

# Webcast Summary



Michael Buchanan  
Deputy Chief Investment Officer

## Finding Opportunity Amidst Hope, Doubt, and a New US Administration

*There has been a significant shift in interest rates and valuations since the US presidential election, but looking at the fundamental landscape, we don't believe things have changed that much. Markets are reacting to the anticipation of improved growth, higher but manageable inflation and a better economic backdrop for businesses. The agenda of the new administration is certainly pro-growth, and there is likely to be a positive economic impact. However, when it comes to the implementation of their initiatives, the administration is likely to face some challenges. In our view, the level of optimism that is priced into the market is perhaps unwarranted and at this point it is not validated by fundamentals.*

*The outlook for global growth remains slow but sustainable at about 3%, and although they have rebounded significantly following Donald Trump's election, inflation expectations remain lower than mid-2014 levels. We will discuss how Western Asset is positioned with this environment as an overall backdrop. We continue to favor a fixed-income portfolio with emphasis on specific spread sectors and a long duration bias.*

### The Fixed-Income Environment Post Election

- The new administration's agenda includes strong pro-growth policies.
- The market is pricing in successful implementation of these new initiatives. Furthermore, concerns involving trade and immigration appear limited.
- While we are likely to witness rapid action on certain policies, fulfillment of all the President-elect's objectives will be met with challenges.
- In our view, the markets have moved too far too fast. Our current portfolio positioning emphasizes specific spread sector strategies complemented with a long duration bias.

### Growth, Inflation and the Federal Reserve (Fed)

- Global growth is slow but sustainable at about 3%. It is a bit optimistic to think that the US economy, which is approximately 20% of world GDP, will be able to reverse that global growth trend.
- Looking at the S&P 500, almost 50% of revenue for those companies comes from outside the US. To think that the US will be immune to global forces is somewhat flawed. We are in a global economy, like it or not.
- Global debt-to-GDP ratios are continuing to grow and we believe it is reasonable to assume that these global debt loads will create a bit of a drag when it comes to improving growth prospects.
- Inflation expectations remain lower than mid-2014 levels, although they have rebounded significantly following Trump's election.
- Following the change in the outlook for fiscal policy and growth, expectations for Fed hikes have moved closer to the Federal Open Market Committee's own expectations.

### Focus Items for the President-Elect

- While the new administration is seeking to improve growth, challenges remain and it will likely take time to enact reforms.

- Tax cuts, particularly for corporations, have been a primary source of market optimism. The administration wants to hit the ground running and tax reform is one area where they may be able to enact change fairly quickly. While there are still details to work out, we feel we will see some meaningful reductions in corporate taxes early in the Trump presidency.
- The administration is proposing \$1 trillion in infrastructure spending over 10 years. The impact of this magnitude of spending could be powerful, but funding these projects can be complicated. During the Obama administration, projects that were thought to be “shovel-ready” weren’t as “shovel-ready” as they anticipated. We think we will see infrastructure spending that will be a net positive for the economy. There is some likelihood that it won’t be as robust as the Trump administration is projecting—we think there will be a pickup, but it will be a measure of magnitude.
- When it comes to the administration’s plans for deregulation, it is important to remember that regulatory changes are complex, and not all can be approved solely by the executive branch. Regulation related to energy, the Department of Labor Fiduciary Rule and other labor laws will need to go through a rulemaking process, which will take time. Full repeals of Obamacare and Dodd-Frank are unlikely, given Congressional involvement, and the White House has almost no control over the regulations that the Fed manages in regard to banks, such as capital requirements and leverage and liquidity ratios.
- Regarding trade and immigration, on a net basis the US balance of trade appears manageable. In isolation though, exports and imports are very large numbers. We think it’s unreasonable to assume that the trading partners of the US won’t retaliate in some way, shape or form if the US changes its trade agreements on an individual basis.

#### Investment Implications

- We favor a fixed-income portfolio with emphasis on specific spread sectors and a long duration bias.
- In developed country corporate credit, we continue to see opportunities in investment-grade credit, high-yield and bank loans.
  - Within investment-grade, bank asset quality continues to improve. We are maintaining an overweight to financials. We currently favor US versus non-US, although we are seeing select opportunities in Europe, and we remain cautious on healthcare/pharmaceuticals.
  - In high-yield, default rates are likely to remain historically low and we are maintaining opportunistic exposure. We feel US valuations are more attractive than non-US and we are maintaining overweights to metals and mining and energy.
  - With its compelling valuations and a strong fundamental backdrop, the bank loan sector works well as a complement to our duration bias and we are maintaining an overweight.
- In emerging markets (EMs), headwinds for EM growth have increased with the election results. Given policy uncertainty, we favor sovereigns/currencies with less sensitivity to US trade policy, such as Brazil and Russia.
- Within mortgage-backed securities (MBS), consumer and real estate fundamentals remain strong. We currently favor non-agency residential MBS to agency MBS due to more attractive valuations.
- We believe rates have moved too far too fast and we plan to maintain a long duration position.

#### Q&A Highlights

- While it’s not Western Asset’s base case, we have to respect that there is the probability for higher rates. It is interesting to note that bank loans typically do well in a rising-rate environment. There will be some pickup in interest expense if rates go materially higher, but it will probably surprise in terms of how minimal that will be because of the way corporates have locked in lower-rate, longer-term debt in this low interest rate environment.
- The presumption is if rates are going higher that the overall economy is doing better. And if the overall

economy is doing better, that should speak well for corporate credit from a fundamental standpoint. It has historically been the case that credit can do quite well in a rising-rate environment.

- We did add a little bit of duration to our client's portfolios post-election. We looked at the fundamentals of interest rates in the US, which are a byproduct of growth and inflation, and working with our economic team we had a hard time validating a 10-year rate of close to 2.5%.
- Dramatically higher rates in a short period of time are going to be very challenging for all of fixed-income. But historically in a gradual rising rate environment, there are certain components of fixed-income that can do very well. Bank loans can do very well if we start to see real traction in rates moving higher. We also think financials are going to do very well, given a backdrop of higher rates and a tightening Fed. Energy and metals and mining are also sectors that still have room to tighten.
- Even though we've rallied quite a bit from where we were at the beginning of this credit cycle, there is still more credit compression that we could see. It's reasonable to assume that we can offset some of that rate hike with some tightening in spread sector positions.

*Copyright © Western Asset Management Company 2016. This presentation is the property of Western Asset Management Company 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. Past results are not indicative of future investment results. This presentation is for informational purposes only and reflects the current opinions of Western Asset Management. 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 Management 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. Potential investors in emerging markets should be aware that investment in these markets can involve a higher degree of risk. Any forecast, projection or target is there to provide you with an indication only and is not guaranteed in any way*

*Western Asset Management Company Distribuidora de Títulos e Valores Mobiliários Limitada is authorised and regulated by Comissão de Valores Mobiliários and Banco Central do Brasil. 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 dealer whose business is investment advisory or agency business, investment management, and Type II Financial Instruments Dealing business with the registration number KLF B (FID) No. 427, and members of JIAA (membership number 011-01319) and JITA. Western Asset Management Company Limited ("WAMCL") is authorised and regulated by the Financial Conduct Authority ("FCA"). In the UK this communication is a financial promotion solely intended for professional clients as defined in the FCA Handbook and has been approved by WAMCL. Potential investors in emerging markets should be aware that investment in these markets can involve a higher degree of risk.*