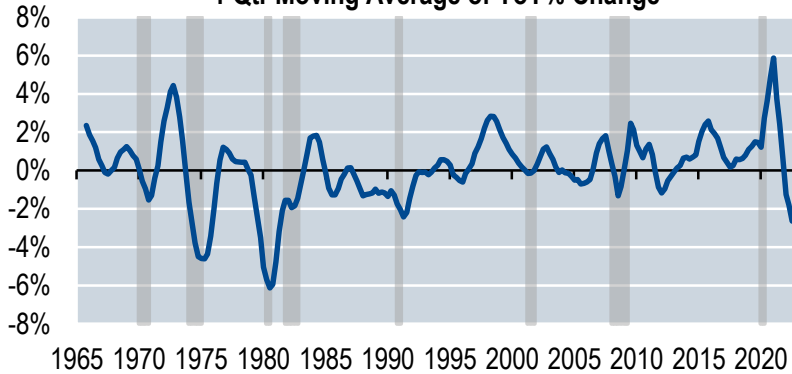
Source: Bloomberg. As of 31 Dec 22

# Wage Growth Decelerating



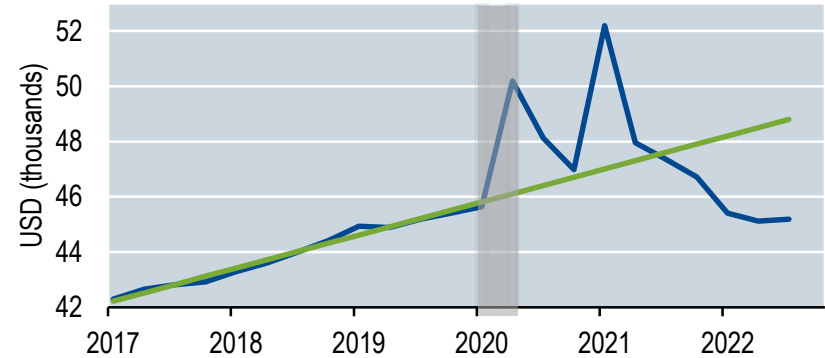
# Inflation Challenges Households

**Real Weekly Earnings**  
4-Qtr Moving Average of YoY% Change



Source: Haver Analytics. As of 31 Dec 22

**Per Capita Real Disposable Income**



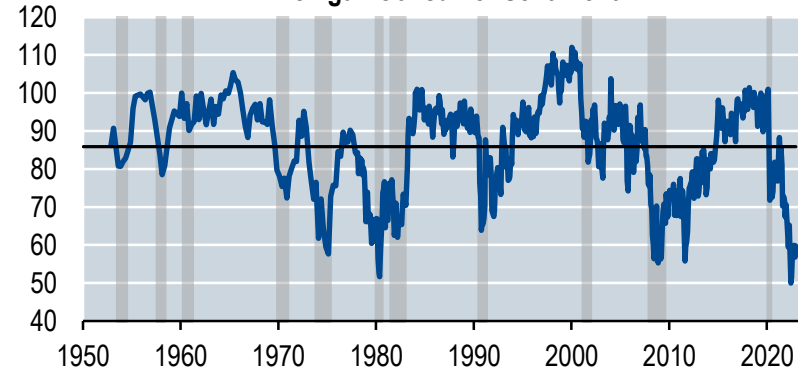
Source: Haver Analytics. As of 31 Dec 22

**US Personal Saving as a % of Disposable Personal Income**



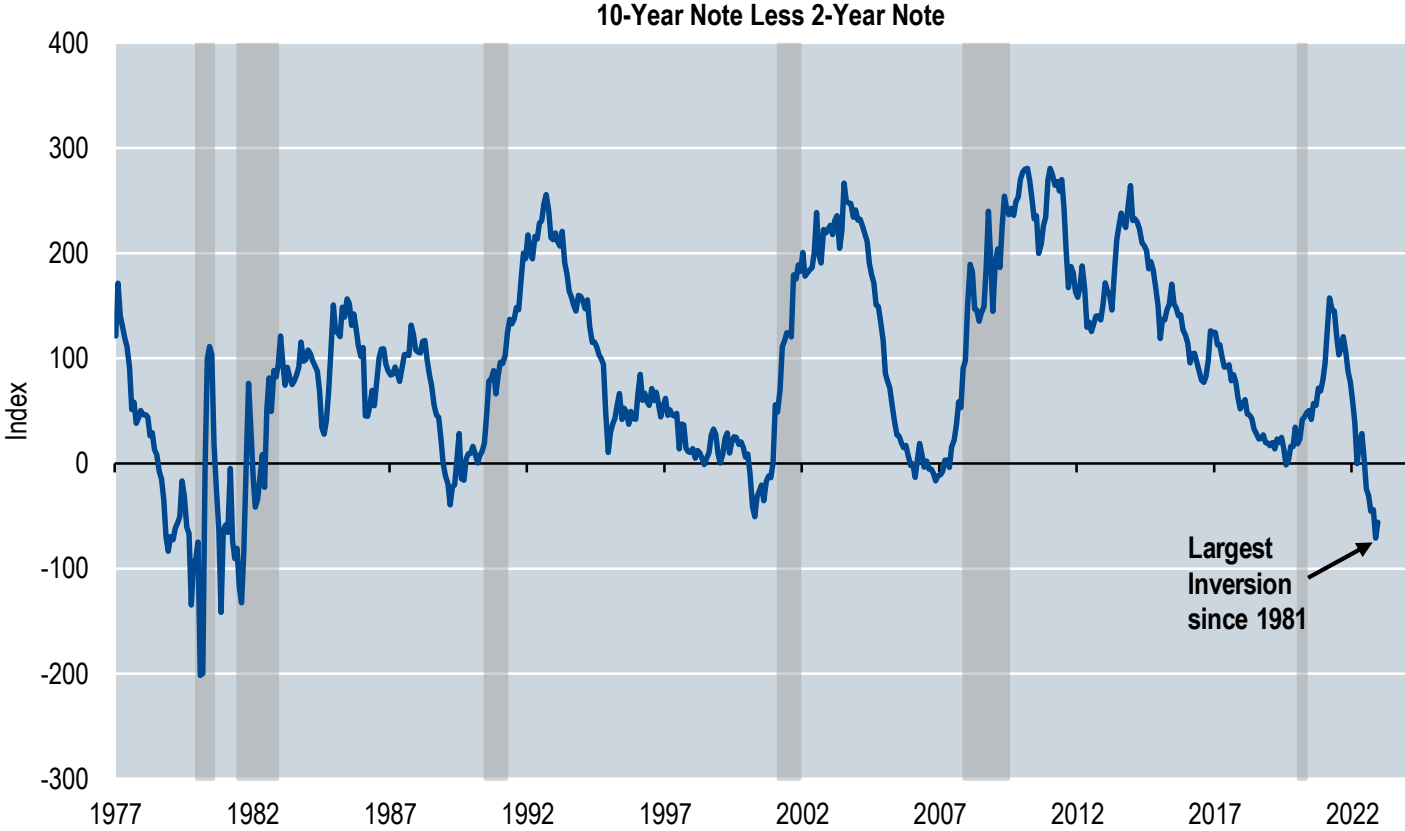
Source: Haver Analytics, U.S. Bureau of Economic Analysis. As of 30 Sep 22

**Michigan Consumer Sentiment**



Source: Haver Analytics. As of 31 Dec 22

# Yield Curve Indicates Slower Growth and Inflation

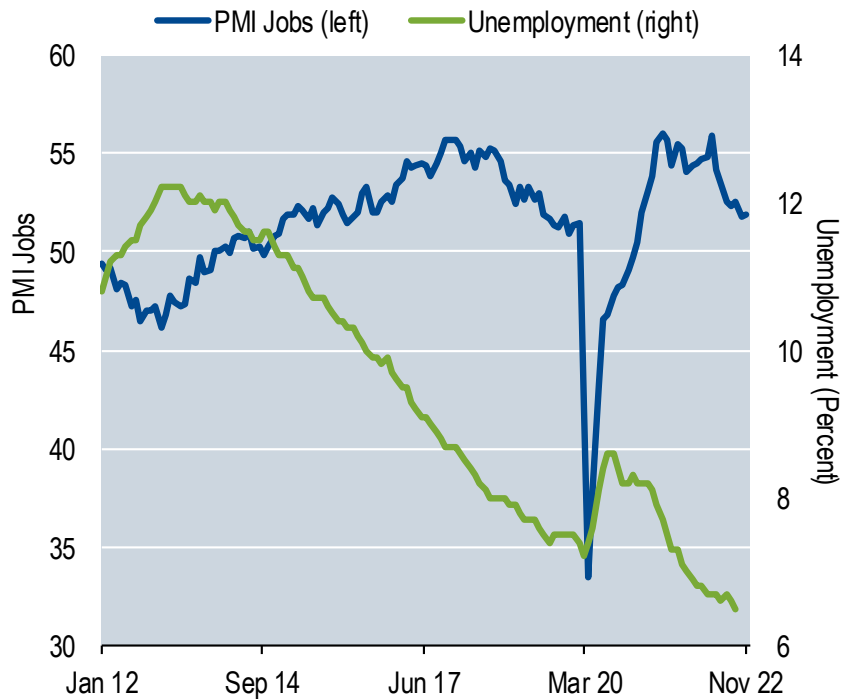


Source: Bloomberg. As of 31 Dec 22

# Europe's Growth Has Held in Well but Demand Is Weakening and Support Is Waning

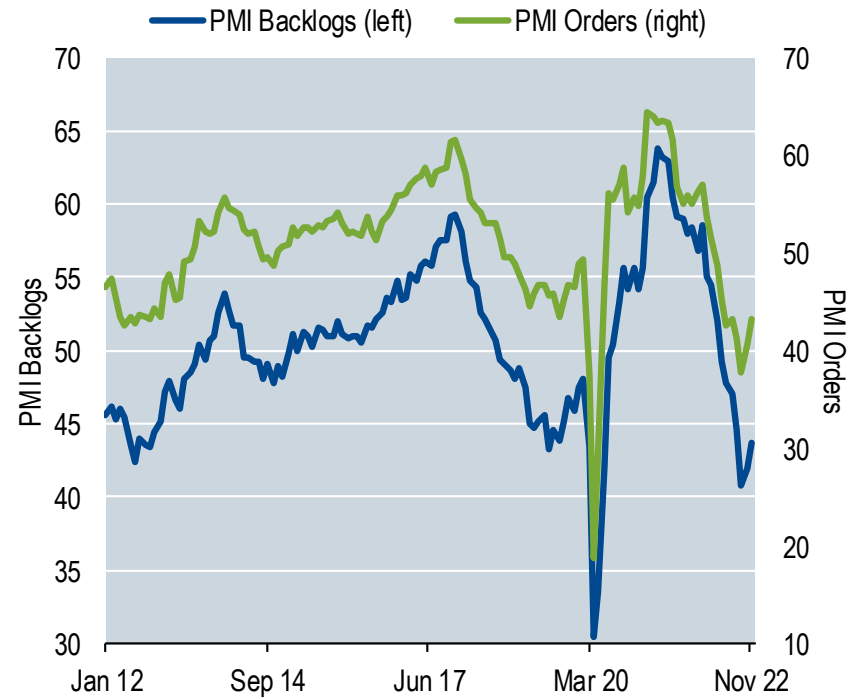
- Clement weather, easing supply-chain issues and large order backlogs have supported growth
- Over time current production will reflect current weak demand
- Unemployment is low, but forward-looking indicators point to a gentle rise

### Employment Indicators



Source: Royal Bank of Scotland, S&P Global, Eurostat/Haver Analytics. As of 31 Dec 22

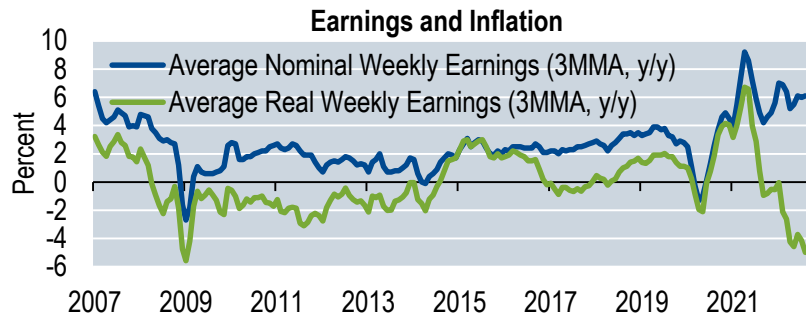
### Demand Indicators



Source: Royal Bank of Scotland, S&P Global, Eurostat/Haver Analytics. As of 31 Dec 22

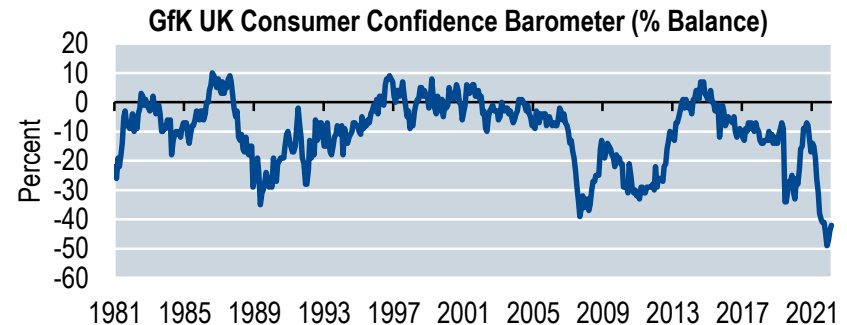
# United Kingdom: Growing Economic Pessimism

- Bank of England has raised the policy rate meaningfully (to 3.50% most recently) and active gilt sales are underway
- Market turmoil seen in September acted as a confidence shock and further tightened financial conditions
- Falling real incomes and higher costs of living (energy and food inflation) are reducing discretionary spending
- Higher mortgage costs further squeeze household budgets and the property market is weakening
- Consumer sentiment is at all-time lows, even lower than the pandemic and GFC

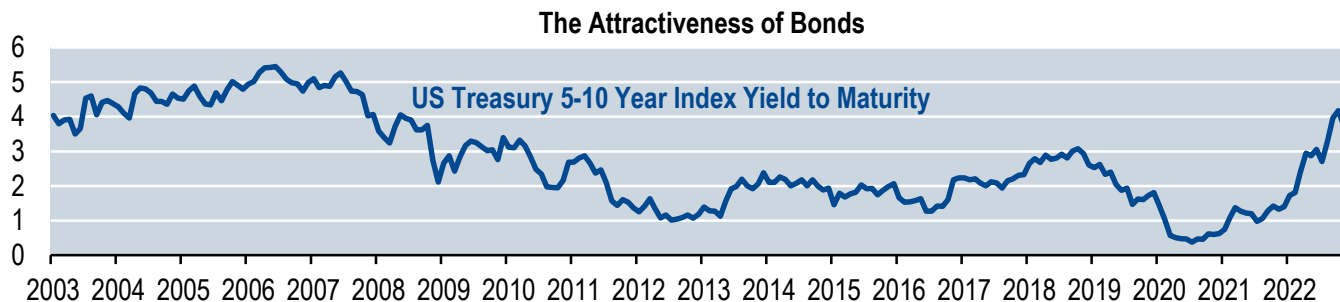


Source: Office for National Statistics/ Haver Analytics. As of 31 Oct 22

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



Source: Bloomberg, GfK NOP. As of 31 Dec 22

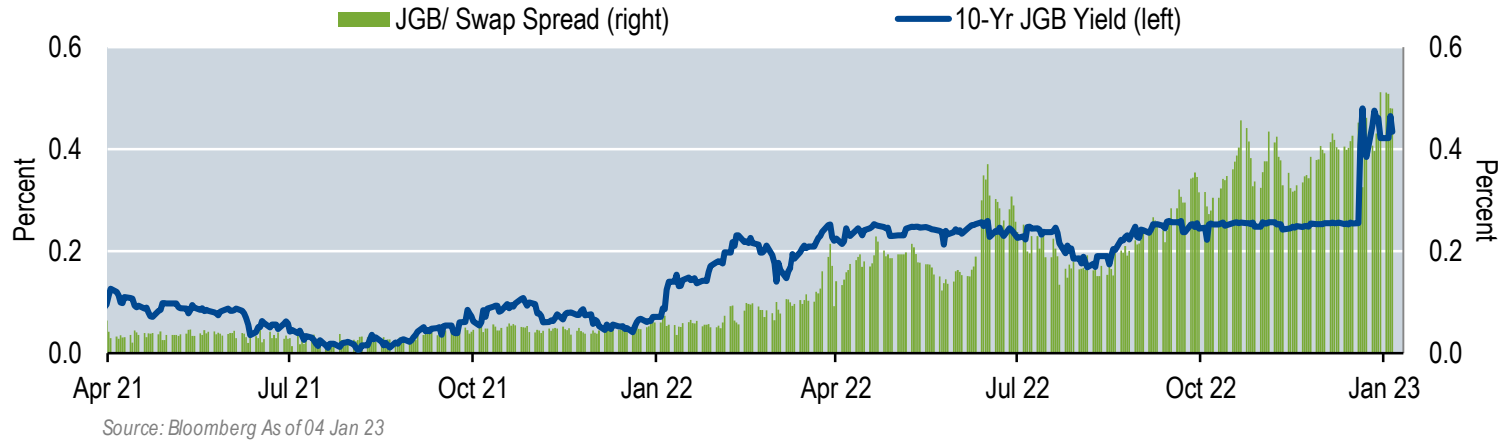


Source: Bloomberg. As of 31 Dec 22

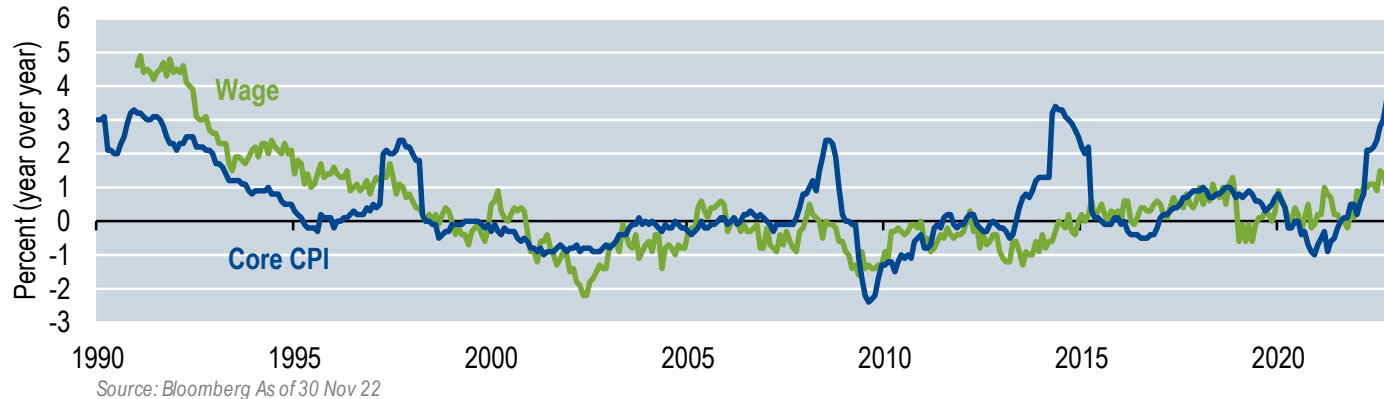
- The market reaction was outsized given UK's relatively low debt/GDP (87% vs EU average of 96%)
- BoE intervened to halt downward price spiral due to huge margin calls and forced selling by LDI firms. Stressed backstop only, not monetary policy
  - Temporary operations to buy nominal and inflation-linked gilts. Delayed start of active QT
- New PM and Chancellor, Sunak and Hunt, have returned to more orthodox economic approach
  - November's Autumn Budget reversed many of the mini budget policies and detailed £55 billion fiscal consolidation to ensure declining debt/GDP in the medium-term, alongside OBR forecasts

# Investors Continue to Show Doubts About Yield Curve Control (YCC)

We're seeing wider spreads between JGBs and Swap rates.



# Wage Pressure Remains Low Despite the Elevated Core CPI



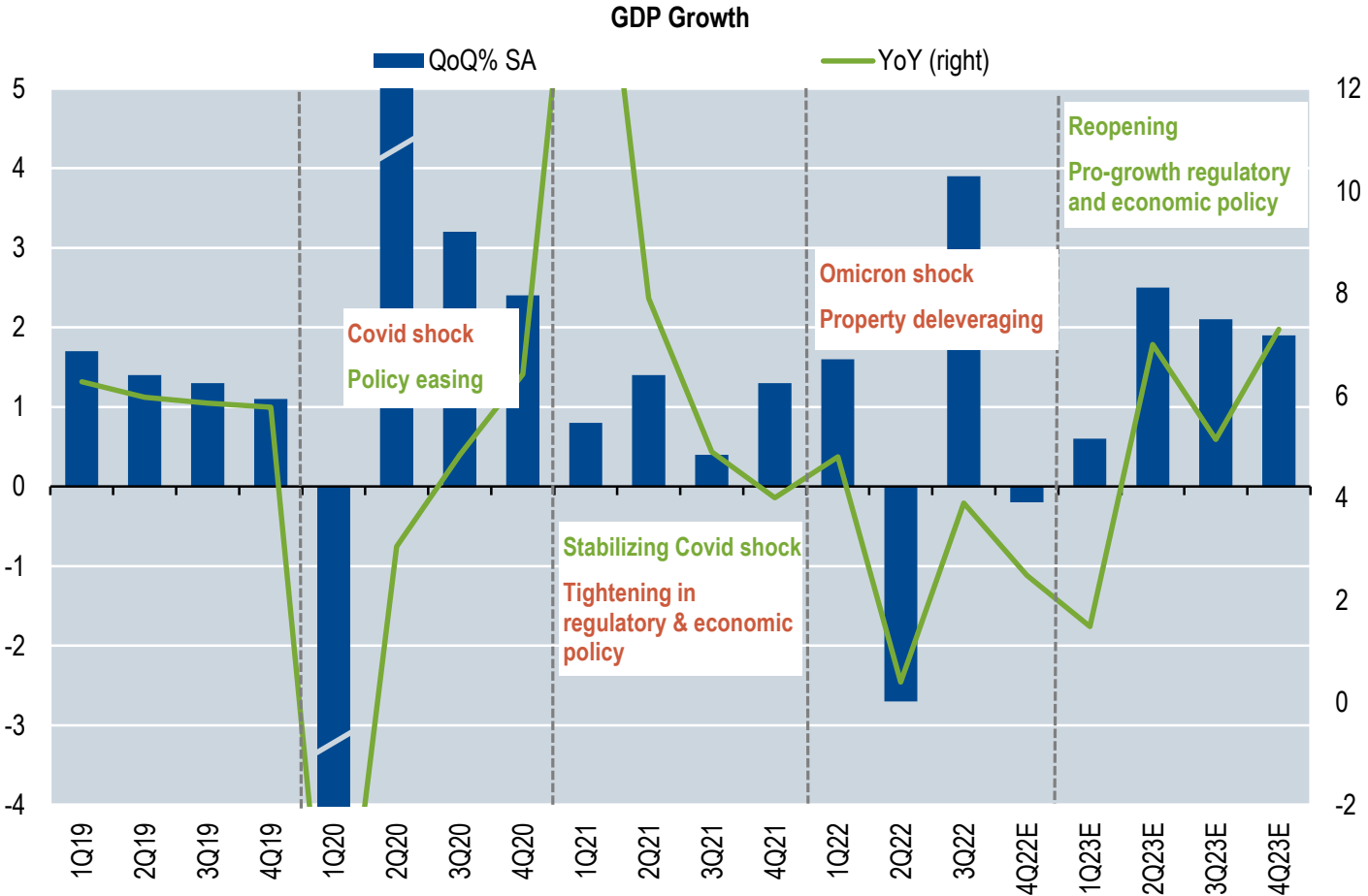
- The BoJ expects core inflation to rise by 2.9% YoY for FY2022 and by 1.6% YoY for FY2023 and 2024 respectively
- The BoJ mentioned that achieving the price stability target of 2 percent requires wage increases

# China Pulls a Pro-Growth U-Turn in Policy

Covid

Property

Business Reopening



Source: NBS, Morgan Stanley

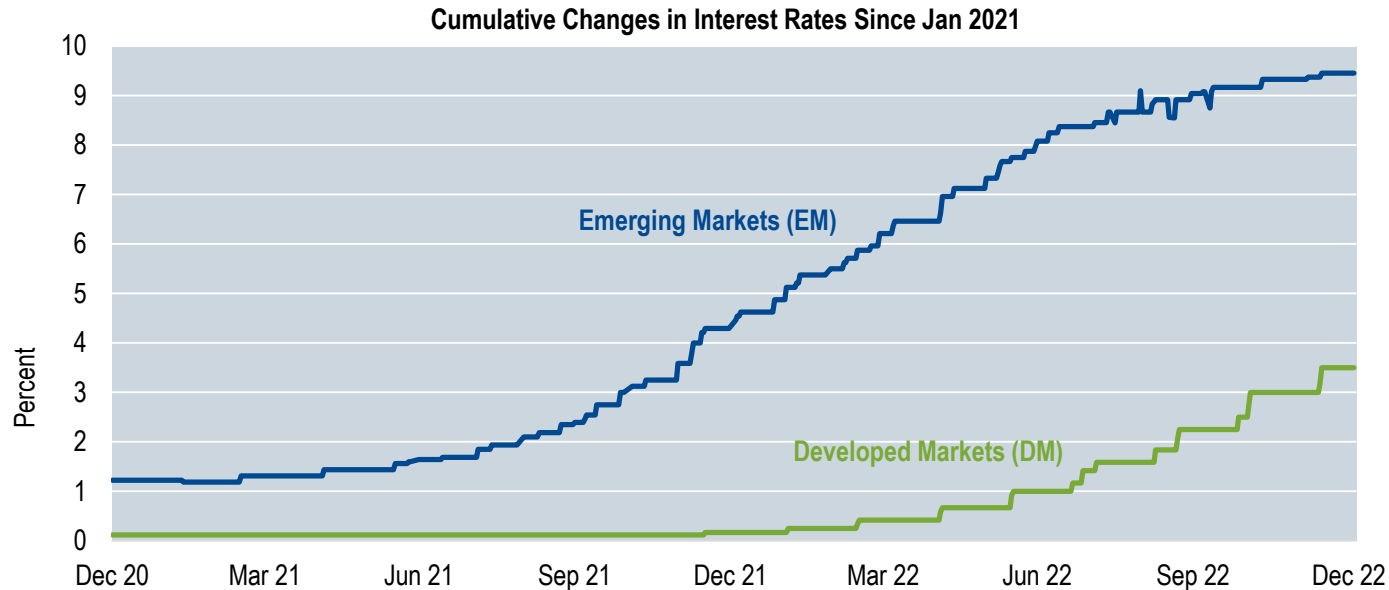


# EM Monetary Tightening Cycle to Consolidate in 2023

Following aggressive hikes in the past year and given nascent signs of abating inflation risk, the policy focus of EM central banks will pivot toward growth.

EM central banks are closer to the end of the tightening cycle relative to the developed world.

Adjusted for inflation, select EM local yields are attractive.



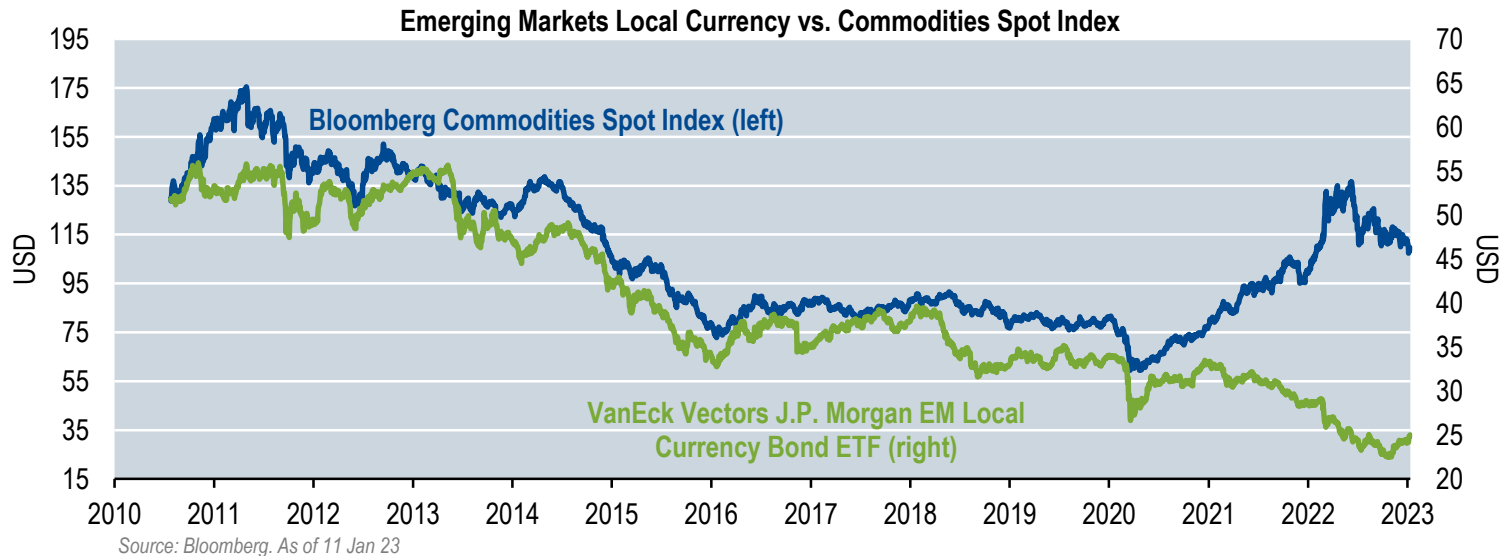
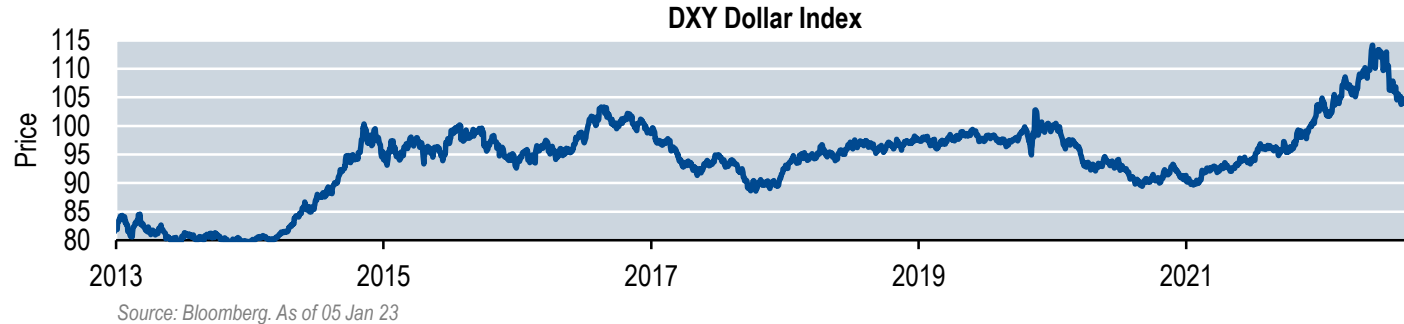
Source: Bloomberg. As of 03 Jan 23

Note: Emerging Markets (EM)=Average of Brazil, Chile, Czech Republic, Mexico, Peru and Poland; Developed Markets (DM)=Average of US, EU and UK

# The USD and Commodities: Key Emerging Markets Drivers

USD relative strength and commodity prices are both inputs into EM economic conditions and returns.

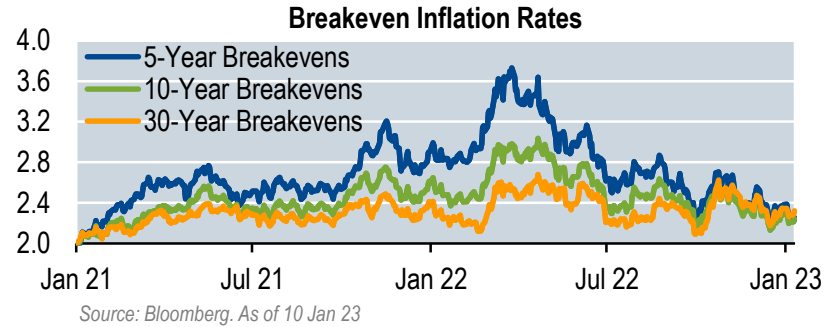
A Fed pause combined with China reopening bodes well for EM



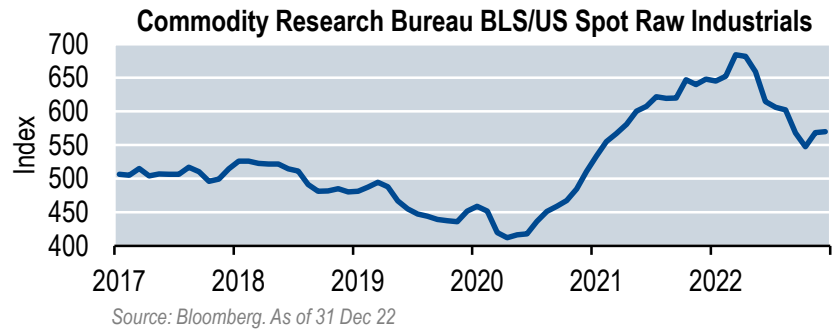
# Not Paul Volcker's Inflation

Volcker follows 18 years of rising inflation, Powell faces 18 months.

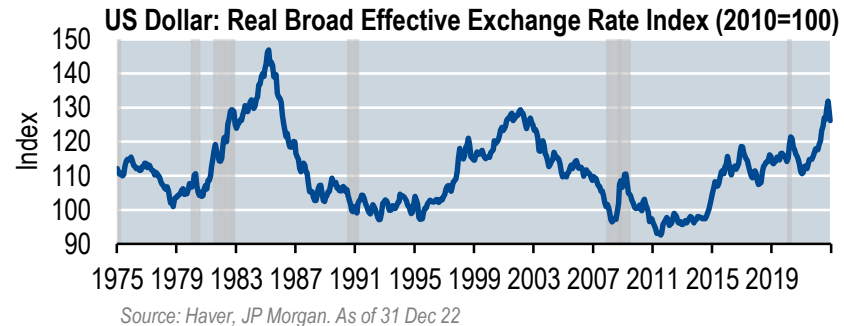
## Inflation Expectations



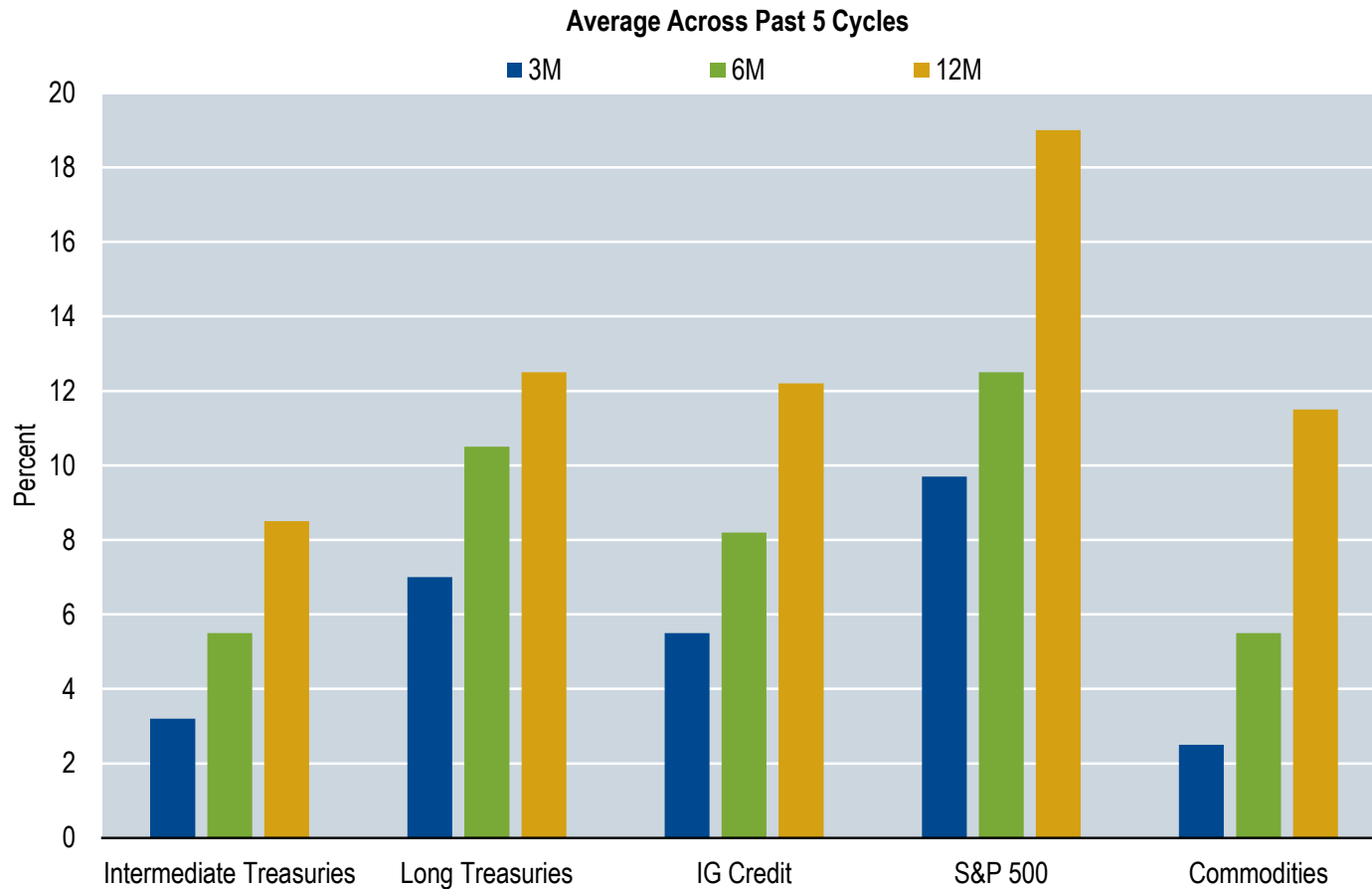
## Commodity Prices



## US Dollar



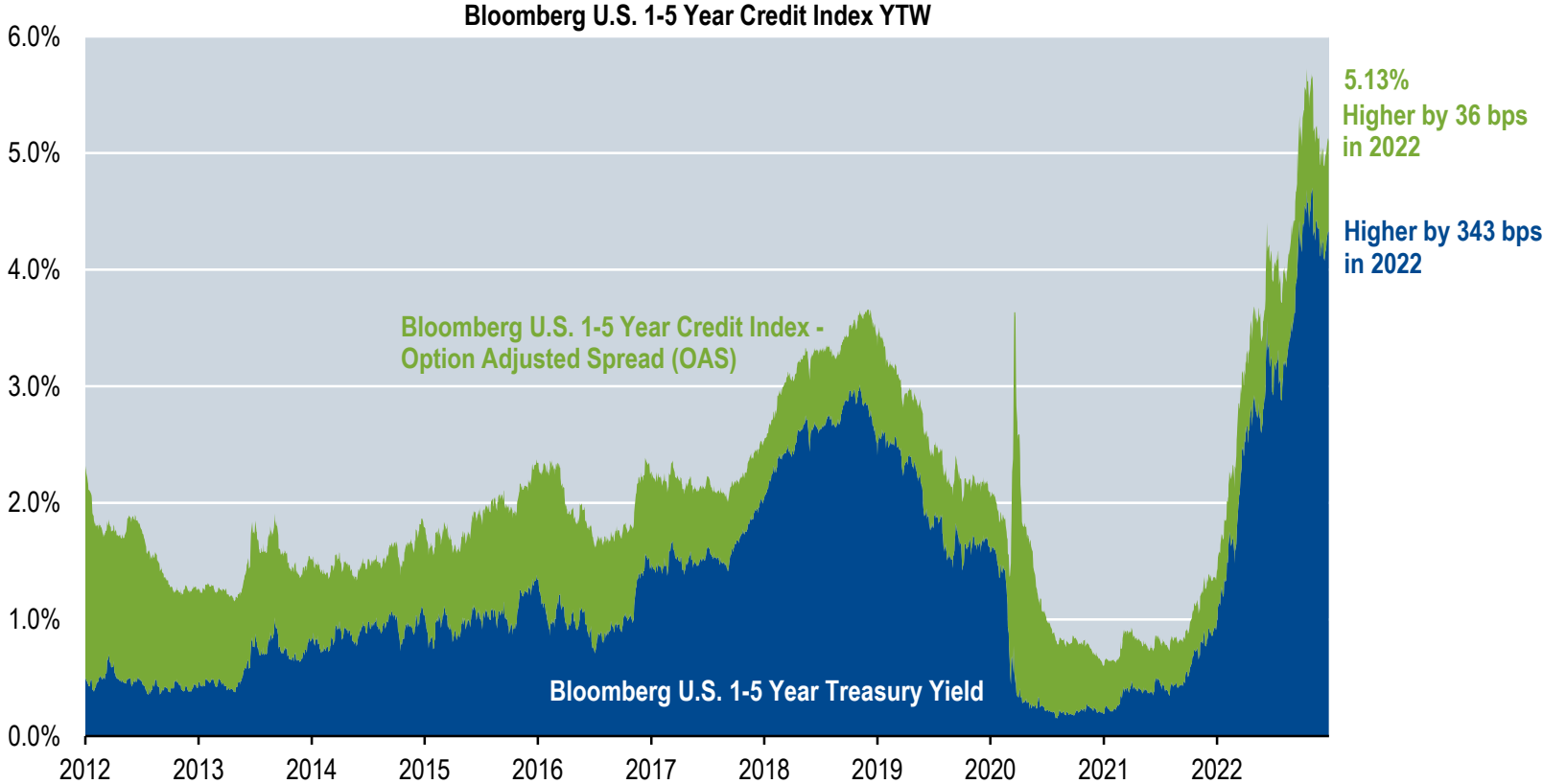
# Returns Following a Peak in Fed Funds



Source: Bloomberg. As of 31 Dec 22

Past investment results are not indicative of future investment results.

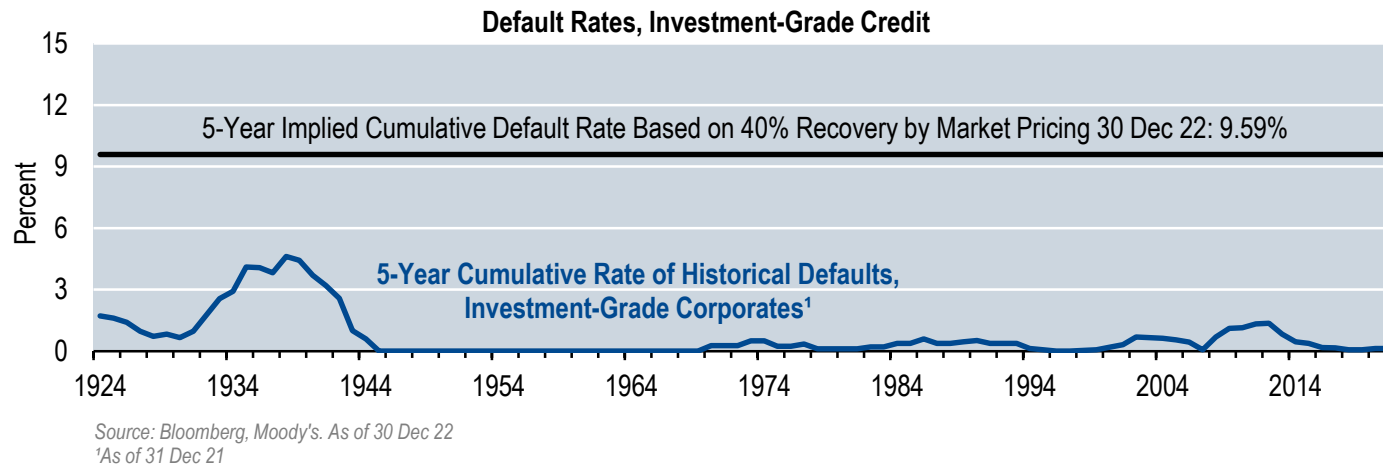
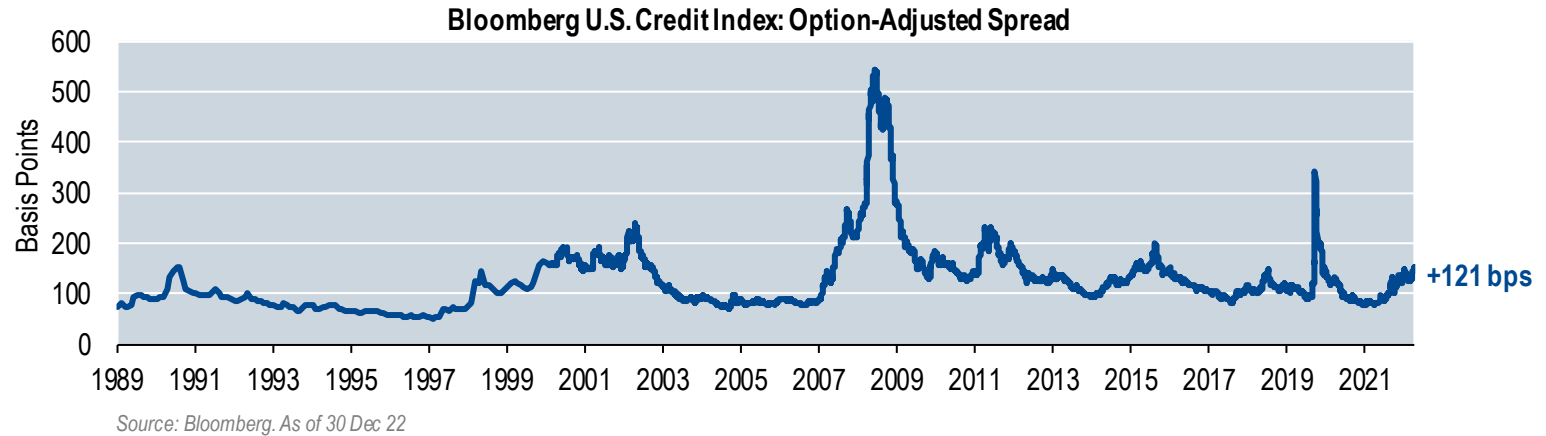
# Valuations Improved – Significant Increase in Both Treasury Yields and Credit Spreads



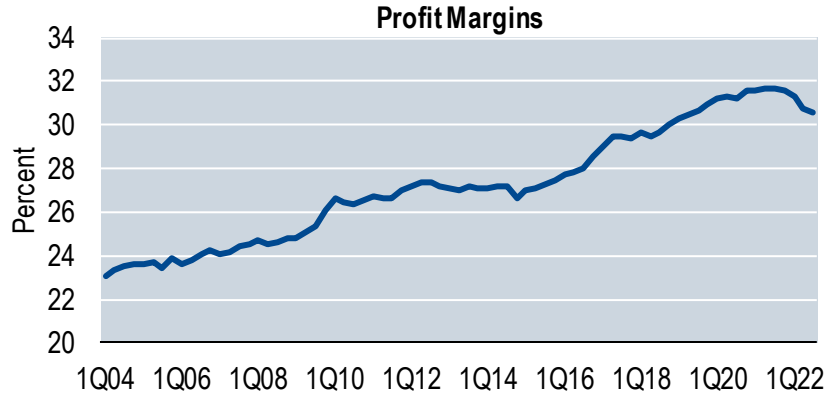
Source: Bloomberg. As of 30 Dec 22

# US Investment-Grade Credit

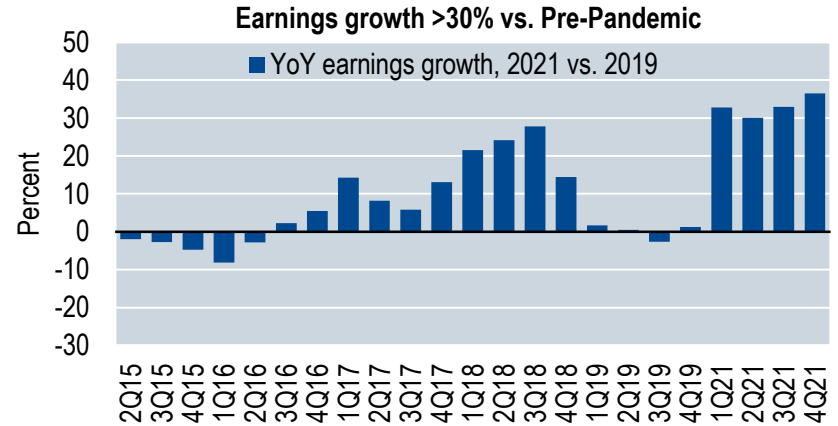
## Spreads and Default Rates



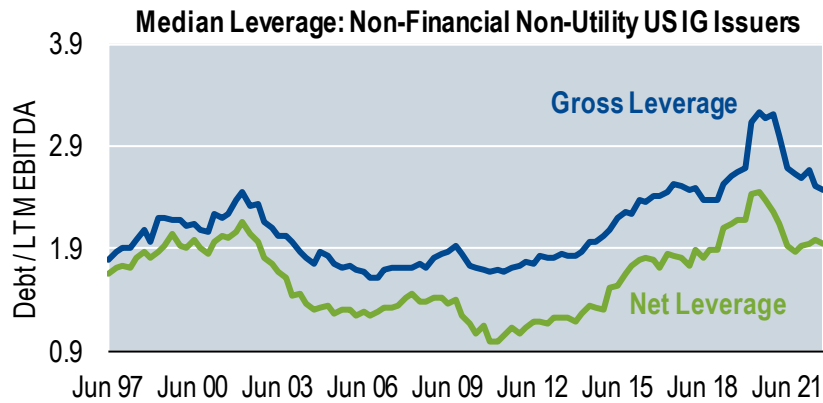
# Cash Flow and Debt Metrics Support Investment-Grade Credit



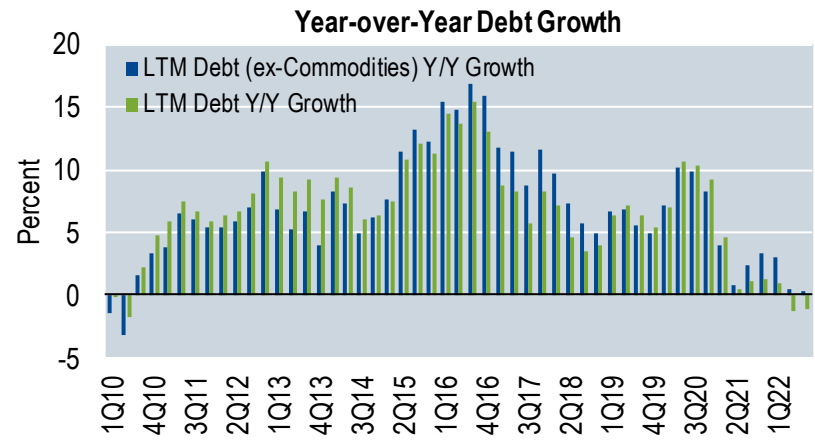
~180 Non-Financial Companies (JULI Based)  
 Weighting based on amount of debt in the benchmark  
 Source: J.P. Morgan. As of 30 Sep 22



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.



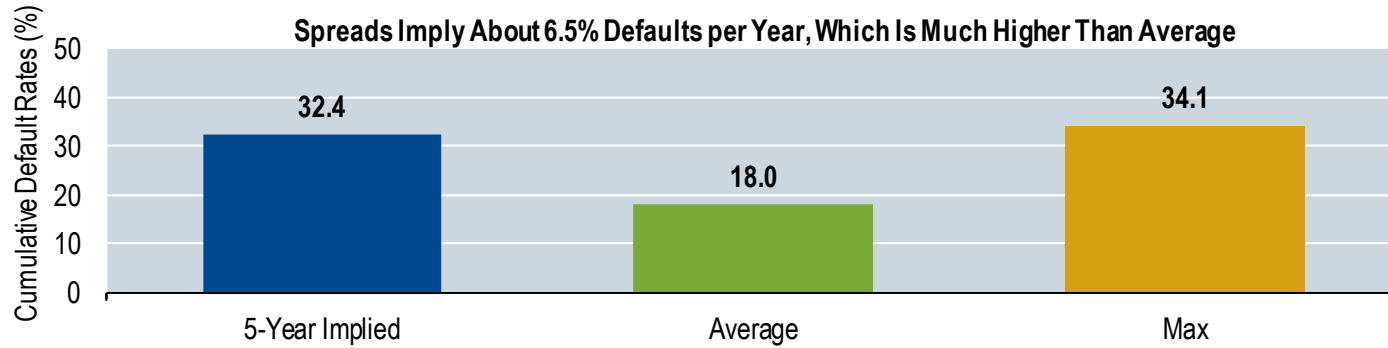
Source: BofA Global Research\*. As of 30 Sep 22



Source: J.P. Morgan. As of 30 Sep 22

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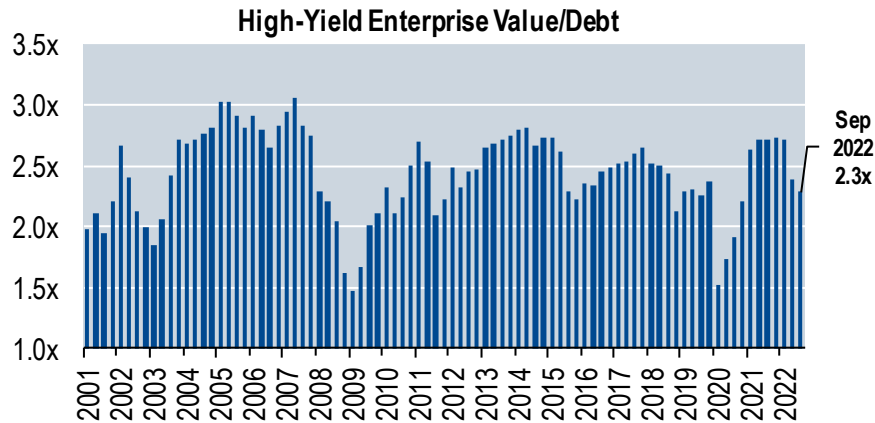
# High-Yield Valuations Are More Compelling



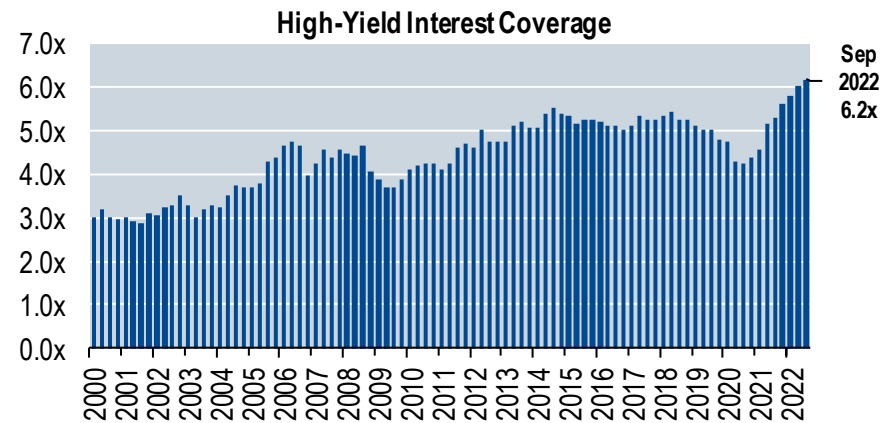
Source: Moody's, Westem Asset. As of 31 Dec 22. 40% recovery assumption was used and spread used to imply cumulative defaults over 5 years. Worst cumulative 5-year default period from 1970-2021 was 1992

## Fundamentals Are Supportive For Low Default Rates

- **Asset coverage remains healthy despite decline in equity multiples**
- **Ability to service debt also supportive of lower than average defaults**



Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 30 Sep 22

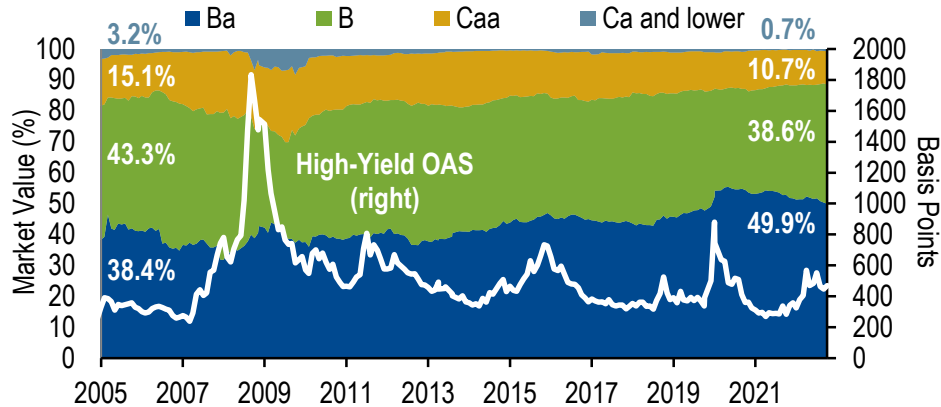


Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 30 Sep 22

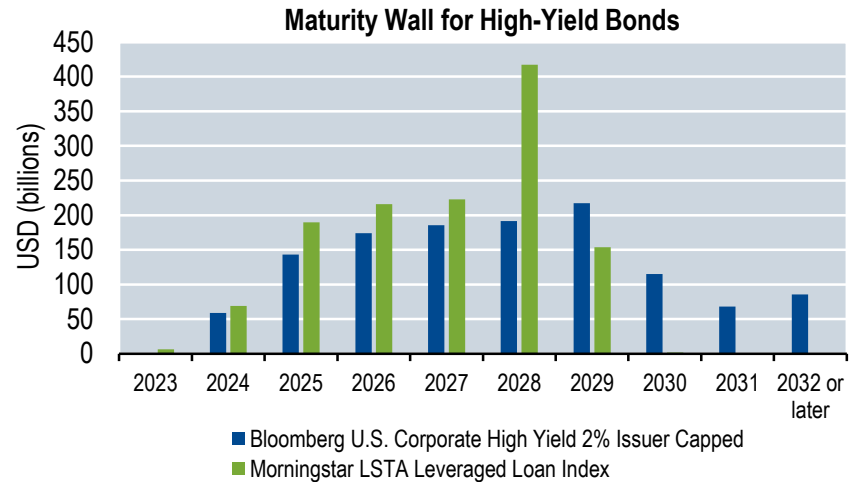


# Highest Credit Quality in Decades With Low Refinancing Risk

- Credit quality is the highest in decades
- Over 50% of the high-yield index is rated BB
- Refinancing risk is relatively low
- Maturities for high-yield bonds are limited over the next 24 months



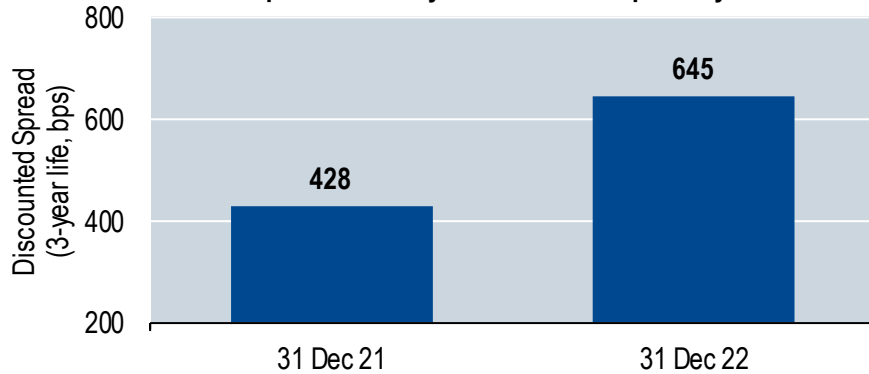
Source: Bloomberg. As of 31 Dec 22



Source: Bloomberg. As of 31 Dec 22

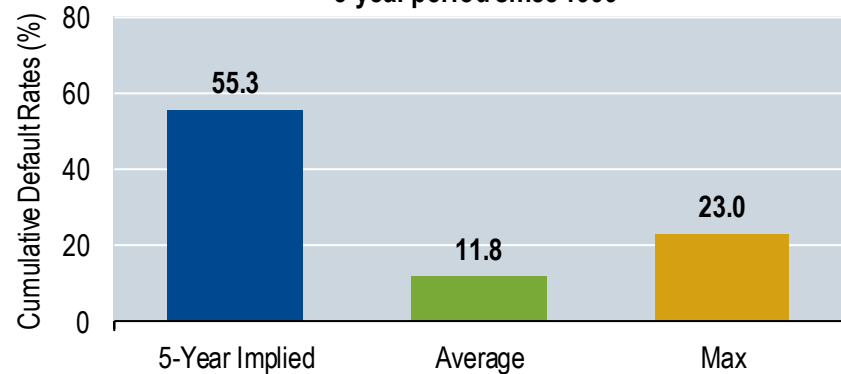
# Bank Loan Valuations Are More Compelling

Spreads rose by more than 200 bps last year



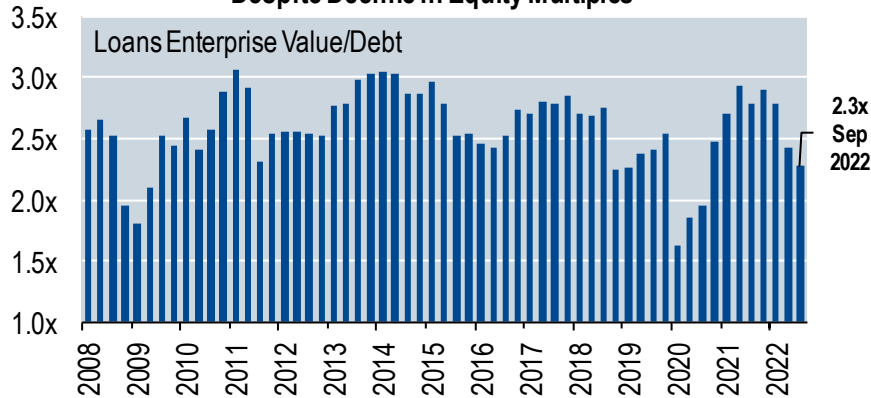
Source: PitchBook Data, Inc. As of 31 Dec 22

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



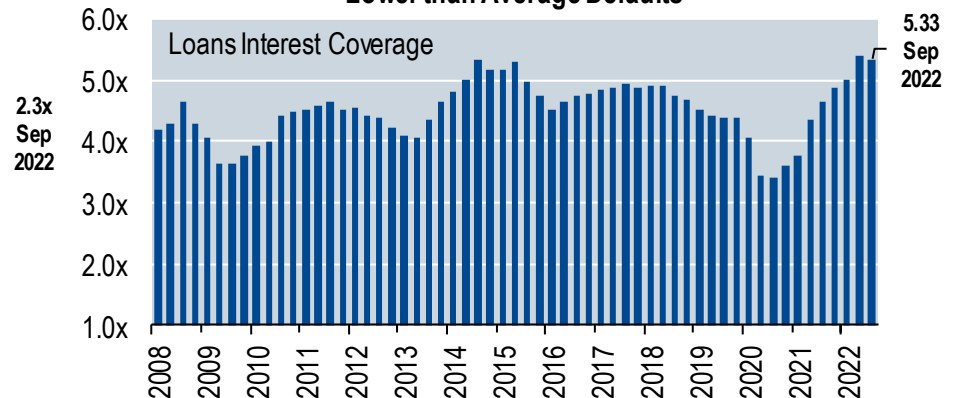
Source: PitchBook Data, Inc., Western Asset. As of 31 Dec 22  
60% recovery assumption was used and spread used to imply cumulative defaults over 5 years.  
Worst cumulative 5-year default period since 1999 was 2003

Asset Coverage Remains Healthy Despite Decline in Equity Multiples



Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 30 Sep 22

Ability to Service Debt Also Supportive of Lower than Average Defaults

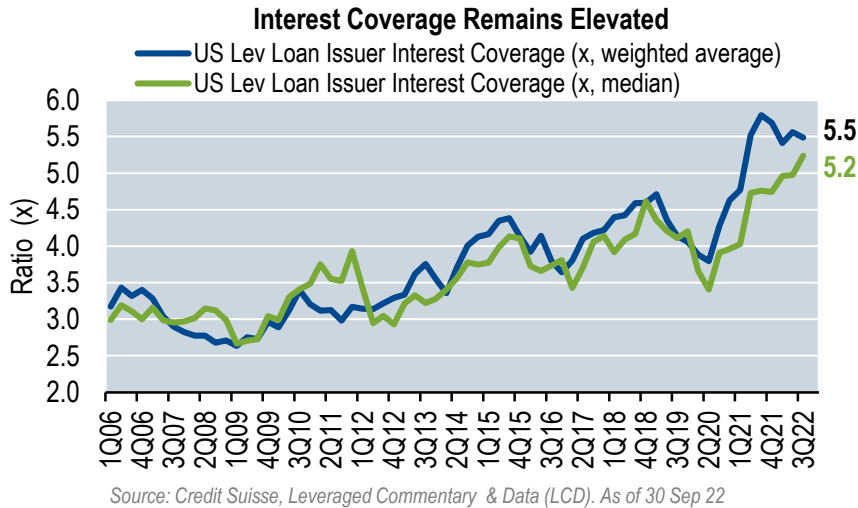


Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 30 Sep 22

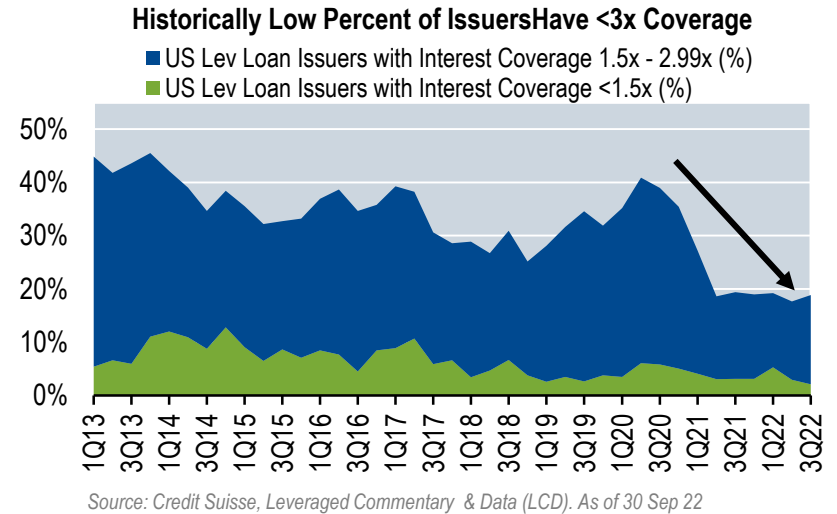
# Bank Loan Fundamentals Remain Supportive

Interest coverage remains near decade highs as EBITDA and interest expense rose.

- Interest coverage remains supportive for relatively low default rates

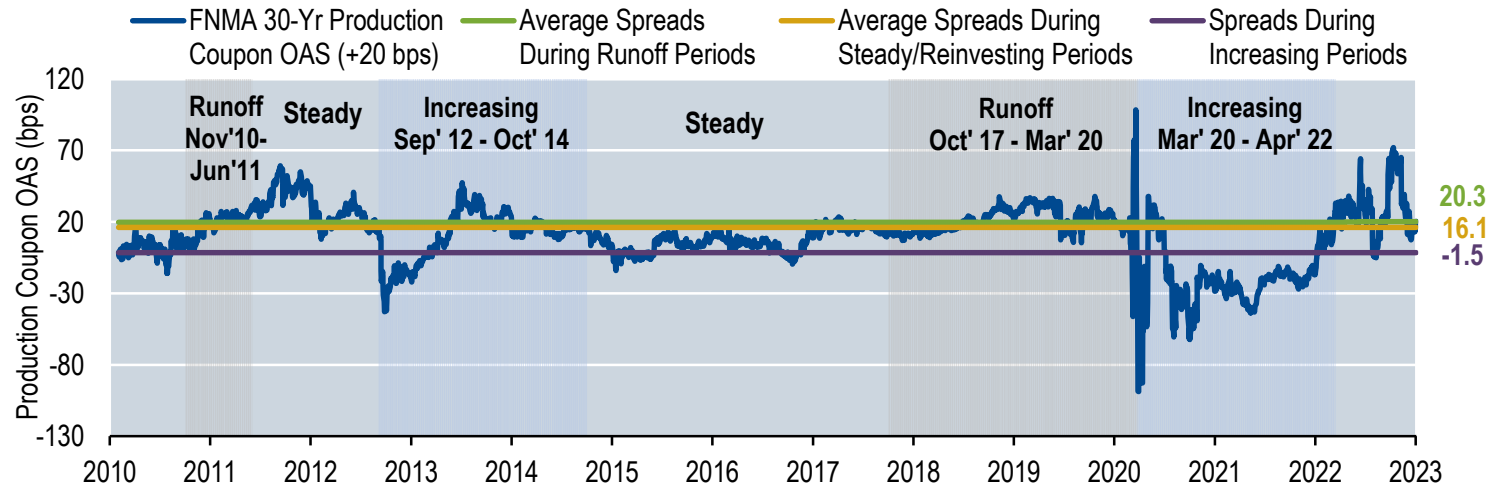


- Issuers with low coverage ratios is a relatively small part of the market



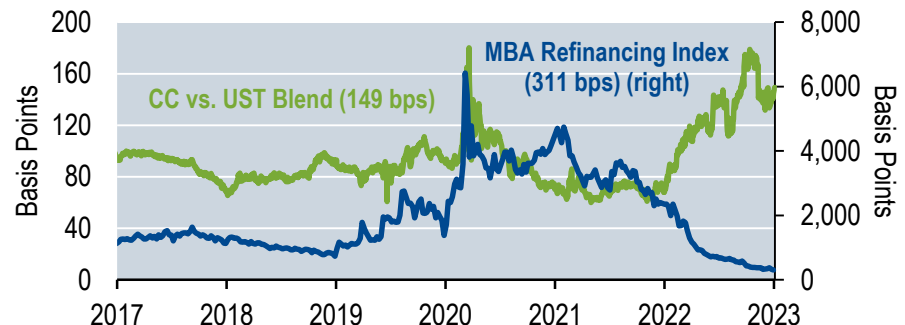
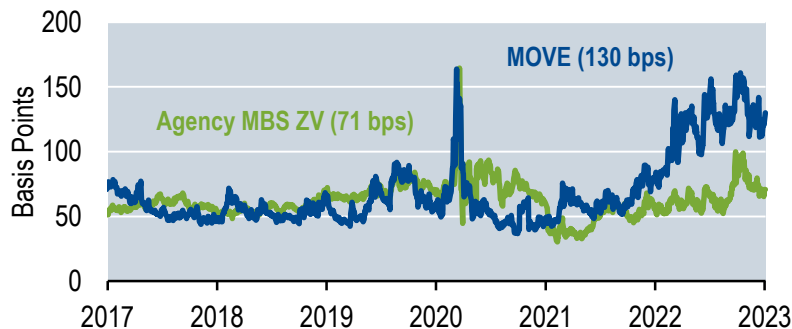
# Agency Mortgage-Backed Securities

- Mortgage spreads have widened significantly in 2022 as Fed support diminished



## Agency MBS Fundamentals and Valuations Have Improved

- Agency MBS spreads have widened with elevated volatility and are beholden to lower levels of volatility
- Prepayment risk reduced as mortgage borrowers have little refinancing incentive
- A Fed pause or pivot would prove supportive for MBS



Source: Bloomberg, MS Research, Western Asset As of 03 Jan 23

# 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
- Credit spreads are well wide of the levels we saw pre-Covid and in December 2018, the last time the Fed hiked the US economy into a recession

Spreads	Representative RMBS CRT Below IG	BAML RMBS Legacy Below IG	Bloomberg Non-Agency CMBS BBB	Bloomberg US IG Corporate	Bloomberg US High Yield
31 Jan 20	178	123	250	102	390
<b>30 Dec 22</b>	<b>483</b>	<b>297</b>	<b>673</b>	<b>130</b>	<b>470</b>
Difference Since 31 Jan 20	306	173	423	28	80
31 Dec 18	246	127	371	153	526
<b>30 Dec 22</b>	<b>483</b>	<b>297</b>	<b>673</b>	<b>130</b>	<b>470</b>
Difference Since 31 Dec 18	238	170	302	-23	-56

Source: Bloomberg, Bank of America, Western Asset. As of 30 Dec 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.

## Inflation should ease substantially during 2023

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

## Federal Reserve Policy Outlook

- Stickiness of lagging inflation measures has postponed the pause and elevated the peak rate
- Forward inflation indicators display substantial progress
- Fed's policy goal is to pause at restrictive rate and allow inflation to fall
- We expect the Fed to pause in Q1 2023

## Fixed-Income Outlook

- US growth will slow but will avoid recession
- Global growth has downshifted, but with China's reopening, will remain resilient
- Global inflation will continue to recede
- The dollar will weaken moderately
- Emerging markets will shine
- Central bank overtightening is a meaningful risk
- Spread sectors are extremely attractive but the outlook is clouded by macro risk
- Geopolitical uncertainty continues to add to volatility



**Thank you.**



# Risk Disclosure

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