Ken Leech
Chief Investment Officer

WESTERN ASSET

Webcast Summary

2Q23 Market & Strategy Update

Markets were jolted by a spate of bank failures in the past few weeks, both in the US and Europe. Our long-term confidence in the strength of the overall banking system remains intact, however, given our view that the largest US banks are better capitalized and much more able to handle shocks than they were during the global financial crisis—and the regulation that came on the heels of the crisis is largely responsible. Credit markets digested the bank-related news, which resulted in a shortened time horizon for the Fed's expected rate pause, according to market pricing. Despite this backdrop of elevated stress, we think EM appears well positioned for outperformance, but selection remains key.

Market Review

- Yields rose in February as central banks remained hawkish, with prices rising by more than expected and employers continuing to hire workers.
- However, given the tumultuous events in the banking sector in the last few weeks, yields declined in March, with government bonds displaying their traditional diversification benefits and helping to offset the volatility in credit markets.
- Without the emergence of banking stress, it is reasonable to think short-term rates would be much higher than where they are today.
- Nonfarm payrolls, Consumer Price Index (CPI) and retail sales all came in above expectations.

Banking Turmoil

- We do not believe the recent failures of Silicon Valley Bank, Signature Bank or Credit Suisse mean the entire banking system is at risk. While we recognize that there are clearly some banks with issues, we believe the system as a whole is sound.
- We think that the central banks have the ability to use their tools to protect the banking system and while for many the global financial crisis may come to mind, today's situation is not really analogous.
- Banks have been very, very conservative, their loan delinquencies and charge-offs are extraordinarily low, and total deposits are near all-time highs. As a result, the quality of banking assets is very sound.
- US President Joe Biden and Treasury Secretary Janet Yellen have made an implicit guarantee to protect bank depositors; however, only an act of Congress could provide an explicit guarantee.
- Safeguarding the stability of banks takes precedence over the need to slow inflation, according to remarks by Federal Reserve (Fed) Chair Jerome Powell on March 22.
- The banking woes may indeed hasten the end of the Fed's tightening campaign.

© Western Asset Management Company, LLC 2023. This publication is the property of Western Asset and is intended for the sole use of its clients, consultants, and other intended recipients. It should not be forwarded to any other person. Contents herein should be treated as confidential and proprietary information. This material may not be reproduced or used in any form or medium without express written permission.

Inflation

- Inflation, which has been a very crucial part of our discussion over the last few years, must take a bit of a back seat to the current banking stress, which is extremely complex.
- The disinflationary process is underway, though it will take time and its path will be uneven. The Fed agrees, but Powell said he is "cautious on declaring victory" against inflation.
- We view the Fed's tight policy, which it is primarily citing to be the result of inflationary pressures, as still relying on lagging indicators.
- The market is now pricing in a tremendous number of Fed rate cuts, approximately 100 bps by the end of the year. This is at odds with Powell's recent remarks, however, and the Fed's dot plots show a leveling out with maybe one more tightening.
- Powell was very firm that rate cuts are off the table, mentioning the need to maintain his inflation credibility.
- The Fed's base case is still the prevalent narrative that we're all working with. The risk case, however, is the prospect of the banking stress becoming a systemic crisis.
- Currently, the fear of broad-based banking contagion and economic slowdown is priced with a huge probability. That fear is palpable. Our strong view is that such systemic risk is not there, and that the Fed's toolkit and its desire to manage the problem will take out that risk premium.

US Economic Outlook

- We continue to expect US growth to slow this year, but not necessarily into recession. Should we dip into recession, we expect it will be shallow.
- One of the greatest risks to the US economy continues to be the potential for Fed overtightening.
- Our overall outlook for US growth and inflation has been slightly diminished by the banking turmoil.
- The US dollar should continue to weaken moderately.

Global Economic Outlook

- While global growth has downshifted, China's reopening should help growth remain resilient.
- We expect global inflation will continue to recede.
- **Europe:** The European Central Bank (ECB) is still focused on inflation, but may not raise rates as expected just two weeks ago—though cuts may not happen, either. The ECB dropped forward guidance from its messaging to be open to new developments.
- **China:** Prior fears of ongoing Covid restrictions, property market weakness and government pressure to overregulate were all reversed this year. Growth of 5%-6% is likely for 2023.
- **Japan:** Bank of Japan (BoJ) leadership is changing with Kuroda stepping down. Despite the leadership change, there will be continuity to maintain stimulative policy. We do expect challenges as the year goes on, with moderate growth of 1%-2% and inflation pressures building.
- **EM:** A Fed pause combined with China's reopening bodes well for the emerging markets (EM) outlook.

Investment Themes

- **Overall risk assets:** Spread sectors are still attractive, although they have been clouded by the shadow of a possible policy mistake and of course persistent geopolitical risks.

- **Investment-grade:** Spreads have widened as the cloud of macro risk continues to permeate, not unlike how they behaved amid the S&L crisis (circa 1990). Investors are being paid for default risk versus what's reasonably expected, but US spreads relative to other countries look compelling.
- **High-yield:** We believe the market is pricing in pessimism that is out of line with current fundamental metrics. Although cracks are emerging for the most levered companies, the ability to service debt remains supportive of lower than average defaults.
- **Bank loans:** With interest coverage remaining near decade highs as EBITDA and interest rate expenses rose, bank loan fundamentals remain supportive of the asset class.
- **Structured product:** Fundamentals and valuations look attractive for agency mortgage-backed securities (MBS), with spreads having widened significantly as the Fed and bank support diminished.
- **EM debt:** With EM central banks' tightening cycle expected to consolidate this year ahead of their developed market (DM) peers, adjusted for inflation, we view select EM local yields as attractive.

Q&A Highlights

- While the Fed is charged with maintaining financial stability, it has a poor track record of managing the interest rate cycle. We also know that monetary policy operates with long and variable lags, but the Fed can't seem to stop watching data from one meeting to the next.
- The banking challenge has been a major curveball, and we haven't seen deposit flight like this in a long time. Tight monetary policy has contributed to this weakness but the economy continues to be resilient. Absent the current banking challenge, the Fed was likely to tighten even more.
- Market pricing shows the opposite: there is a tail risk that the banking challenge gets away from the Fed. If the bank crisis resolves in the next weeks/months, we could be in a different spot of aggressive Fed easing. While the Fed's track record is poor, higher nominal GDP is a big factor to consider for the economy in managing any downturn.
- Regarding the potential banking crisis, we think it's essential to differentiate confidence waning in some regional banks versus in the system overall. There shouldn't be weak confidence in the system. The deposit flight is not coming out of the entire system, just out of less capitalized banks. Policy response has been correct, working quickly to restore deposit confidence, with leadership getting the message out that backstop tools are available. Some banks may need to be consolidated and will see greater regulatory scrutiny.
- AT1 securities are not appropriate for all investors. While we are not writing off the sector completely, we will continue to be extremely selective.

Past results are not indicative of future investment results. This publication is for informational purposes only and reflects the current opinions of Western Asset. Information contained herein is believed to be accurate, but cannot be guaranteed. Opinions represented are not intended as an offer or solicitation with respect to the purchase or sale of any security and are subject to change without notice. Statements in this material should not be considered investment advice. Employees and/or clients of Western Asset may have a position in the securities mentioned. This publication has been prepared without taking into account your objectives, financial situation or needs. Before acting on this information, you should consider its appropriateness having regard to your objectives, financial situation or needs. It is your responsibility to be aware of and observe the applicable laws and regulations of your country of residence.

Western Asset Management Company Distribuidora de Títulos e Valores Mobiliários Limitada is authorized and regulated by Comissão de Valores Mobiliários and Brazilian Central Bank. Western Asset Management Company Pty Ltd ABN 41 117 767 923 is the holder of the Australian Financial Services Licence 303160. Western Asset Management Company Pte. Ltd. Co. Reg. No. 200007692R is a holder of a Capital Markets Services Licence for fund management and regulated by the Monetary Authority of Singapore. Western Asset Management Company Ltd is a registered Financial Instruments Business Operator and regulated by the Financial Services Agency of Japan. Western Asset Management Company Limited is authorised and regulated by the Financial Conduct Authority ("FCA") (FRN 145930). This communication is intended for distribution to Professional Clients only if deemed to be a financial promotion in the UK as defined by the FCA. This communication may also be intended for certain EEA countries where Western Asset has been granted permission to do so. For the current list of the approved EEA countries please contact Western Asset at +44 (0)20 7422 3000.