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WESTERN ASSET

Webcast Summary

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Strategy Update: US Core and Core Plus

After a tumultuous year for all financial assets in 2022—marked by extremely high volatility, a very large upside surprise in inflation and a breakdown of the historical correlation between equities and fixed-income—this webcast addresses what happened with our US Core and Core Plus strategies last year and how we're positioning our portfolios for the future. John Bellows and Travis Carr also provide their latest investment outlook, insights regarding expectations for Fed policy and reasons why they are optimistic that the strategies' performance will improve in the year ahead.

Here are some key takeaways.

2022: Year in Review

- Entering 2022, the Federal Reserve (Fed) forecast that it would be appropriate to raise rates by 75 basis points (bps) over the year, but it ended up raising rates by more than 400 bps.
- The rate hikes were driven by stronger than expected inflation, but the sheer magnitude of the pivot caught financial markets off-guard; large surprises tend to correspond with large changes in prices.
- 2022 was also the worst years for US Treasuries (USTs) over their more than 150-year history, and marked only the second time we saw back-to-back years with negative total returns.
- Also last year, most financial assets were positively correlated. Typically, fixed-income and equities have a negative correlation and therefore bonds are used as an effective diversification strategy.
- As a consequence of the lack of correlation, the volatility of our portfolios exceeded our expectations. What's more, rate volatility dramatically exceeded market expectations. As a result, positions that were sized to be moderate at the beginning of the year ended up contributing a disproportionate amount to total volatility of the portfolios.
- The last two months of 2022, however, were quite different, with valuations restored, as demonstrated in higher yields, and a dramatic change in economic data.

Inflation

- After rising sharply through most of 2022, inflation indicators moderated significantly in the last two months of the year. These included nominal declines in retail sales, contractions in industrial production and increasing pressure in the housing market.
- Wage inflation is also moderating, and is currently at about 4% on an annualized basis. This is in stark contrast to indicators at the start of last year, which suggested that wage inflation was running in the 6%-8% range.
- Improvements in the labor market are good for real incomes and the economy, with much more hiring reported for January, but we expect hiring to slow in the future.

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Fed Policy

- While much of the monetary policy response last year was in reaction to elevated inflation, we expect the Fed to be somewhat slow in responding to the reversal of inflationary pressures.
- We think the Fed will be extremely cautious before pausing or even cutting rates, as the larger risk from its perspective is easing policy too early and risking the persistence/recurrence of high inflation.
- The Fed's current policy is already in restrictive territory—with the fed funds rate slightly above 4.5% and the run rate for inflation is approximately 3.0%—and we believe the Fed would like to keep it that way for some time.
- Our expectation is that the Fed will hike again in March, but another rate increase in May is much less certain. We think that will be heavily dependent on both the employment and inflation data.
- While the market is currently pricing in rate cuts starting later this year, we think that's likely premature and the Fed is more likely to pause than cut.
- When the Fed does reduce rates, it may cut faster than in previous cycles due to moderating inflation or challenged growth.

Portfolio Positioning/Investment Outlook

- Since the end of October 2022, the Bloomberg Aggregate Bond Index is up 7%. Investment-grade spreads are in 50 bps and high-yield spreads are in 150 bps. As a result, Western Asset portfolios have outperformed meaningfully in this kind of environment over the last three months.
- Currently, our portfolios are overweight credit risk. This is in line with our broad macro outlook and expectation for the Fed to pause in May. Once the Fed is on hold, we think the market will react positively to that certainty and inflation could fall, giving investors some hope that the Fed would cut rates later.
- We think this is a very favorable time for corporate credit, as we expect to have positive nominal GDP growth or to be at least around zero. This is a helpful environment for corporations to continue to make their debt payments and meet their target financial metrics (as opposed to during a time of contracting economic activity).
- We are sensitive to the fact that the yield curve is currently inverted, which historically has predicted economic recessions. However, our view is that it likely indicates a slowdown in nominal GDP growth, even though levels were very high last year, at about 6%.
- Emerging markets (EM) did well last year, and we think there's more room to go this year. Rates are still elevated in many EM countries, but declining US and overall developed market (DM) inflation should also benefit EM investors. Of course, we're watchful for idiosyncratic risks and are very thoughtful in terms of our position sizes.

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