

The Big Picture

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

3Q24 HIGHLIGHTS

- In the US, bond yields are likely to take their cue from a cooling labor market, and moderating goods and services inflation. Expected Fed rate cuts later this year have the potential to push market yields lower, even as political uncertainty adds to volatility.
- In Europe, the rate-cutting cycle is underway, and we expect two more cuts later this year as the disinflationary trend persists.
- In the UK, confidence is growing for an imminent rate cut given slower wage growth, ongoing goods deflation and more slack in the labor market.
- In China, we do not expect any broad-based stimulus, but continued targeted measures to support its growth recovery.

OVERVIEW

Global growth and inflation rates continue to decline. Ongoing deflationary pressures in China, tightening financial conditions in both the US and Europe, and subdued demand for manufacturing and services in several countries are easing price pressures worldwide. These trends, coupled with a measured and gradual approach to easing monetary policy by major central banks, are expected to further dampen economic growth and inflation. This, in turn, should lead to lower developed market (DM) government bond yields and a modestly weaker US dollar. Concerns remain about potential monetary policy missteps, inflation rates stabilizing above central bank targets, stronger-than-expected growth in the US and increased US Treasury (UST) supply to cover a growing fiscal deficit. These factors could lead to periods of heightened market volatility. Spread sectors such as emerging markets (EM), high-yield bonds, bank loans and select areas of the mortgage-backed securities (MBS) space offer attractive yields but remain vulnerable to unanticipated shifts in macroeconomic sentiment, geopolitical developments and ongoing uncertain monetary policy trajectories.



Michael Buchanan

Co-Chief Investment Officer

“Global disinflation is progressing, with US core PCE nearing the Fed’s 2% target. US economic growth remains strong, though a slight slowdown is expected without a recession. This should allow for central bank rate cuts later this year. The US election adds uncertainty, but market impacts may be limited. We find value in high-quality high-yield bonds, bank loans, CLOs, and local currency EM debt, especially Mexican bonds.”





Kevin J. Ritter

Head of
Emerging Markets

“The investment landscape is evolving rapidly in 2024. We are observing economic shifts across major markets, with anticipated policy adjustments in Western economies and mild deflationary trends from China. As a result, emerging markets present a compelling carry and total return opportunity, particularly in frontier market sovereigns with wide valuations and unique credit stories.”

KEY DRIVERS AND RELATIVE VALUE BY REGION

US: Soft Landing Underway

+ US demand is expected to slow as employment gains decline and savings rates drift back to pre-pandemic levels. Monthly core inflation should continue to run near Federal Reserve (Fed) target levels, helped by modest goods deflation, shelter inflation near pre-pandemic levels and services inflation moderating. US bond yields remain high relative to pre-pandemic growth and inflation.



EUROPE: More Rate Cuts on the Horizon

+ The European Central Bank (ECB) has delivered one cut so far, and we expect two more this year. Inflation has fallen, and this has increased faith in ECB forecasts for the disinflationary trend to continue. Growth seems to have bottomed out, but some forward-looking indicators suggest a modest rebound. We maintain our overweight duration via both nominals and real yields.



UK: Rate Cuts in Sight

+ UK inflation slowed to the Bank of England’s 2% target in May. Services price growth is gradually slowing and offset by deflation in the price of goods. Slack continues to return to the labour market and forward-looking indicators signal a slowing of wage growth, which should allow the Bank of England (BoE) to lower the Bank Rate. We anticipate UK gilts to provide positive returns.



CANADA: Not Waiting for the Fed

+ Canadian inflation has clearly turned down and the labor market has rolled over, particularly for the private sector. The Bank of Canada (BoC) initiated its rate cutting cycle in June and will further cut rates even if the Fed is delayed. The Canadian economy and inflation are close to meeting recent BoC forecasts and inflation is expected to continue to trend down given the slack in the economy.



AUSTRALIA: Higher for Longer

+ Inflation progress has stalled while structural headwinds caused by excess immigration and housing supply is causing havoc with services inflation. The Reserve Bank of Australia is on the back foot with a “higher for longer” message. Activity has slowed in line with tighter policy, but the economy remains well-supported by the strength of agricultural exports, tourism and education sectors.



JAPAN: Higher Rates Ahead

- We expect Japan’s economy to grow at an annualized rate of 1.5% to 2.0% in the second half of 2024—which is above its potential growth rate—and that inflation will remain above 2%. As such, we expect the Bank of Japan to raise policy rates at a cautious pace while it steadily reduces government bond purchases. This should result in higher Japanese government bond yields and curve flattening



CHINA: No Cavalry on the Horizon

+/- We expect some support in view of slower growth momentum in 2Q, and full-year growth to remain between 5.0% and 5.5%. We do not expect broad-based growth stimulus but 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: Election Indigestion Subsiding

+ While the unexpected Morena Party election landslide introduced short-term volatility, a commitment to conservative fiscal accounts and pragmatic cabinet picks should help allay investor concerns. Disinflationary trends are likely to accelerate in 2H24; Mexico should be able to resume the easing cycle toward year-end. Nearshoring remains a long-term supportive secular trend for the economy.



INDIA: Stars Aligning

+ A solid economic story supported by strong foreign direct investment flows (on increasing friendshoring benefits) and significant foreign exchange (FX) reserves in the top five globally. Local bonds are expected to outperform given attractive carry relative to peers and strong technical tailwinds associated with EM bond index inclusion.



BRAZIL: Valuations Compensate for Risks

+ Brazil’s recent S&P and Fitch upgrades reflect persistent economic resilience even under the seemingly “leftist” Lula administration. The monetary easing cycle has paused; meanwhile, still-high nominal and real rates are expected to support the Brazilian real.





Ryan J. Kohan

Head of
Bank Loans

“We believe that investing in select debt tranches of CLOs that are backed by broadly syndicated bank loans can offer investors significant opportunities. Higher-rated tranches are expected to perform well in both bullish and bearish bank-loan-spread environments due to their robust structural protections, making them a compelling choice for risk-adjusted returns.”

WESTERN ASSET SECTOR THEMES

Investment-Grade (IG) Corporate Credit

In the US, underlying corporate fundamentals remain resilient. Profit margins and leverage are off post-pandemic peaks, yet remain robust enough to weather a slower economic backdrop. Spreads are at the tight end of the range and do not offer much cushion against negative surprises; but in the meantime, yield-based buyers are keeping the technical backdrop supportive. +/-

In Europe, IG fundamentals continue to look strong and inflows continue. Spreads have moved sideways over the last quarter and look fair value for most sectors at 20 bps inside the long-term average. +/-

In Australia, fundamentals remain sound despite the prospect of the economy slowing. We maintain an overweight in credit, particularly in 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 the prudent behavior of management teams, balance sheet strength and technicals. We continue to see some opportunity in service-related sectors that are still recovering from pandemic-era recession (i.e., reopening trades including airlines, cruise lines and lodging), energy (E&P), and potential rising stars. We are more cautious on consumer products, retailers and home construction. +

In Europe, HY corporate fundamentals remain fairly sound. Primary issuance continues to be dominated by refinancing activity. We remain selective with a BB/B rating focus as spreads remain tight and rangebound. +/-

Bank Loans

Bank loan spreads are relatively attractive. We favor consumer-services-driven businesses where demand remains robust, as well as certain less discretionary consumer product companies that may offer attractive yields and more resilient business profiles. We remain cautious on certain industries such as chemicals and communications, and we are finding higher-quality collateralized loan obligation (CLO) tranche investments to be attractive. +

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). We believe that 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 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 Treasury inflation-protected securities (TIPS) real yields are attractive at near two-decade highs, and breakeven inflation (BEI) levels are at Fed targets throughout the curve. TIPS should outperform cash on a total return basis, but may struggle to find support versus nominals as inflation continues to trend down. BEIs are at best fair value versus nominal USTs in our base case scenario, but could be attractive as a diversifier within US bond portfolios. +

European inflation expectations (via 5-year swaps) have averaged around 2.10% so far in 2024, which is consistent with the ECB achieving its inflation mandate. The richness of the 30-year tenor has reduced to a more normal level. We remain neutral on inflation at these levels. +/-

In Japan, the consumer price index remains above 2% and wage growth is gaining momentum. We maintain an overweight to Japanese real yields versus nominal yields as the current BEI rate is still below 2%. +

WESTERN ASSET SECTOR THEMES *continued*

Municipals

We remain constructive on tax-exempt municipal debt considering elevated supply levels, near decade-high income opportunities, and favorable after-tax relative value for investors subject to tax rates. We prefer lower-rated IG securities as fundamentals remain favorable, and believe investors are better compensated to move out the yield curve. +

Emerging Market (EM) Debt

We believe that frontier market sovereigns continue to represent a compelling carry and total return opportunity, given still-wide valuations and key idiosyncratic credit stories. +

While FX will remain highly macro-driven, select Latin American local currency bonds can benefit from continued disinflation and an eventual start to the Fed cutting cycle. Conversely, Asian local currency bonds look unattractive given historically low yields relative to USTs. +/-

EM corporates continue to maintain strong balance sheets, especially compared to their DM peers. With sector spreads at historically tight levels, we are seeking value in the primary market and in shorter-dated HY corporates. +/-

Annabel Rudebeck

Head of
Non-US Credit/
Portfolio Manager



“We’re currently focusing on select opportunities in the banking sector, given its resilient performance and improved risk management. We see continued strength in gaming, and maintain a fundamentally constructive view on telecommunications and media, despite higher interest rates. The energy sector also presents potential for attractive total return due to increased M&A activity.”

WESTERN ASSET INDUSTRY THEMES

Industry	Key Observations
Auto & Related	While our overall outlook remains neutral on automotive and related industries, we have a slight positive bias due to the United Automobile Workers (UAW) strike resolution, a healthy labor market and balanced supply and demand.
Banks	We are maintaining a large overweight for top-quality global banks due to their resilient performance, as banks have lower risk profiles due to stringent regulations, heightened oversight and improved risk management following the global financial crisis.
Energy	We view the energy sector as a carry trade with the potential for total return given increased M&A activity. Oil demand is softening in line with slower global growth; however, OPEC supply management and elevated geopolitical risks are increasingly driving prices.
Food & Beverage	Consumer spending is constrained by high interest rates and lower savings; however, improved supply chains are expected to increase cash flows.
Gaming	We see opportunities in continued strength in Macau, Singapore and balanced growth in the US in the gaming industry. We also favor a neutral positioning with a preference for exposure to Macau.
Health Care	We are maintaining an underweight in IG health care due to the cyclical and secular decline in credit quality, rich valuations and negative event risks.
Metals & Mining	We believe that yields offer decent carry and some total return opportunities in the metals & mining space, especially with M&A activity. We are focused on copper as concentrate markets and supply outlooks tighten.
Pharmaceuticals	Underweight IG pharmaceuticals have provided many headwinds. Lower-rated specialty pharma is expected to pursue aggressive liability management this year.
Retailing	We believe that rising freight rates due to unrest surrounding the Red Sea may impact retail margins. Discretionary retailers may see flat sales while non-discretionary retailers may see moderate sales growth
Telecommunications & Media	Our view of the telecommunications & media space is fundamentally constructive, despite higher interest rates and its capital-intensive nature. Muted subscriber and earnings growth are generally balanced by conservative financial policies for the largest global telecommunications companies.

WESTERN ASSET INDUSTRY THEMES *continued*

Industry	Key Observations
Transportation	Consumers continue to prioritize spending on travel versus the purchase of goods. Elevated demand for premium and corporate air travel is a tailwind for the large, legacy airlines with significant international exposure, while low-cost carriers suffer from higher operating costs and lower fares caused by excess domestic capacity.
Utilities	We maintain an underweight to the utilities sector given material negative free cash flow. Our preference remains first mortgage bonds and selective participation in unsecured operating company and holding company bonds.

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