SECOND QUARTER 2024

The Big Picture

Western Asset's latest insights on economic drivers and credit markets for fixed-income investors

Michael Buchanan

Co-Chief Investment Officer

"This quarterly report provides an in-depth analysis of the global economic landscape and its implications for fixed-income. It identifies key economic drivers, monetary policies and market trends across regions, presenting a valuable resource for investors seeking to navigate the complexities of the current financial environment, to help them make informed decisions and identify potential opportunities in the fixed-income market."

2Q24 HIGHLIGHTS

- In the US, bond yields are likely to remain sensitive to whether growth and inflation are moderating. The expected Fed rate cuts later this year should help push market yields lower.
- In Europe, more pieces of the disinflationary jigsaw puzzle are falling into place, suggesting that the first rate cut will take place at the ECB June meeting.
- In the UK, we also see the BoE as close to cutting, with the June meeting seen as most likely.
- In China, we maintain our view that officials will continue with an accommodative monetary policy stance given a number of economic headwinds.

OVERVIEW

Global growth has downshifted and inflation rates worldwide are generally receding. Deflationary pressures in China, tightening financial conditions in the US and Europe, and subdued demand for manufacturing and services across a number of countries are easing price pressures globally. These trends, coupled with the major central banks promoting a measured and gradual approach to easing monetary policy, are expected to further dampen economic growth and inflation, which, in turn, should lead to lower developed market (DM) government bond yields and a modestly weaker US dollar. That stated, concerns over monetary policy mis-steps, inflation rates stabilizing above central banks targets, stronger-than-expected growth in the US and increased US Treasury (UST) supply to cover a growing fiscal deficit are all phenomena that may lead to periods of heightened market volatility. Spread sectors such as emerging markets (EM), high-yield, bank loans and select areas of the mortgage-backed securities (MBS) space offer attractive yield, but we acknowledge their vulnerability to unanticipated shifts in macro-related sentiment, geopolitical developments and the ongoing uncertainty over monetary policy rate trajectories.

Mark S. Lindbloom

Head of Broad Markets

"All eyes are on the central banks this year. Expectations are for rate cuts in the US, Europe, the UK and Canada, along with continued accommodative policy in China. As an active manager, we see opportunity given the improving macroeconomic environment, and continue to be optimistic that we will find value for investors in fixed-income."

KEY DRIVERS AND RELATIVE VALUE BY REGION

US: Soft Landing Still in Sight

\+ US demand is expected to slow as savings rates trend back to pre-Covid levels. Core inflation should move toward Federal Reserve (Fed) target levels, helped by goods and shelter costs moderating. US bond yields remain high relative to pre-pandemic growth and inflation, and are likely to remain sensitive to whether growth and inflation are moderating. The expected Fed cuts should help push yields lower.

EUROPE: All Eyes on June

\+ European Central Bank (ECB) policy has reached a level that ECB policymakers believe will bring inflation to target over their forecast horizon. Further declines in core inflation and softer wage data will build confidence in that pathway. We pared back our exposure in 4Q23 and have recently begun to add a little more duration via 5-year German nominal and 7-year German real yields.

UK: Rate Cuts Are "In Play"

\+ Forward-looking indicators suggest economic activity will remain subdued as the labor market loosens further. We expect the slowing of inflation to continue, falling below 2% during 2Q. Focus should remain on the timing and scale of future Bank of England (BoE) rate cuts. Given our outlook, the market could still be underestimating the rate cuts to come. UK gilts should provide positive returns.

CANADA: Waiting for the Turn

+/− The Canadian economy has underperformed Bank of Canada (BoC) and market expectations. Inflation and wage data have also now clearly turned down, permitting the BoC to initiate rate cuts before the Fed. However, the housing market may stay the BoC's hand. With real estate prices ticking higher, non-shelter core inflation may have to fall below 0% year-over-year rather than the current 0.7%.

AUSTRALIA: Steady as She Goes

\+ The economy has meaningfully slowed and inflation has stepped lower. The strength of exports, immigration and tourism provide strong support for the economy and the direct transmission of monetary policy by the Reserve Bank of Australia will be supportive. As a result, a soft landing is most likely. We remain tactical in the 10- and 20-year parts of the curve as volatility remains the norm.

JAPAN: Rates Expected to Ratchet Higher Over Time

− Given positive trends with growth, wages and inflation, the Bank of Japan's (BoJ) next steps likely will be more hikes. We expect, however, the pace of future hikes to be gradual and made with caution, as there is considerable uncertainty about their impact. The BoJ also forecasts stable inflation, (i.e., +2.4% for FY24 and +1.8% for FY25). We expect higher Japanese government bond (JGB) yields.

CHINA: Focus Remains on the Long Term; Short-Term Challenges Persist

\+ We expect 2024 growth to come in between 5% and 5.5%, with policymakers focused on economic recovery. We do not expect broad-based growth stimulus; rather, we expect continued, targeted measures. China is expected to maintain an accommodative monetary policy stance and remains the only large major economy to continue to be in easing mode.

MEXICO: Outperformance Drivers Remain in Place

\+ Disinflation and nearshoring trends bode well for the economy; presidential elections in June 2024 should yield an executive more pragmatic than AMLO. Mexico's easing cycle started in March; however, the central bank should remain prudent—both nominal and real rates remain high.

INDIA: Investing in Growth

\+ Strong economic story supported by a balance of payments surplus, moderating inflation, strong FDI flows and significant FX reserves (in the top 5 globally). Narendra Modi is likely to serve his third consecutive term as Prime Minister of India. Local bonds are expected to outperform given attractive carry relative to peers and strong technical tailwinds associated with EM bond index inclusion.

BRAZIL: Carry Trade with Rates Upside

\+ Recently upgraded by S&P and Fitch, persistent economic resilience remains even under the seemingly "leftist" Lula administration. The monetary easing cycle has started making rates attractive, meanwhile still high nominal and real rates are expected to support the Brazilian real.

Walter Kilcullen

Head of US High Yield

"We continue to see opportunity in high-yield credit, bank loans and collateralized loan obligations due to attractive spreads and strong fundamentals. Our thesis for high-yield is that yield levels are very attractive and we seek to benefit our clients by investing in specific issuers whose credit quality we believe is robust or improving."

WESTERN ASSET SECTOR THEMES	
Investment-Grade (IG) Corporate Credit	
In the US, underlying corporate fundamentals remain resilient as profit margins and leverage are off local peaks but stabilizing. Spreads are at the tight end of the range and already pricing in a soft landing. As such, they do not offer much cushion against negative surprises.	+/−
In Europe, IG corporate fundamentals are holding up relatively well despite a soft growth picture. Spreads continued to contract in 1Q and are slightly tight to historic average levels.	+/−
In Australia, fundamentals still remain sound despite the prospect of the economy slowing. We remain overweight credit, particularly short-dated holdings, with a preference for select REITs and utility/infrastructure assets that have regulated resets. We also favor senior unsecured major bank and foreign national champion bank issuance.	+
High-Yield (HY) Corporate Credit	
In the US, HY credit spreads reflect relatively strong fundamentals and technicals. We continue to see opportunity in service-related sectors that are still recovering from the Covid-led recession (i.e., reopening trades including airlines, cruise lines and lodging) and potential rising stars. We are more cautious on consumer products, retailers and home construction.	+
In Europe, corporate fundamentals are generally okay given recent earnings. We remain selective on the new-issue calendar with a BB/B focus and we remain cautious on certain cyclical sectors (i.e., chemicals, building materials, packaging) and companies with heavy refinancing needs.	+/−
Bank Loans	
Bank loan spreads are relatively attractive. We see more opportunity in select consumer cyclicals and are more cautious on basic industries and communications. We favor securities with discounts to their call price.	+
Collateralized Loan Obligations (CLOs)	
We see more opportunity in AAA, BBB and select BB rated debt tranches of CLOs that are invested in broadly syndicated bank loans (BSLs). In our view AAAs and BBBs should continue to perform well in either bullish or bearish bank-loan-spread environments given strong structural protections.	+
Mortgage and Consumer Credit	
Agency mortgage-backed securities (MBS) offer attractive spread valuations with low prepayment risk. We favor 30- and 20-year over 15-year MBS, higher coupons and non-benchmark sectors, focusing on security selection to enhance yield and convexity profiles.	+
In non-agency residential MBS (RMBS), while real estate is facing various challenges due to broad economic uncertainty, we do not see a significant risk of defaults in the broad residential market. We are opportunistic on credit risk transfer (CRT) securities as well as non-QM deals that present strong borrower profiles and higher credit qualities.	+
In non-agency commercial MBS (CMBS), low leverage exposures on high-quality real estate with meaningful borrower equity present compelling opportunities to lend in both the conduit and single-asset/single-borrower (SASB) market. New origination screens particularly attractive on a yield versus credit risk basis; however, some high-quality seasoned credits may offer outsized total return opportunities.	+
Off-the-run sectors and issuers across higher credit quality consumer and commercial asset-backed securities (ABS) sectors can provide attractive risk/reward relative to IG corporates. Bank selling may result in opportunities in the form of risk transfers or outright portfolio sales in the auto sector.	+
Inflation-Linked	
US TIPS real yields are attractive at levels well above prior cycle highs, and breakeven inflation (BEI) levels are at Fed targets throughout the curve. BEIs are at best fair value versus nominal USTs in our base case, but could be attractive as a diversifier within US bond portfolios.	+
Inflation expectations in the eurozone have fallen quite sharply and were a large driver of the bond rally in 4Q23. We are currently neutral on inflation at these levels. 30-year paper is still a little rich versus historical averages, whereas shorter tenors are at the average.	+/−
In Japan, inflation-linked JGBs remain undervalued as the current 10-year BEI is well below 2%. We maintain an overweight to Japanese real yields against nominal yields.	+
Municipals	
We remain favorable on tax-exempt municipal debt, which offers attractive nominal municipal yields and after-tax relative value opportunities. We prefer lower-rated IG securities, which remain supported by the credit cycle.	+

WESTERN ASSET SECTOR THEMES *continued*	
Emerging Market (EM) Debt	
We believe frontier market sovereigns represent a compelling total return opportunity in 2024, given still-wide valuations and key idiosyncratic credit stories.	+
While FX will remain highly macro-driven, elevated EM local bond yields, particularly in Latin America, can benefit from continued disinflation and a US soft landing. Conversely, Asian local currency yields remain historically low relative to USTs.	+
EM corporates continue to maintain strong balance sheets, especially compared to their DM peers. We are currently focused on EM primary issuance at a concession to secondary issuance.	+/−

Annabel Rudebeck

Head of Non-US Credit/
Portfolio Manager

"The firm is also focusing on pockets of opportunity in the auto sector, expecting continued strength in gaming, and maintaining a fundamentally constructive view on telecommunications and media, despite intense competition. Overall, there are pockets of opportunity across all industries, but comprehensive analysis is required to make that determination."

WESTERN ASSET INDUSTRY THEMES

Industry	Key Observations
Auto & Related	• We maintain a neutral outlook with a slight positive bias • Positive factors: UAW strike resolution, healthy labor market, balanced supply/demand
Banks	• Recommend a large overweight for top-quality global banks due to resilient performance • Banks have lower risk profiles due to stringent regulations, heightened oversight and improved risk management post-GFC
Energy	• We view the sector as a carry trade with the potential for total return • Oil demand softening in line with slower global growth; however, OPEC+ supply cuts and elevated geopolitical risks should buoy prices
Food & Beverage	• Consumer spending constrained by high interest rates and lower savings • However, improved supply chains are expected to increase cash flows
Gaming	• Continued strength expected in Macau, Singapore, and balanced growth in the US • We favor a neutral positioning with a preference for exposure to Macau
Health Care	• Underweight investment-grade health care due to the cyclical and secular decline in credit quality, rich valuations and negative event risks
Metals & Mining	• Yields offer decent carry and some total return opportunities, especially with M&A activity • We are focused on copper as concentrate markets and supply outlook tighten
Pharmaceuticals	• Underweight investment-grade pharma given many headwinds • Lower-rated specialty pharma expected to pursue aggressive liability management this year
Retailing	• Rising freight rates due to unrest surrounding the Red Sea may impact margins • Discretionary retailers to see flat sales; non-discretionary expected to see moderate sales growth
Telecommunications & Media	• Fundamentally constructive on the sector despite higher interest rates adding pressure to such a capital intensive sector
Transportation	• Robust passenger demand expected as consumers increasingly pivot toward experiences vs. goods , with airlines gaining pricing power • Revenue trends have increased and provided airlines with enhanced pricing power that should result in improved earnings
Utilities	• Underweight the sector due to material negative free cash flow • Preference for First Mortgage bonds and selective participation in Unsecured Operating Company and Holding Company bonds

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March 31, 2024

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