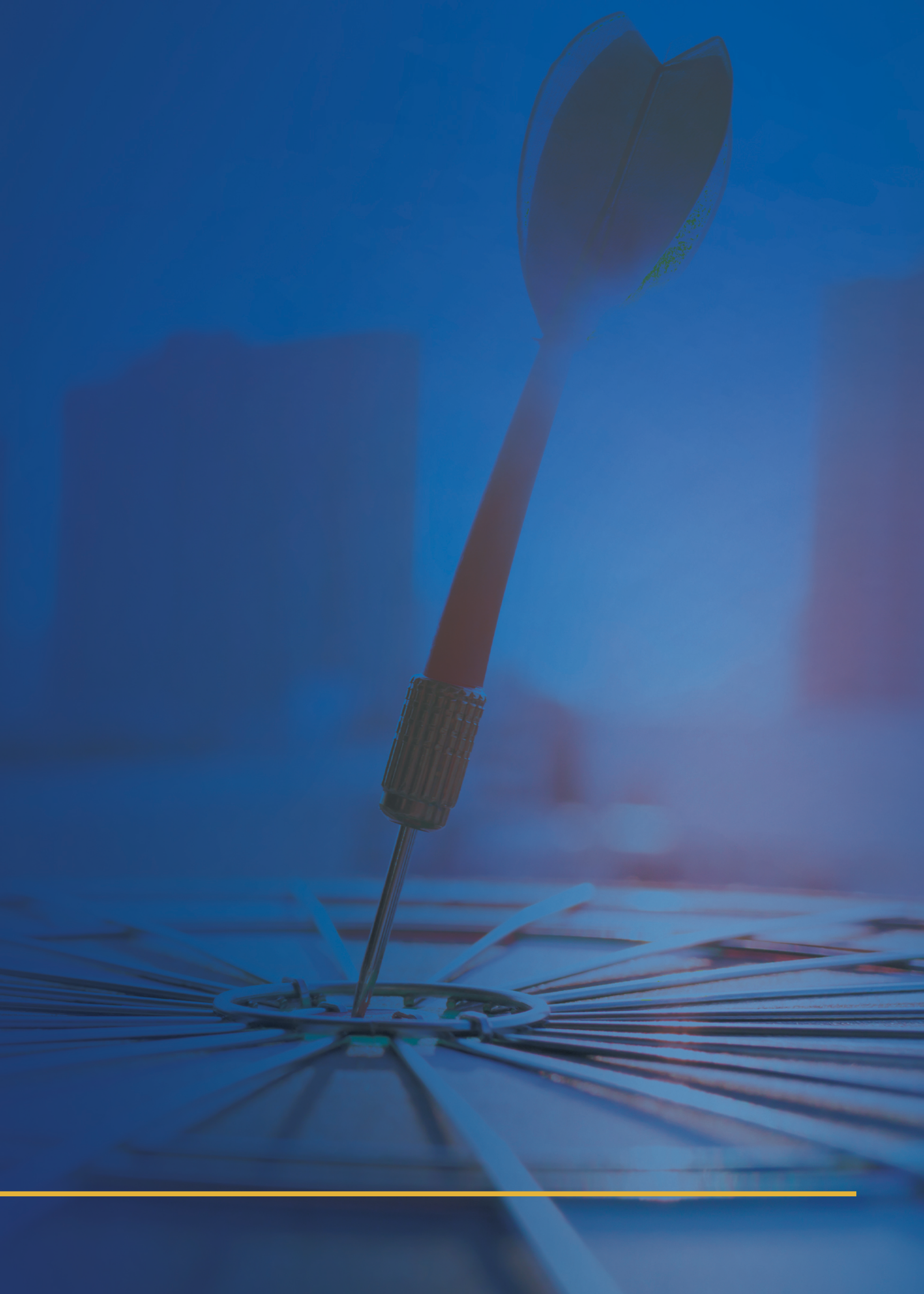
Fixed-Income Insights

WESTERN ASSET
A Franklin Templeton Company

Key Convictions 1Q24



One Team

With more than 50 years of experience, $388.9 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.

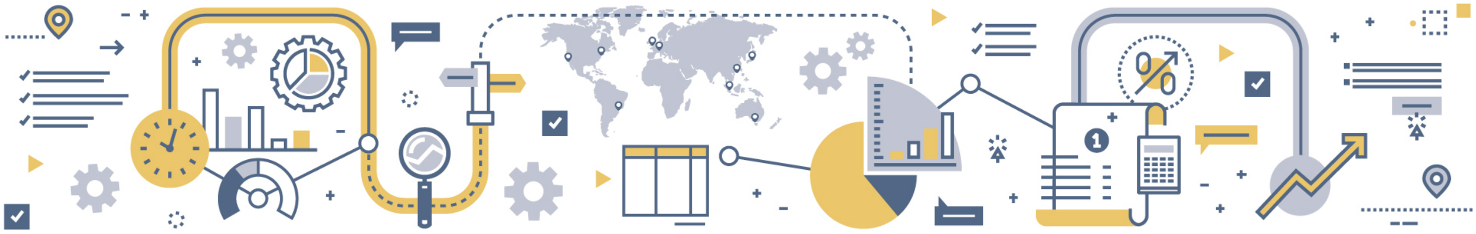
One Focus

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

*As of December 31, 2023

Market Insights at a Glance

We believe that the ongoing disinflation process, combined with moderate global growth and the potential for central banks to ease monetary policy, presents a favorable backdrop for fixed-income markets. This summary is intended to aggregate the Firm's current overall views and present an at-a-glance dashboard.*



Growth

Convictions

- We expect US growth to slow somewhat, at about a 2% rate for the year.
- With Europe on the brink of a recession, we expect only weak growth there.
- China's growth target of 5% may be difficult to achieve considering property sector headwinds.
- Global growth overall has already started to downshift.

Rationale

Global growth continues to see headwinds in the form of tight credit conditions, low savings rates, high interest rates and normalization of labor demand.

Inflation

Convictions

- US inflation is receding and we expect the downward trajectory to continue. Core Consumer Price Index (CPI) is running at about 3%, down from 7.5% a year ago.
- UK inflation has been on a downward path, with recent prints also surprising to the downside.
- Inflation in China is not considered a problem, and China could even become a source of deflation.

Rationale

Disinflation is broad-based and appears to be ongoing across various global economies.

Rates

Convictions

- Real rates in the US are still high, and market estimates of the longer-term neutral rates are elevated compared to the Fed's current expectations.
- Emerging market (EM) rates are elevated, and with an easing cycle about to start and foreign exchange (FX) expected to be well-behaved, there is optimism for EM local currency opportunities.

Rationale

With inflation receding and growth moderating, central banks, including the US Federal Reserve (Fed),, are expected to pivot from tightening to easing, potentially leading to lower interest rates in 2024.

Monetary Policy

Convictions

- The Fed has shifted from a stance of aggressive tightening to a more accommodative position, with the possibility of rate cuts in 2024.
- The European Central Bank has been cautious but is expected to shift to a less restrictive policy as growth and inflation remain subdued.
- The Bank of England is anticipated to shift to a less restrictive policy regime due to subpar growth and developing labor slack.

Rationale

We expect central banks to ease monetary policy due to ongoing disinflation, allowing for potential rate cuts in 2024 as inflation approaches targets and growth moderates.

Banking

Convictions

- Fears of a banking sector collapse erupted in early 2023, but markets have since realized that vulnerabilities were idiosyncratic and limited to smaller less-regulated regional banks.
- Despite waning systemic fears, the Fed's quarterly Senior Loan Officer Opinion Survey (SLOOS) has shown that banks tightened lending standards in 2023 to levels typically observed during recessions.
- The SLOOS also indicated loan demand fell across all types in 2023.

Rationale

Tight credit conditions are one of the headwinds facing the US economy that is likely to prevent a return to the very fast growth experienced recently.

Geopolitics

Convictions

- Geopolitical uncertainty continues to add volatility to the markets.
- There is a trend toward "nearshoring" or "friendshoring," where supply chains are being reconfigured to rely on countries that are not seen as adversarial, benefiting countries like Mexico.
- The war between Russia and Ukraine has significant implications, particularly for China, as it raises questions about the investability of the region.

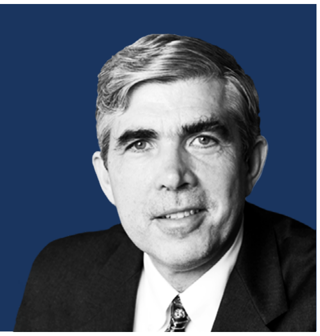
Rationale

The prospect for spread sectors, particularly corporate credit, is obscured by the unpredictability of geopolitical events and associated hazards.

The Power of Inflation

"The big story has been over the last few years, the path of inflation. That's the major storyline, the enormity really has changed the landscape in a pretty powerful way. It's allowed the Fed to pivot from the possibility of a further tightening to actually outlining a path for ease."

— **Ken Leech**, Co-Chief Investment Officer



*As of January 31, 2024

The Difference a Year Makes

The dramatic drop in inflation globally over the past year has allowed central banks to pivot from tightening monetary policy to preparing for easing. This shift has fueled powerful rallies across most areas of fixed-income. We expect further disinflation ahead, albeit unevenly, as global economic growth moderates. Downshifting global growth, falling inflation trends and central bank easing provide a favorable backdrop for fixed-income heading into 2024. Risks remain due to geopolitical uncertainty, central banks potentially moving too slowly or a sharp slowdown in growth. We see particular value in some spread sectors such as select portions of the commercial mortgage-backed securities (MBS) sector, BB high-yield bonds and EM debt, particularly Latin America.

Western Asset's Base Case and Investment Implications:

- The Firm expects a fairly optimistic scenario will be the most likely outcome, with a falling inflation rate and resilient growth.
- We believe that global growth will remain resilient with US growth slowing but avoiding a recession.
- Global inflation should continue to recede, in part motivated by stabilizing commodity prices.
- We think expectations for future rate cuts are likely to accelerate.
- We favor high quality, higher yielding, diversified strategies for income and total return; we expect generally slower growth, which is distinct from no growth.
- Our higher quality bias in credit, in addition to some select floating-rate exposure in structured credit and loans should provide some portfolio resilience should central banks move back to more restrictive policies.

The Case for Fixed-Income in 2024

The recent improvement in the economic landscape suggests a promising outlook for fixed-income this year, as declining inflation trends are likely to prompt the Fed to cut rates. Historically, bonds have yielded positive returns following a cessation of rate hikes (Exhibit 1), and the current hiking cycle which commenced in March 2022 is expected to pivot to rate cuts later this year.

Exhibit 1: Post-Hike Return Bumps for Bonds Over the Years

			Bloomberg US Aggregate Index Returns			
Period	**Rate Hike**	**Event**	**+6-Mos**	**+1-Yr**	**+3-Yr**	**+5-Yr**
Mar 1988 - Feb 1989	3.25%	Savings and Loan Crisis	9.4%	12.9%	12.3%	11.0%
Feb 1994 - Feb 1995	3.00%	Bond Market Massacre	8.9%	17.1%	10.2%	7.3%
Jun 1999 - May 2000	1.75%	Dot-com Bubble	7.7%	13.7%	11.1%	7.8%
Jun 2004 - Jun 2006	4.25%	Housing Bubble	5.4%	6.5%	6.6%	6.6%
Dec 2015 - Dec 2018	2.25%	Oil Price Collapse	6.0%	8.8%	5.0%	1.0%
Average	**2.90%**		**7.5%**	**11.8%**	**9.0%**	**6.8%**
Mar 2022 - Present◊	5.25%	Inflation Spike Post COVID-19	-	-	-	-

Source: Bloomberg, Federal Funds Rate Index, US Aggregate Bond Index. Returns for periods greater than one year are annualized. ◊As of 31 Dec 23. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

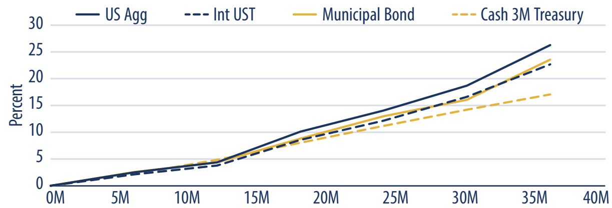
Cash Is Not Always King

Cash-equivalent investments (money markets, certificates of deposit, etc.), while often considered a safe haven, are not necessarily superior to fixed-income. Historically, they have been notably poor performers when compared to other asset classes, offering minimal growth potential. Additionally, the strategy of market timing, which includes tactical cash allocations, is rarely effective and does not typically yield better results than a well-diversified portfolio.

Unlike cash investments that have zero correlation to stocks and merely dilute a portfolio's overall performance, fixed-income investments can offer negative correlation to stocks, providing a valuable offset to risk and enhancing a portfolio's resilience. Furthermore, fixed-income investments mitigate reinvestment risk by typically offering a range of maturities and interest rates, allowing for strategic reinvestment that can adapt to changing economic conditions, something that cash-like investments cannot match.

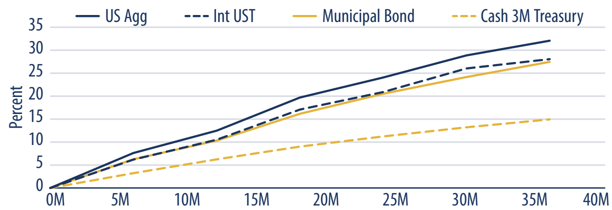
What's more, bonds have a long history of negatively correlating to stocks, whereas cash has been nearly uncorrelated. During US recessions, bonds have successfully served investors as both an offset to equity risk and a good source of returns relative to cash, with the average cumulative return for bonds, once again, doubling the return on cash investments.

Exhibit 2: Cumulative Bond Returns Relative to Cash Beginning with the ***First*** Rate Hike



Source: Bloomberg. As of 30 Nov 23.[1]

Exhibit 3: Cumulative Bond Returns Relative to Cash Beginning with the ***Last*** Rate Hike



Source: Bloomberg. As of 30 Nov 23.[1]

Western Asset Investment Themes

Asset Class	Our View
Overall Risk Assets	Strong corporate fundamentals and central bank easing provide a favorable backdrop for risk assets, though parts of credit markets appear richly valued following sharp rallies. Selectivity is warranted and we maintain a bias to go up in quality.
Investment-Grade	Current valuations appear somewhat expensive. Fundamentals remain supportive given balance sheet improvements.
High-Yield & Bank Loans	Rising stars (BB high-yield issuers that are poised to be lifted (upgraded) into investment-grade) offer particular value with additional room for price gains and upgrades yet to be fully reflected. Bank loans can provide floating-rate income buffers amid a rising-rate environment, but upside may be limited at this later stage of the cycle.
Structured Product	Agency MBS provide relatively attractive yield profiles with the sector poised to benefit should the Fed slow its mortgage runoff pace. Parts of non-agency residential and commercial MBS offer selective value but require in-depth credit analysis.
EM Debt	EM local debt stands out for its attractive valuations and high real yields as EM central banks pivot to cuts. USD-denominated sovereign issuers also merit consideration.

Definitions

"**AAA" and "AA"** (high credit quality) and **"A" and "BBB"** (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations **("BB," "B," "CCC,"** etc.) are considered low credit quality, and are commonly referred to as "junk bonds."

The **Bloomberg US Aggregate Bond Index** measures the performance of the investment-grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities and commercial mortgage-backed securities (agency and nonagency).

The **Bloomberg Municipal Bond Index** is a market value-weighted index of tax-exempt, investment-grade municipal bonds with maturities of one year or more.

The **Bloomberg US Treasury: Intermediate Index** measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with maturities of 1 to 9.9999 years to maturity.

The **Bloomberg US Treasury Bellwethers 3 Month Index** measures the performance of Treasury bills with a maturity of less than three months.

Disinflation is a temporary slowing of the pace of price inflation and is used to describe instances when the inflation rate has reduced marginally over the short term.

A **Mortgage-Backed Security (MBS)** is a type of asset-backed security that is secured by a mortgage or collection of mortgages.

The **Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS)** is a quarterly survey of up to 80 large domestic banks and 24 branches of international banks. Conducted by the Federal Reserve Board, the survey is completed in time to be discussed at Federal Open Market Committee (FOMC) meetings.

Spread sectors refers to sectors of the bond market, such as taxable bonds that are not Treasury securities, and includes securities such as agency securities, asset-backed securities, corporate bonds, high-yield bonds and mortgage-backed securities.

[1]US Agg = Bloomberg US Aggregate Bond Index. Int UST = Bloomberg US Intermediate Treasury Index. Cash 3M Treasury = Bloomberg US Treasury Bellwethers 3 Month Index. Municipal Bond = Bloomberg Municipal Bond Index. M=months. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Please note that an investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges. Past performance is no guarantee of future results.

Equity securities are subject to price fluctuation and possible loss of principal. **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. **International investments** are subject to special risks including currency fluctuations, social, economic and political uncertainties, which could increase volatility. These risks are magnified in **emerging markets. Commodities and currencies** contain heightened risk that include market, political, regulatory, and natural conditions and may not be suitable for all investors.

U.S. Treasuries are direct debt obligations issued and backed by the "full faith and credit" of the U.S. government. The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity. Unlike U.S. 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 U.S. government. Even when the U.S. 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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