



2Q23 Market & Strategy Update

March 23, 2023

Ken Leech

Chief Investment Officer

Current banking stress extremely complex but not systemic

Fed tightening near end

Disinflation ongoing but uneven

Fixed-income outlook

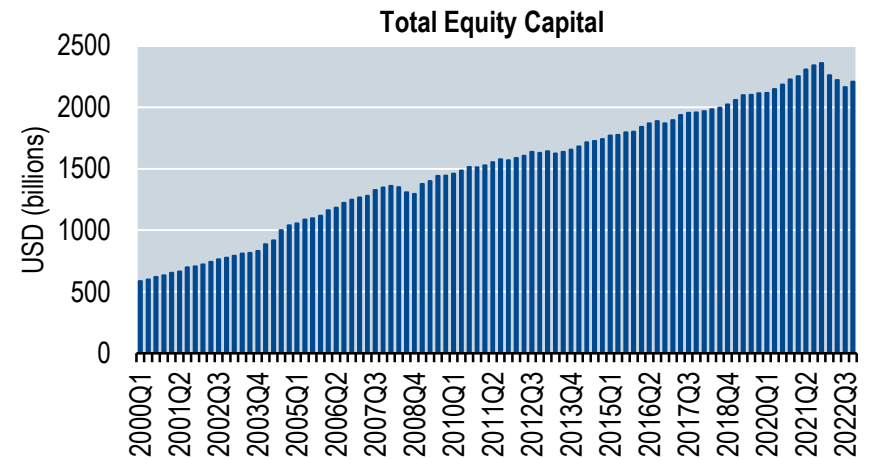
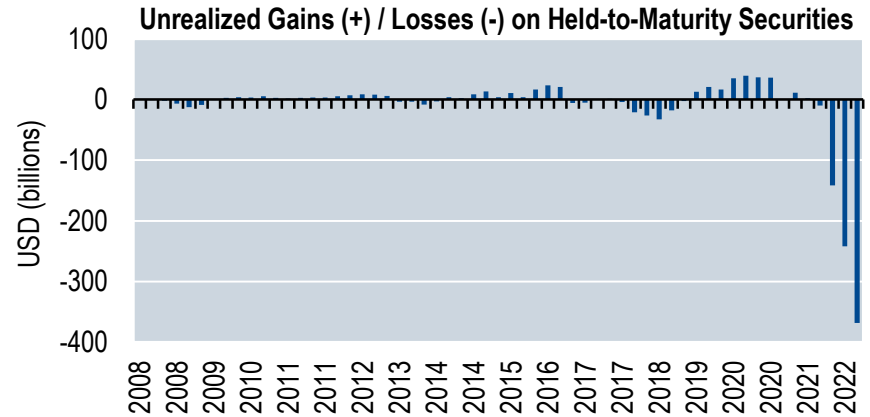
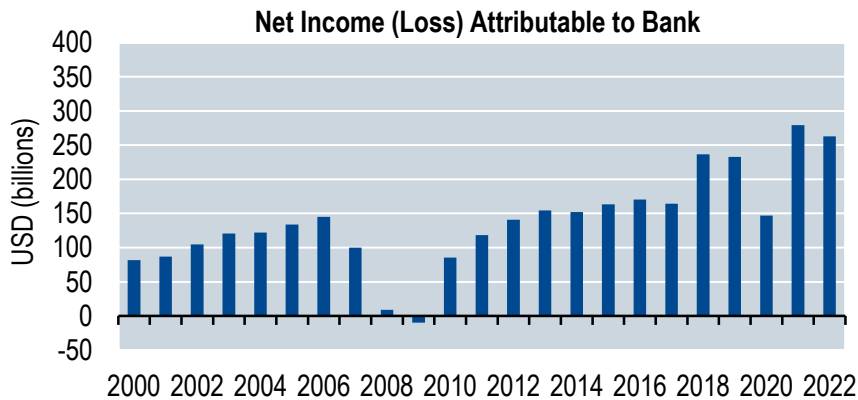
- US growth will slow but should avoid recession
- Global growth has downshifted, but with China's reopening will remain resilient
- Global inflation will continue to recede
- The dollar will weaken moderately
- Emerging markets should outperform
- Central bank overtightening is a meaningful risk
- Spread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

US Banking System is Well Capitalized

Unrealized losses in held-to-maturity securities: \$360 bn

Annual income in 2022: \$260 bn

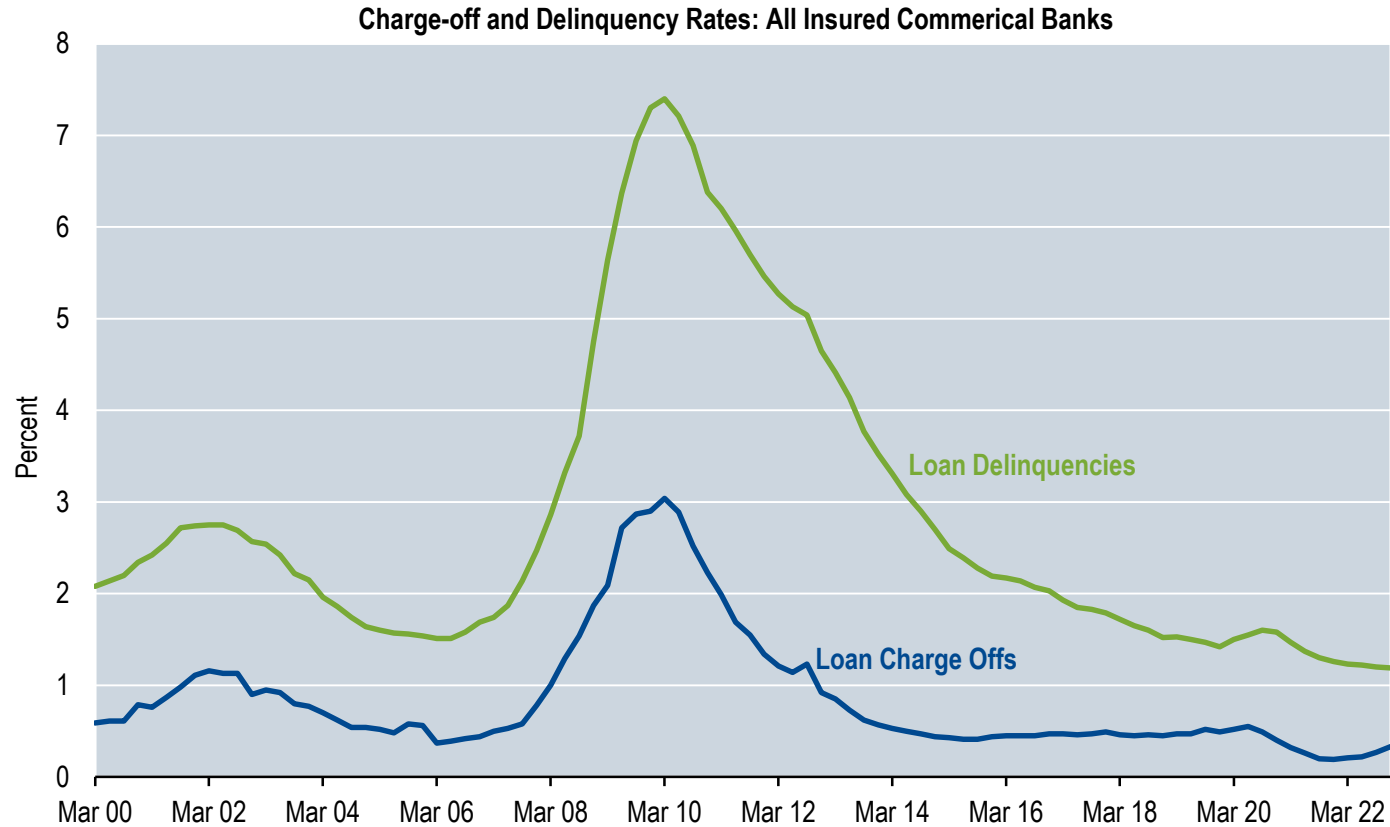
Equity Capital at the of 2022: \$2,200 bn



Source: FDIC. As of 31 Dec 22

Bank Asset Quality Remains High

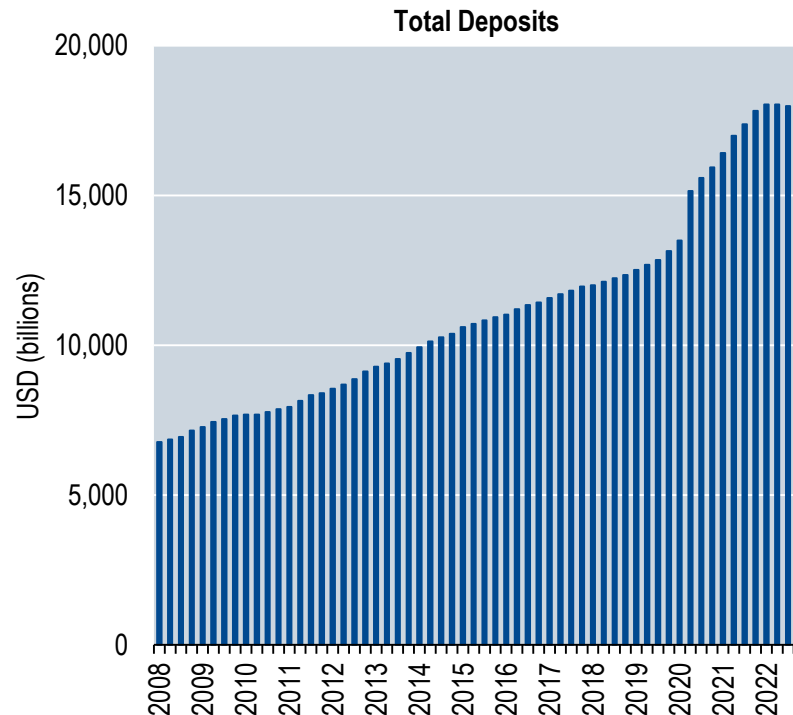
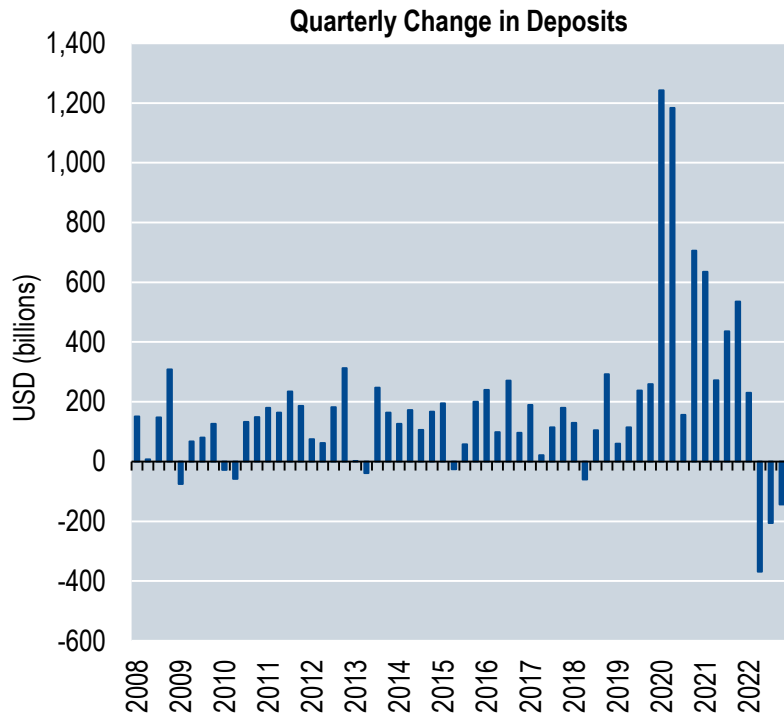
Delinquency rates and charge-off rates remain near historically low levels



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

Deposits Remain Abundant

Deposit outflows have been small relative to the large inflows in 2020



Source: Federal Reserve, Haver. As of 28 Feb 23

Policy Response

Implicit Guarantees:

- President Biden: “Americans can have confidence that the banking system is safe. Your deposits will be there when you need them”
- Secretary Yellen: “Our intervention was necessary to protect the broader US banking system. And similar actions could be warranted if smaller institutions suffer deposit runs that pose the risk of contagion”

Liquidity Provision:

- Emergency Tools: Bank Term Funding Program (BTFP)
- Traditional Tools: Discount window and Federal Home Loan Bank borrowing
- More than \$450 of emergency liquidity was provided during the week ending March 17

Other:

- Consolidation of weaker banks
- Further capital and regulatory standards for small and medium-sized banks

March FOMC Meeting

Focus on financial stability; limited scope for rate cuts

Financial Stability:

“The Federal Reserve working with the Treasury Department and the FDIC took decisive actions to protect the U.S. economy and strengthen public confidence in our banking system. These actions demonstrate that all depositors' savings in the banking system are safe.”

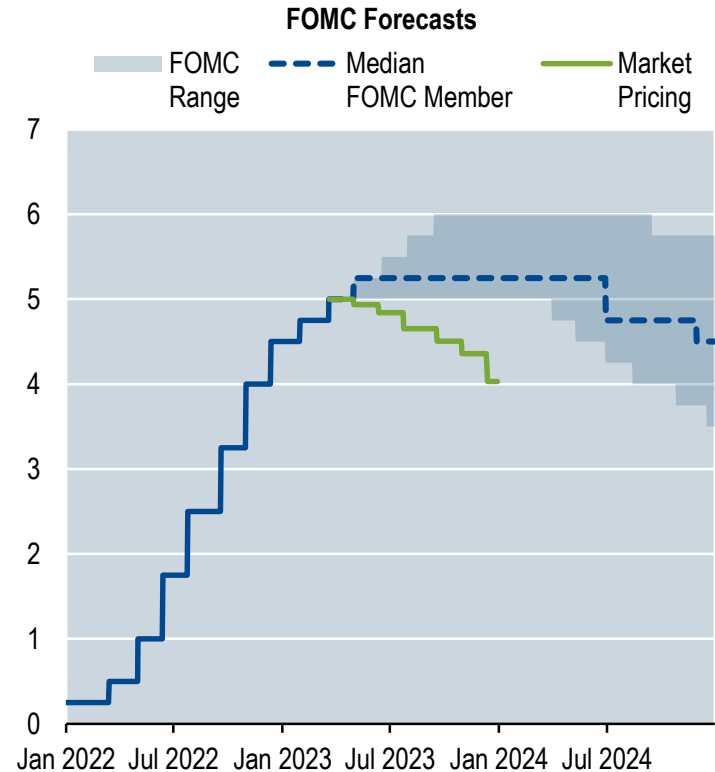
“Our banking system is sound and resilient with strong capital and liquidity.”

Limited Scope for Rate Cuts:

“Inflation remains too high, and the labor market continues to be very tight. My colleagues and I understand the hardship that high inflation is causing, and we remain strongly committed to bringing inflation back down to our 2% goal.”

“In that most likely case, participants don't see rate cuts this year. They just don't.”

– Fed Chair Powell, 21 Mar 23



Source: Federal Reserve, Bloomberg. As of 22 Mar 23

Fed Policy

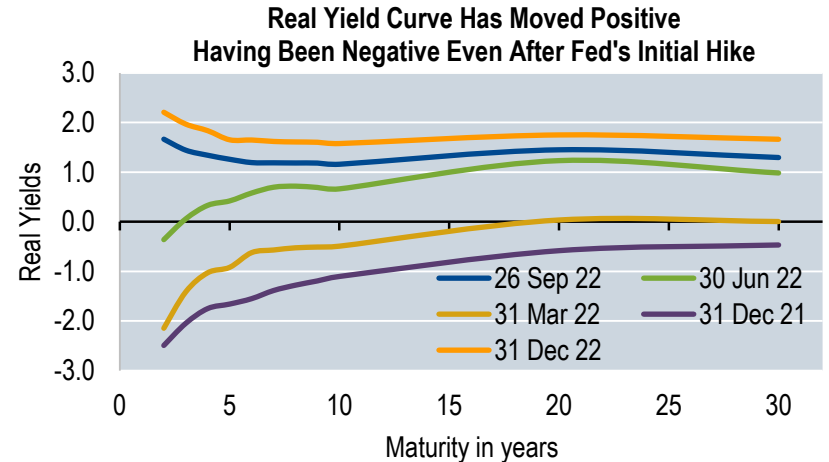
Behind the disinflation curve, policy is now restrictive.

“I will say that it is gratifying to see the disinflationary process now getting underway.”

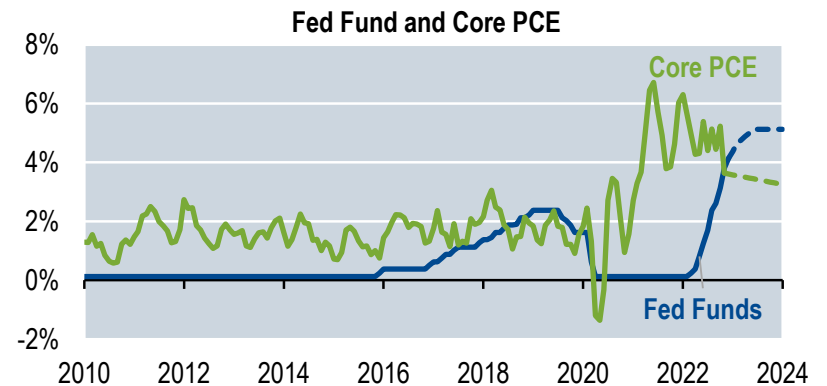
“We’re going to be cautious about declaring victory and sending signals that the game is won because we’ve got a long ways to go. It’s the early stages of disinflation.”

“We’re living in a world of significant uncertainty. I would look across the spectrum of rates and see that real rates are now positive across the yield curve. I think policy is restrictive. We’re trying to make a fine judgment about how much is restrictive enough. That’s all.”

– Fed Chair Powell, 2 Feb 23

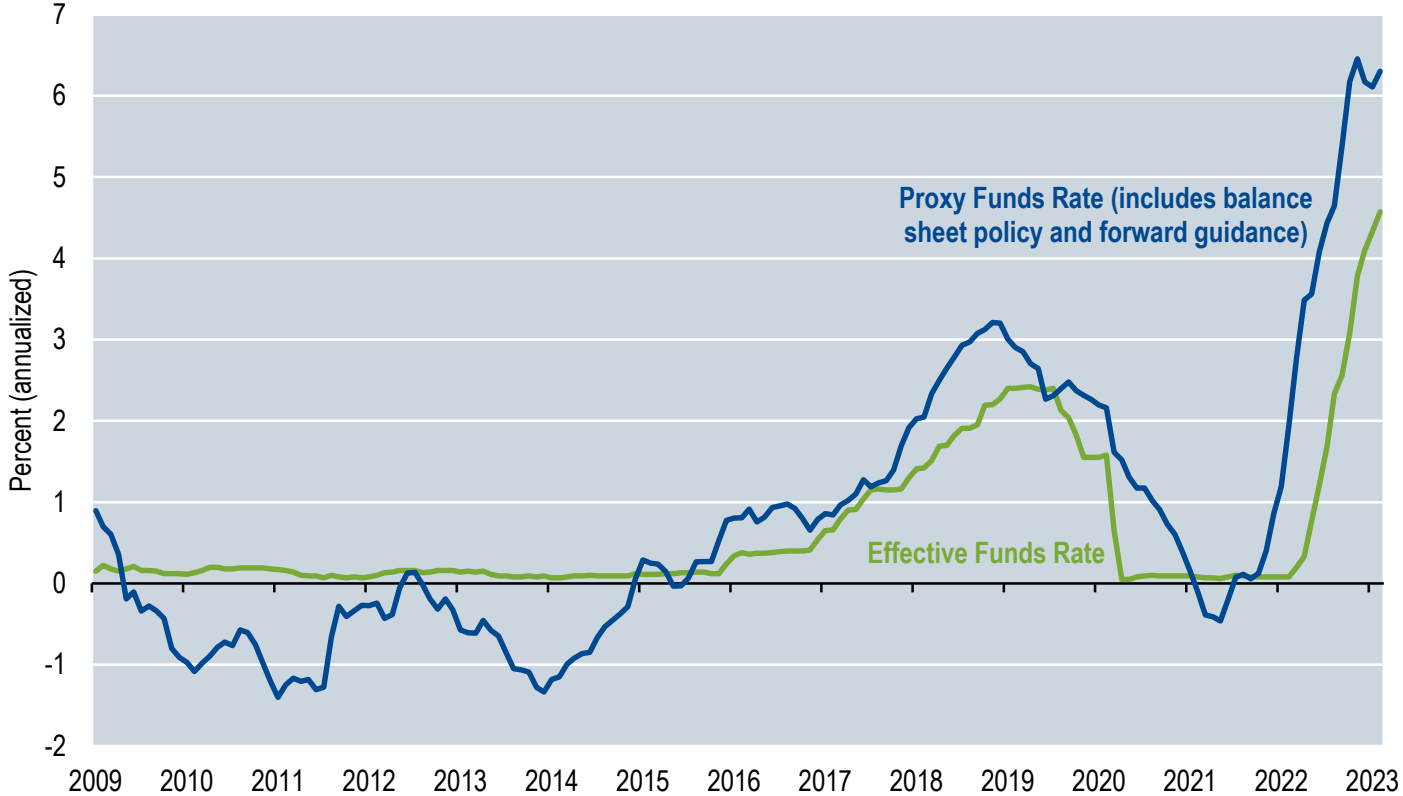


Source: Bloomberg



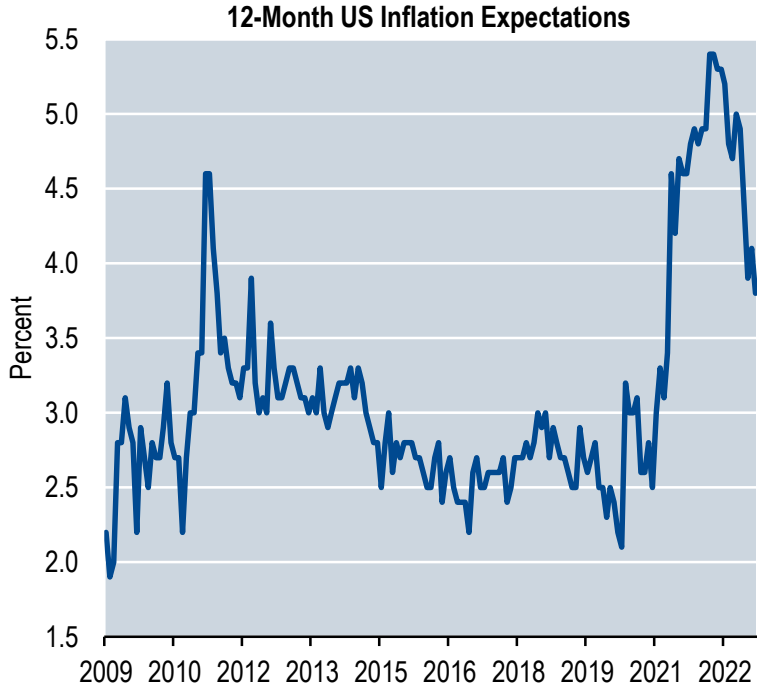
Source: Haver Analytics, Federal Reserve. As of 31 Dec 22

Monetary Policy Is Already Tighter Than It Looks

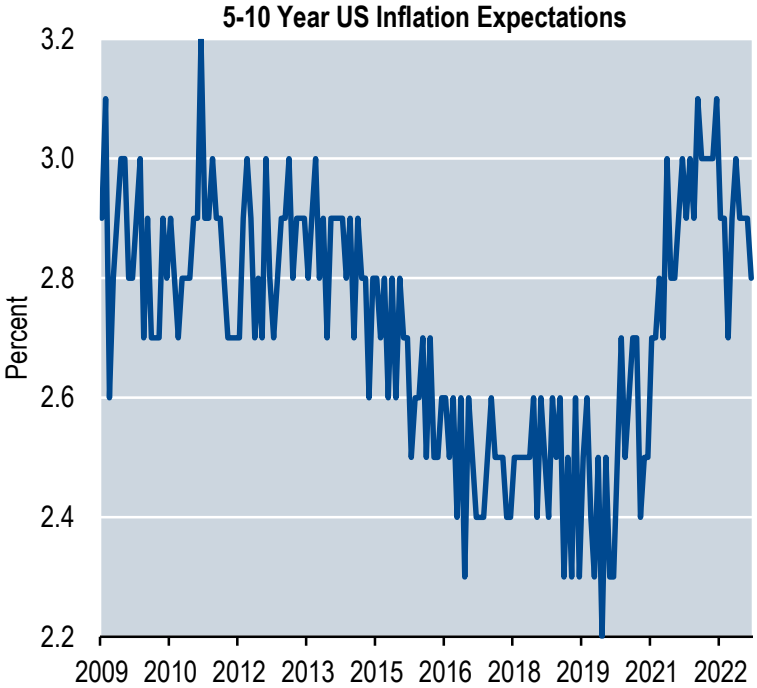


Source: Federal Reserve, Freddie Mac, The Bond Buyer, Moody's, Choi et al. (2022). As of 28 Feb 23
Proxy Funds Rates uses public and private borrowing rates and spreads to infer the broader stance of monetary policy. When the Federal Open Market Committee uses additional tools, such as forward guidance or changes in the balance sheet, these policy actions affect financial conditions, which the proxy rate translates into an analogous level of the federal funds rate.

Inflation Expectations Falling

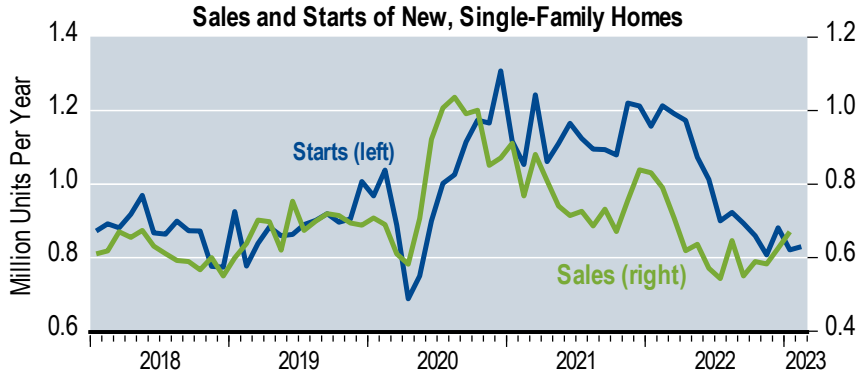


Source: Haver Analytics, University of Michigan. As of 21 Mar 23

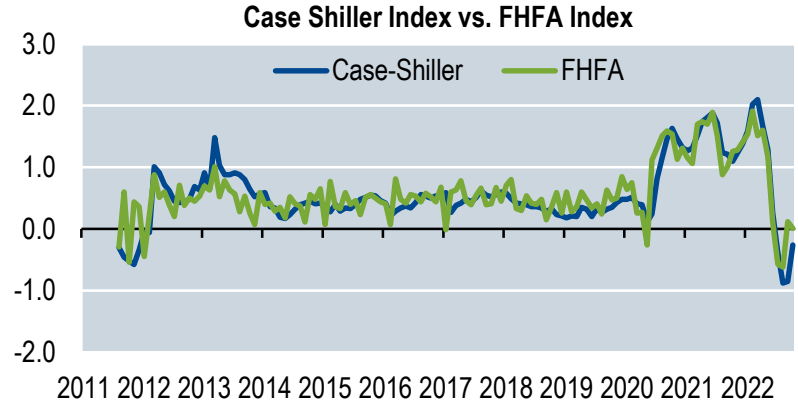


Source: Haver Analytics, University of Michigan. As of 21 Mar 23

Housing Market Turning



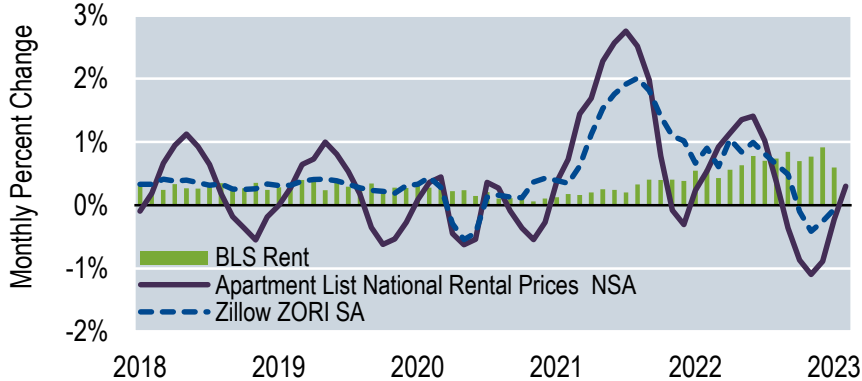
Source: Census Bureau. As of 28 Feb 23



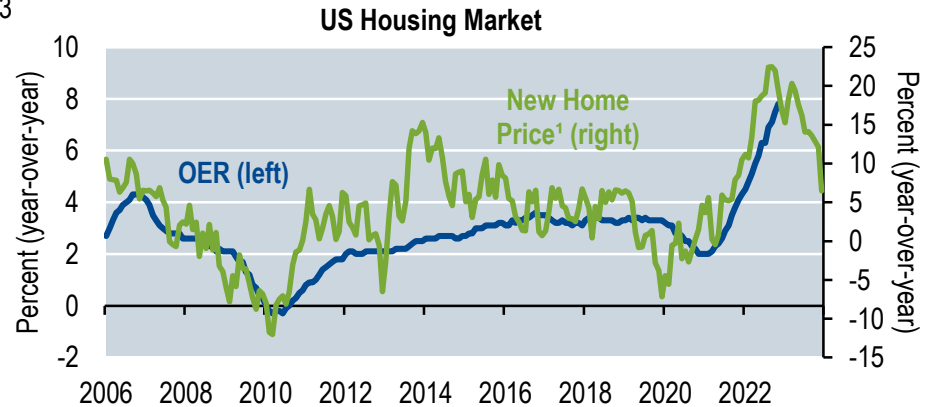
Source: Haver Analytics. As of 31 Dec 22

Asking Rents Decelerating Sharply From 2021 Highs

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



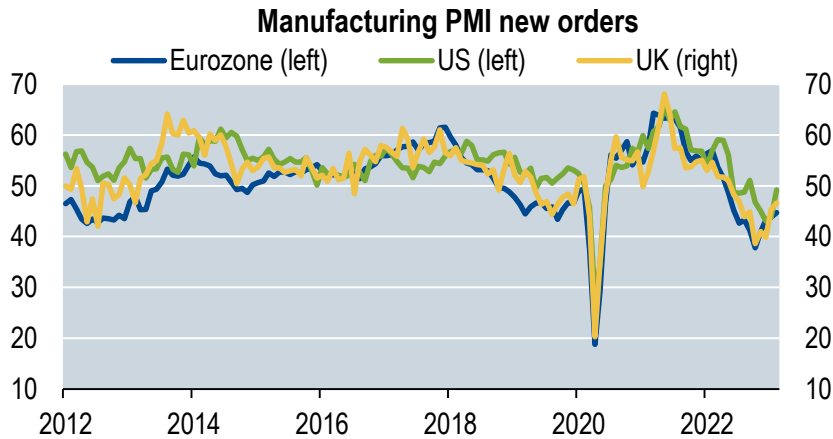
Source: ApartmentList.com, Zillow, BLS. As of 28 Feb 23



As of 31 Jan 23

¹Shown as 3-month moving average and advanced by 14 months

Softening Sales, High Inventories and Improving Supply Chains



Source: Haver Analytics. As of 28 Feb 23



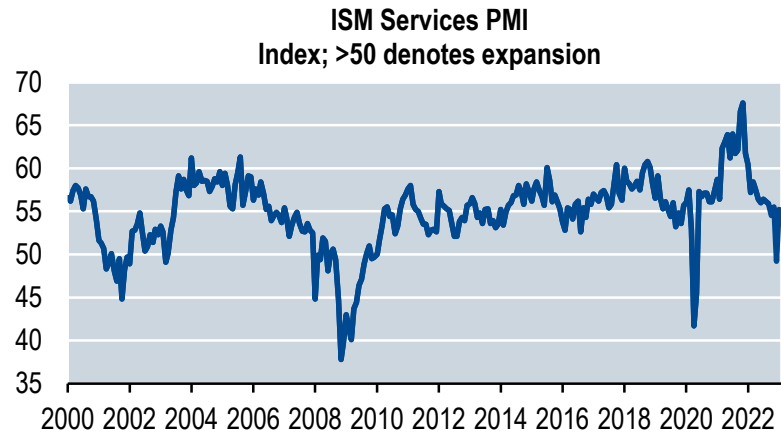
Source: JP Morgan, Haver Analytics. As of 28 Feb 23

Supply-Chain Improvement Has Led to Lower Manufacturing Inflation

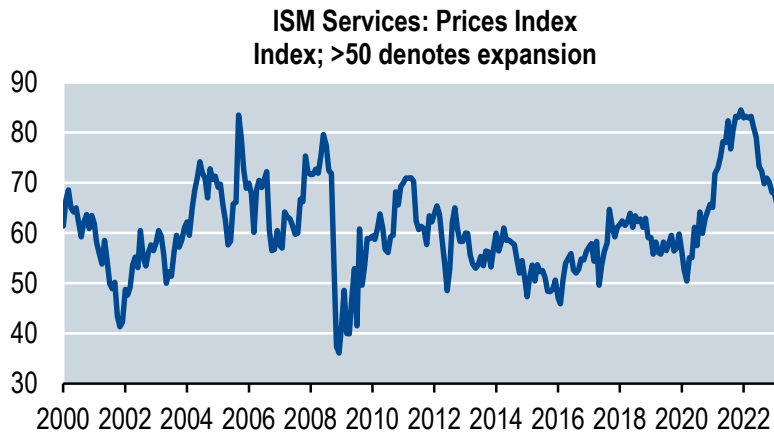


Source: Haver Analytics. As of 28 Feb 23

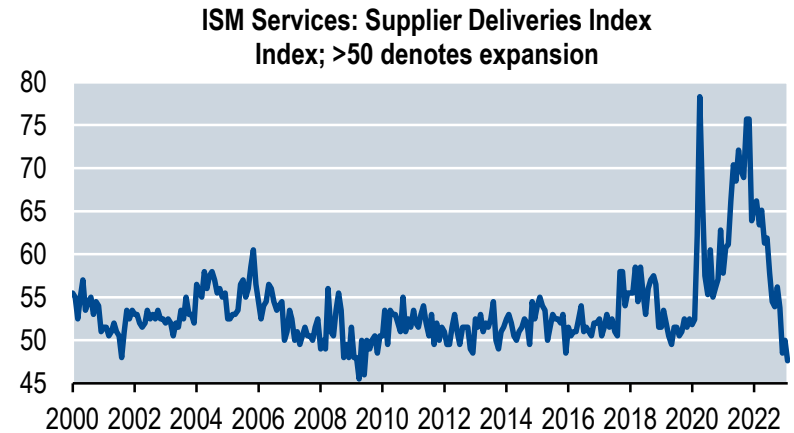
Signs of a Turn in the Service Sector?



Source: Bloomberg. As of 28 Feb 23

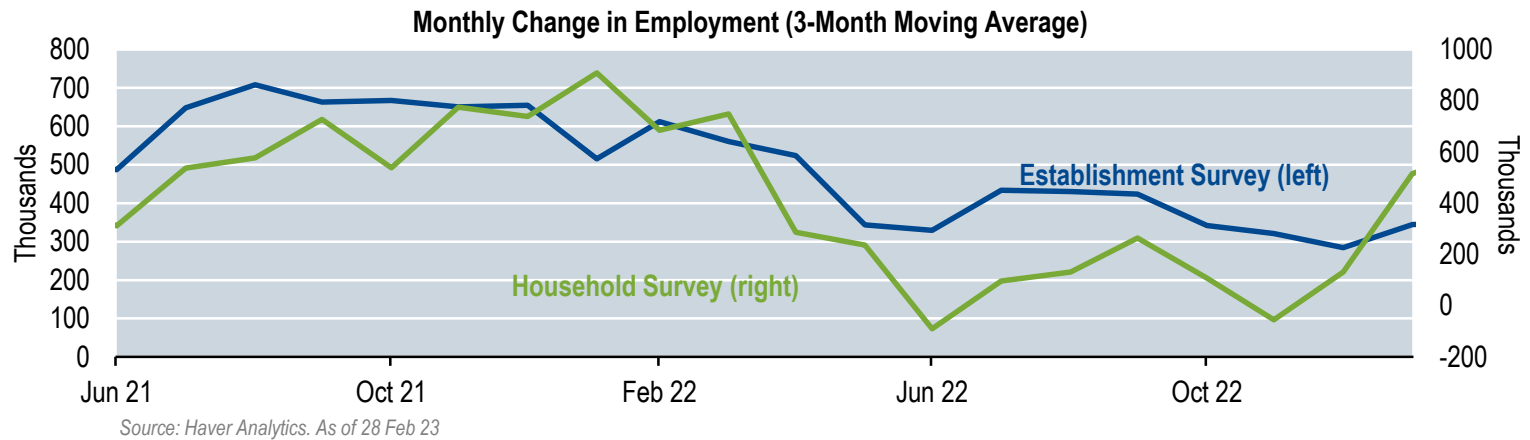
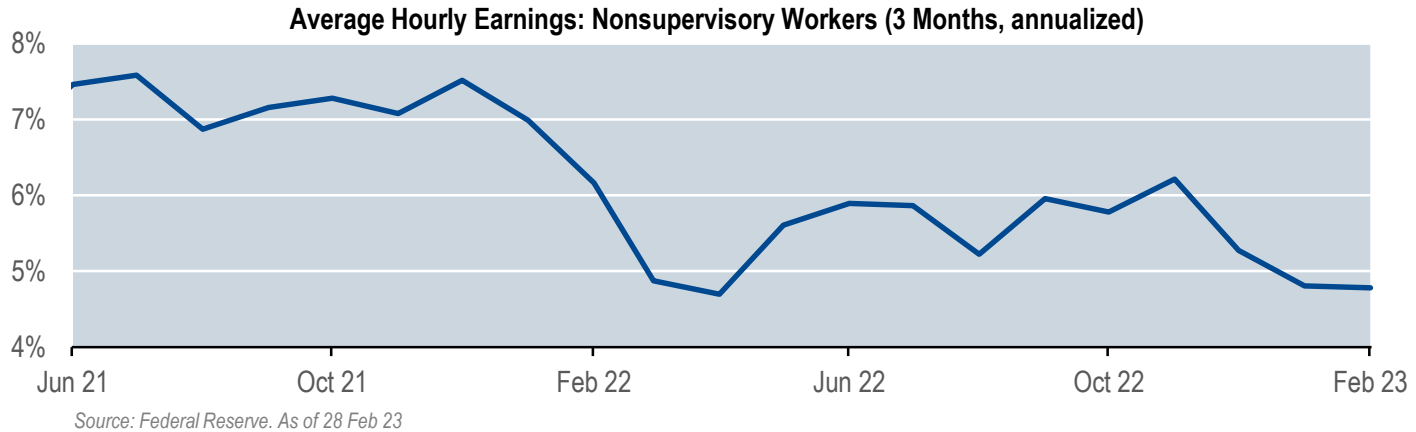


Source: Bloomberg. As of 28 Feb 23



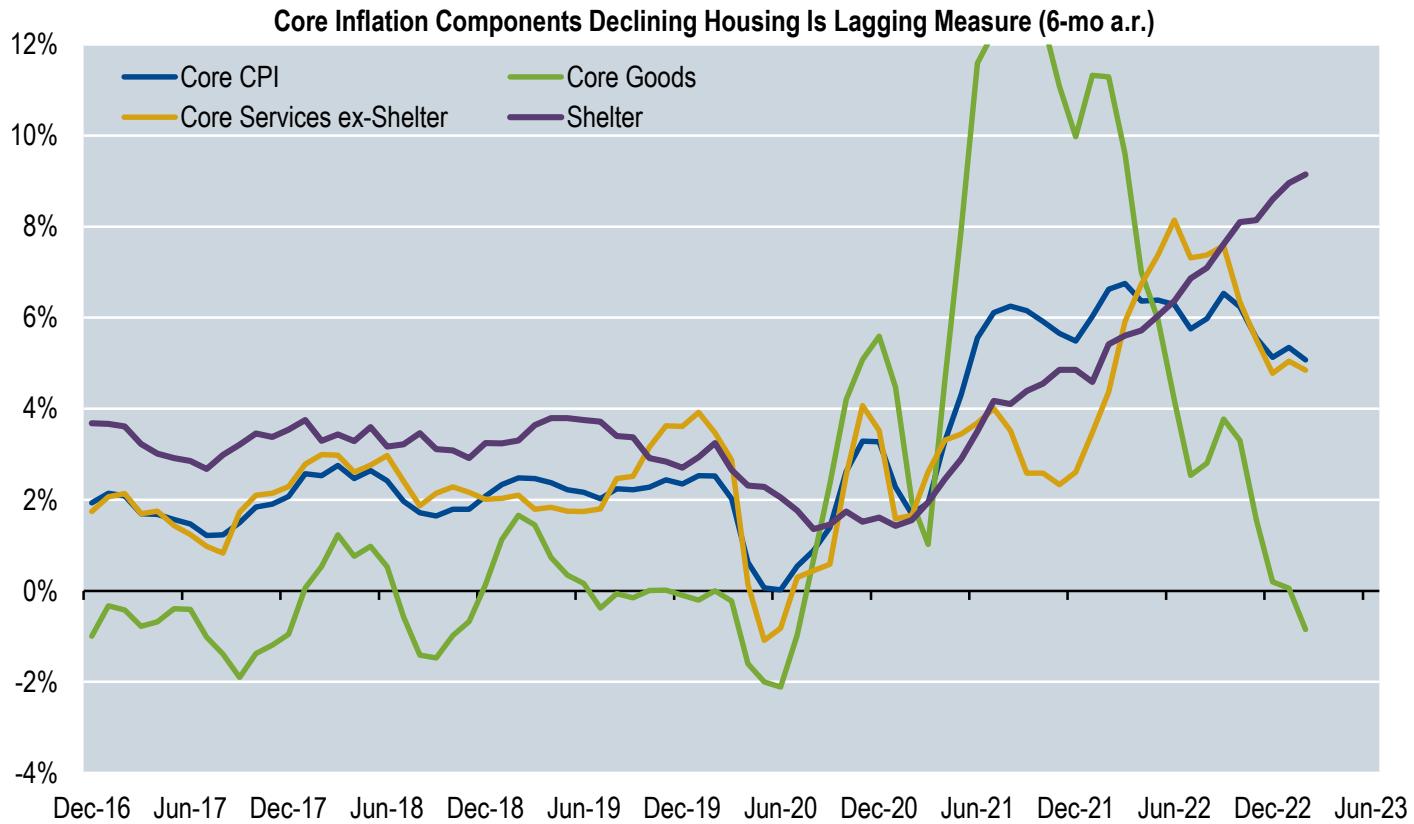
Source: Bloomberg. As of 28 Feb 23

Wage Growth Decelerating



“The process of getting inflation back down to 2% has a long way to go and is likely to be bumpy.”

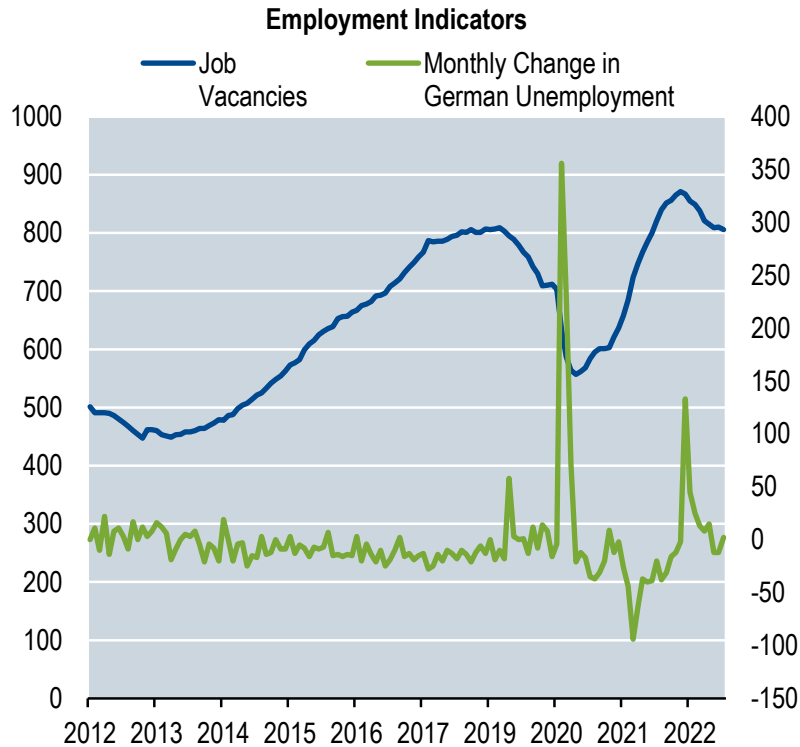
– Fed Chair Powell, March 22, 2023



Source: Bureau of Labor Statistics. As of 28 Feb 23

Europe's Growth Prospects Have Improved but Remain Weak

- Demand has improved but forward-looking indicators remains soft
- Past support to production from healing supply chains and large order backlogs are receding
- Jobs market has slowed modestly but remains buoyant



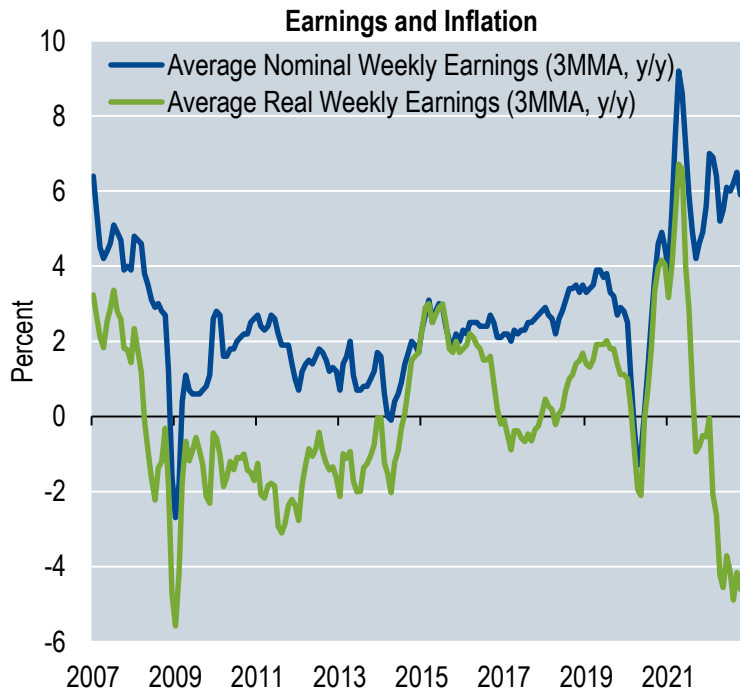
Source: Federal Employment Agency, Haver Analytics. As of 28 Feb 23



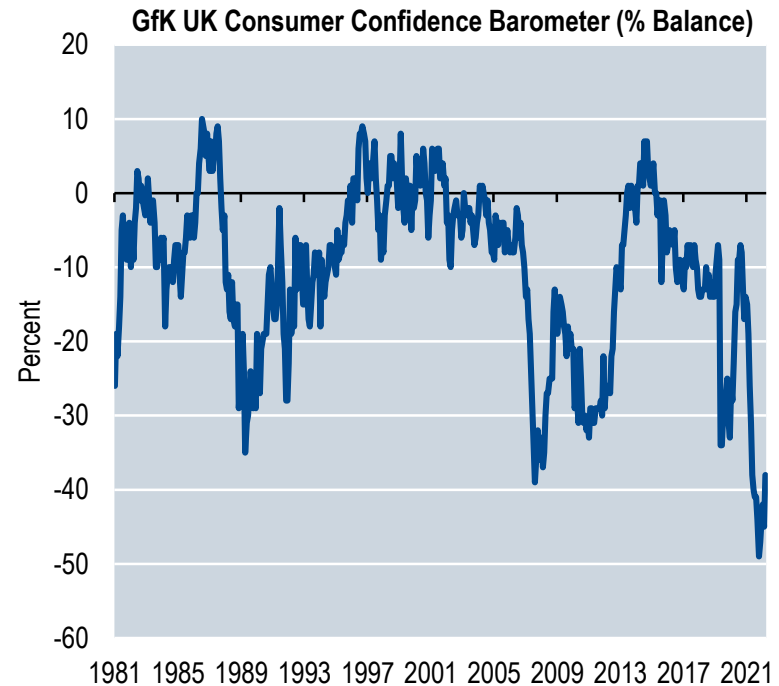
Source: Bundesministerium für Wirtschaft und Technologie, SPG/Haver Analytics. As of 28 Feb 23

United Kingdom: Slowing Activity

- Bank of England has raised the policy rate meaningfully and active gilt sales are underway
- Deeply negative real wage growth and higher costs of living (energy and food inflation) reduce discretionary spending
- Higher mortgage costs further squeeze household budgets and the property market is weakening
- Market turmoil last autumn acted as a confidence shock and further tightened financial conditions
- Consumer sentiment is at all-time lows, even lower than the pandemic and GFC



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



Source: GfK NOP/ Bloomberg. As of 28 Feb 23

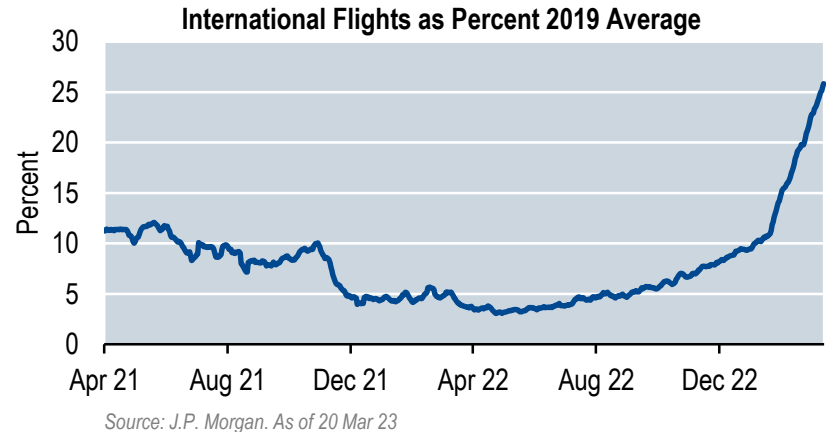
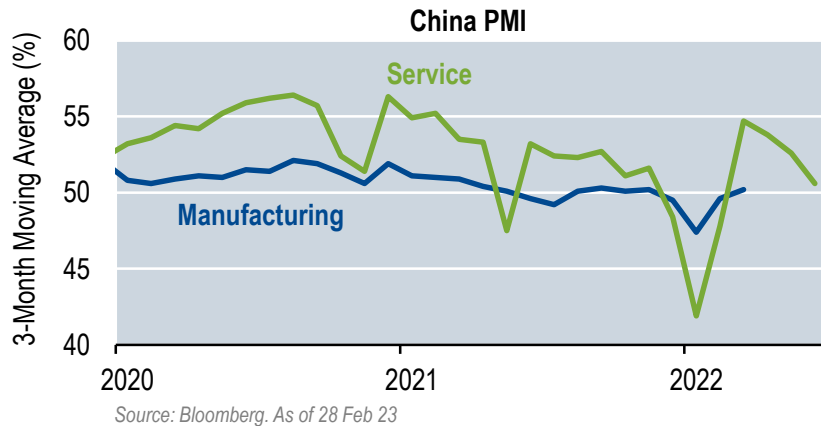
The above reflects current opinions of Western Asset and are subject to change with market conditions.

China Outlook: Cyclical Rebound, Secular Concerns



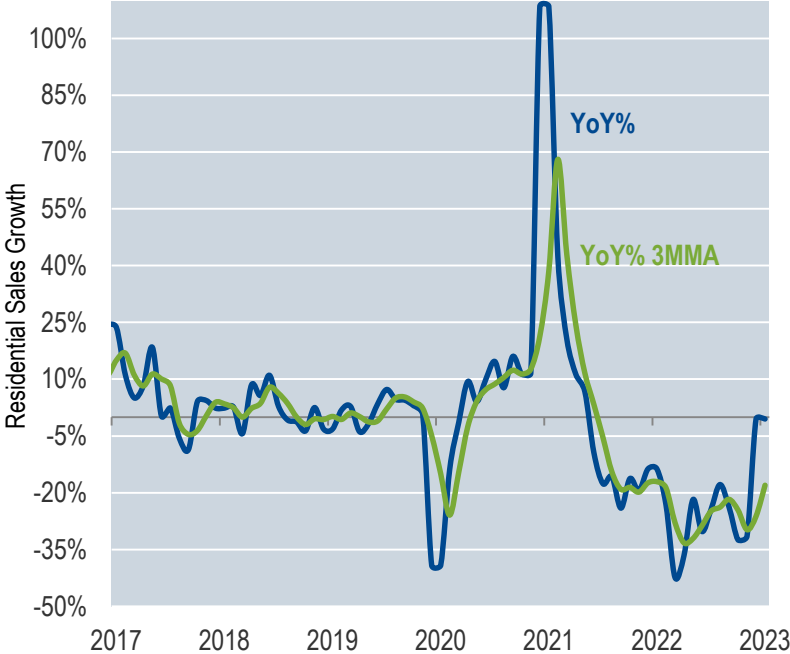
2023 Growth

- Abrupt exit from zero-Covid strategy in early December sets the stage for growth recovery in the first half of 2023
- Broad policy accommodation should nonetheless remain intact until the economy is on strong footing
- Support for property market should help contain further fallout from current market doldrums
- Consumption will be a key growth driver, although the trend in China remains unimpressive
- Services should see a strong boost from increased travel – both domestic and international

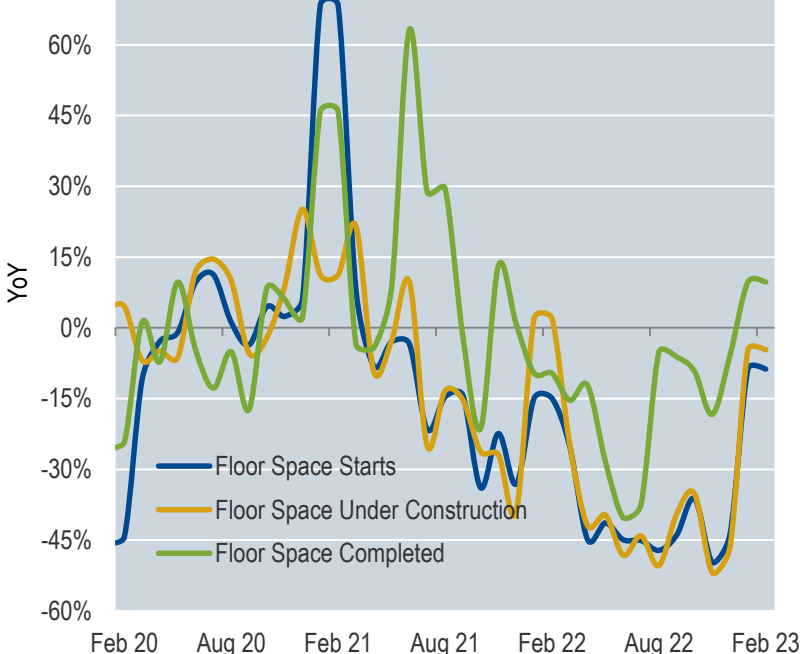


China: Signs of Stabilization in Property Sector

Rebounding Property Sales in Jan-Feb



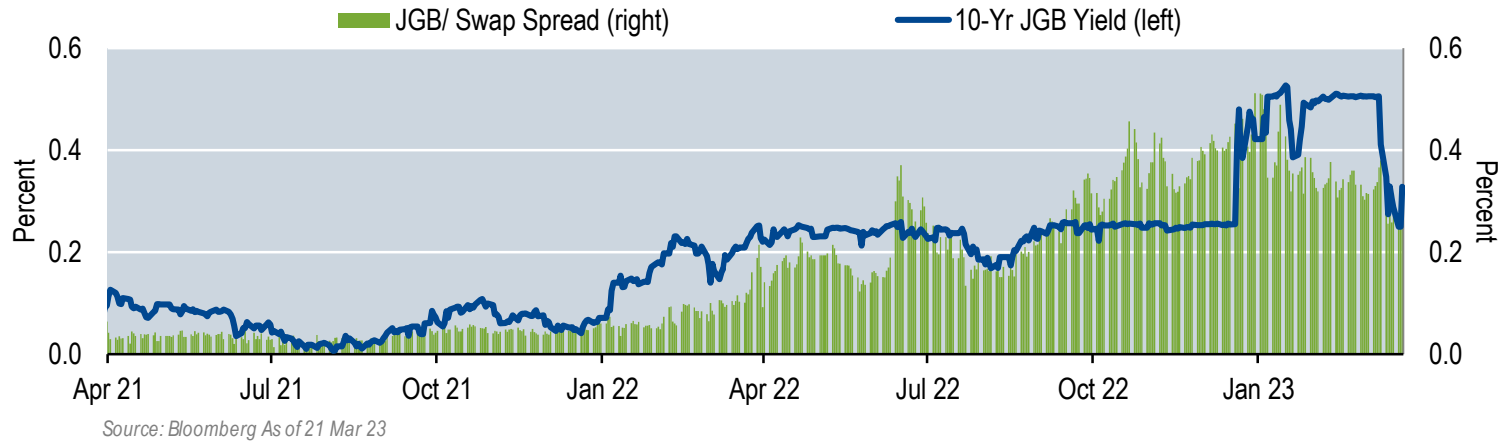
... Together with Improving Property Construction Activities



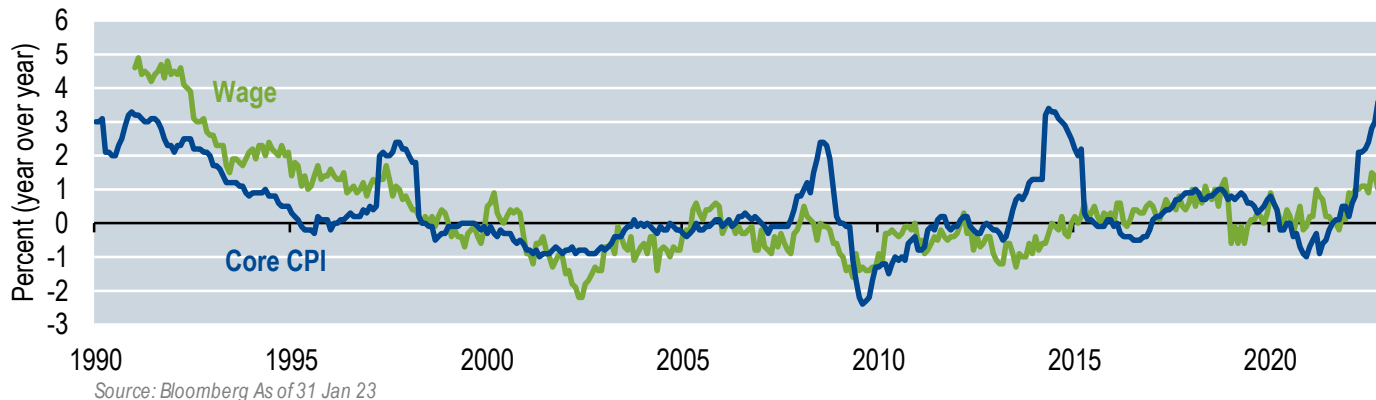
Source: CEIC, NBS, Morgan Stanley Research. As of 28 Feb 23

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

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



Wage Pressure Is Building but Remains Contained 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

The Two Tiers of the US Banking System

We prefer large US banks over regionals.

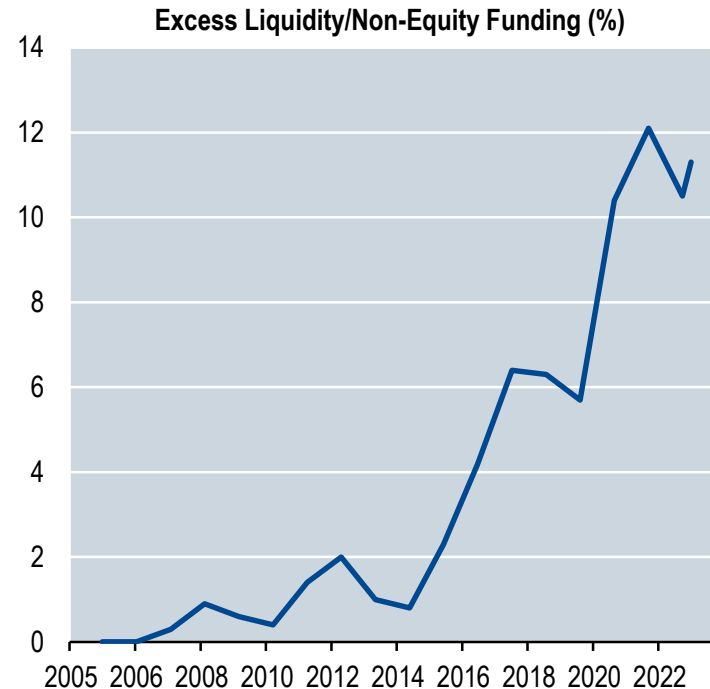
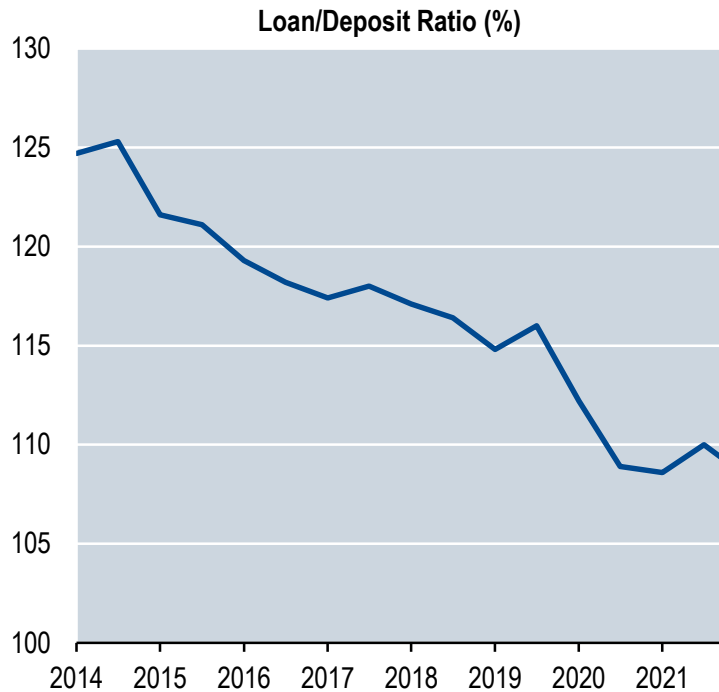
	Regulatory Scrutiny	Balance Sheet Strength	Deposit Mix	Interest Rate Risk	Current Market Confidence
Large US Banks	High	Very High	Diversified, Low Risk	Low	High
Regional US Banks	Moderate	Moderate	Narrow, Medium Risk	Medium	Low

Expectations:

- Large banks will get stronger while weaker regionals will consolidate
- Regulation (and issuance) will increase for regional banks
- Regional bank ratings will come under pressure

European Banks

Funding models have largely been fixed since the Global Financial Crisis

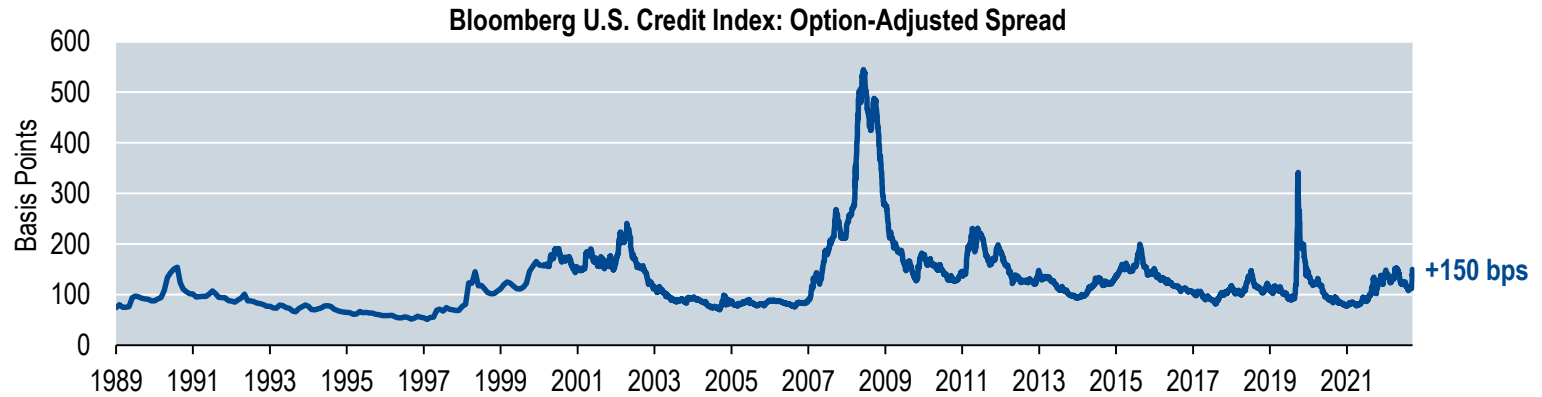


Funding models for European banks have largely been fixed since the global financial crisis

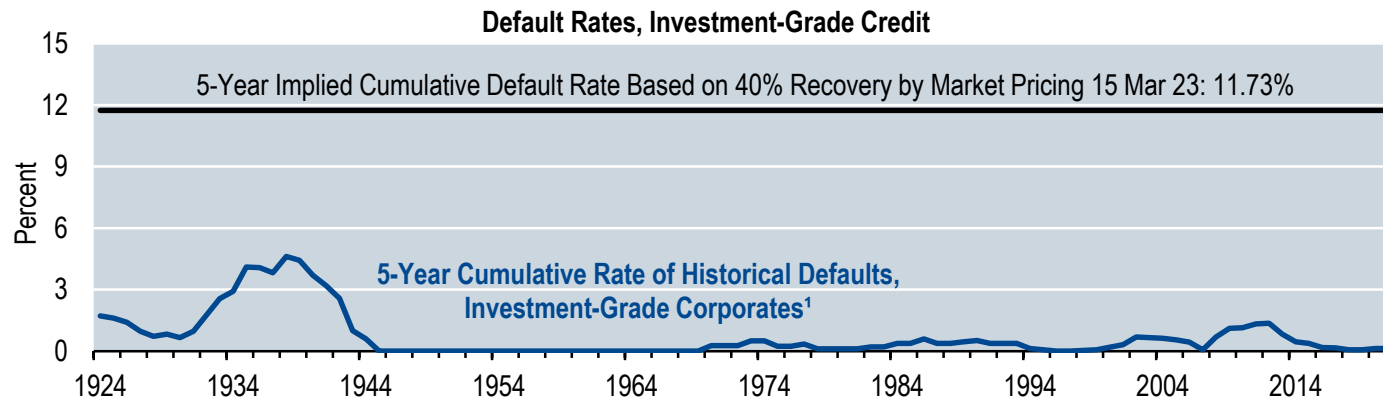
- Much higher retail deposits
- Much lower wholesale funding
- Central bank liquidity backstops

US Investment-Grade Credit

Spreads and Default Rates



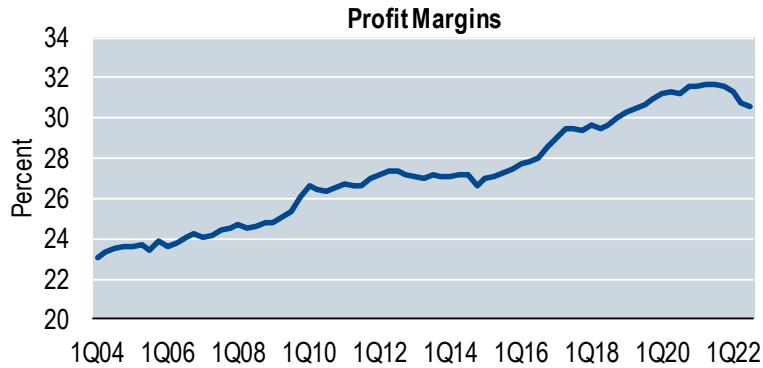
Source: Bloomberg. As of 15 Mar 23



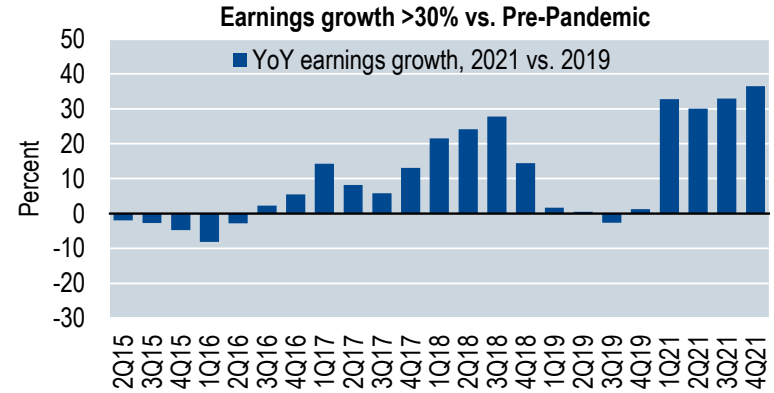
Source: Bloomberg, Moody's. As of 15 Mar 23

¹As of 31 Dec 21

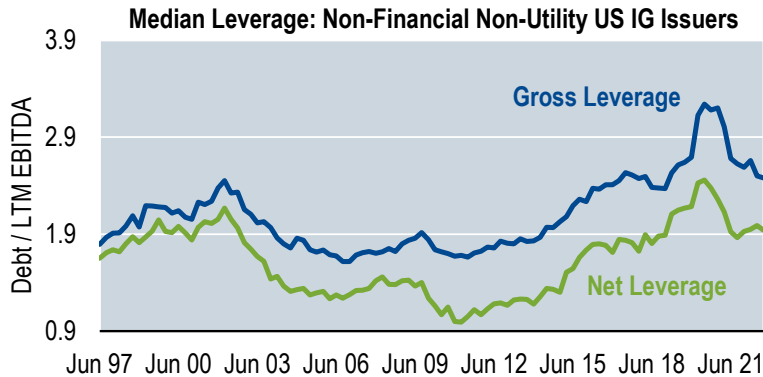
Cash Flow and Debt Metrics Support Investment-Grade Credit



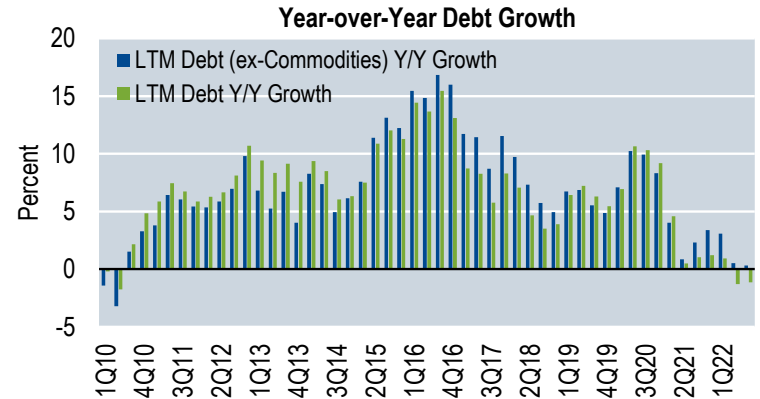
~180 Non-Financial Companies (JULI Based)
 Weighting based on amount of debt in the benchmark
 Source: J.P. Morgan. As of 30 Sep 22



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

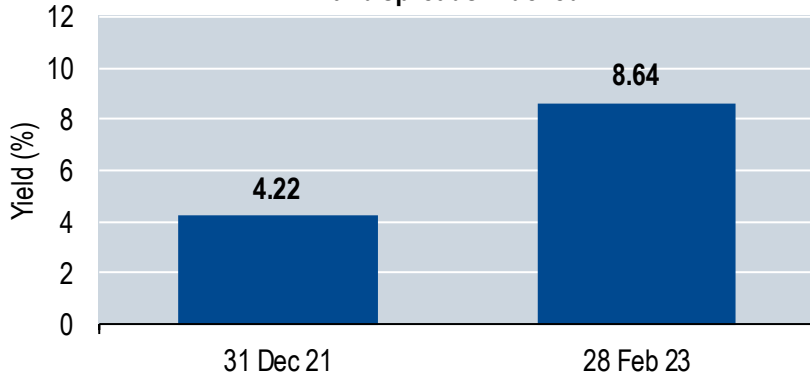


Source: J.P. Morgan. As of 30 Sep 22

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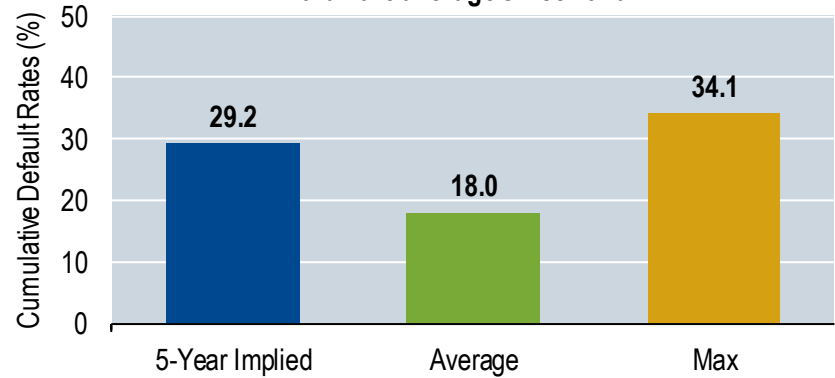
High-Yield Valuations and Fundamentals

Yields rose by more than 4% since 2021 as rates rose and spreads widened



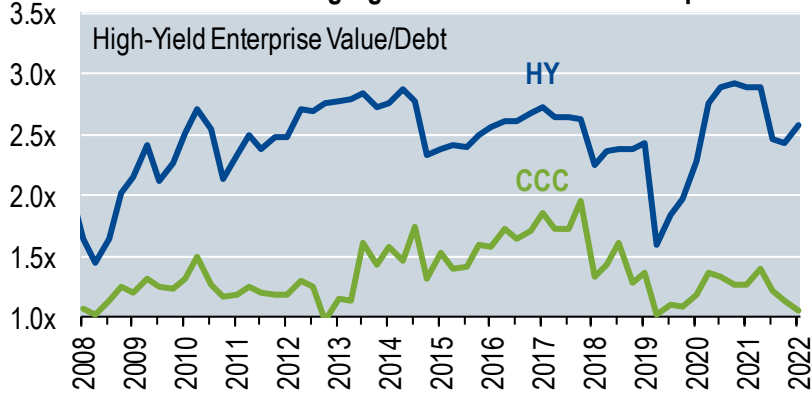
Source: Bloomberg. As of 28 Feb 23

Spreads now imply much higher defaults than the average since 1970



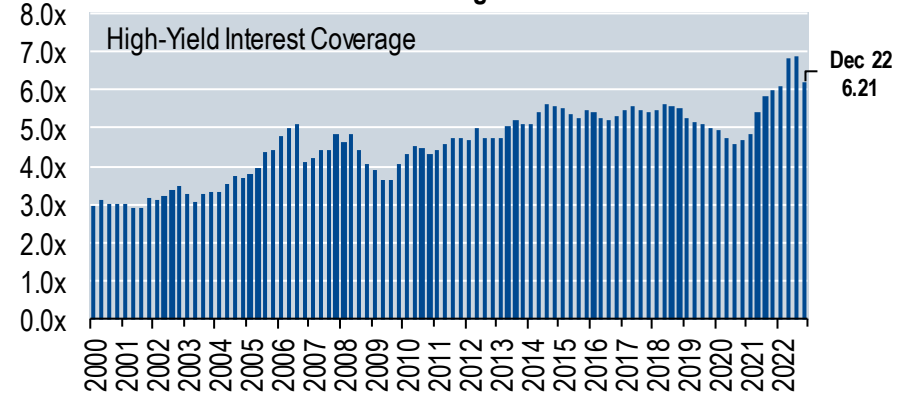
Source: Bloomberg, Moody's, Western Asset. As of 28 Feb 23
40% recovery assumption was used and spread used to imply cumulative defaults over 5 years.
Worst cumulative 5-year default period since 1970 was 1992

Cracks Are Emerging for the Most Levered Companies



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

Ability to Service Debt Also Supportive of Lower than Average Defaults

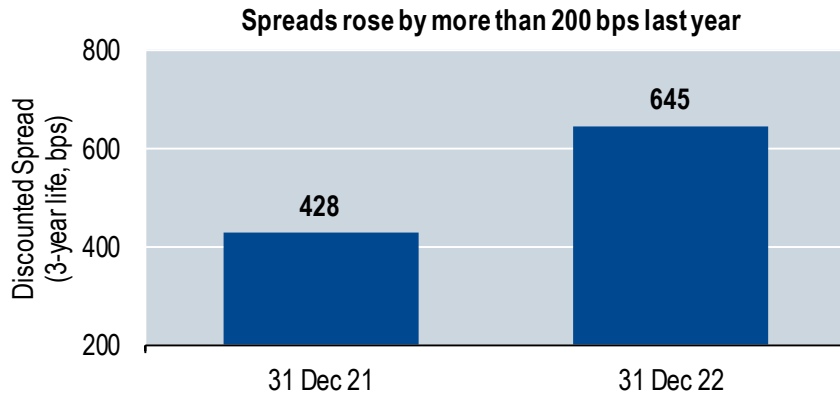


Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Dec 22

Bank Loan Fundamentals Remain Supportive

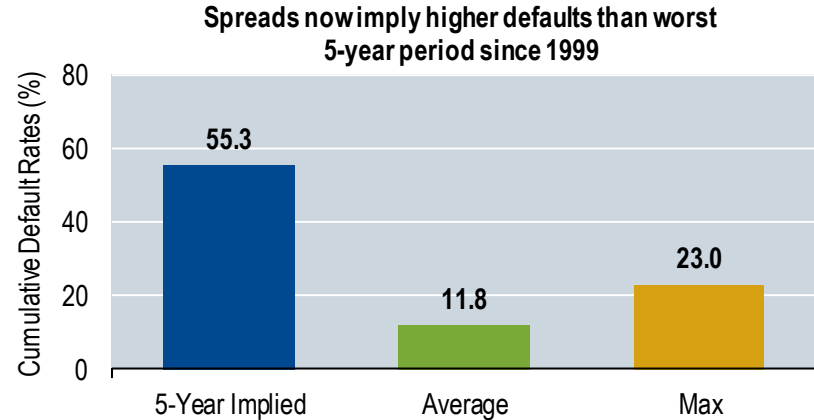
Interest coverage remains near decade highs as EBITDA and interest rate expense rose.

- Interest coverage remains supportive for relatively low default rates

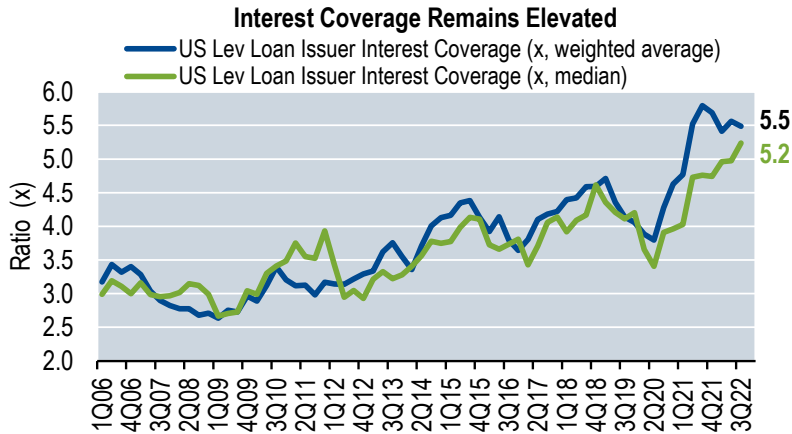


Source: PitchBook Data, Inc. As of 31 Dec 22

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

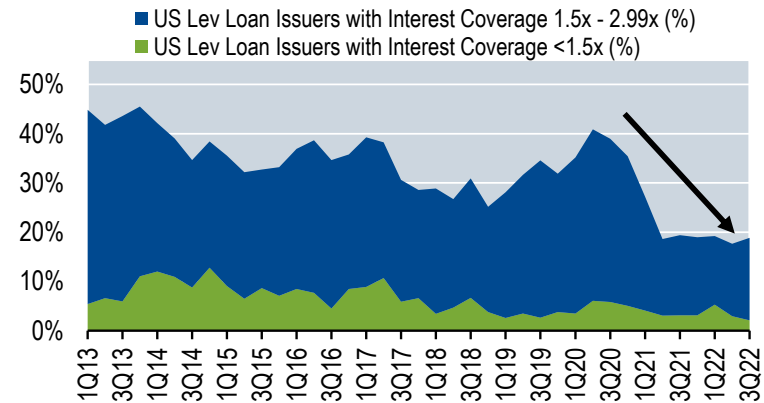


Source: PitchBook Data, Inc., Western Asset. As of 31 Dec 22
60% recovery assumption was used and spread used to imply cumulative defaults over 5 years.
Worst cumulative 5-year default period since 1999 was 2003



Source: Credit Suisse, Leveraged Commentary & Data (LCD). As of 30 Sep 22

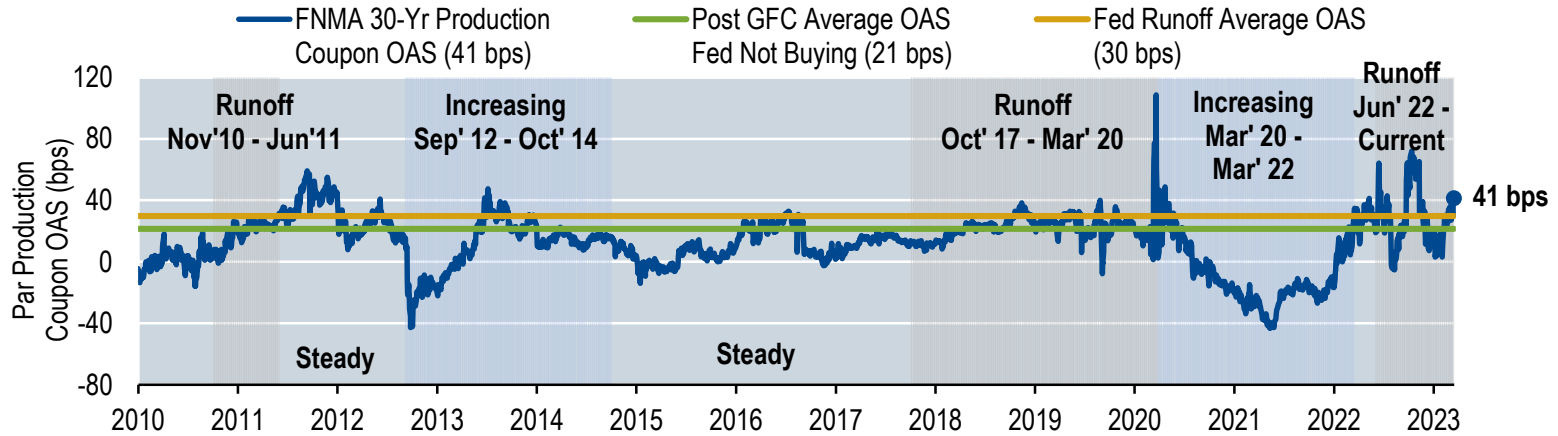
Historically Low Percent of Issuers Have <3x Coverage



Source: Credit Suisse, Leveraged Commentary & Data (LCD). As of 30 Sep 22

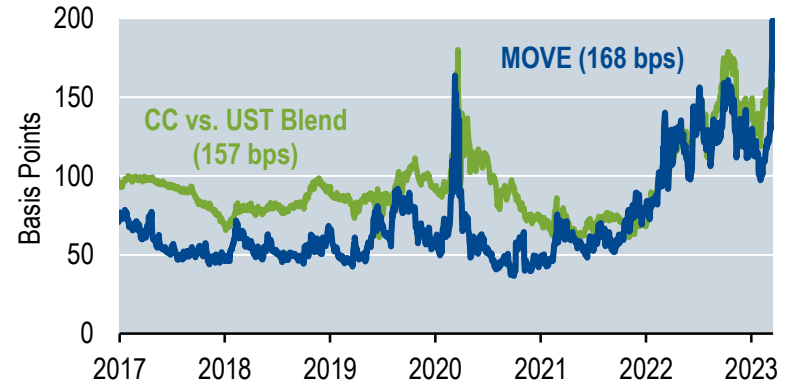
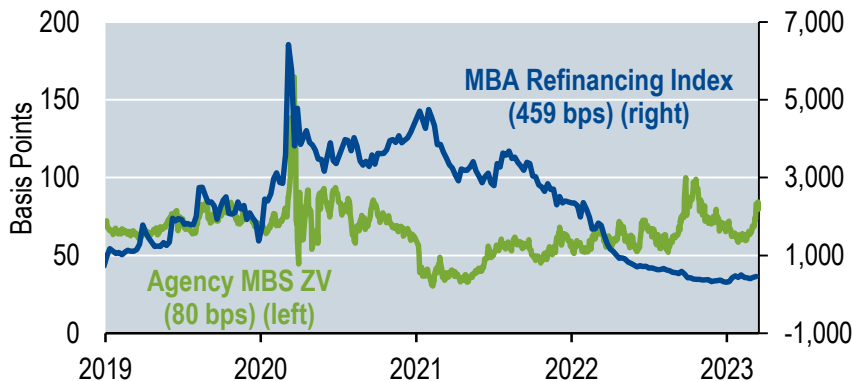
Agency Mortgage-Backed Securities

- Mortgage spreads have widened significantly as Fed and bank support diminished
- Currently around average levels when Fed balance sheet is in runoff



Agency MBS Fundamentals and Valuations Look Attractive

- Agency MBS spreads have widened with elevated volatility
- Prepayment risk remains muted as mortgage borrowers have little refinancing incentive



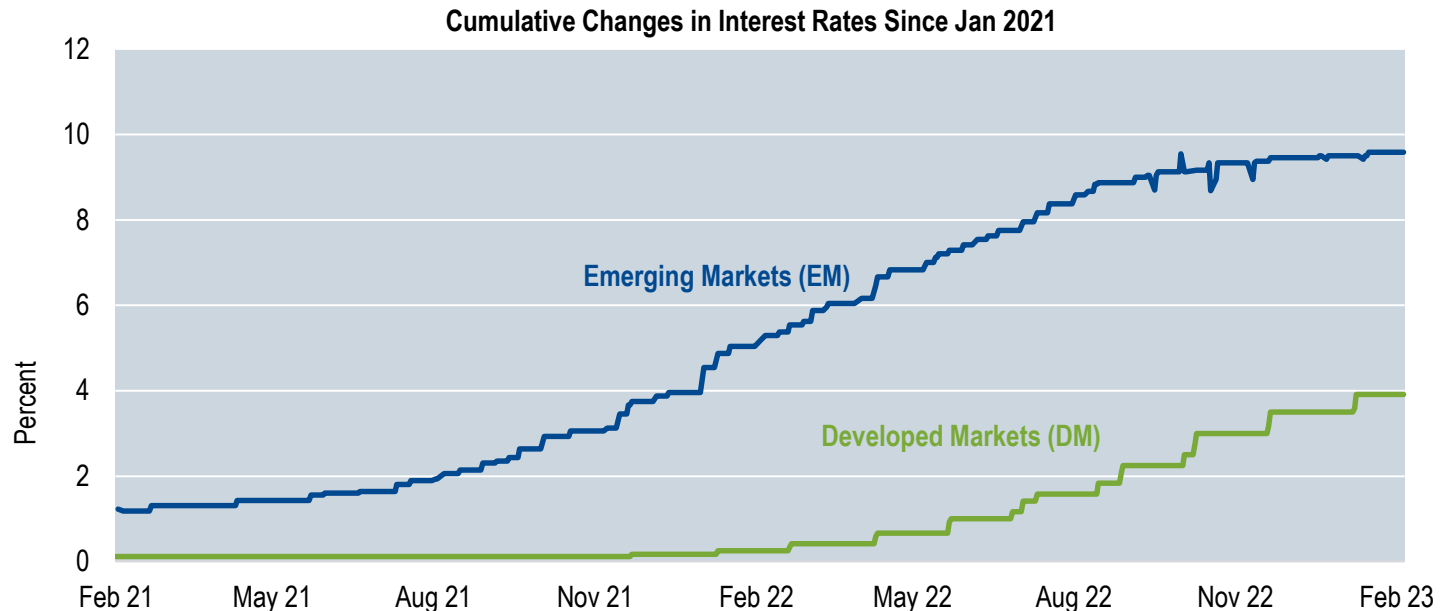
Source: Bloomberg, MS Research, Western Asset. As of 16 Mar 23

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.



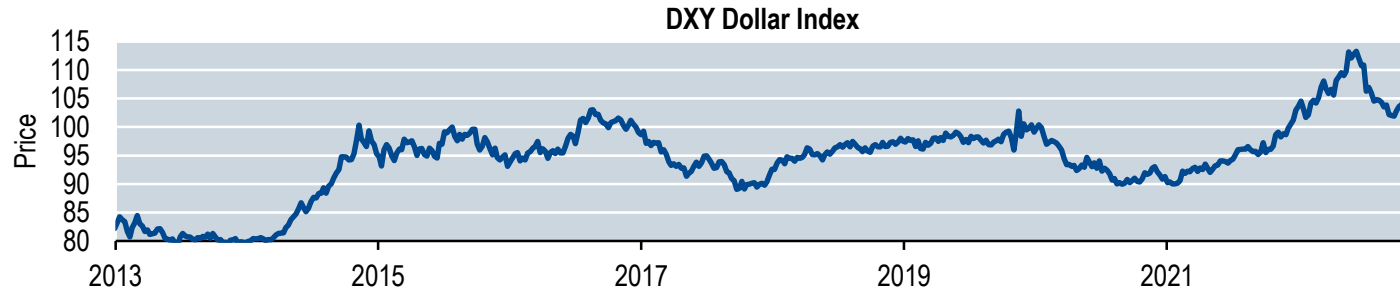
Source: Bloomberg. As of 01 Mar 23

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

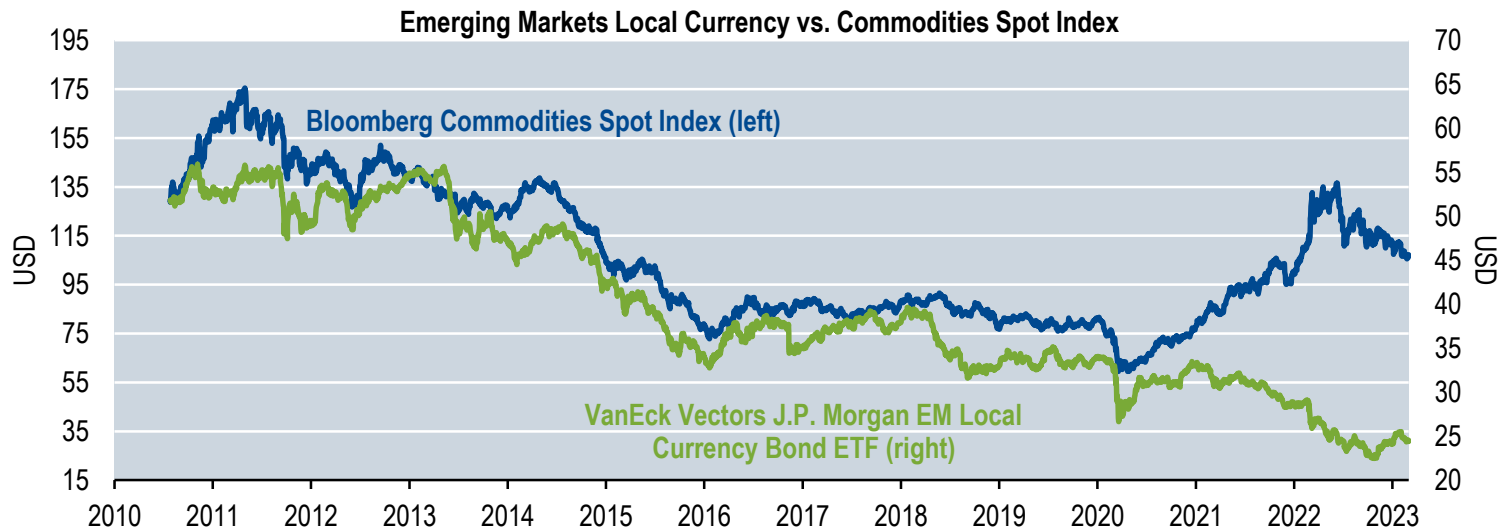
The USD and Commodities: Key Emerging Markets Drivers

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



Source: Bloomberg. As of 24 Feb 23



Source: Bloomberg. As of 02 Mar 23

Current banking stress extremely complex but not systemic

Fed tightening near end

Disinflation ongoing but uneven

Fixed-income outlook

- US growth will slow but should 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 should outperform
- Central bank overtightening is a meaningful risk
- Spread sectors are still attractive but the outlook is clouded by macro risk
- Geopolitical uncertainty continues to add to volatility



Thank you.

Risk Disclosure

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