Western Asset Management Company

Presenter: Mike Buchanan
September 22, 2016
8:00 AM PDT

Charles Colby: Welcome to Western Asset's webcast. Thanks for joining us. Mike Buchanan, Western Asset's Deputy Chief Investment Officer and the head of our Global Credit Team last joined us in early June to discuss the value that we continue to see in credit markets.

With credit continuing to tighten over the intervening three months, Mike's joined us today to discuss our current outlook on global credit and where we see the most compelling opportunities in this relatively more challenged environment.

Mike's comments will be followed by a brief Q&A session. You can submit your questions throughout the webcast by typing on the left-hand side of your screen. The slides are also available for download in that location. Mike, over to you.

Mike Buchanan: Great, thank you, and thanks for tuning into our webcast. The title of our webcast is "When Value Gets Harder to Find, Stay Disciplined and Get Smarter." It's an interesting title for sure, and I would say it's hard to argue with. But the message that we wanted to convey with this was threefold.

One, value, indeed, is much more challenging to find in this market. I think we could all agree on that. Two, we constantly remind ourselves to stay disciplined. And as Western Asset always has, we let the intersection of fundamentals and valuations determine opportunity for us. And we really don't stray from that. And three and finally, I think to find real value in this market you do have to expand the landscape for fixed-income and don't necessarily expect to find opportunities in those areas or those portions of the market that maybe have been so rewarding previously.

So, in our previous two webcasts, in February and then more recently in June, we highlighted what we thought was a very compelling opportunity in spread product in general, but really in particular, corporate credit. And I think, if you look at returns year-to-date, and we will go through this a little bit more in detail, without question they're very impressive.

So where we stand right now is we have to ask ourselves, is there opportunity left? Does value remain? And those are the questions that we are going to get to, but the short answer is, yes. Although we would say that the answer isn't as obvious or emphatic as it was only three months ago.

And if you recall, if you tuned in to either those webcasts, our premise for why we felt like there was real opportunity in the market was based on three things. And I would say they were all equally strong; we had compelling valuations, certainly strong technicals and supportive fundamentals. And they really provided that the foundation for our outlook. And as we sit here today, I would say although those three remain in place, technicals have really taken over as the strongest factor.

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Valuations in our opinion have shifted from meaningfully cheap to fair. And fundamentals are showing some slight evidence of decay, but it's not overly alarming to us, but it's just something were recognizing and we are tracking. So with that in mind, we've implemented some risk-reduction strategies across our portfolios. We'll talk about how we've been doing that, but it's generally been through select issue sales as well as certain sector rotation. And we are also still are finding opportunity in fixed-income markets. It's not necessarily where we were only a quarter or two ago. And we will highlight some of those opportunities.

The macro theme supporting our view haven't changed too much. As we've been saying for a long time, we believe the global recovery is in process, it's on track, although I think we can all agree that the pace is miserably slow. And we certainly appreciate that the risks are to the downside. We do think that this is an environment that is going to continue to engage central banks. And that accommodation that we've seen over the previous four or five years will still be with us in various forms.

We do think that Federal Reserve (Fed) hikes are going to be limited. What we're really looking for are three factors. We think growth has to hit the targets that the Fed is looking for. They are watching inflation expectations very closely, and also financial conditions. And until we get improvement in all three of those, we think any kind of meaningful rate hikes going forward are unlikely. So we expect this very low rate environment to persist for some time.

And in terms of what it means for our current strategy. Again, a little bit of de-risking, but we continue to emphasize spread sectors. We think there is still room for improvement, but we are reducing the overall magnitudes of our overweights.

So let's first go a little deeper into the investment themes backing our view. And obviously you have to start with global growth and I think we could all admit that global growth is challenged. And you can see from this slide, global growth has downshifted and is nowhere close to where we expected it to be three years previous. You can see that expectations for emerging market growth, probably the one thing to note on the slide has improved. Whereas back in 2013, the expectation was for relatively flat growth in emerging markets and developing markets.

You can see now with both India and China remaining solidly in positive territory and with Russia and Brazil coming out of recession, there seems to be renewed hope that emerging economies can start moving in the right direction. And if you look at developed markets, again, they have downshifted and really no discernible signs or expectations for growth. So it's kind of consistent with what I mentioned earlier—a very slow global growth environment.

But despite this sluggish growth, you look at fixed-income and the results have been impressive to say the least, especially since February if you go back to the first five or six weeks of the year. And I think it's surprising to see where we are on a year-to-date basis. So if you look at high-yield, and we're up over 14% year-to-date. Good luck finding anyone who predicted a mid-teens type return for high-yield.

You move over to US investment-grade—keep in mind, US investment-grade started the year with a yield of a little over 3%. So the fact that it generated, year-to-date, over 9 percent returns really is something to note.

Emerging markets, the corporate market, was probably the most hated market going into 2016. Again, very solid results and even rates, again, the same story, not as impressive since February, but still strong results on a year-to-date basis.

So, where do we go from here? Well, first I think you have to look at the overall fixed-income landscape. I think this is a really interesting slide. This is developed markets sovereign debt, and it shows how much debt is trading at zero or negative yields. I think it's something we all know, we are all aware of, but when you see it graphically like this, I think there's one conclusion, well, actually probably two.

One is that there certainly is a lot of debt that you wouldn't call fixed-income, you would call it fixed-loss. Second, if you want to go to where yields are, where income is, and that's generally been our premise that investors want positive yield or income. The US really sticks out as a market that you have to be at least looking at and making some very careful observations and probably expect money to migrate that way.

If you look at the next slide, you look at global develop market and yields broken down further. It's really the same story, whether you're talking about sovereign on the left or if you're looking at corporates on the right, you'll see that if want any kind of reasonable yield, the US is where you have to be.

And I think that's not surprising. We've all heard this story about how the US markets are attracting overseas money. We are seeing it in various forms. Here's one measurement on the bottom, where you could see that clearly the demand for US fixed-income is on the rise. It kind of validates that point I was mentioning earlier, about the strong, robust technical support for US markets. When we think of the stool supporting these markets right now and the three legs of the stool being technicals, valuations and fundamentals, we think right now the strongest leg of that stool is the technical support.

And at Western Asset, what we are always looking to do is, we are always looking for that advantage that we get from fundamental analysis as well as valuations, and also technicals. So I think that it's one of the reasons why we've taken some risk off the table more recently.

I mentioned earlier that fundamentals might be fraying a little, and I think this deserves further explanation. So, from our standpoint we are seeing fundamentals fraying, but it's not something we are alarmed about because we have to recognize it's fraying that's coming off very supportive levels. So whether you're looking at overall revenue trends, EBITDA or cash flow trends or cash on the balance sheet, from our standpoint, these metrics still support an investment in credit. And if valuations are there, we are happy to put our client's money, put our own money, into these various markets.

The one measure, the one metric, that's probably gotten the most attention recently is leverage. And you can see here that's something that in isolation would be concerning, and I think it really demands a further look. So that's what we are going to do next is we are going to take a look at what's causing these increases in leverage.

Global merger and acquisition activity has been robust. 2015 was a record year of over $4 trillion. 2016, although not likely to surpass 2015, is still going to be strong. So there's been a lot of merger and acquisition activity, and that's really what's causing these increases in leverage or the meaningful increases in leverage. And from our standpoint, that's a little more digestible than what I would call organic increases in leverage where cash flows are decreasing and EBITDA is decreasing, there's fundamental problems with the overall business.

This is more engineered increases in leverage, which isn't great, but what I would tell you is that especially the types of acquisitions that we've seen, it's like companies acquiring other like companies. So companies in the same business where when you look at the synergies, there's a real credible case that you can get cost savings and that you will be able to bring leverage down. And I think in many cases, that's really what

management teams have articulated. They've articulated that, yes, this is a great opportunity. We are going to buy this company, but ultimately we will bring leverage back down to where we were before.

So we view the spike that you have seen in leverage as somewhat temporary. I think the numbers validate that. When you look at the bottom of the slide, you'll see that this is data from the previous three years, but on average, companies when they do an acquisition have increased their leverage multiple by a turn. And you can see pretty consistent deleveraging going forward. So Anheuser's not even on this page, but Anheuser-Busch buying SAB Miller took a three times leverage balance sheet up to five times, but has communicated a clear, and we think a concise strategy to bring that down to three times levered again by 2018.

So the point is from our standpoint that the fundamentals are OK, they are supportive, and they're certainly not signaling a turn in the credit cycle. But moving over to the question of value, where is the value in this market? It's a challenge, no doubt. I'm using the European corporate market to highlight a point here. We've even had recently two issues that have priced with a negative yield, which is something that I never thought I'd see in my career, but the trend is telling you something here; yields are dramatically lower here.

So obviously, if we are looking for opportunity in fixed-income, as I said earlier, we have to expand the landscape of what we are looking at. And I think that the following slide is a pretty good visual. You might have seen this before, I think we've had it in a previous webcast. But it looks at fixed-income from two different vantage points; one from a yield perspective, the other on a spread basis. And not surprisingly on a yield basis, given we are in an ultra-low yield environment. Most of these fixed-income markets, everything from investment-grade down through high-yield, are trading at very—on a historical basis, at least—very low yield levels.

But when you look at it on a spread basis, you'll find that, it's not as stressed or not as stretched, I should say. In particular, a few markets stand out, the credit markets in general, but US loans. And also, emerging-market local bonds are trading above their midpoint, closer to their widest ranges. And I think that alone isn't the reason to invest in these. Obviously, you have to not only have a valuation component, you have to have the fundamental component and also be respectful of technicals.

But I think the two markets that we are going to hone in a little more on are US loans and emerging-market local bonds. Those are areas that we've been increasing allocations to. We do think they stand out as an outlier and as a compelling opportunity in this market. To some extent, we are also going to talk about structured product. We think there are select opportunities there. But first in bank loans, the one thing I would say here is that you kind of have to compare bank loans with high-yield. You have got quite a bit of overlap in those markets, although keep in mind bank loans are generally senior secured.

But if you look at the overall spread of bank loans, it's compressed quite a bit to high-yield. And the actual yield advantage or the incremental yield that you're giving up to go from high-yield into bank loans, depending on whose index you want look into how you're going to measure the bank loan yield; it's probably only in the area of about 40 to maybe 60, 70 basis points. So you're not giving up a lot of yield to be senior and secured.

One thing that we think is probably even more compelling, or will be compelling at some point in time is the floating-rate aspect of bank loans. You are seeing a couple things here. One, LIBOR is increasing lately. A lot of the bank loan market had LIBOR floors embedded in them. And LIBOR was well below the LIBOR floors for some time. That is going away.

So what it means from our standpoint is that if you do get interest rate hikes, if you do get a rising-rate environment, you're more likely to see levered loans or bank loans readjust or recalibrate their coupon on a one-for-one basis. So, in effect, you will participate in a rising-rate environment. I think that's something that although may not be a big market focus now, if and when we get to a point where rates start climbing, I think you could see a lot of technical support and a lot of money coming into this asset class.

So bank loans are a nice way from our vantage point to play what we call, the supportive fundamental environment, yet protect yourself a little bit if and when rates do start to rise. And if the opposite happens, if you get this persistent low-rate environment, we don't feel like we're giving up too much yield or too much income to be in loans. So that's an area where we've been increasing our overall allocations.

Emerging markets, in particular local emerging markets, you can see here the divergence between the US Treasury and a diversified basket of EM local bonds. That's grown quite a bit. And as I mentioned earlier, the expectations again for fundamental improvement in emerging market economies is there. Now, whether that comes to fruition or not will be seen, but our view is that these economies are improving, and you are likely to see some fundamental improvement.

And that, if you go over to the right portion of the slide, if you're worried about currencies, and a lot of people have asked us or noted that these currencies have rallied recently and it maybe feels like your you're getting into this a little late. I think you need to put it in perspective; you have to go back to December 2012, and you see a real dramatic devaluation in the basket of EM currencies. So the rally we've seen recently is very small on a relative basis to the damage that's been done. So we think that there's quite a bit of room for improvement here. It is certainly an area where you can get very generous yield in a world where generous yield is incredibly tough to find.

Finally, I mentioned structured products. We do see select opportunities in structured products. One to note is on the commercial loan side. And if you can see the blue chart, the CMBS chart, really stands out as an outlier. These are just historical spreads where you've had, and obviously we talked about high-yield corporate, but non-agency mortgages. And as we've mentioned earlier, BBB corporates all rallying.

CMBS has turned the other way, and we still think there's a strong fundamental case there, and that's another area where we're taking advantage of and reallocating some of the proceeds from our sales.

So in conclusion, I want to reiterate that, again, we still think there's opportunity in fixed-income. We still emphasize the spread sectors. But we are taking some risk off the table; I think, if you were bullish three months ago, just based on valuations, you have to be less bullish today. And we are and we're recalibrating our positions in the portfolio to reflect that.

We still find decent opportunities out there. As I said, bank loans does stand out as well as local emerging markets and some opportunities in structured product. And just a note or a point on the credit cycle; this comes up very often. We don't see a turn in the credit cycle anytime soon. We've been saying this for a while, but we think this particular cycle has longevity and we don't see the signals yet that would indicate that this cycle's going to turn within the next few quarters.

So with that, I will turn it back to the moderator for any questions.

Charles Colby: Thanks, Mike. We did receive a handful of questions from our listeners, and I would remind our listeners that they can continue to submit questions on the left-hand side of their screen.

The first question that we did receive was regarding central bank policy. Specifically off the back of a really heavy news day yesterday with both the Fed and Bank of Japan issuing statements almost within 12 hours of each other. Could you discuss how Western Asset's portfolios were positioned going into the announcements? And what's our expectation for the Fed to increase rates in either November or December and how would that decision impact credit markets?

Mike Buchanan: Yes. So, we did not expect the Fed to move; I think most didn't expect the Fed to move, although there were some outliers there. So we weren't overly surprised yesterday with the statement that came out with the no-hike.

In terms of how we were positioned, it's kind of as I articulated. We have an emphasis on spread product. It's not as emphatic as what it was a few months ago, but we still think that's the market that can outperform. And one area that's served us well or one strategy that's served us well over the years, given our overweight to spread product, is having duration. And although at times there's some breakdown in the correlation, those breakdowns tend to be temporary and it's been a reliable hedge for us.

So if we're going have an overweight to spread product, typically we'll have longer duration in our portfolios. So that's how we were positioned. It turns out that that was very good positioning to have, given not only how risk has done, but also how rates have done post the Fed and I think most interpreting the Fed's communication as being a little more skewed to the dovish side.

Charles Colby: Thanks, Mike. So you mentioned a few places in your presentation that fundamentals were made favorable, but maybe on the margin they're fraying. And you also mentioned that the credit cycle still continues to have legs. But could talk a little bit about what stage of the credit cycle that you think we're in generally? And then possibly the signals. You mentioned we haven't seen the signals for the end of the credit cycle yet, but what would Western Asset look for to indicate that the credit cycle is possibly moving toward the latter stages?

Mike Buchanan: Yes. I mean, it's a very fair question and I'll do my best to answer it as succinctly as possible. There's no question we are in the latter stages of the credit cycle. But as we've been saying for a while, we do think this credit cycle is likely to be extended.

So typically, credit cycles, maybe last, on average, six to seven years. We're a good seven, eight years into this particular cycle. So, we already are at the longer range as far as cycles go. But it's not surprising, when you think about the damage that was done in 2007 and 2008; the risk profile or the risk spirits of those individuals who are operating companies, it's just going to take them longer than it typically would to start pursuing that risk-taking behavior that ultimately leads to a turn in fundamentals.

So what we're looking for, really, are those metrics, those leading indicators that tell us risks are building. Because, quite frankly, you have to have a build-up of default risk. And then, not only do you need that build-up of default risk, but you also need a catalyst to translate that default risk into actual defaults.

So the leading indicator is the build-up of default risk. And, a good indicator you can follow or track is leveraged buyout activity. So as much as I mention that M&A is up a lot, if you look at leveraged buyouts, they're surprisingly very low right now. Over the past few years, despite sponsors having ample cash to

execute buyouts, they really haven't been pursuing those buyouts, and I think part of that is regulation. It's very tough now for a buyout firm to get the kind of leverage that they did pre-crisis.

So I think that's a good leading indicator. I think also the feedback that our research team gets from management teams when they talk to management teams and not just what they say, but really what they're doing when you look at capital expenditures. What are they doing with the money? Is it something that kind of makes sense? Or is it something that maybe is veering off their typical strategy?

It's indicators like that that tell us, all right, is their risk-taking behavior changing? And I think that's a pretty reliable sign when you see a meaningful turn there. That tells you at least that that default risk is building in the market. And then, like I said, you still need a catalyst to turn that into a default.

So I still think we've got smooth sailing, although not without volatility. But I don't think we have to fear an imminent end to the credit cycle; I think you've got at least a year or more before we have to start worrying about that.

Charles Colby: Thanks. You consistently noted in your presentation the technical tailwinds that the US credit market has at its back. What do you anticipate the impact will be if those tailwinds stop? And do you see that as a big risk to the US credit market, that there could be a sudden reversal if that were to come to pass?

Mike Buchanan: It's a risk I think you have to be respectful of. And the risk you're talking about, I think the only way that that really happens in a meaningful way is that globally we move or shift to a higher-rate environment. And what could trigger that? It could be a real crisis of confidence in the ability of central banks to keep rates anchored at these low, low levels. It could be a shock to growth to the upside, which maybe wouldn't be that bad for corporate credit.

So I think you have to be respectful of the conditions that could lead to the higher rates. But again, at Western Asset, we are always looking at the fundamentals. And the fundamentals, not just in the corporate credit markets or our structured product markets or emerging markets; we are looking at fundamentals in government markets as well.

And what we see right now indicates that when we look at growth, not only in the US but globally, when we look at inflation not only in the US but globally, we really don't see indicators that tell us that there's a risk that rates should move meaningfully higher. So we are respectful of that factor you mentioned that could drive yields higher, or that could shift or change the inflow pattern we have seen to US credit. But we think it is unlikely to happen, and we think as long as you look at the landscape and that page that we showed earlier that shows just how dominant negative, or zero-yielding fixed-income is globally, I find it hard to believe that that money won't continue to flow into these markets that offer some kind of positive income or yield.

Charles Colby: Thanks Mike. We had another listener ask about sector rotation, specifically what sectors we have looked at, and we've taken some profit from, or de-risk from? And then, where we have rotated that money to where we are seeing some better fundamentals coupled with good valuations?

Mike Buchanan: Yes, again, the sales that we've executed have been more on the corporate credit side. We had what I would call a meaningful overweight to both US high-yield and US investment-grade. We've certainly gotten very strong returns from those sectors. So we are taking down the magnitude of that overweight.

I want to be careful, though, because we're still overweight in those sectors. We still think there is a strong argument or a reasonable argument that you get outperformance from those sectors, but it's all about calibrating your risk/reward. As I said, all else being equal, if valuations aren't as compelling today as they were three months ago or six months ago, you are going to own less. So that's where we have taken the money, bringing down corporate exposure; both high-yield and investment-grade. And, as I mentioned, we have redeployed that to the bank loan space as well as through local emerging markets. So those are the bigger thematic sector rotations that we've executed.

Charles Colby: Thanks Mike. I have time for one more question. And specifically, a listener asked for you to discuss the biggest risk to Western Asset's scenario in our positioning. And I know you mentioned a bit earlier, but if you wanted to expand a little bit on some of the hedges that we have had in our portfolios to protect against those specific risks?

Mike Buchanan: As I mentioned, we do believe that global growth is slow but positive. But as our Chief Investment Officer, Ken Leech, always reminds us, that slow growth is very close to no growth or negative growth. And I think you have to be respectful of that.

And I think, given how we are positioned, still with an emphasis on spread product, albeit not to the magnitude that we had earlier, the biggest risk that we have is a downshift in global growth that gets us dangerously close to the global recession. And as a hedge, there's a number of ways, and depending on which portfolio strategy I mentioned earlier, the most obvious hedge and the one that has been very good to us, very reliable to us, has been duration. We continue to run duration in a way that's consistent with our risk positioning. So that's, again, been a reliable hedge.

I think also we have a team that's constantly looking at cheap ways or interesting ways to buy some protection, whether that's buying puts or put spreads on CDX; both investment-grade and high-yield. Many of our portfolios utilize those types of strategies to protect us on the downside in those types of tail risks. So there's quite a few ways that we can defend our portfolio in that kind of environment.

What I always say, though, is ultimately the best line of defense is fundamental research. That's something that Western Asset really prides itself on. We invest a lot of money in our global research team. And it's at that individual issuer selection point where we think we really have an advantage, even in a market that's challenged. I think, the great thing about fixed-income is fundamentally if you're right, ultimately you are going to get your coupons and you are going to get paid back at maturity. And that's something that our research team never loses sight of.

Charles Colby: Thanks Mike. That's all the time that we have for questions. And we really appreciate the fantastic insight.

And thanks again for our listeners for joining us. A replay of this webcast will be available using the original link. And the slides that Mike referenced in this presentation will be available for download at that location. We did receive a number of questions that we were not able to address. In those instances, your Client Service Executive will be contacting you shortly to discuss.

Finally, we would like to invite everyone to join us for our next webcast, which is scheduled for October 6. It'll be Western Asset's CIO, Ken Leech, providing his global macro outlook. Again, thank you for listening.

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