Fixed-Income Insights

Western Asset

Key Convictions 1Q23

One Team

With more than 50 years of experience, $394.9 billion* in assets under management and nine offices around the world, Western Asset is recognized as one of the world's leading active fixed-income managers.

One Platform

Western Asset operates as a single team with an open, integrated investment platform bringing together the combined experience and fixed-income acumen of investment professionals throughout the world.

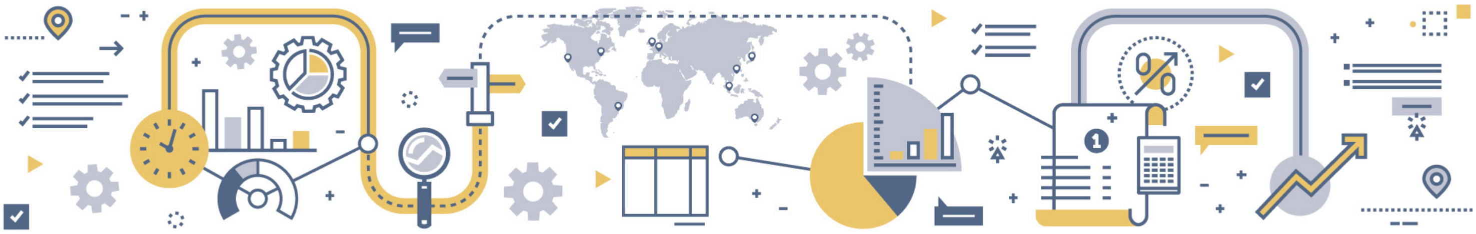
One Focus

Western Asset specializes in actively managing fixed-income strategies, employing a proven investment philosophy and process to manage capital risk and help drive long-term investment growth for clients.

As of December 31, 2022

Market Insights at a Glance

On the heels of a turbulent 2022, valuations for fixed-income have not been this attractive in a long time. The following summary is intended to aggregate the Firm's current overall views and present an at-a-glance dashboard.*



Growth

Convictions

- Global growth has downshifted, which should also reduce global inflationary pressures
- In the US, we think growth will be slow this year, but a recession will be avoided
- In China, we've just seen a remarkable U-turn toward pro-growth policy with the widespread removal of its Covid restrictions

Rationale

Against this backdrop of slower global growth, we expect the US dollar will weaken moderately over the year.

Inflation

Convictions

- We expect inflation to ease substantially in 2023
- We think the stickiness of lagging inflation measures has postponed the Fed's rate hike pause and elevated the peak inflation rate
- Forward-looking inflation indicators, however, display substantial progress in inflation's decline

Rationale

We see evidence the war against inflation in the US is being won—as evidenced by the declines in both the monthly Consumer Price Index (food and energy) and prices of existing single-family homes.

Monetary Policy

Convictions

- In the US, as we expected, the Fed hiked 25 bps on Feb 1, a downshift from its last hike of 50 bps
- In the UK, the Bank of England raised rates to 3.5% in December 2022. Part of the reason why the bond market did so poorly last year was, in our view, reflected in the challenges we saw with the Liability-Driven Investing debacle and the fear that policy lost its mooring, but we're encouraged by new UK leadership's policies

Rationale

We believe fighting inflation continues to be the top priority for global central banks, and as more inflation indicators show declines, the likelihood of rate pauses (and cuts) increases.

Fiscal Policy

Convictions

- Global fiscal stimulus is turning into global fiscal drag, as Covid-related support is now reversing very meaningfully around the globe
- In the US, monetary conditions are tightening, as evidenced by a precipitous decline in the M2 money supply

Rationale

The overall reversals of global fiscal policy deployed to fight Covid should also serve to tamp down inflation.

Housing

Convictions

- US home prices appear to have peaked and are declining
- Sales and starts have been plummeting, with the inventory of new homes nearly back to 2007 levels

Rationale

We expect to see a major pullback in the home building market and substantial home price declines.

Geopolitics

Convictions

- The Russia/Ukraine conflict continues to pose massive geopolitical uncertainty
- The cessation of Russian natural gas exports forced eurozone energy prices substantially higher in 2022 and will likely push into recession those eurozone countries with greater Russian energy dependence

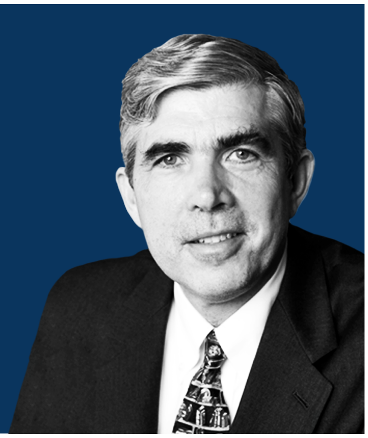
Rationale

Any positive developments related to the situation in Ukraine could be extremely beneficial to the investment outlook.

Fixed-Income Valuations Restored

"Last year was just spectacularly volatile for all asset classes, including fixed-income. But the upside is that the combination of higher rates and wider spreads means that valuations were restored in a very meaningful way. As a result, the starting point really is exceptional from a fixed-income standpoint, with real rates positive across the curve. We haven't seen this since the global financial crisis, and it is all happening against a backdrop of falling inflation. The debate now is how fast and how far can it fall. But the key point is that the market now has some confidence that inflation is falling and is going to be contained. Given this environment and the relative attractiveness of rates, we think 2023 will be the year when emerging markets should finally have their day in the sun."

— **Ken Leech**, Chief Investment Officer



*As of December 31, 2022

The Case for Fixed-Income in 2023

After a very difficult period last year, we think 2023 will be a time of renewed optimism for fixed-income. Simply stated, valuations in the fixed-income market have not been this good in a very long time. Of course, that's a reflection of the enormity and pervasiveness of last year's bear market. Not only did rates move higher but spreads also widened on non-Treasury sectors. The starting point matters and that is what fuels our optimism for the fixed-income asset class this year. We think, more attractive valuations against a backdrop of falling inflation sets the table for a promising 2023.

Falling Inflation Should Bolster Recovery

Declining inflation will likely be extremely supportive for all financial assets, and fixed-income specifically. The Consumer Price Index (CPI) for core goods in the US is clearly on a downtrend. Food and energy prices, as well as home prices in a number of countries, are also well off their highs (Exhibit 1). We think all these indicators are straightforwardly showing that inflation is in a very downward pattern and, perhaps more importantly, are well within ranges that are acceptable to the Federal Reserve (Fed). Service inflation remains a key data point to keep an eye on given the fact that it has been stickier than the other components of the inflation calculation. That being said, we are optimistic that service inflation is trending lower. But on the whole, our view is that the inflation picture is one of decline. Inflation coming down will allow the Fed to pause its hiking cycle and hopefully avoid a deep recession. Slower growth and lower inflation will allow bonds to be bonds once again. In the event that growth slows even more than anticipated, we expect long US Treasuries to resume their negative correlation to other asset classes and serve as ballast to our portfolios.

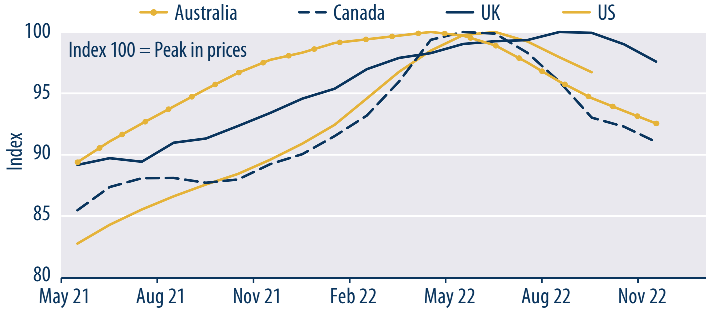
Investment-Grade Credit Illustrates Opportunity in Fixed-Income

As you can see in Exhibit 2, the yields on investment-grade corporate bonds have risen to a point that we haven't seen for almost 20 years (with the exception of the global financial crisis). Corporate balance sheets remain sturdy and we aren't seeing the excesses that we have in the past. While spreads on investment-grade credit have tightened from their wides in 2022, the all-in carry from investment-grade credit makes it an important anchor component of our strategies.

EM Well Positioned to Lead Fixed-Income Outperformance

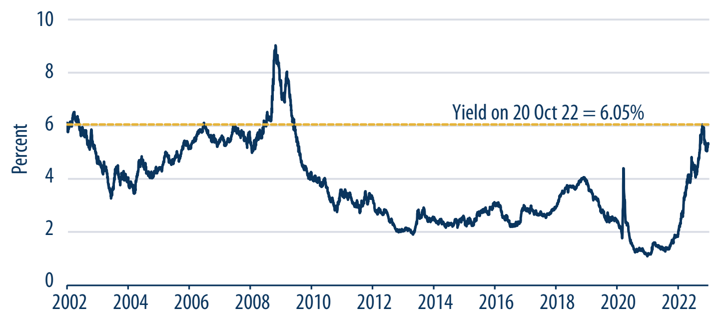
We're also optimistic that emerging markets (EM) will outperform in 2023. After a very aggressive tightening campaign by EM central banks, we think they are closer to the end of their tightening cycle relative to developed market (DM) central banks. As a result, we expect EM central banks to pivot toward growth this year, with rate pauses or even cuts. Adjusted for inflation, we think EM yields are attractive. A weaker US dollar and China coming off of its draconian Covid lockdowns also bode well for EM. Of course, issue selection remains key.

Exhibit 1: Global Home Price Inflation on the Decline



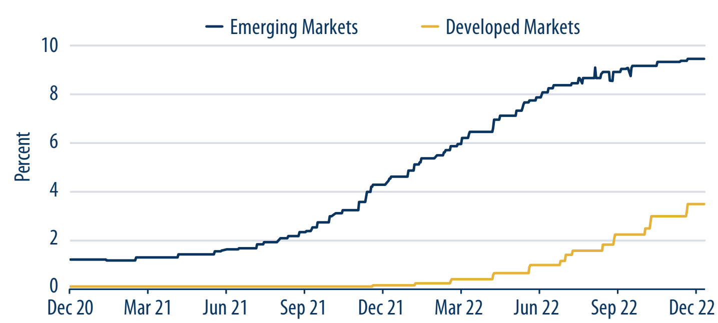
Source: Haver Analytics, Terra Net. As of 30 Nov 22.

Exhibit 2: Intermediate Investment-Grade Corporate Yields



Source: Bloomberg. As of 31 Dec 22

Exhibit 3: Cumulative Changes in Interest Rates Since January 2021



Source: Bloomberg. As of 03 Jan 23
Note: EM=Average of Brazil, Chile, Czech Republic, Mexico, Peru and Poland; DM= Average of US, EU and UK

Proceeding With Cautious Optimism

Our view for the year ahead is that US growth will slow, but we'll avoid an outright recession. Although global growth has already seen a downshift, we believe China's recent and rather abrupt reversal of its "zero-Covid" policies will prove to boost its growth rate and perhaps lift the global rate somewhat. We're hopeful global inflation will continue to fall, even if just modestly, and believe firmly that inflation "expectations" have the power to help curtail actual inflation. Take, for instance, the experience of the 1970s when inflation was truly remarkable in double digits. When nearly everyone in the US believed inflation would continue to rise they took precautions. It dramatically changed how consumers behaved. But that's not what we have today—inflation expectations are very well anchored. And while the US dollar is weakening, it's not even close to what we saw 50 years ago when it was in an outright freefall as investors fled the currency. In our view, this is also an ideal time for active investment managers. Looking ahead, we're confident that our diversified investment approach of using top-down macro strategies along with bottom-up sector/subsector and issue selection—which has historically shown the ability to outperform in a variety of different market environments—will be able to take advantage of current market dislocations.

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