PM EXCHANGE

featuring Michael C. Buchanan, Co-CIO

Webcast Summary

Ryan K. Brist, CFA
Head of Investment-Grade Credit

Greg E. Handler, CFA
Head of Mortgage and Consumer Credit

Simon Miller
Portfolio Manager

The Compelling Case for Credit and Higher-Quality Bonds

Western Asset hosted a PM Exchange webcast led by Co-CIO Michael Buchanan, who was joined by Portfolio Manager Simon Miller, Head of Mortgage and Consumer Credit Greg Handler and Head of Global Investment-Grade Credit Ryan Brist. Together, the panelists discussed the dynamics driving markets and policy since Covid, inflation, central bank policy and recession fears, which cumulatively describe a fairly optimistic if uncertain background for fixed-income. In this conversation, our thought leaders discussed opportunities in the corporate credit space, why they believe higher-quality credit deserves special attention as well as credit fundamentals, valuations and opportunities in both residential and commercial real estate. Finally, each explains where they see the most significant opportunities and risks.

Here are some key takeaways.

ON THE OUTLOOK AHEAD FOR FIXED INCOME

MCB

- While it is certainly possible that rate volatility and uncertainty could persist over the near term, we are encouraged by today's higher yields in fixed-income. It is our view that investors right now have a unique opportunity to combine both quality and higher yields, which is something we have not seen in a long time.
- Western Asset's base case scenario in the US is not a recession; we expect more of a soft-landing scenario, though we are managing for other possibilities and building portfolios that will thrive through a variety of market conditions. Western Asset has always used duration very successfully as a diversifying risk factor, and going forward we believe that investors will see a restoration of the inverse correlation between equities and fixed-income.
- The foundation of our philosophy has always relied on disciplined, fundamental research, both top-down or bottom-up. Timing matters, and it is important that investors understand the fundamentals and how they will likely evolve going forward.
- We make a strong argument that there are compelling opportunities in idiosyncratic, bottom-up credit selection. Rather than buying the index, there are pockets of relative value that active managers can take advantage of by focusing on individual credit selection.

ON THE IMPACT OF INCREASED RATES ON INVESTMENT-GRADE CORPORATES

RB

- The credit market has been remarkably resilient under the higher-rate regime we are experiencing. Companies are selling more lemonade, meaning top-line growth is happening. Profit margins reside near all-time highs. Large, investment-grade corporations refinanced their balance sheets in 2020 and 2021, pushed out the maturities of their debt and borrowed at really low rates. They aren't forced borrowers in today's market. So overall, I'd say fundamentals in investment-grade credit are pretty good.

© 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.

- As an investor, we're seeing a lot of two-, three- and five-year issuance and a lot less supply out the curve in 20- and 30-year maturities. Right now, we can invest in a high-quality, well-diversified corporate bond portfolio at a rate of 5.75% to 6.0%. It looks really good to us.
- Still, nobody knows if we're going to have a recession in 12 or 24 months. The list of worries is long. It includes a possible re-acceleration of inflation, higher-for-longer rates, a Federal Reserve (Fed) policy mistake and the disappointing Chinese reopening. It's important to remember that the investment-grade markets have very low default rates over long periods of time, and it has been proven that investment-grade credit and the higher-quality portions of mortgage credit perform really well in slow-growth environments. And that's what we have in the US right now. Positive but unimpressive growth.
- Fundamentals and technicals are pretty good and we'd characterize corporate bond spreads as "fair" as they currently reside just inside of long-term averages. High-quality fixed-income looks pretty good to our team.

ON US MORTGAGE MARKET

- It is starting to look like the Fed has been able to engineer a soft landing for US housing. During the peak Covid boom, home prices were growing at over 20% per year. And then, when the Fed saw that starting to filter through to inflation, they were aggressively hiking rates. Home prices actually declined a little bit in the second half of 2022 and into the beginning of this year.
- Home builders have done a good job of managing their pipelines and not overbuilding. And [many] homeowners locked in ultra-low rates [before the Fed began raising rates] so they are not incentivized to sell. There has been a dramatic pull-back in the supply of housing.
- We've seen a nice rebound this year and a return to the normal 3% to 5% annual home price growth that we had before Covid. We do believe that we have reached a nice equilibrium. For that reason, we think housing will not necessarily be a headwind for growth into next year and we should see disinflation come through.
- The Fed should be happy with lower rent growth and lower home price growth. And, on top of that, the yields and spreads [on mortgage credit] we're seeing are very attractive—some of the highest we've seen in the last 10 years.
- The agency MBS market has been under a lot of pressure. Last year, by most measures, was one of the worst years in terms of performance. A lot of that was [due to] the Fed hiking cycle. As they pulled back and as rates went back up, agency mortgages underperformed. This year, they've had a lot of volatility again, [especially compared to] US Treasuries. There's been additional supply from some of the regional banks that was unanticipated and that's been largely absorbed. Now with mortgage activity low, we think that these [agency MBS] are cheap versus comparable duration Treasuries. They're yielding about 5.2%, which is 75 basis points (bps) higher than their equivalent Treasury duration. These are spread levels we haven't seen since 2008 to 2009, due to the fact that banks are a little hesitant to buy.
- [We are looking] at value relative to Treasuries and high-quality investment-grade credits. We could see a nice total return as spreads start to normalize, especially into next year, as we do think the Fed will be starting to cut rates—and interest-rate volatility has been one of the biggest headwinds. As the market gets comfort around the Fed's endgame and the timing and pace of [potential] rate cuts, I think the agency market should outperform.
- Finally, there's concern about the resumption of student loan payments. We've seen a sharp tightening in lending conditions [following] the regional bank crisis. Lower subprime borrowers will feel the squeeze of higher rates and tighter lending [standards]. But overall lending has remained prudent. Leverage is back to pre-Covid levels but we're mindful of some of the headwinds that consumers will be facing.

ON THE COMMERCIAL REAL ESTATE MARKET

SM

- There have certainly been a lot of pressures on the commercial real estate market since Covid from a fundamental perspective, and more recently, from rising rates. Rising rates have had a limiting effect on transaction activity as there is more uncertainty around financing coupons or cap rates for pricing assets. This leads to widening bid/ask spreads. Over the first half of the year, we saw volatility with the combination of regional banking challenges and rate hikes, and transaction activity was down 44% over the 10-year average for commercial real estate.
- Over the summer, while we did see rates back up by almost 100 bps on the 10-year Treasury, credit spreads tightened and stabilized after the market worked out the stresses from the regional banking crisis. Volatility has put folks on the sidelines. As the financing rate widens, cap rates also need to widen. Buyers are looking for lower prices or they must be willing to accept a lower initial return on their purchases. This has created a sort of stalemate between buyers and sellers.
- The regional banking turmoil created an additional pressure point that has created shrinking demand for commercial real estate broadly. Historically, regional and local banks financed approximately 30% of commercial real estate markets, and these banks are especially meaningful for smaller properties outside of city centers, where local banks work closely with local market participants.
- Office real estate is challenged fundamentally, but location matters. Nationwide, office space [utilization] is only about half of where it was pre-Covid, and office real estate is seeing a perfect storm of lower occupancy rates and a near-doubling of mortgage rates since the time of loan origination.
- We have been very cautious on office exposure for several years, but there are some green shoots in office real estate. Certain markets are depressed with large overhangs of supply, like Chicago, downtown Los Angeles and San Francisco, but there are other metro areas like Miami that have seen demand improve since 2020. In places like New York City, it is hard to paint the office sector with a broad brush because it is more about the location, age of the building and quality of the property.
- While we are being very cautious about the risk we are taking in office real estate, we are not avoiding the sector altogether. We see select opportunities in higher-quality real estate, particularly Tier-1, class-A properties. There are some very interesting entry points today when the market has had such a negative sentiment overall.
- Debt capital markets—and in many cases, public equities—are forward-looking and have already repriced to distressed levels. Hospitality and retail data centers have been a great story, and we have seen repricing to the positive side in the public equity and debt markets. We think there are great opportunities to step in as a lender or as a capital provider, but investors should be cautious as the distressed story is going to take years to play out.

ON WHAT KEEPS THEM UP AT NIGHT:

RB

- One of the long-term themes we're working on in our portfolios is that it has become okay to lend to technology over the last 15 years. Now it's okay in the bond market to lend to soft assets, no contracts, and now it's bled its way down into the lower quality tiers of the credit markets. As bond investors we're thinking about [the] downside, something that we spend a lot of time on and it's an underweight in our strategies.

MCB

- My fear is, and we talk a lot about this in our strategy meetings, is that perhaps there are signs that the economy is actually already moving in a direction of slower growth. And there's a risk certainly that the Fed could overstay their welcome at higher rates. So, I think we have to continue to be vigilant in terms of watching policy, watching the interplay between central bank policy as well as what we're seeing in terms of real-time numbers and what those trends look like.

ON PRIVATE CREDIT IN THEIR RESPECTIVE SECTORS

SM

- Private credit always has been, and will continue to be, a substantial factor in the commercial real estate financing markets, [either in the form of] liquid capital or liquid credit. We find the liquid credit sectors very attractive today as we think investors can be a price maker setting the structure, the covenants, leverage and types of sponsors.

GH

- Interestingly, we get this question a lot: With supply down, how do we source opportunities? In the second half of this year and into next year, I think banks will be looking to diversify their funding sources. We are going to see some high-quality bank assets that normally would be sitting on balance sheets start to make their way into private credit markets. And we do think there will be some good opportunities there.

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 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.