Ken Leech
Chief Investment Officer

Western Asset

Webcast Summary

3Q23 Market & Strategy Update

While inflation has been the driving force primarily responsible for Fed rate hikes, it appears that the "long and variable lags" are still working through the system as inflation trends downward, albeit very unevenly. Today, as we continue to emerge from the tumultuous Covid era, central bank tightening is likely nearing its end, if it's not already there, and the "soft landing" we've hoped for—avoiding recession—is looking ever more likely, though caution is still warranted. Global growth overall has downshifted yet remains resilient, especially with China's reopening. As the US dollar weakens moderately, EM may still have its day in the sun. Investment-grade corporate bonds and other spread sectors remain attractive.

Market Review

- Yield curves have flattened. Spread sector yields are the highest we've seen in about 10 years, and in some sectors, 20 years.
- Inflation tailwinds have turned into headwinds; disinflation is ongoing but uneven.
- Stress seen in the regional banking sector is extremely complex but has not proven to be systemic.
- The labor market is improving, with wage growth moderating.

Banking Turmoil

- Stark differences can be seen between large US banks and regional banks; we prefer large banks, which benefit from high regulatory scrutiny and balance sheet strength.
- Regional bank ratings will continue to face pressure.
- We expect large banks to grow stronger while weaker regional banks will likely consolidate.

Inflation

- The response to Covid unleashed unprecedented monetary and fiscal policy experimentation. Once reopenings began, we saw incredible demand shock against very constrained supply driving prices sharply higher.
- The Ukraine-Russia war exacerbated inflation even more, driving up commodity prices and putting additional strain on supply chains.
- China's resurgence of Covid late last year put even more pressure on supply chains and drove inflation to all-time highs.
- The tailwinds for inflation by now have either abated or even turned into headwinds.

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- Fiscal policy largesse is now gone, and the speed with which monetary policy has been tightened really reversed course. Now for the first time since the Great Depression the M2 money supply has gone negative.
- At this point, we believe any further monetary tightening would exacerbate the M2 challenge.
- Inflation represented by core Consumer Price Index (CPI) remains "sticky," but we think lags are still working their way through the system and inflation will continue to decline.

US Economic Outlook

- US growth is slowing down but a recession can still be avoided. Additional policy tightening by the Federal Reserve (Fed) poses risks to growth.
- Consumer spending continues to be resilient due to excess savings, but saving rates are declining and demand is slowing.
- We expect US inflation to trend lower due to various factors such as the decline in fiscal stimulus, tighter monetary policy, easing supply-chain issues and slowing demand.

Global Economic Outlook

- Global growth is also slowing but remaining resilient, with China's reopening boosting global growth.
- Global inflation is receding, with the disinflationary environment supporting spread sectors and government bonds.
- Emerging markets (EM) are attractive due to valuations and policy easing, and appear well positioned to benefit from global growth.

Investment Themes

- **Overall risk assets:** We remain cautious given risks of slowing growth or overtightening but believe current spreads adequately compensate investors.
- **Investment-grade:** IG energy is extremely attractive, even considering the recent decline in oil prices. We're encouraged by conservative managements, de-levered balance sheets, improved cash flows, cost reductions and capital discipline.
- **High-yield:** Valuations are compelling. We believe the market is pricing in pessimism that is out of line with current fundamental metrics. Spreads imply much higher defaults than the average since 1970.
- **Bank loans:** While bank loans have suffered due to the fear of weaker economic growth, valuations are very attractive with spreads having moved relative to high-yield in a way they haven't in quite some time, presenting opportunity.
- **Structured product:** While real estate prices are expected to cool from the record increases, market spreads are elevated with increased risk premiums. Agency mortgage-backed securities (MBS) spreads have widened with elevated volatility and yield curve inversion.
- **EM debt:** While EM has been challenged for a long time, this year EM has done well and we expect the trend to continue. USD-denominated EM government bonds and corporate names are looking good, and local currency bonds should be attractive given the backdrop.

Q&A Highlights

- While our disinflationary view could be wrong due to uncertainties, a broad range of indicators point to slowing inflation.
- Fed officials are unlikely to adopt an inflation target above 2% in the current environment. Rather, they continue to focus on bringing inflation down to the 2% target.
- The Fed should pause rate hikes to avoid overtightening.
- Regarding our positioning, we have overweights in both the front end and long end of the US yield curve. Long bonds are attractive if inflation trends to 2%.
- Commercial real estate risks are serious but manageable.
- There are plenty of opportunities in lower-rated corporate bonds. We prefer higher-quality credit over lower-quality bonds due to higher risks in the latter.
- EM countries like Mexico and India could benefit from changes in global supply chains.

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