Investment Highlights

US Agency MBS

Western Asset
A Franklin Templeton Company

Objectives

The US Agency MBS strategy seeks to maximize total return relative to its benchmark on a risk-adjusted basis.

The return target provided is gross of fees and based on current economic and market conditions and is subject to change based on a change in these conditions. Actual results may be greater or less than the target, and there is no guarantee any target will be achieved.

Market Review

During the third quarter, US Treasury (UST) bond yields drifted lower and the 10-year yield hit its lowest level in over a year; the yield curve bull-steepened and the 2s-10s segment disinverted and turned positive for the first time since mid-2022. US economic data increasingly showed the balance of risks shifting more convincingly in favor of a Federal Reserve (Fed) rate cut, which culminated in the Fed initiating a long-awaited rate normalization cycle and delivering its first rate cut since March 2020. Despite a dramatic but short-lived risk-off episode in early August—which saw the VIX Index rising to an intraday high of nearly 60—risk assets ultimately rallied as credit spreads tightened and the S&P 500 Index hit a new record high toward the end of the quarter.

In the US, data releases reinforced the trend of a softening job market and continued disinflation. Nonfarm payrolls rose by 142,000 in August, which fell short of consensus expectations. Revisions to the prior months' additions pushed the three-month average to its lowest level since mid-2020. The unemployment rate crept higher—rising to 4.3% in July, which triggered debate over the "Sahm Rule" and whether the jobless rate indicated that the economy is already in a recession—before ticking lower to 4.2% in August. Meanwhile, inflation continued to decelerate with core and headline Consumer Price Index (CPI) falling to 3.2% and 2.5% year-over-year (YoY), respectively, from 3.4% and 3.3% at the end of the second quarter, respectively.

In its September meeting, the Federal Open Market Committee (FOMC) reduced rates by 50 basis points (bps), bringing the fed funds target rate to a range between 4.75% and 5.0%. Following the decision, Fed Chair Jerome Powell cited greater confidence that inflation is moving sustainably toward the Fed's target while the labor market was in better balance, allowing for the recalibration given the balance of risks to both sides of its dual mandate. In the post-meeting press conference, Powell described the outsized 50-bp cut as a "recalibration" of policy, likely in an attempt to downplay expectations for 50-bp cuts moving forward and to better align market expectations with the outlook of the broader FOMC.

The updated Summary of Economic Projections showed that the median FOMC member now calls for an additional 50 bps of rate cuts over the balance of 2024, matching the market's pre-meeting consensus. The median forecast for the long-term fed funds rate was raised from 2.8% to 2.9%, reflecting a broadening view that neutral policy rates may have increased relative to pre-pandemic assessments. With the unemployment rate currently sitting at 4.2%, the year-end 2024 median projection was raised to 4.4%, indicating that further softening in the labor market is the base case for most committee members. With respect to the Fed's preferred inflation measure, the core Personal Consumption Expenditures (PCE) price index, year-end 2024 and 2025 projections were modestly marked down in response to recent softer-than-expected inflation data, and longer-term projections continue to expect a move back toward the Fed's 2% target by the end of 2026. Real GDP projections moved modestly lower for the remainder of 2024 and were left unchanged for 2025 and beyond.

In Europe, the European Central Bank (ECB) cut its deposit rate by 25 bps to 3.50% for a second time this easing cycle and left the door open to the possibility of another cut in October. In the UK, the Bank of England cut its Bank Rate by 25 bps to 5.00% in its August meeting but kept rates on hold in September—indicating that a gradual approach to easing remains appropriate. Diverging from the monetary easing bias elsewhere, in July the Bank of Japan (BoJ) hiked its policy rate to 0.25% from 0.0%-0.1% and announced plans to shrink its balance sheet. After the BoJ's rate hike triggered concerns over an unwind of "carry" positions and contributed to the brief spike in global risk aversion in August, BoJ policymakers helped to stabilize sentiment by emphasizing that they may refrain from further tightening in the event of extreme volatility. In China, policymakers announced a larger-than-expected economic support package to bolster the economy after several months of data releases showed a slowdown. Finally, the Mexican central bank cut its benchmark rate by 25 bps to 10.50% as core inflation moderated to its lowest level since early 2021.

During the quarter, corporate credit and structured product spreads tightened. Emerging market (EM) local yields fell in aggregate and hard currency EM bond spreads tightened. The S&P 500 Index rose 5.5% while West Texas Intermediate (WTI) oil plummeted more than 16% to around $68/barrel. The US dollar depreciated versus developed market (DM) currencies but was mixed versus EM currencies. Over the quarter, UST yields plunged and the yield curve bull-steepened with the 2s-10s segment turning positive from -35 bps to +15 bps and the 5s-30s segment steepened further from +18 bps to +56 bps. Two-year UST yields fell from 4.71% to 3.66%, 5-year yields fell from 4.33% to 3.58%, 10-year yields fell from 4.36% to 3.81% and 30-year yields fell from 4.51% to 4.14%.

US agency mortgage-backed securities (MBS) posted a total return of 5.53% for the third quarter, 78 bps better than the equivalent Treasury return. The option-adjusted spread (OAS) of the index tightened by 5 bps over the quarter to 42 bps. Conventional 30-year securities including Fannie Mae, Freddie Mac and uniform MBS outperformed the index, returning 5.86%, and the Ginnie Mae 30-year underperformed the index, returning 4.96%. Within the coupon stack, 1.5% to 4.0% coupons outperformed the overall index. Defensive sectors like 15- and 20-year MBS also underperformed the index.

Performance

Western Asset's US Agency MBS Composite returned 5.36% gross of fees in 3Q24, underperforming the composite's primary benchmark, which returned 5.53%. For the past 12 months, the composite returned 12.39% gross of fees versus 12.32% for the benchmark.

Benchmark: Bloomberg US Mortgage Backed Securities USD Unhedged Index

Returns (%) as of 30 Sep 24	3 Mo	YTD	1 Yr	3 Yr	5 Yr	10 Yr	SI*
Composite (gross)	5.36	4.87	12.39	-1.27	0.14	1.54	3.25
Composite (net)	5.28	4.64	12.06	-1.56	-0.16	1.23	2.94
Benchmark	5.53	4.50	12.32	-1.20	0.04	1.41	3.09

Returns (%) as of 31 Dec 23	3 Mo	1 Yr	3 Yr	5 Yr	10 Yr	SI*
Composite (gross)	7.17	4.64	-2.90	0.35	1.54	3.11
Composite (net)	7.09	4.33	-3.19	0.05	1.23	2.80
Benchmark	7.48	5.05	-2.86	0.25	1.38	2.97

*Source: Western Asset *Since Inception: 01 May 06*

Past performance does not predict future returns. *Returns for periods greater than one year are annualized. Gross-of-fees returns are presented before management fees, but after all trading expenses. Net-of-fees results are calculated using a model approach whereby the current highest tier of the appropriate strategy's fee schedule is used. Effective January 1, 2020, for annual periods where the actual account weighted fees are higher than the composite model fee, the actual account weighted fees will be used for the net-of-fee composite return calculations. Net-of-fee composite return calculations using actual account weighted fees may include fund returns that incur higher fees than those applied to separately managed accounts. Please see Performance and Risk Disclosure for more information.*

Scorecard

We thought that …	Therefore, we …	And the results …	
Duration could serve as a valuable diversification strategy and risk-off hedge.	Reduced our overall duration as a hedge to our up-in-coupon positioning.	Duration and yield-curve positioning added to performance over the quarter.	+
Agency MBS offered attractive spread valuations with low prepayment risk. Diminishing Fed holdings and limited bank purchases remained headwinds but presented investment opportunities.	Remained focused on portfolio construction with underweights to lower coupons in agency MBS versus a slight overweight to higher coupons.	Agency MBS detracted from performance, primarily due to the underperformance of Ginnie Mae 30-year securities.	–
The commercial MBS (CMBS) market has reopened with year-to-date issuance volume on pace with the 2013-2020 average. While AAA bonds now merely screen as "fair," spreads remain wide across mezzanine and subordinate bonds and secondary markets offer a wide variety of total return opportunities. CMBS is one of the few active CRE financing markets, and capital is being deployed to take advantage of the cyclical opportunity.	Maintained our off-benchmark exposure to non-agency CMBS.	Our exposure to non-agency CMBS and agency CMBS detracted from performance.	–
There were options for portfolio diversification and better yield opportunities relative to low-coupon generic agency MBS, which made up a significant portion in the index.	Continue to maintain our non-benchmark allocations.	Asset-backed securities exposure detracted from performance.	–

Investment Outlook

Our base case calls for further weakening in global growth and further declines in inflation with a greater emphasis on services disinflation. Goods price inflation is running modestly below pre-pandemic levels, but with ongoing deflationary pressures from Asia, it's hard to see a meaningful persistent uptick moving forward. Services inflation remains elevated, but wage pressures are abating as job markets soften and service sector demand is slowing. Headline inflation is close to target in most advanced economies, which has allowed central banks to reduce policy rates as their inflation concerns lessen while growth concerns rise. Growth is slowing in the US and remains moribund in the rest of the world. At the same time, lower policy rates and the recent Chinese stimulus package should lessen recessionary fears. We remain overweight to interest rate duration, but less so as rates have fallen, and markets have moved closer to our base case. Spread sectors have performed well and we expect this to continue if the downward growth trajectory remains gentle and services disinflation continues. However, valuations now have less yield advantage to offset potential macro and political risks going forward. EM debt appears to remain fundamentally attractive, but both internal and external political risks have hampered performance in some countries.

Agency MBS performance has been challenged due to minimal Fed and bank demand, but the fundamental picture has greatly improved. The sector offers attractive spreads with lower prepayment risk. With disinflation ongoing but uneven and a resilient economy, the Fed beginning to reduce rates is a tailwind for lower volatility. Spreads are currently above average levels as the Fed's balance sheet is in runoff and looks historically attractive. With prevailing mortgage rates hovering around the high 6% range and the average borrower locked into a 3.5% rate, refinancing activity remains structurally muted. We anticipate a further reduction in mortgage industry excess capacity and tighter bank lending standards to further weigh on financing activity, while home prices are supported by a limited supply of houses on the market and decreased affordability. With this backdrop of low prepayment risk and limited mortgage origination supply, we are constructive on the investment prospects for agency MBS while actively repositioning across subsectors, coupons and collateral selection. We favor 20- and 30-year MBS versus 15-year securities, and specified pools that offer better risk-adjusted yields and convexity profiles. We continue to allocate to both agency and high-quality non-agency CMBS for portfolio diversification and total return opportunities.

Portfolio Exposure

Sector Exposure	Portfolio (MV%)	Benchmark (MV%)
GNMA	20.00	23.32
FNMA	35.00	74.80
FHLMC	30.69	1.75
Agency Hybrids	0.68	0.00
CMBS	8.07	0.00
Non-Agency MBS	0.87	0.00
Asset-Backed	1.44	0.00
Cash & Cash Equivalents	3.27	0.13
Total	**100.00**	**100.00**

Source: Western Asset. As of 30 Sep 24

Portfolio Characteristics	
Leverage	None
Credit Quality	AAA
Effective Duration (yrs)	5.10
Spread Duration (yrs)	5.18
Yield-to-Worst (%)	4.68

Source: Western Asset. As of 30 Sep 24

Sector allocation includes look-through to any underlying commingled vehicles if held. All weightings are a percentage of total market value. A negative cash position may be reported, which is primarily due to the portfolio's unsettled trade activity. Data may not sum to total due to rounding.

The **US Agency MBS** strategy does not offer any capital guarantee or protection and you may not get back the amount invested. **Past investment results are not indicative of future investment results.**

The strategy does not offer any capital guarantee or protection and you may not get back the amount invested. The strategy is subject to the following risks which are materially relevant but may not be adequately captured by the indicator:

Concentrated: The strategy's investment approach may result in the strategy being focused in one, or a small number of, countries, sectors or asset classes compared to other investment strategies. This means that the strategy may be more sensitive to economic, market, political or regulatory events than other strategies that invests across a broader range of countries, sectors and asset classes.

Interest Rates: Changes in interest rates may negatively affect the value of the strategy. Typically as interest rates rise, bond values fall.

Liquidity: In certain circumstances it may be difficult to sell the strategy's investments because there may not be enough demand for them in the markets, in which case the strategy may not be able to minimise a loss on such investments.

The following **investment terms** may be used within these materials:
Cash Flow Yield (CFY) the option-adjusted measure of expected return.
Convexity is the second order, option-adjusted price sensitivity to a parallel shift in interest rates.
Duration is the option-adjusted price sensitivity to a parallel shift in interest rates.
Key Rate Duration (KRD) is the option-adjusted price sensitivity to the changes in interest rates located close to the given key interest rate tenors (e.g., 6M, 2Y, 5Y, 10Y, 20Y, 30Y).
Option Adjusted Spread (OAS) is a measure of expected excess return over the risk-free rates that considered embedded options and possible pre-payments.
Spread Duration is the option-adjusted price sensitivity to the change in option adjusted spread.
Yield-to-Worst (YTW) is the lesser of yield-to-maturity or yield-to-call across all known call dates.
Credit ratings are based on each portfolio security's rating as provided by the following Nationally Recognized Statistical Rating Organizations ("NRSRO"): Standard and Poor's ("S&P"), Moody's Investors Service ("Moody's"), Fitch Ratings, Ltd. In the absence of an NRSRO rating, Western Asset may assign a comparable rating. The credit quality of the investments in the portfolio does not apply to the stability or safety of the portfolio. The portfolio itself has not been rated by an independent rating agency.

Returns (%) as of 30 Sep 24	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**	**SI***
Composite (gross)	12.39	-1.27	0.14	1.54	3.25
Composite (net)	12.06	-1.56	-0.16	1.23	2.94
Benchmark	12.32	-1.20	0.04	1.41	3.09

Rolling 1-Year Performance Returns Period Ending:	**30 Sep 24**	**30 Sep 23**	**30 Sep 22**	**30 Sep 21**	**30 Sep 20**
Composite (gross)	12.39	-0.61	-13.84	0.32	4.29
Composite (net)	12.06	-0.91	-14.10	0.02	3.98
Benchmark	12.32	-0.17	-13.98	-0.43	4.36

Returns (%) as of 31 Dec 23	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**	**SI***
Composite (gross)	4.64	-2.90	0.35	1.54	3.11
Composite (net)	4.33	-3.19	0.05	1.23	2.80
Benchmark	5.05	-2.86	0.25	1.38	2.97

Returns for periods greater than one year are annualized.
***Since Inception: May 1, 2006. Benchmark: Bloomberg US Mortgage Backed Securities USD Unhedged Index. Base currency: USD**

Western Asset claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Western Asset has been independently verified for the periods from January 1, 1993 to December 31, 2023.

A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. The US Agency MBS Composite has been examined for the period of January 1, 2014 to December 31, 2023. The verification and performance examination reports are available upon request.

US Agency MBS Composite

Composite Inception Date: 05/1/2006 | Composite Creation Date: 05/15/2008

	No. of Accts	Gross Total Return	Net Total Return	Benchmark Total Return	Gross Total 3-Yr St Dev	Benchmark Total 3-Yr St Dev	Internal Dispersion	Mkt. Value USD Mil	Percentage of Firm Assets	Firm Assets USD Mil
2014	1	6.99%	6.68%	6.08%	2.47%	2.22%	-na-	1,092	0.23%	466,036
2015	1	1.95%	1.65%	1.51%	2.55%	2.31%	-na-	1,112	0.26%	433,747
2016	2	1.31%	1.01%	1.67%	2.26%	2.11%	-na-	2,306	0.55%	419,207
2017	3	2.54%	2.23%	2.47%	1.83%	1.75%	-na-	2,884	0.66%	436,309
2018	3	1.01%	0.71%	0.99%	2.22%	2.26%	-na-	3,176	0.75%	424,136
2019	3	6.58%	6.26%	6.35%	2.10%	2.15%	-na-	3,293	0.72%	455,276
2020	3	4.28%	3.97%	3.87%	2.10%	2.17%	-na-	2,943	0.61%	479,810
2021	3	-0.69%	-0.98%	-1.04%	1.69%	1.71%	-na-	3,325	0.68%	488,490
2022	2	-11.90%	-12.17%	-11.81%	5.58%	5.62%	-na-	2,363	0.60%	391,756
2023	2	4.64%	4.33%	5.05%	7.57%	7.66%	-na-	2,335	0.61%	385,964

Base Currency: USD | **Composite Minimum:** No minimum asset size requirement as of 1/1/2020 (previously USD25 million).

Description: The Western Asset US Agency MBS strategy aims to maximize total return and add value through subsector rotation and security selection, while approximating benchmark risk. The strategy invests in a diversified portfolio of exclusively agency mortgage-backed securities guaranteed by Ginnie Mae, Fannie Mae and Freddie Mac.

Benchmark Description: The current benchmark is the Bloomberg US Mortgage Backed Securities USD Unhedged Index.

Strategy Fee Schedule: .30 of 1% on the first USD100 million, .15 of 1% on amounts over USD100 million.

Gross-of-fees returns are presented before management fees, but after all trading expenses. Net-of-fees results are calculated using a model approach whereby the current highest tier of the appropriate strategy's fee schedule is used. Effective January 1, 2020, for annual periods where the actual account weighted fees are higher than the composite model fees, the actual account weighted fees will be used for net-of-fees composite return calculations. Net-of-fees composite return calculations using actual account weighted fees may include fund returns and performance-based fee returns that incur higher fees than those applied to separately managed accounts. The portfolios in the Composite are all actual, fee-paying and performance fee-paying, fully discretionary accounts managed by the Firm for at least one full month. Investment results shown are for taxable and tax-exempt accounts and include the reinvestment of all earnings. Any possible tax liabilities incurred by the taxable accounts have not been reflected in the net performance.

Composite returns are measured against a benchmark, when applicable. The benchmark is unmanaged and provided to represent the investment environment in existence during the time periods shown. For comparison purposes, its performance has been linked in the same manner as the Composite. The benchmark presented was obtained from third party sources deemed reliable but not guaranteed for accuracy or completeness. Benchmark returns and benchmark three-year annualized ex-post standard deviation are not covered by the report of independent verifiers.

Internal dispersion is calculated using the asset-weighted standard deviation of annual gross returns of those portfolios that were included in the Composite for the entire year. Periods with five or fewer accounts are not statistically representative and are not presented. The three-year annualized ex-post standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period.

Western Asset's list of composite descriptions, limited distribution pooled fund descriptions, broad distribution pooled funds descriptions, policies for valuing investments, calculating performance, and preparing GIPS reports, and all returns for strategies with inception prior to January 1, 2014 are available upon request.

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