FRANKLIN TEMPLETON

WESTERN ASSET

SECOND QUARTER 2026

The Big Picture

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

Michael Buchanan, CFA

Chief Investment Officer

"Despite geopolitical tensions and the resultant volatility in energy markets, the global backdrop is supported by policy momentum and stable corporate fundamentals. A protracted conflict risks stagflation; however, economic and political incentives point to near-term de-escalation. In this environment, disciplined active management remains essential as we position portfolios to capitalize on selective opportunities across global credit, EM and structured sectors."

2026 HIGHLIGHTS

- The Middle East conflict and resultant energy supply shock have spiked market volatility. Longer-term inflation expectations remain anchored for now, but rising near-term inflation expectations have tightened financial conditions via fears of central banks leaning hawkish.
- US growth remains resilient as the region is energy-independent while deregulation, tax refunds and policy support are also supportive.
- Europe and the UK confront potential labor-market headwinds and are highly exposed to volatile energy prices, but fiscal measures in Germany may help to stabilize the outlook.
- In Asia, China's recovery remains policy-driven amid structural challenges, while in Japan, expansionary fiscal policy will likely lead to a steeper curve.
- Credit fundamentals across IG and HY remain strong, with issuance elevated by AI-related capex, M&A activity and refinancing needs.
- Securitized sectors—select parts of MBS, CLOs and CMBS—offer relative value despite pressure in consumer and CRE pockets.
- EM continues to benefit from positive fundamentals while relative value varies between the local, corporate and sovereign markets.
- Investor sentiment has stayed constructive, supported by strong fundamentals and appealing yields despite geopolitical and commodity-driven risks.

OVERVIEW

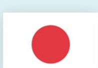
Geopolitical tensions are the defining feature of the macro outlook with energy supply shocks expected to weigh on near-term growth and inflation. Before these pressures the global economic backdrop was gradually improving as fiscal support, easier financial conditions and moderating inflation were helping to strengthen the 2026 outlook. We believe the drastic shift in central bank policy expectations is somewhat overdone and that longer-term growth and inflation targets are still attainable. In the US, policy tailwinds and deregulation will likely support activity despite signs of softer labor conditions. Europe and the UK are more vulnerable to volatile energy prices and face labor-market challenges but German fiscal expansion may offer some stabilization. China's recovery remains policy-driven while Japan's expansionary fiscal policy will likely lead to a steeper curve there. Credit markets remain supported by strong fundamentals and healthy demand, with issuance elevated by AI-related capex and M&A. Select parts of structured products and emerging markets (EM) also offer attractive relative value. Despite crosscurrents from geopolitics and commodities, investor sentiment remains constructive.

Nicholas Mastroianni, CFA

Portfolio Manager

"The global growth outlook improved steadily in early 2026, supported by fiscal stimulus, easing financial conditions, and expectations for continued disinflation. While geopolitical risks have tempered this optimism, the US remains well positioned for continued growth, benefiting from energy independence, strong corporate and consumer balance sheets, sustained large-scale capital investment, and a constructive corporate backdrop."

KEY DRIVERS AND RELATIVE VALUE BY REGION

US 	Trend-like growth and disinflation remain in place.	Our 2026 base case calls for trend-like GDP growth, stable to improving labor markets and core inflation falling in the second half of the year (H2). The war in Iran and private credit concerns have shifted the range of potential outcomes. A prolonged conflict could raise energy prices, hurting US growth and inflation, complicating the Federal Reserve's mandate. We plan to add duration as rates rise and selectively add to spread sectors if spreads widen from current tight levels.
EUROPE 	The ECB is patient as German fiscal expansion takes hold.	European GDP has demonstrated steady if unspectacular growth in recent quarters and we expect this to continue this year. Geopolitical risks remain with Europe particularly vulnerable to the cost of energy imports, which could undermine consumer spending and corporate margins. The impact of German fiscal expansion will be closely monitored both in terms of growth and inflation, where signs of wage pressure remain a concern. The European Central Bank (ECB) should remain data-dependent.
UK 	Energy import costs rising; little room for government stimulus.	The Bank of England stands "ready to act as necessary" due to the Iran conflict. Caution is likely to be expressed into 2Q26 as growth/inflation impact is assessed. The government is abiding by fiscal rules that limit scope to loosen materially. Local elections in May, with Prime Minister Keir Starmer vulnerable to leadership challenges. The UK is exposed to volatile commodity import prices, especially for natural gas.
CANADA 	Fiscal spending supports growth while BoC rates remain on hold.	GDP growth rebounded in recent months after a hit from fluctuating US tariff policy. Canada is relatively immune to direct effects from Mideast turmoil. The Consumer Price Index (CPI) is above target but wage growth is declining and inflation should follow suit. USMCA renegotiation is starting and is likely to be a headwind. With policy rates already at the low end of neutral, the Bank of Canada (BoC) should remain on hold in 2026.
AUSTRALIA 	Inflation pressures keep the RBA in policy-tightening mode.	Inflationary pressures caused by government spending and low productivity forced the Reserve Bank of Australia (RBA) to tighten monetary policy in order to slow growth. The record quick flip from easing to tightening is likely to stun some borrowers and with inflation pressuring again, not helped by Middle East tensions, real wages are slipping. This will likely help to bring down consumption. Growth should remain sound but it is clear that an economic speed limit is in place for now.
JAPAN 	JGB yields likely to stay rangebound with a steeper bias.	We anticipate Japanese government bond (JGB) yields to fluctuate in a range. The market has fully priced in future rate hikes (i.e., two in the next 12 months) and inflation is expected to moderate to below the Bank of Japan's (BoJ) 2% target. On the other hand, the economy is expected to grow and expansionary fiscal policy (consumption tax-cut and defense spending) may inevitably put upward pressure on yields, especially the longer end of the curve. We expect a steeper yield curve ahead.
CHINA 	CGB yields to remain low; yuan is on a slow appreciation path.	Positive Xi-Trump relations could anchor stability in the near term. China's economic recovery to be supported by accommodative monetary policy with Chinese government bond (CGB) yields likely to remain low but with a slower headline growth target of 4.5%. Consumer and business confidence remains key and dependent on continued policy support,
MEXICO 	Banxico cuts priced out; USMCA and policy catalysts ahead.	Mexico's growth outlook for 2026 has been revised modestly higher, with Banxico lifting forecasts toward ~1.6% on improved late-2025 momentum and resilient exports. Inflation remains above target, but markets are pricing a gradual Banxico rate-cut cycle as price pressures trend toward goal. Deep US-Mexico economic integration and nearshoring dynamics underpin confidence that should support investment over time.
INDIA 	EU and US trade deals positive, but borrowing set to be high.	India announced trade deals with both the EU as well as the US. We believe these developments are positive for the Indian equity story as well as India's overall balance of payments. However, the FY27 budget details have indicated a gross borrowing of INR17.2 trillion, an increase of around INR2.5 trillion, a negative for the India bond market. As such, we hold a neutral view on duration. As India imports a great deal of its energy requirements, we are cautious on the rupee.
BRAZIL 	Rate cuts priced in ahead of election volatility risk.	Brazil's economy appears likely to grow moderately in 2026, with inflation easing toward target and markets pricing the onset of a SELIC easing cycle after a prolonged restrictive stance. GDP is forecast to slow toward ~1.5% this year, supporting potential cuts from early 2026 as inflation moderates. Despite macro resilience, the October 2026 presidential election remains a dominant risk, with policy direction and fiscal credibility likely to drive volatility.

Prashant Chandran, CFA

Head of US-Based Emerging Markets Team

"Geopolitical tensions and oil market volatility haven't derailed our constructive view on EM, despite monetary policy tilting less accommodative. High real yields, supportive local policy and renewed inflows continue to support performance. Select frontier market sovereigns with IMF backed reforms and selective EM corporates offer compelling carry and diversified alpha opportunities."

WESTERN ASSET SECTOR THEMES	FUNDAMENTALS	TECHNICALS	VALUATIONS
Investment-Grade (IG) Corporate Credit			
US: Q4 earnings/fundamentals were resilient. Corporations highlight divergence between low- and high-end consumers. Valuations have a lower margin of safety (OAS 83 bps) despite volatility in rates/stocks. Strong technicals could weaken, elevated debt issuance in '26 to fund AI capex plans and the M&A pipeline is growing. Money center banks can help us to play offense in a defensive way as we wait for opportunities.	🟢	🟢	🔴
Europe: Fundamentals remain sound. AI-related and US-domiciled borrowing is being absorbed. Demand for credit remains firm, especially from yield-seeking investors. Spreads have moved off the YTD tights at 80 bps, but still close to 2H25 average leaving little margin for safety. Pockets of opportunities remain in financials, utilities and select property companies. We remain cautious on chemicals and autos.	🟢	🟢	🔴
Australia: Corporate fundamentals remain strong. Ongoing backup in yields continues to underpin local and offshore demand for AUD debt, supporting technicals. Spreads have been well-contained given recent geopolitical risks. Future spread performance will be tied to global volatility, as domestic credit risk is low, and there is very limited exposure to AI capex rollout and AI impacted sectors.	🟢	🟢	🟠
High-Yield (HY) Corporate Credit			
US: Fears of private credit contagion bled into the public markets in the lead-up to the risk-off environment that accelerated with the conflict in Iran continuing throughout March. Spreads widened ~70bps from late January's tights as the spike in energy led to concerns around end consumer. Focus remains on corporate fundamentals and if access to capital remains easy. Recommend leaning into HQHY on recent weakness.	🟢	🟢	🟠
Europe: Fundamentals continue to be overall positive with low default rates. Net supply continues to be manageable. Lower-rated issues and chemicals have been underperforming. Continue to focus on BB/B rated issuers with a bias toward telecom/cable, and select consumer and capital goods companies. Valuations are less expensive given recent repricing.	🟢	🟢	🟠
Bank Loans			
US bank loans remain an income-driven strategy with 70% trading above par. AI fears have triggered a broad sector selloff, creating chances to buy misunderstood credits at wider spreads. Value can be found in defensive sectors, select software names, wide single-Bs and loans vs. bond situations. With 8% yields and default rates expected in the 3.5%-4.0% range, current volatility offers an attractive entry point.	🟢	🟠	🟢
Collateralized Loan Obligations (CLOs)			
Spreads are attractive post recent backup. Software/AI risk has been topical which has led to higher price dispersion. AAAs offer attractive yield and continue to be in demand by real money, ETFs and banks. BBBs remain well insulated and current valuations are starting to look like an attractive entry point. We are cautious on BBs where we remain selective and seek discounted bonds with lower tail risks.	🟠	🟠	🟢
Mortgage and Consumer Credit			
Agency MBS: Yield and spreads have narrowed but remain attractive on a risk-adjusted basis compared to high-quality corporate credit bonds. With current mortgage rates around 6.5%, prepayment risk increased in recently originated mortgages with rates above 6.75% but the bulk of US mortgage borrowers remain locked in sub-4% mortgage rates, which supports the fundamental backdrop.	🟢	🟢	🟠
NARMBS: We maintain a neutral outlook in terms of home prices considering that both existing and new-home supply increased meaningfully in 2025. In addition, there is continued downward pressure on housing affordability which has weakened borrower demand. Collateral performance measures remain positive which continues to provide strong fundamentals to residential securitized credit.	🟠	🟠	🟢
CMBS: The market has remained well supported during 1Q26. Issuance has continued along the record pace of 2025 with SASB deals driving the bulk of the volume. Fundamentals are steady to improving across most property sectors; however, we remain cautious on the hospitality market. Beta to broader market credit products has increased but spreads remain wide to historical levels down the capital structure.	🟢	🟠	🟢

WESTERN ASSET SECTOR THEMES *continued*	FUNDAMENTALS	TECHNICALS	VALUATIONS
ABS: Consumer fundamentals are challenged for lower-credit consumers while high-credit consumer performance shows stabilization. We would expect a strong tax-refund season to provide a meaningful but temporary improvement to consumer performance. Our primary focus remains staying up in quality on consumer credit and specialty sectors with positive fundamentals.	🟠	🟢	🟢
Inflation-Linked			
US: Treasury inflation-protected securities (TIPS) got a boost from the oil price surge though this effect was almost wholly concentrated in the one-year breakeven inflation rate. TIPS do have a modest role in our US strategies as future policy shifts could prove inflationary and because real yields still are a good value. Both institutional and retail investors look to be adding TIPS "just in case."	🟠	🟠	🟢
Japan: The current level of 10-year breakeven inflation at 1.75% looks fair due to the expected moderation in inflation throughout 2026 with the upward bias from the conflict in the Middle East and the possible fiscal risk in Japan.	🟢	🟠	🟠
Municipals			
Public finance fundamentals remain healthy. Reinvestment demand continues to support higher-quality paper. Valuations reflect these strengths, limiting further potential spread compression. We're emphasizing disciplined risk selection, favoring investment-grade securities with limited below-investment-grade exposure, and maintain duration in the intermediate segment of the curve to balance income and flexibility.	🟠	🟢	🟠
Emerging Market (EM) Debt			
Sovereigns: EM sovereigns widened modestly amid the Iran conflict, with little difference between energy importers/exporters. Fundamentals and flows remain positive but valuations also remain tight. We are holding positions with a focus on hedging. If volatility eases, we prefer select frontier market sovereigns built on a fundamental turnaround and IMF support over IG counterparts given cheap valuations and attractive carry.	🟢	🟠	🔴
Local EM: Geopolitical risks caused modest outflows and a local rates selloff, but we expect strong EM performance, supported by accommodative US policy, a weaker USD and resumed flows as volatility eases. Lower tariffs should boost growth. We favor Latin America and South Africa for high real yields and declining inflation. Given elevated energy prices, we would add to energy exporters as volatility subsides.	🟢	🟢	🟢
EM Corporates: Aided by steady inflows, spreads remain near historical tights despite recent widening. Fundamentals and balance sheets are strong across most subsectors while supply has broadened and is well subscribed. Recent spread widening has not been enough to entice us to add exposure. We remain cautiously optimistic looking to add alpha via subsector and issuer selection while being tactical with new issues.	🟢	🟢	🟠

René Ledis
Research Analyst

"The duration and severity of the energy and commodity supply shock will remain a source of market volatility with far reaching implications for downstream sectors and profit margins. While these risks may produce intermittent shocks, they also create market dislocations and opportunities for active managers to selectively position. We continue to focus on resilient sectors and disciplined risk management as conditions evolve"

WESTERN ASSET INDUSTRY THEMES	
Industry	Key Observations
Auto & Related	Currently recommend a market weight in global autos. Demand in the US is expected to moderate after last year's pre-buy ahead of Liberation Day price increases and the revocation of the EV tax credit. Tight valuations, the likelihood of increased EV impairments and potential for rating agency downgrades are already reflected in our portfolios.
Banks	We continue to overweight the strongest European and US banks based on their de-risked business models, robust balance sheets and still-stringent regulation. This is our "defensive way to play offense" as 10-year senior banks still trade wide of the IG Credit Index.
Energy	Geopolitical tensions have escalated causing closure of the Strait of Hormuz. Disrupted trade flows have caused commodity prices to spike as the market rebalances from surplus levels. Production shut-ins are occurring in the region as storage approaches capacity. Strategic reserves are intact and domestic US industry remains disciplined.

WESTERN ASSET INDUSTRY THEMES *continued*	
Food & Beverage	Demand in the food sector remains resilient but food companies trade rich given the defensive nature, although food companies are also responding to rapidly changing consumer tastes. Demand in the beverage category remains bifurcated as demand for non-alcoholic beverages continues to take market share from alcoholic beverages.
Gaming	US gaming fundamentals remain relatively healthy, though we are closely monitoring for demand or spending shifts across all income tiers. Macau and Singapore growth stories remain on track, based on our recent on-the-ground diligence, with mid to high single-digit gross gaming revenue gains expected in 2026.
Health Care	We remain underweight IG and equal weight HY health care. 2026 remains a transition year for managed care; we await the final MA rate notice for 2027 (April release) as our next major catalyst. The provider outlook remains steady and we see additional upside derived from steady DPP approvals offset by the expiry of enhanced subsidies.
Metals & Mining	Commodity demand remains firm while new supply is constrained. Underinvestment continues and companies focus on consolidation for future growth opportunities. The heightened geopolitical risk places a spotlight on future growth but this would likely defer needs not discount them. Watchpoints are economic factors, tariffs and China.
Pharmaceuticals	We are underweight IG and market weight HY pharma. Headline risks are more manageable now that we are past tariff and MFN impacts; we expect more IG M&A activity in 1H26. In HY, we are focused on names with visible credit catalysts (i.e., rising stars, LME, M&A, etc.) and downside protection.
Retailing	Higher-income consumers continue to spend thanks to the wealth effect, while lower-income consumers increasingly trade down to value-oriented retailers. In Q2, retail sales should benefit from tax refunds and lower tariffs, while retailers maintain disciplined inventory management, productivity initiatives and price adjustments.
Technology	AI model improvements are driving higher hyperscaler capex and issuance, boosting semis and servers but raising software disruption fears. Surging memory prices will pressure PC/smartphone shipments and hardware margins. Strong AI infrastructure demand keeps HY issuance elevated amid ongoing computer shortages.
Telecommunications & Media	Fundamentals remain stable despite wireless maturity, fiber expansion and FWA growth; we favor large issuers for their defensive profiles, recurring revenue and strong free cash flow. In media, cord cutting and weak advertising persist, driving M&A activity, and we prefer scaled streaming platforms and exposure to digital ads, live events and sports.
Telecommunications & Media (European)	EU telco price pressure remains high vs. US and are higher QoQ in the UK and Netherlands. Overweight well-positioned names with low M&A risk due to defensiveness and free cash flow growth on opex/capex cuts. Neutral on media/tech as AI fear opens opportunities on software names. Avoiding advertising/agencies due to cord cutting and low ad spend.
Transportation	Elevated energy prices will be a material financial headwind for all transportation companies, who are able to pass along higher fuel costs on a delayed basis that will pressure operating margins. Consumer demand for air travel may also begin to wane as higher energy costs shrink travel budgets.
Utilities	The industry continues to chase the AI/DC buildout power requirements; backlogs are increasing and capex is growing negative free cash flow. Consequently, debt issuance is increasing. Utilities are protecting customers/affordability with large load tariffs and mitigating their own risks. Companies are still managing close to downgrade thresholds.
Utilities (European)	European integrated utilities are expected to post largely stable earnings in 2026, driven by growth in regulated activities and offset by normalizing generation earnings. Elevated energy transition capex will require significant bond issuance, but investments are increasingly focused on lower-risk regulated assets and financed conservatively.

GLOSSARY

The One Big Beautiful Bill Act of 2025 is a US federal statute passed by the 119th United States Congress containing tax and spending policies that form the core of President Donald Trump's second-term agenda. The bill was signed into law by President Trump on July 4, 2025.

Capital expenditure (capex) refers to investment spending in long-term assets (fixed assets). These expenditures include new buildings, machinery, and other equipment needed for an organization's day-to-day operations. Most companies use capex financing to fund their long-term investments.

Free cash flow (FCF) is the cash a company generates from operations after accounting for the cash outflows required to support and maintain its capital assets.

The **European Central Bank (ECB)** is the central bank of the European Union countries which have adopted the euro.

The **Bank of Japan (BoJ)** is the central bank of Japan.

JGBs are the bonds issued by the government of Japan, which is responsible for the interest and principal payments.

The **Reserve Bank of Australia (RBA)** is Australia's central bank and derives its functions and powers from the Reserve Bank Act 1959.

The **Brazilian real (BRL)** is the official currency of Brazil.

Collateralized loan obligation (CLO) are structured financial products that pool corporate loans and sell them to investors in different risk categories known as tranches. CLOs allow banks to reduce regulatory capital requirements by selling large portions of their commercial loan portfolios to international markets, reducing the risks associated with lending.

Mortgage-backed securities (MBS) is a type of asset-backed security that is secured by a mortgage or collection of mortgages

Non-agency mortgage-backed securities (NARMBS) are those issued by private entities and not by federal agencies (Fannie Mae, Freddie Mac and Ginnie Mae); they are also called non-conforming loans.

Commercial mortgage-backed securities (CMBS) is a type of mortgage-backed security that is secured by the loan on a commercial property.

A **carry trade** is a strategy where you borrow money in a low-interest-rate currency (funding currency) and use it to buy assets in a higher-interest-rate currency (target currency) or higher-yielding assets, aiming to profit from the interest rate difference, known as the "carry".

Duration is a measure of the price sensitivity of a fixed-income security to an interest rate change. It is calculated as the weighted average of the present values for all cash flows and is measured in years.

The **Consumer Price Index (CPI)** measures the average change in U.S. consumer prices over time in a fixed market basket of goods and services determined by the U.S. Bureau of Labor Statistics.

Gross Domestic Product (GDP) is the total monetary value of all final goods and services produced within a country's borders during a specific time, typically a quarter or year.

An **Option-Adjusted Spread (OAS)** is a measure of risk that shows credit spreads with adjustments made to neutralize the impact of embedded options. A credit spread is the difference in yield between two different types of fixed income securities with similar maturities.

The **global financial crisis (GFC)** refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009.

Exchange Traded Funds (ETF) are a type of investment company which are bought and sold on a securities exchange.

An **asset-backed security (ABS)** is a financial security backed by a loan, lease or receivables against assets other than real estate and mortgage-backed securities.

A **liability management exercise (LME)** is an out-of-court corporate strategy where a borrower uses existing financing document flexibility to proactively restructure debt, often by issuing new debt or amending terms, to improve its balance sheet, extend maturity, or gain liquidity, typically working with a select group of creditors, sometimes to the disadvantage of others.

EV/EBITDA equals a company's enterprise value divided by earnings before interest, tax, depreciation, and amortization. It measures the price (in the form of enterprise value) investors pay for the benefit of the company's cash flow (in the form of EBITDA).

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by Franklin Templeton

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Fixed-income securities involve interest rate, credit, inflation and reinvestment risks and possible loss of principal. As interest rates rise, the value of fixed income securities falls. **Low-rated, high-yield bonds** are subject to greater price volatility, illiquidity and possibility of default.

Active management does not ensure gains or protect against market declines.

International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. Investments in companies in a specific country or region may experience greater volatility than those that are more broadly diversified geographically. The government's participation in the economy is still high and, therefore, investments in **China** will be subject to larger regulatory risk levels compared to many other countries. There are special risks associated with investments in **China, Hong Kong and Taiwan,** including less liquidity, expropriation, confiscatory taxation, international trade tensions, nationalization, and exchange control regulations and rapid inflation, all of which can negatively impact the fund. **Investments in Taiwan** could be adversely affected by its political and economic relationship with **China.**

Commodities and currencies contain heightened risks that include market, political, regulatory, and natural conditions and may not be suitable for all investors.

US Treasuries are direct debt obligations issued and backed by the "full faith and credit" of the US government. The US government guarantees the principal and interest payments on US Treasuries when the securities are held to maturity. Unlike US Treasuries, debt securities issued by the federal agencies and instrumentalities and related investments may or may not be backed by the full faith and credit of the US government. Even when the US government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.

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