Western Asset

Webcast Summary

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Strategy Update: US Core and Core Plus

Following the difficulties of 2022, the first quarter of this year saw elevated volatility, especially in the rates market. Expectations for a "soft landing" early in the year shifted to concerns that the Fed might have to go "higher for longer." Then in March, turmoil in the banking sector took center stage, raising recession fears, and markets started pricing in the potential for rate cuts. In this webcast, Julien Scholnick and Travis Carr recap the relevant market forces that inform their view for positioning our US Core and Core Plus strategies, and make the case that the appeal of fixed-income has dramatically increased following last year's experience.

Here are some key takeaways.

Market Review

- This year began following the extreme volatility of 2022—levels not see in 40 years—but it has created a much more attractive entry point for yields.
- The traditional negative correlation of stocks to bonds broke down last year, but has since returned.
- The trend of decelerating inflation became more evident beginning in 4Q22 to end the year at about 4%, a significant step down from the 6% rate seen in 2Q22.
- We saw inflation continue to moderate in the first quarter.
- With inflation concerns abating, risks related to slower growth have risen significantly so far this year.

Inflation

- Our view is that we've passed the acute phase of the inflation crisis as inflation pressures overall appear to be easing, with pockets of sticky inflation including shelter and wages.
- The shelter component of the Consumer Price Index (CPI) remains elevated, but this tends to be a lagging indicator.
- Wage inflation has stayed elevated at approximately 4% year-over-year, but appears to be falling gradually.
- Job growth continues to remain robust and supportive of economic growth, but not so strong as to be as to be inflationary.
- By the third quarter of this year we expect the quarterly rate of inflation to be running at about 3%.
- We think inflation will head back down to the Fed's 2% target, eventually. It will likely be a bumpy ride, but there are signs of improvement in supply chains.

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Fed Policy

- Market expectations in March were pricing in several more rate cuts later this year, which we believe were driven by the heightened stress around the banking issue, but have since dissipated.
- Our view is that the Fed is very likely near the end of its hiking cycle.
- We agree with the market consensus (currently at about an 85% confidence level) anticipating one more rate hike in May.

Portfolio Positioning/Investment Outlook

- Regarding portfolio returns, despite last year's setback, we've seen a good rebound in short-term performance levels.
- Given the inversion of the yield curve, we have yield-curve flatteners and added to those in the first six months of 2022. In other words, we reduced our duration at the front end of the curve, recognizing that the predominant risk at the time was higher inflation.
- The risk from higher inflation has now shifted in favor of concerns about lower growth.
- We're broadly holding our positions in Core and Core Plus portfolios; we like the investment-grade sector due to its higher quality. Given that there is still geopolitical uncertainty and some macro uncertainty, we favor this sector but we don't have a broad-based program to add risk at this time—our strategy is to add risk selectively within investment-grade credit, on a name-by-name basis.
- Regarding agency mortgage-backed securities (MBS), we started 2022 with a very large underweight. In 2Q22, fears that inflation was not coming down quickly enough and could prompt the Fed to sell some of its agency MBS holdings caused additional volatility. We used that as an opportunity to cover our MBS underweight and get closer to a neutral position.
- With Silicon Valley Bank and Signature Bank getting taken over by the FDIC, liquidation of their agency MBS holdings are underway. In terms of an entry point or moving to a larger overweight agency MBS position, we think this is a good opportunity to begin to do so.
- Regarding the US reaching its debt ceiling, the risk is that if it's not raised the US will default on its debts. We think it's very unlikely that the US government will not raise the debt ceiling again, but the issue could provoke a temporary or partial government shutdown. However, our view is that a shutdown would not have any lasting macroeconomic implications, but could cause elevated volatility over the short term.

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