Western Asset
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3Q25 Market Outlook: Quarterly CIO Webcast

FEATURING

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Global economic growth is slowing due to ongoing geopolitical tensions, uncertainty around tariffs and persistent fiscal concerns. The US economy is decelerating and recession risks are elevated, while Europe may benefit from policy support and increased defense and infrastructure investment. Inflation is trending toward central bank targets, although it remains more persistent in the US than elsewhere. Central banks are expected to proceed cautiously. Further rate cuts are likely but not imminent. Yield curves have steepened in response to fiscal pressures. Spread sector fundamentals remain strong, but valuations are stretched, necessitating scrutiny in security selection and an up-in-quality bias. Given this investment environment, we favor high-quality credit—particularly in European banks and single-B rated bank loans—with an emphasis on quality positioning and active management across spread sectors.

Global Economic Outlook

- Global growth is slowing, with significant regional variation; Europe may see a modest rebound supported by increased defense spending and infrastructure investment by 2026 or 2027.
- Geopolitical tensions, trade policy uncertainty (especially around tariffs) and fiscal concerns are major sources of volatility and risk for the global economy.
- Tariffs are viewed as a net negative for global growth, but the timing and magnitude of their impact remains unclear.
- China continues to face headwinds from demographic challenges, a struggling property sector and likely further pressure from tariffs.

US Economic Outlook

- US growth is decelerating and the odds of recession are rising, though this is not our base case; growth is expected to remain positive but below trend.
- The US labor market is showing signs of softening amid higher unemployment and jobless claims, but private sector job growth remains stable, particularly within health care and hospitality.
- Fiscal concerns are prominent, with ongoing debates over spending and tax policy contributing to market uncertainty and yield curve steepening.
- The housing market has softened, contributing to the overall deceleration in economic activity.

Inflation

- Globally, inflation is trending toward central bank targets, with some regional differences; the US is experiencing more persistent inflation than other developed market (DM) countries.
- In the US, goods inflation has shown an uptick and may rise further due to tariffs, but this is expected to be offset by a downward trend in services inflation.
- Tariffs are likely to cause near-term disruptions to inflation, particularly in goods prices, but the overall global trend remains favorable.
- In the eurozone, inflation has moderated, supporting recent rate cuts by the European Central Bank.
- The outlook for global inflation is considered "good," with the expectation that disinflation will continue.

Central Banks

- Most DM central banks have shifted toward more accommodative policy, with rate cuts underway in the eurozone and elsewhere.
- The Federal Reserve (Fed) is taking a cautious, data-dependent "wait and see" approach. At least one rate cut is expected in the fall if labor market or growth concerns intensify.
- The Fed's caution is justified by ongoing economic uncertainty, including the potential impact of tariffs on inflation, fiscal policy and labor market developments.
- The path for global policy rates is lower, with the notable exception of Japan, which is still undergoing a rate normalization process.

Investment Themes

- **Duration and Yield Curve Positioning:** We are maintaining a curve steepening trade in the US and other DM economies, favoring shorter maturities in the US but we are shifting toward curve flattening in Japan following recent sharp yield curve steepening.
- **Credit Sectors:** We focus on sectors with durable fundamentals and attractive income, actively rotating to manage risk as valuations become stretched.
- **Investment-Grade Credit:** We maintain a slight overweight to investment-grade corporate bonds, especially those of higher-quality issuers, while closely monitoring for any deterioration in fundamentals.
- **High-Quality, High-Yield Credit:** We favor an up-in-quality approach within high-yield, emphasizing higher-rated credits and select single-B rated bank loans for their attractive relative value.
- **Structured Products:** We see value in higher-quality structured credit, particularly as spreads remain wider than in corporate credit and fundamentals are improving.

Q&A Highlights

- There is no evidence of abrupt or retaliatory selling of US Treasuries (USTs) by foreign investors; the gradual decline in foreign participation reflects a long-term diversification trend rather than a reaction to current US policies or tariffs.
- The market has already priced in expectations that the proposed US budget bill will lack significant fiscal discipline, contributing to the steepening of the yield curve; a surprise would be if the bill included meaningful spending cuts.
- Our team is maintaining a curve steepening trade in the UST market, expecting fiscal concerns to continue driving long-end yields higher.
- Despite tight spreads in both investment-grade and high-yield corporate bonds, current spread sector positioning remains slightly overweight given strong fundamentals; however, this could change quickly if fundamentals deteriorate.