Michael C. Buchanan, CFA
Chief Investment Officer

Moderator:
Catherine Matthews
Global Product Specialist

WESTERN ASSET
A Franklin Templeton Company

Webcast Summary

1Q25 Market & Strategy Update

Fixed-income markets are set for a strong year, driven by attractive yields and income opportunities. Global growth will likely decelerate but remain positive, with the US continuing to outpace other developed economies. Disinflation progress varies globally; the US continues to face challenges. Central banks are widely expected to cut rates further this year, though the extent and timing will differ across regions. Embracing anticipated market volatility will be crucial, particularly due to the incoming Trump administration's policies, including the well-publicized tariffs. The resilience of the consumer is expected to underpin US growth. While credit spreads are tight, strong fundamentals support corporate credit, with specific opportunities in CMBS and CLOs. We also see attractive opportunities in shorter-duration US bonds, European and UK bonds and select EM debt.

Global Economic Outlook

- We expect global growth to decelerate but remain firmly positive, with the US continuing to outpace most developed economies. However, the growth gap between the US and the eurozone should narrow.
- The fight against inflation has progressed significantly around the globe, with headline inflation declining close to target levels in many regions.
- The Federal Reserve (Fed), European Central Bank (ECB) and other central banks are expected to continue easing monetary policy.
- We anticipate market volatility due to the incoming Trump administration's policies, including tariffs, border policies and protectionist rhetoric. These factors will likely create periods of market disruption and opportunities for fixed-income investors.

US Economic Outlook

- We expect the US to continue outpacing most developed economies in terms of growth, although the disparity between US growth and that of other developed economies may narrow somewhat.
- The US labor market shows signs of slowing, with payroll growth decelerating and the unemployment rate increasing. However, this increase is primarily due to an expanding labor force rather than layoffs, indicating underlying strength.
- The resilience of the US consumer, bolstered by strong balance sheets, low debt-to-income ratios and real income gains, should continue to support economic growth. Consumer spending remains robust, driven by factors such as low mortgage rates and strong retail sales.

Central Banks

- Central banks overall are expected to cut rates further in 2025, although the extent and timing of these cuts will vary across different regions.
- The Fed faces challenges in achieving its 2% inflation target. We anticipate some progress toward this target although it remains unclear if it will be fully achieved in 2025.
- The ECB has already cut its deposit rate by 100 basis points since last summer, but policy rates remain high relative to historical averages.
- The Bank of Japan is the only major central bank currently tightening policy, with expectations of further rate hikes to normalize real interest rates.

Expectations for the Next Trump Administration

- Trump's administration is likely to use tariffs as a negotiating tool, with potential tariffs of up to 60% on goods from China and 10% on other countries. This could lead to market disruptions and increased volatility.
- The president can unilaterally drive trade policy, unlike fiscal policy, which means that changes in tariffs and trade agreements can be implemented quickly and may cause sudden market reactions.
- Protectionist rhetoric and policies, such as border policies and transactional alliances, could create uncertainty and volatility in global markets, impacting investor sentiment and economic stability.
- The potential for aggressive international negotiating tactics and new initiatives from the Department of Government Efficiency (DOGE) could introduce further volatility, as markets react to the evolving trade and economic policies of Trump 2.0.

Investment Themes

- **Overall Spread Sectors:** We expect spread sectors to face periods of volatility due to geopolitical and economic uncertainties, including the new Trump administration policies and ongoing fiscal concerns. However, strong fundamentals and technicals in sectors like corporate credit and structured products provide opportunities for selective investment, with a focus on maintaining flexibility to capitalize on market dislocations.
- **Credit Sectors:** Despite tight credit spreads, we continue to find opportunities within the credit sectors, particularly in financials and European credit, where valuations have not tightened as much as in the US, allowing us to capitalize on relative value and strong fundamentals.
- **Investment-Grade Credit:** We are focusing on sectors with strong fundamentals and attractive relative value, such as financials, while being mindful of the tight spreads and positioning portfolio to take advantage of any market dislocations that may arise.
- **High-Yield Credit:** We are maintaining exposure to sectors with good fundamentals and strong technicals, while being prepared to opportunistically add to positions during periods of market volatility, leveraging our sector teams' insights to identify attractive opportunities.
- **Structured Products:** We see attractive opportunities in commercial mortgage-backed securities (CMBS) and collateralized loan obligations (CLOs), where spreads remain wider compared to investment-grade corporate bonds. Fundamentals remain strong, supported by high-quality new issuance and manageable supply.
- **EM Debt:** With nominal rates at decade highs and real yields averaging close to 4%, we see attractive local market rate opportunities in select countries like Mexico.

- **Geopolitical and Economic Risks:** Fiscal concerns in the US and other countries like France and the UK, along with the potential for central banks to stay too restrictive or for growth to be too strong, are key risks that could impact financial markets and fixed-income strategies.

Q&A Highlights

- We are managing expected rate volatility by focusing portfolio duration exposure closer to the policy rate, particularly in the shorter part of the yield curve, to mitigate potential long-end volatility.
- Despite recent concerns about rising default rates in leveraged loans, we remain confident in the asset class, citing strong fundamentals and the likelihood that recent defaults are isolated incidents rather than the start of a broader trend.
- We continue to find opportunities in financials, particularly given the potential for deregulation and the benefits of a steepening yield curve, which could enhance the sector's performance.
- Our team is prepared for various economic scenarios, including the risk of central banks remaining too restrictive or growth being too robust, and has positioned portfolios to navigate these potential outcomes effectively.