

3Q24 Market & Strategy Update

July 11, 2024

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2024 Global Outlook

Disinflation ongoing but uneven

Central banks will ease policy to normalize real interest rates

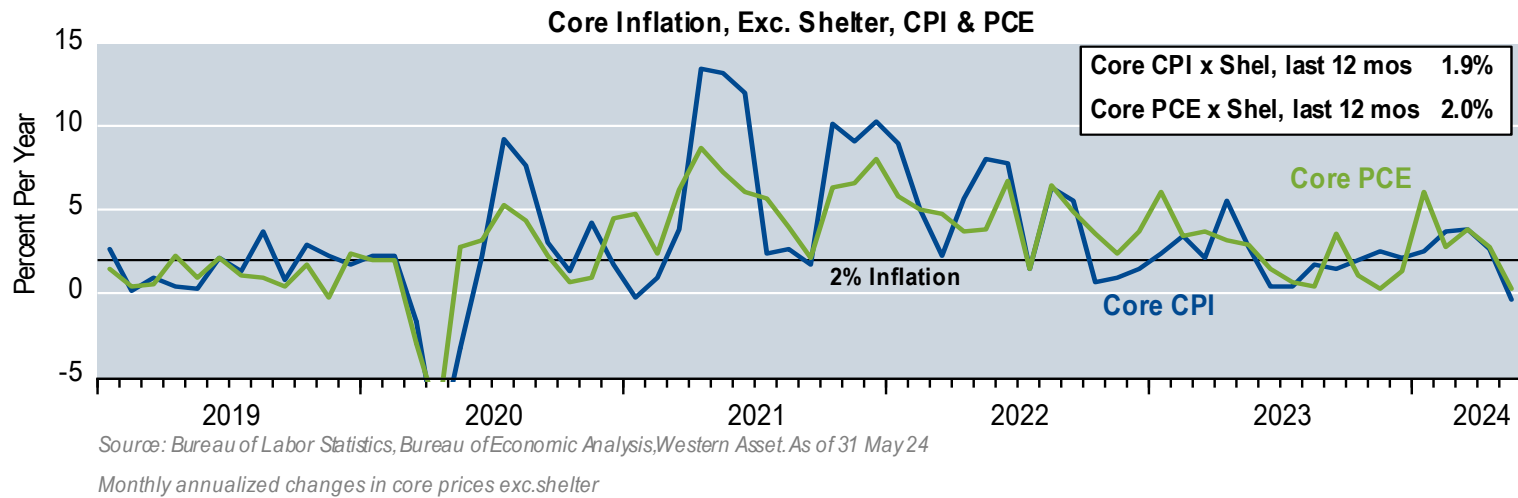
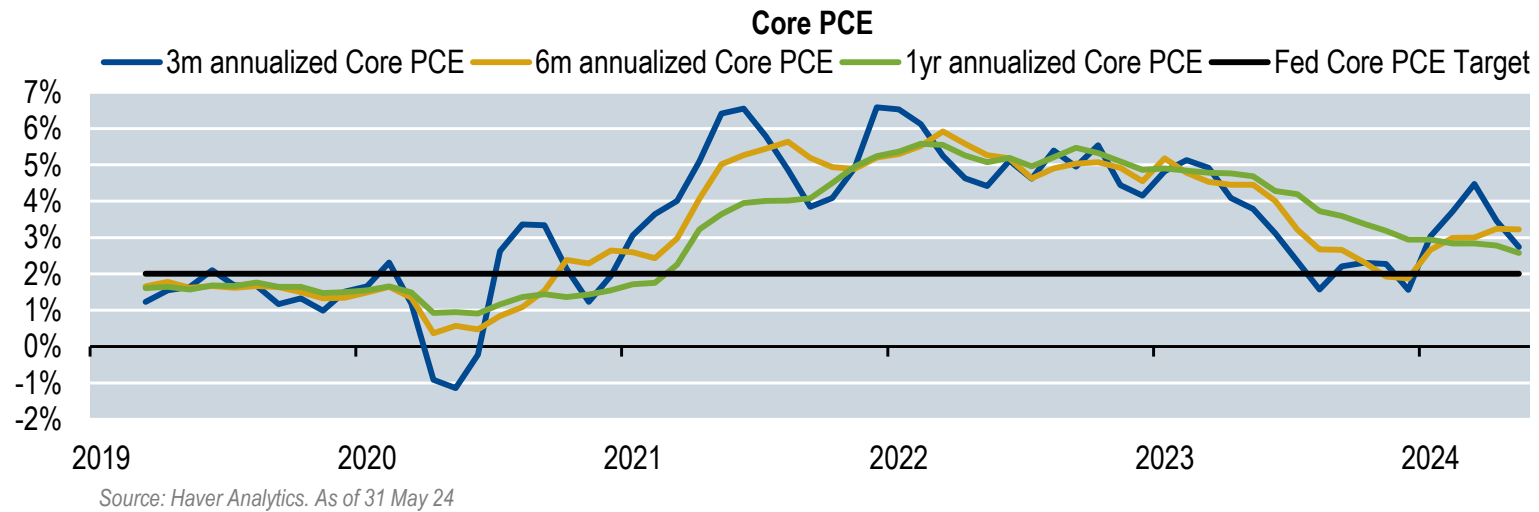
Economy has remained resilient, but is set to slow

Fixed-income outlook

- US growth will slow but should avoid recession
- Global growth has downshifted and China is now a source of deflation
- US core PCE already near Fed target
- Global inflation will continue to recede
- The US dollar will weaken moderately
- Emerging markets—particularly in Latin America—should outperform
- Central banks will need to pivot policy adroitly
- Spread sectors are still attractive but the outlook is clouded by macro risk
- Geopolitical uncertainty continues to add to volatility

Core PCE Nears the Fed's Target

(Core PCE, Core CPI Ex-Shelter Have Been at Target for a Full Year)



Global Disinflation Is Broad-Based and Ongoing

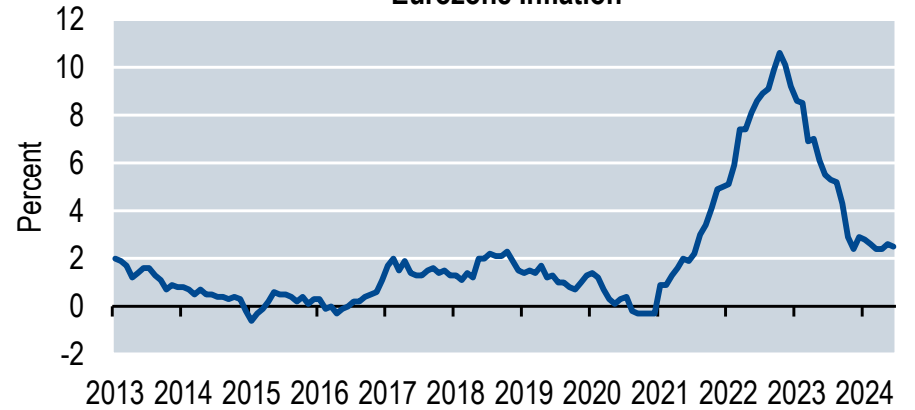
Advanced Economies: Composite CPI

Percent Change Year over Year, Seasonally Adjusted, 2015=100



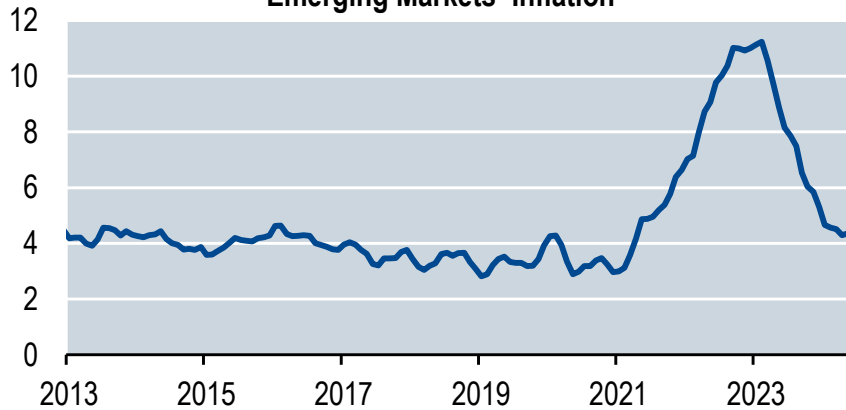
Source: Haver Analytics. As of 31 May 24

Eurozone Inflation



Source: Bloomberg. As of 30 Jun 24

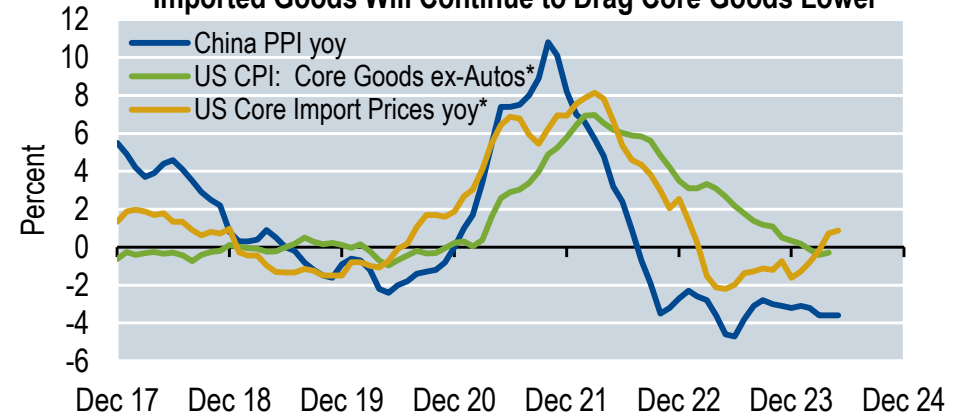
Emerging Markets¹ Inflation



Source: Bloomberg, Western Asset. As of 31 May 24

¹EM = Brazil, Mexico, Colombia, Chile, South Africa, India, Indonesia and Poland

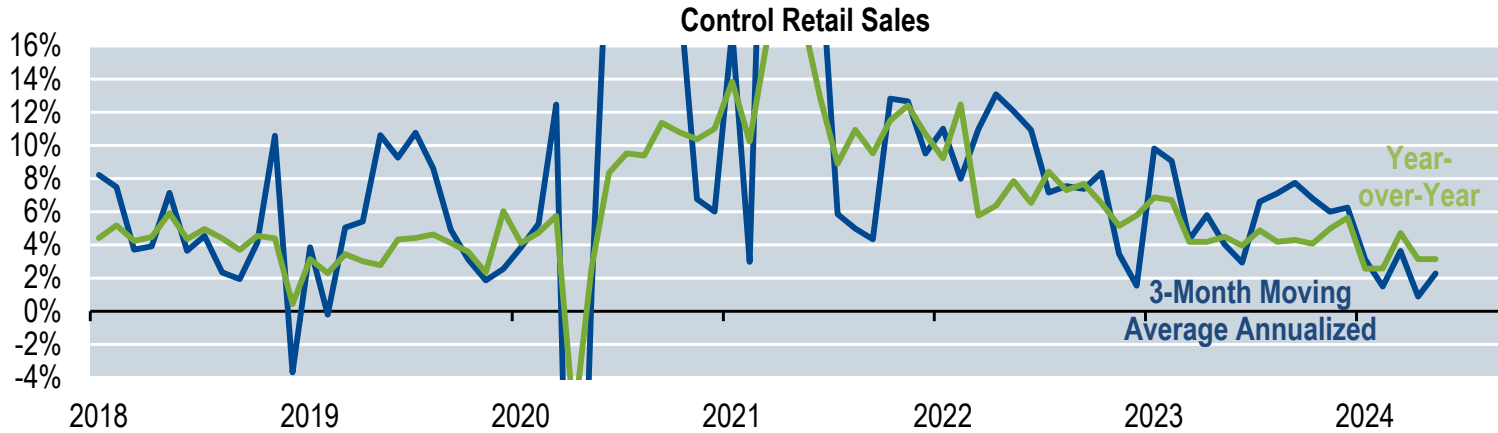
Imported Goods Will Continue to Drag Core Goods Lower



Source: Bureau of Economic Analysis. As of 31 May 24

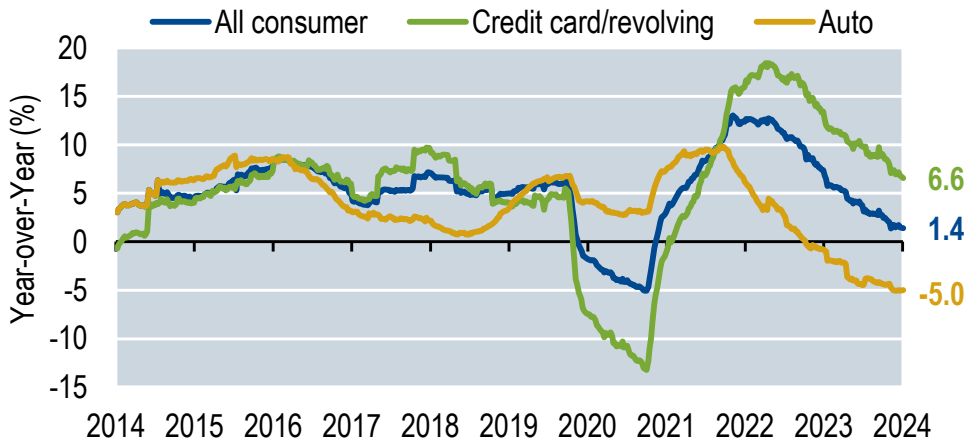
*US CPI and US Core Import Prices as of 29 Feb 24

Consumer Spending Continues to Downshift



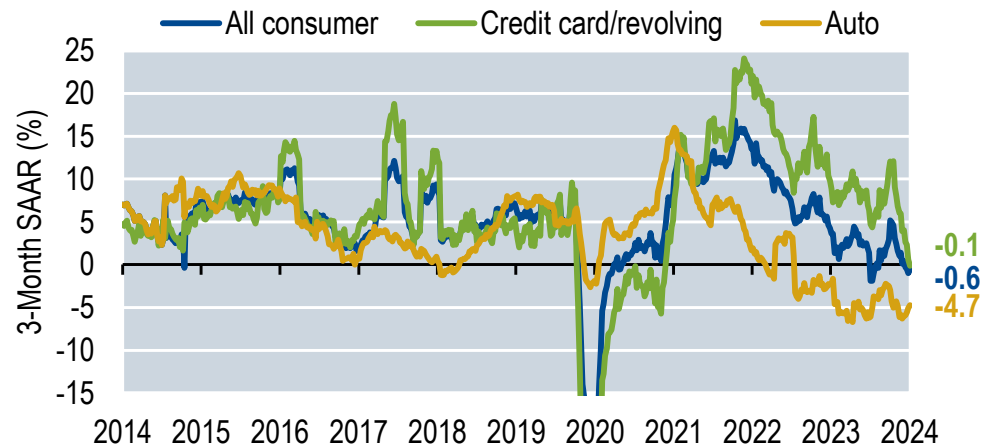
Source: US Census Bureau. As of 31 May 24

US Commercial Bank Lending to Consumers – Year-over-Year



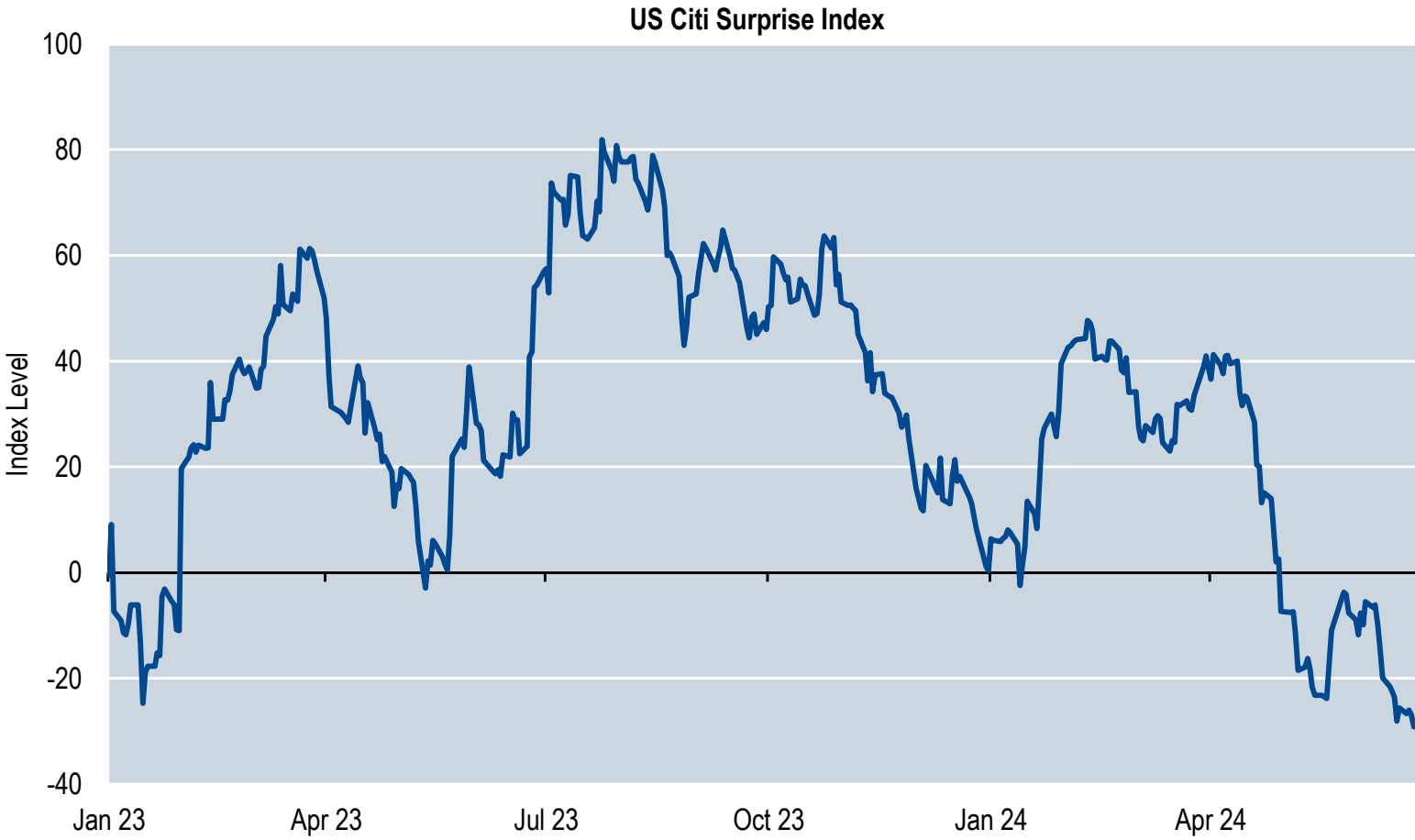
Source: Bloomberg, Federal Reserve, Morgan Stanley. As of 19 Jun 24

US Commercial Bank Lending to Consumers – 3-Month SAAR



Source: Bloomberg, Federal Reserve, Morgan Stanley. As of 19 Jun 24

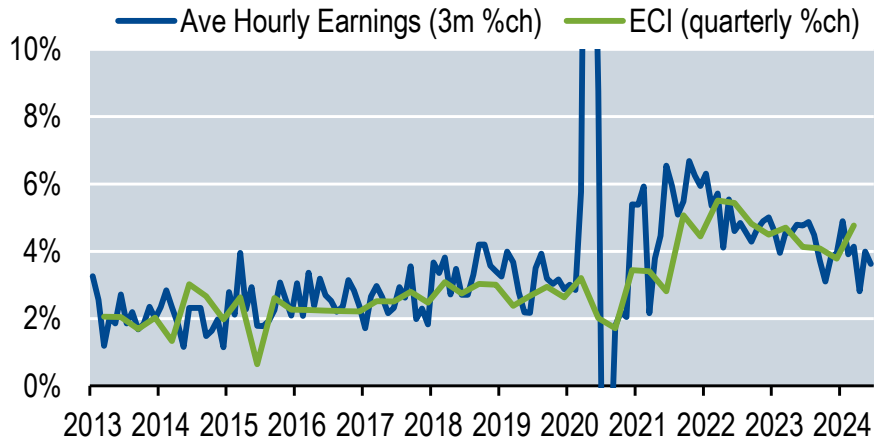
Recent Growth Readings Have Been Soft



Source: Bloomberg, As of 05 Jul 24

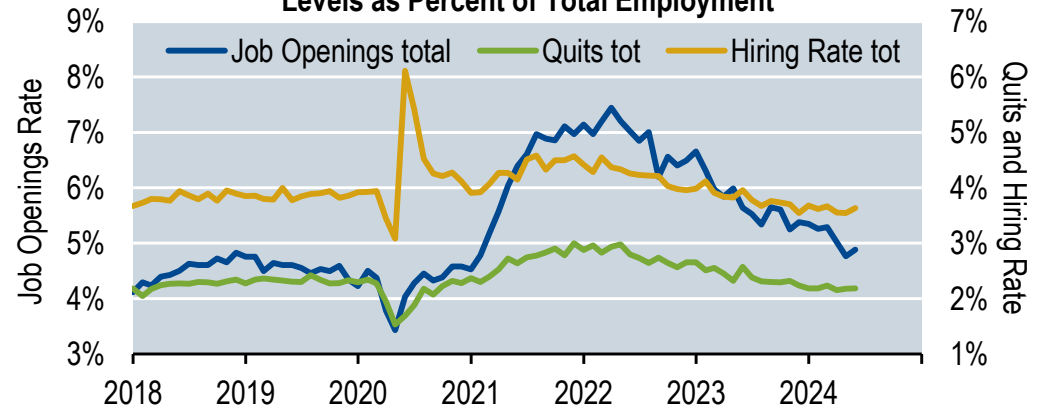
Labor Market May Have Fully Normalized

Wage Growth



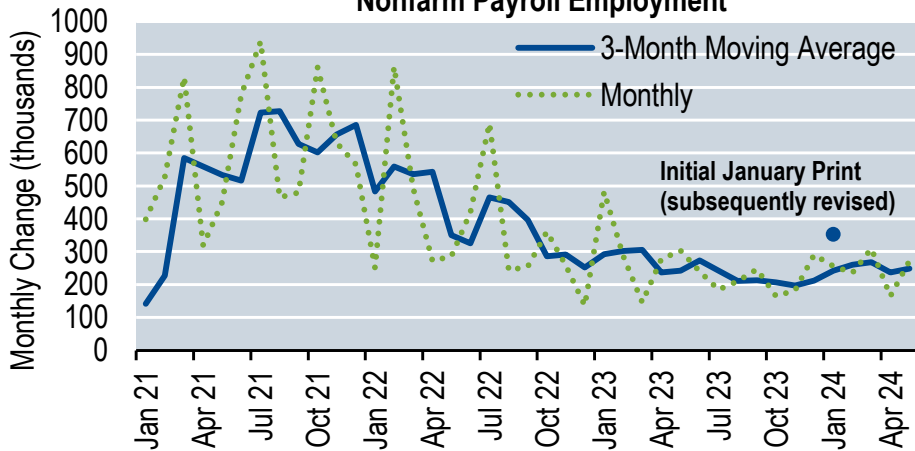
Source: BLS, Haver. As of 31 May 24
Percent change, Annualized rate

Job Openings, Quits, Hiring Rates All Near Pre-Pandemic Levels as Percent of Total Employment



Source: Bureau of Labor Statistics. As of 31 May 24

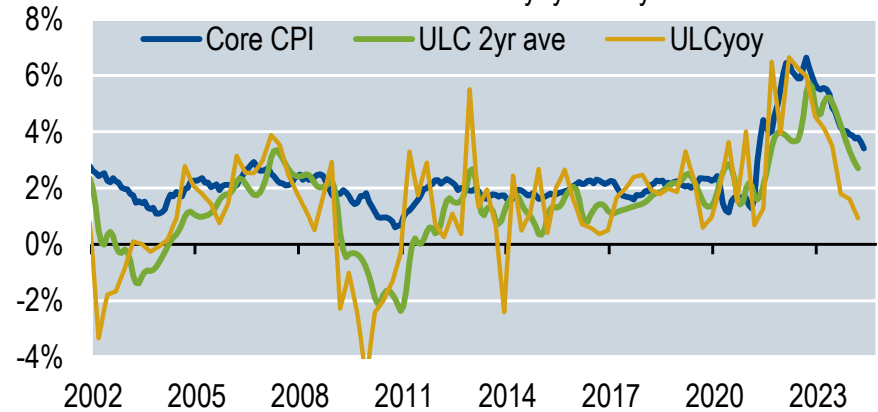
Nonfarm Payroll Employment



Source: BLS, NFIB, Haver. As of 31 May 24

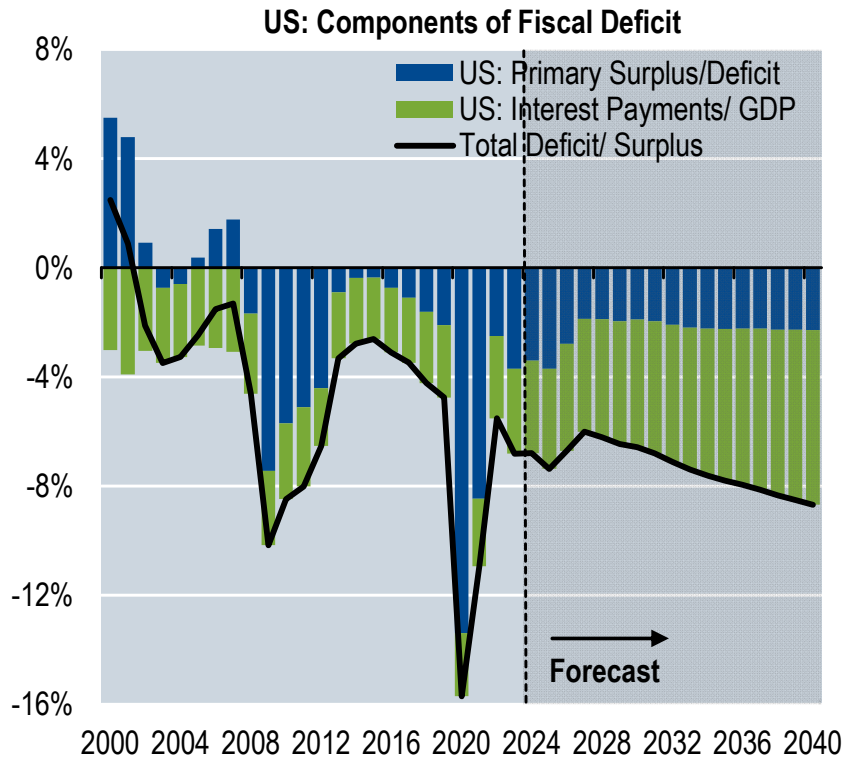
Unit Labor Costs Back Below Core CPI

Nonfarm Business ULC yoy and 2yr saar

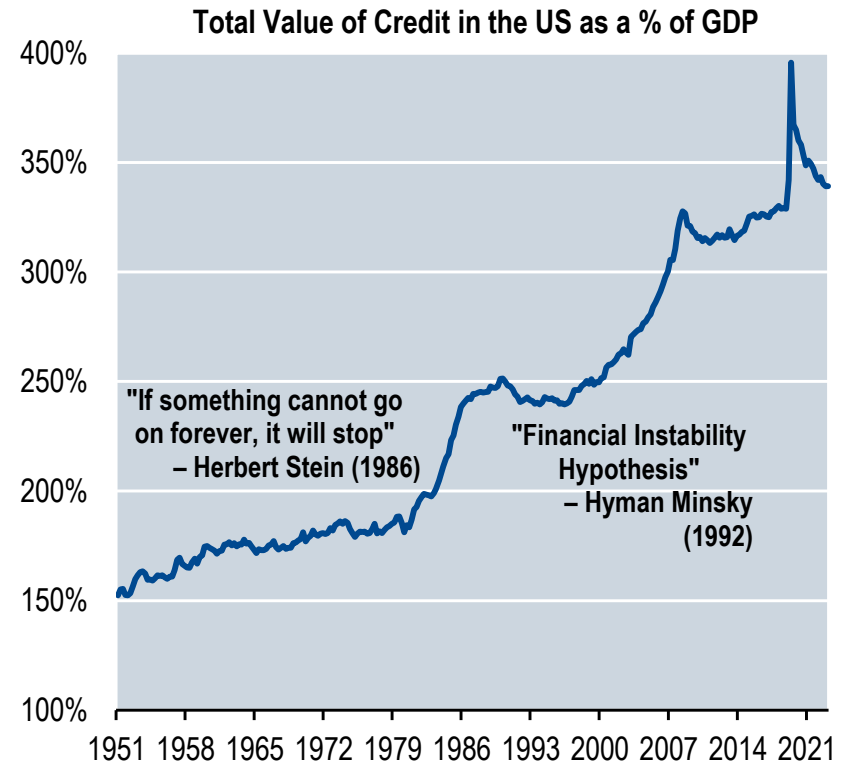


Source: BLS; ULC quarterly data through Q1 2024. CPI monthly data through May 2024
Nominal percent change, year on year.

While Nothing Good Can Be Said About the US Fiscal Deficit – Its Economic Consequences Cut Two Ways



Source: Morgan Stanley. As of 30 Jun 24



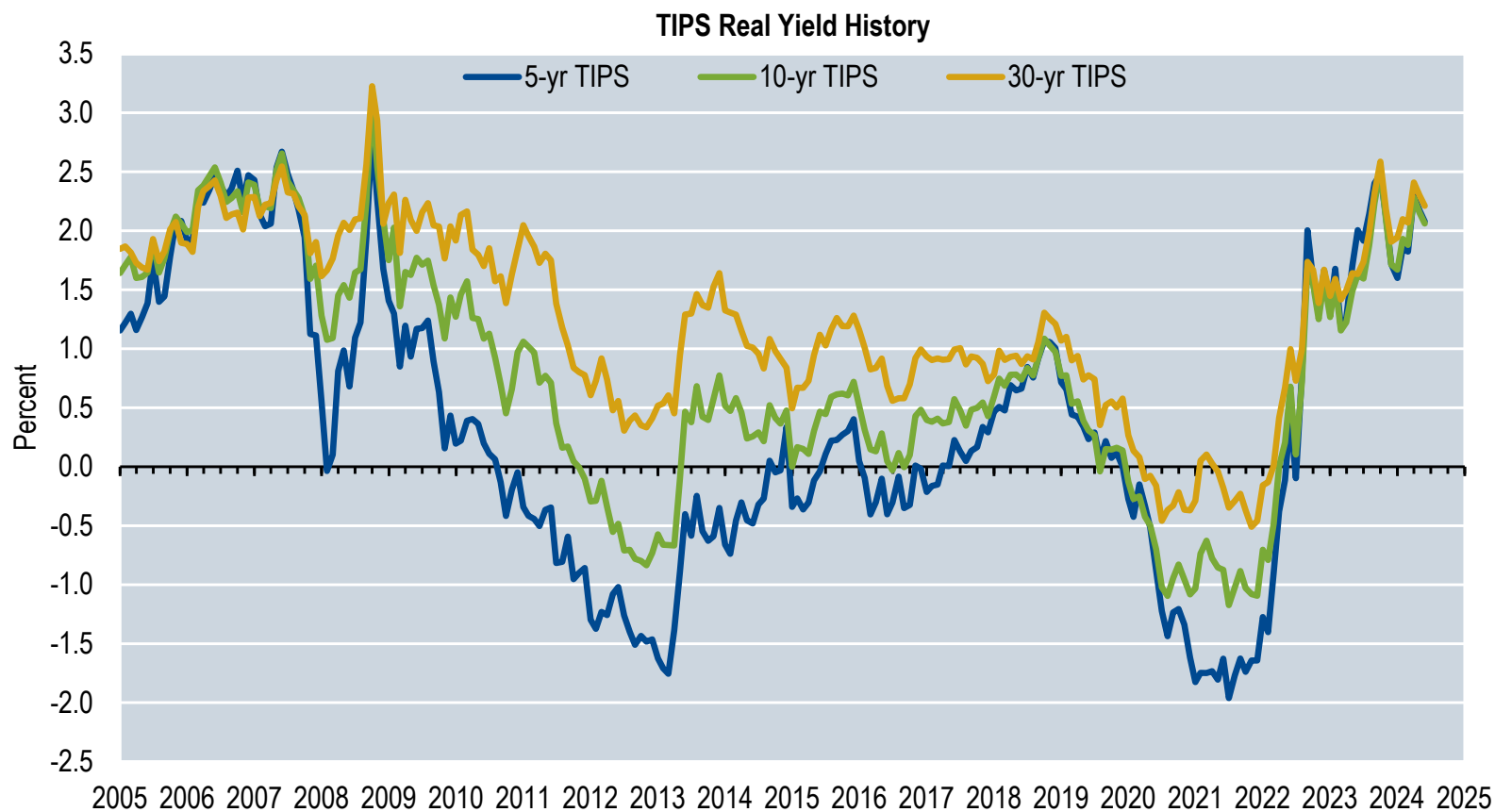
Source: Bloomberg. As of 31 Mar 23

- "Who knows what the next critical level is in fiscal deficit or total credit/GDP?"
- Herb Stein (1986) and Minsky (1992) were right, but they were also early

Real Rates at Two-Decade Highs Are Compelling

2- and 5-year, 5-year forward CPI swaps near 2.5% are close to Fed inflation targets, though a bit below levels seen prior to the GFC

In other words, Real Yields across the curve are near the highs seen in the last two decades



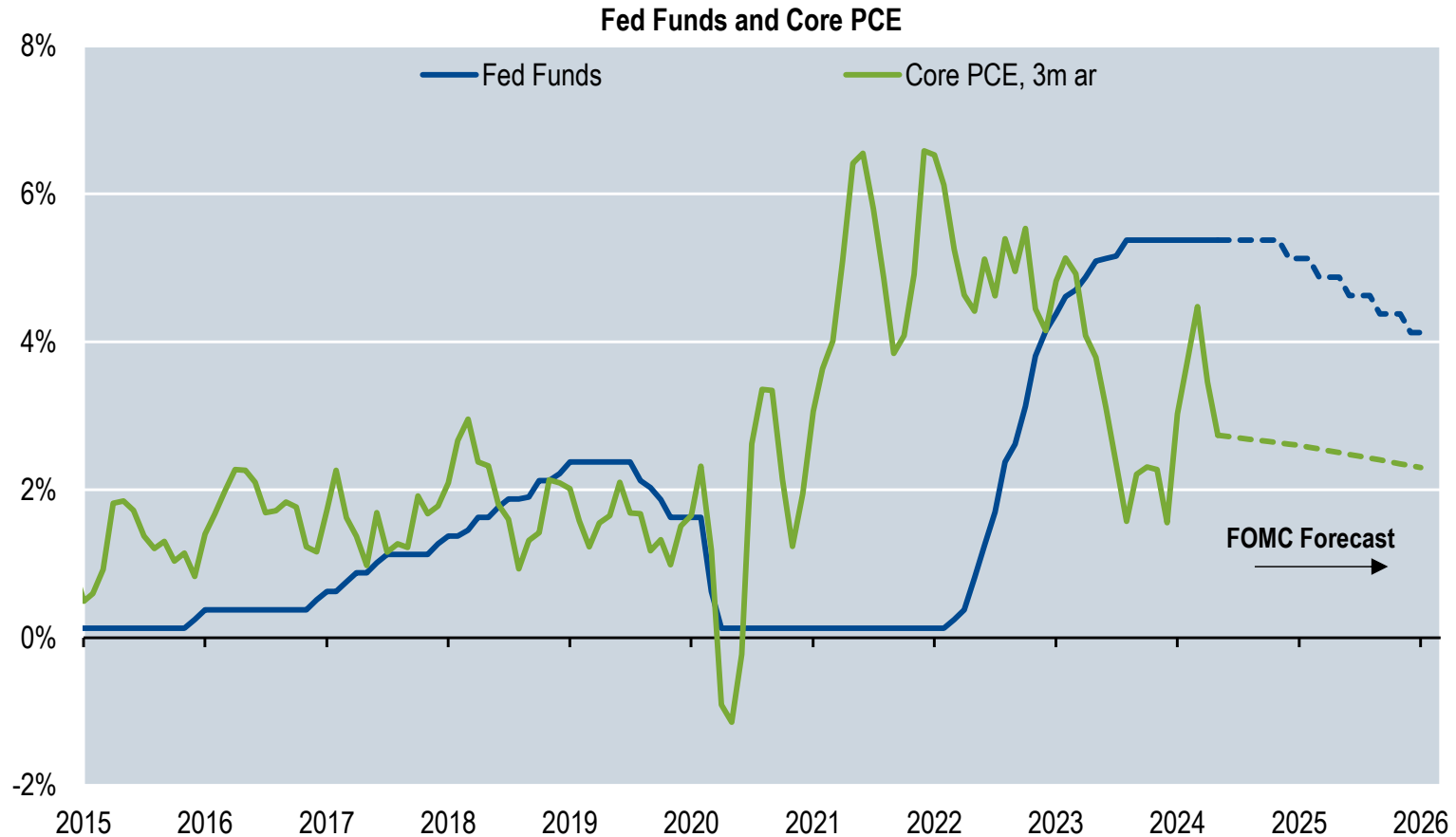
Source: Bloomberg. As of 30 Jun 24

US Federal Reserve

Still on track to cut

No “stag” or “flation”

– Chair Powell, May 1, 2024



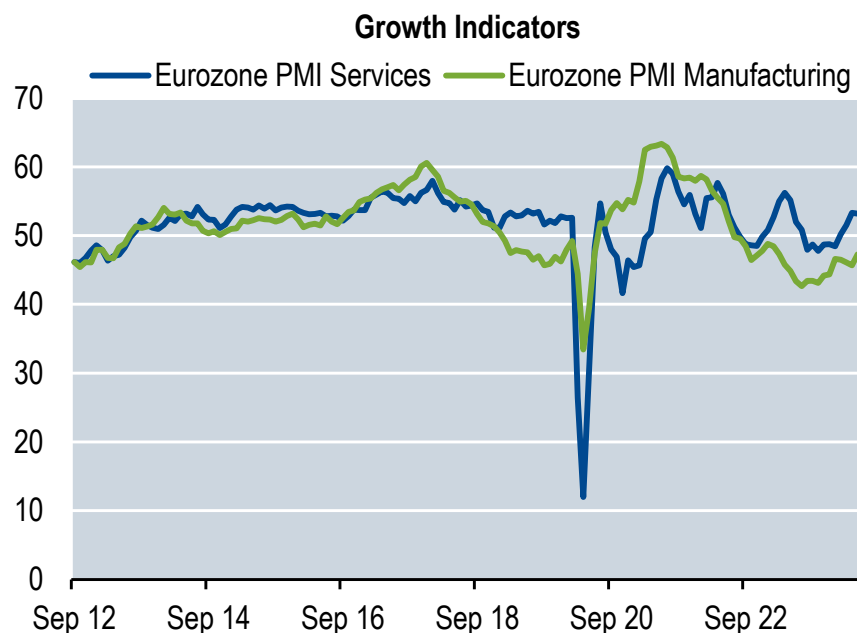
Source: Federal Reserve, Bureau of Economic Analysis, Haver Analytics. As of 31 May 24
There is no assurance that any projection, estimate or forecast will be realized.

Europe: Stagnant Growth with Inflation Closing in on Target

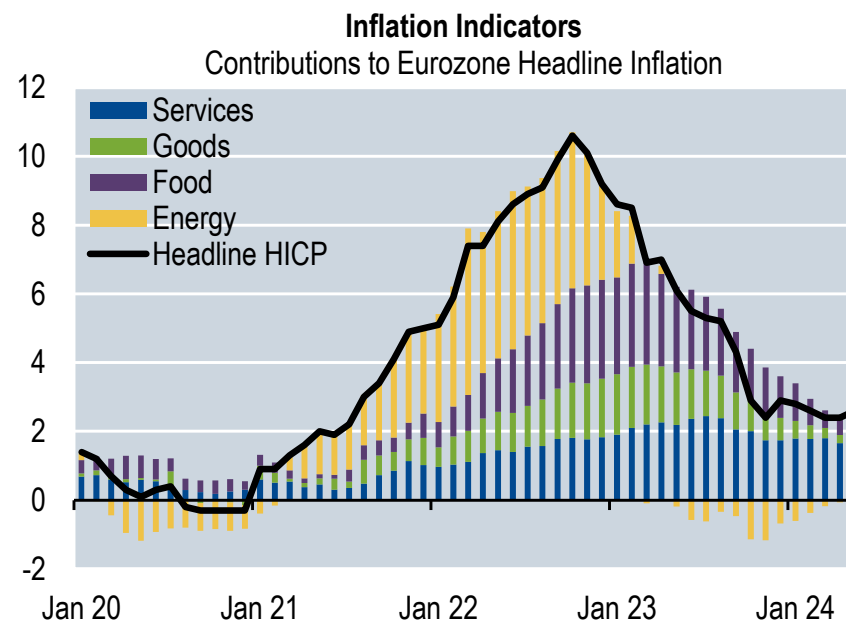
- Growth: Stagnation to modest expansion
- Inflation: Services/Core to begin downtrend
- ECB: Inflation concern ebbing. Two more cuts expected this year
- ECB: Policy historically tight given growth and inflation

	Policy	HICP	GDP
1999 to Current	1.50	2.09	1.39
Current	3.75	2.50	0.10

As of 30 Jun 24



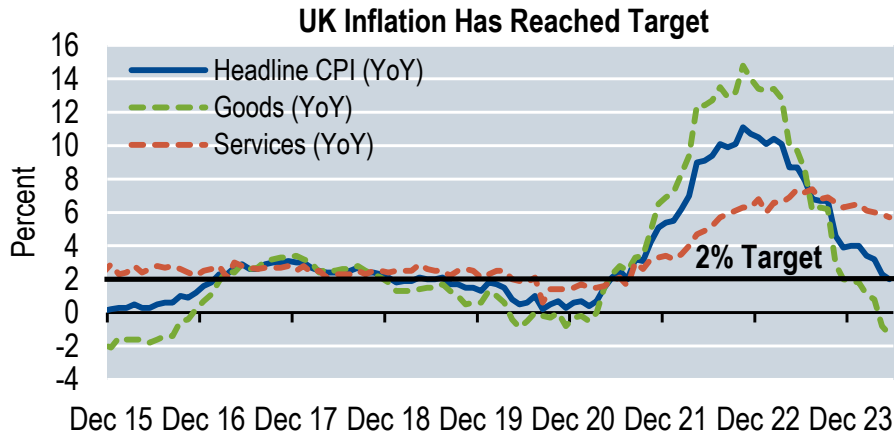
Source: S&P Global, Hamburg Commercial Bank, Haver Analytics. As of 31 May 24



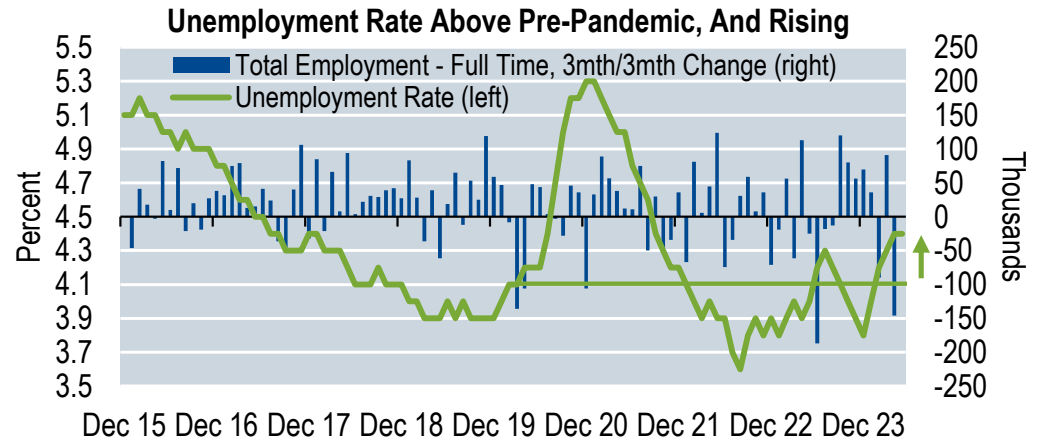
Source: S&P Global, Hamburg Commercial Bank, Haver Analytics. As of 31 May 24

United Kingdom

“Finely Balanced”



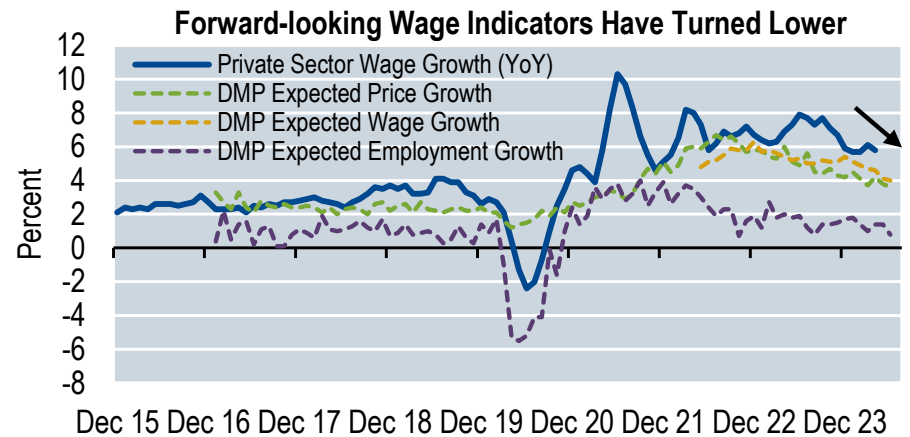
Source: Office for National Statistics, Bloomberg. As of 30 Jun 24



Source: Office for National Statistics, Bloomberg. As of 30 Jun 24

- Slack has returned to the labour market and hiring intentions have declined.
- Wage growth is expected to turn lower, alleviating concerns over domestic inflationary pressures.
- “With the progress we have made, to make sure that inflation stays around the 2% target, and is neither too high nor too low, it is likely that we will need to cut the Bank Rate over the coming quarters and make monetary policy somewhat less restrictive over the forecast period. Possibly more so than currently priced into market rate.”

– BoE Governor Bailey, May 9, 2024



Source: Office for National Statistics, BoE Decision Maker Panel. As of 30 Jun 24

The above reflects current opinions of Western Asset and are subject to change with market conditions.

China Secular Headwinds – Debt, Demographics and De-Globalization

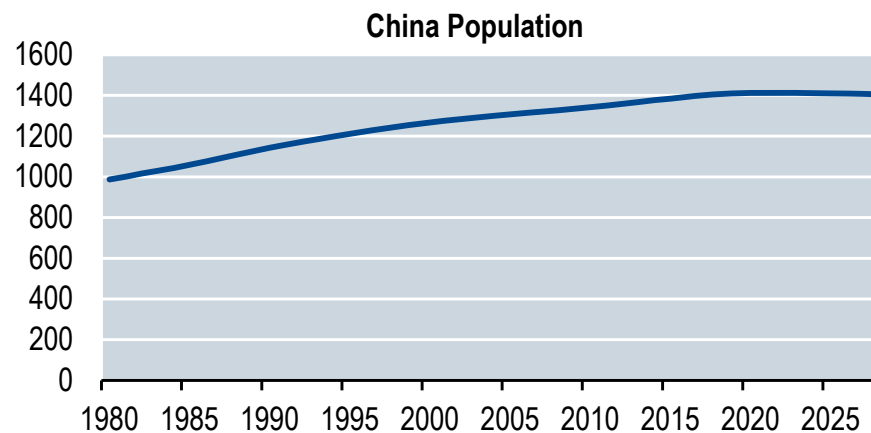
Likely constrain the pace of future growth

Increased debt likely constrains fiscal lever, diminishing returns of using fiscal lever ...



Source: IMF WEO April 2024

LT demand growth likely constrained by demographic trends ...



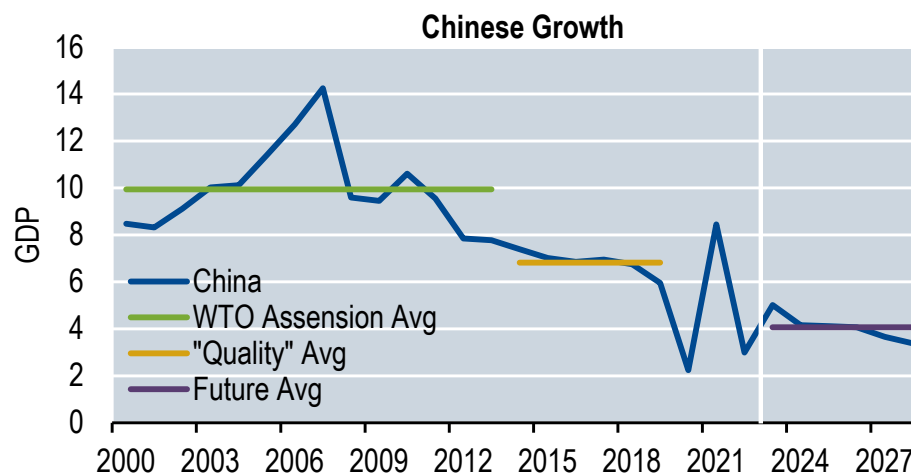
Source: IMF WEO April 2024

De-globalization likely has implications for investment and trade ...



Source: Bloomberg. As of 31 May 24

Lower market expectations for future growth rates ...



Source: IMF WEO April 2024, Western Asset

China: Despite Ongoing Cyclical & Secular Headwinds – 2024 Growth Target Achievable

Flashpoints

- Potential 60% tariffs under Trump 2.0 scenario
- Global pushback on Chinese industrial policies
- Third Plenum
 - Unlikely to see secular/structural shifts
 - Additional incremental policy support for housing sector can be expected

Due to regulatory policy and property market struggles confidence remains challenged...



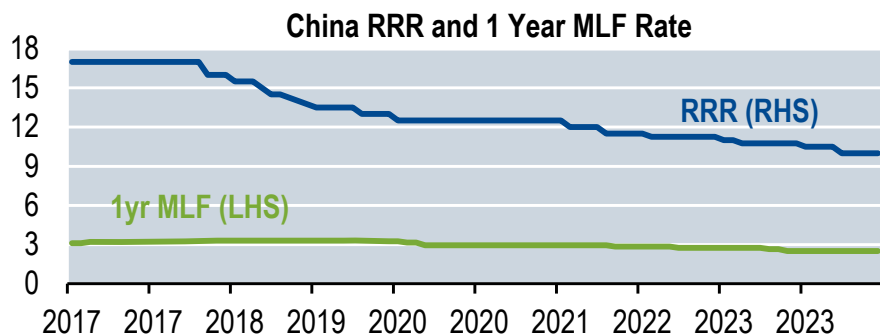
Source: Bloomberg. As of 31 May 24

And as a result, the Chinese are facing deflation not inflation...



Source: Bloomberg. As of 31 May 24

However monetary policy and recent regulatory support for the housing sector have been supportive at the margin...



Source: Bloomberg. As of 30 Jun 24

And Chinese buffers are more than adequate to stave off worse-case scenarios...



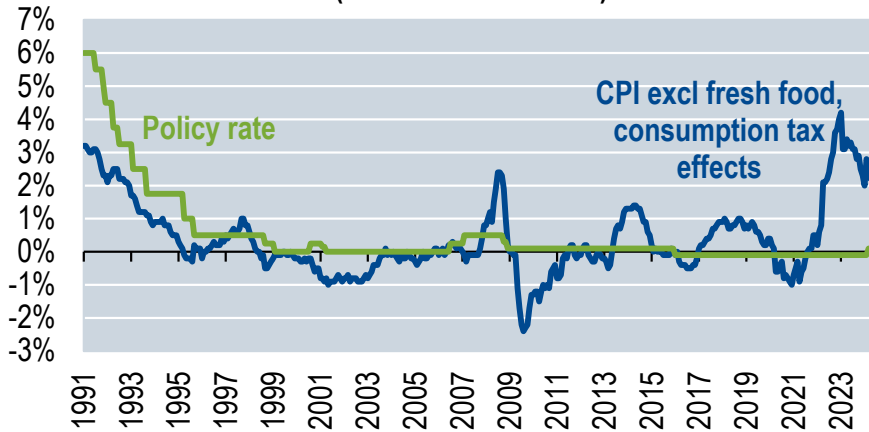
Source: Bloomberg. As of 30 Jun 24

Japan

Higher wages along with higher inflation forecasts strongly suggest Japanese yields need to rise

Policy rate

The BoJ will tighten policy to normalize real interest rates (it is now around -2%).



Source: Bloomberg. As of 31 May 24

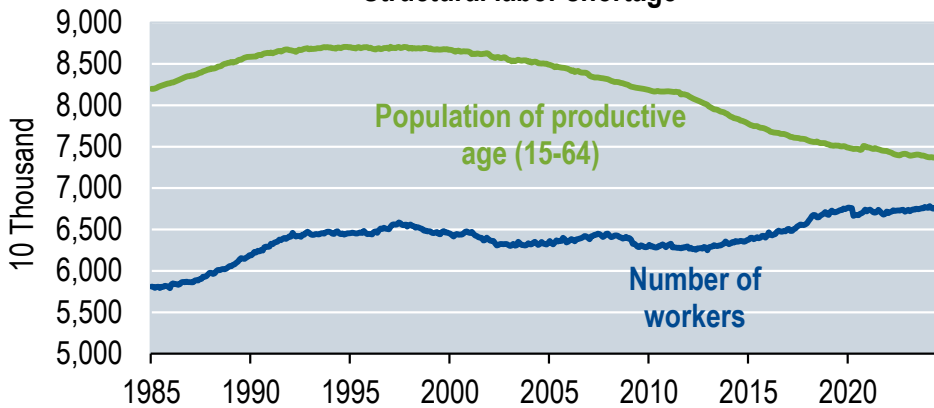
Japanese trade union confederation (Rengo in Japanese) released the preliminary data of the wage negotiation (Shun-to) results on March 15, 2024, i.e., +5.28% Y/Y, the highest level in 30 years.



Source: Rengo, Western Asset. As of 15 Mar 24

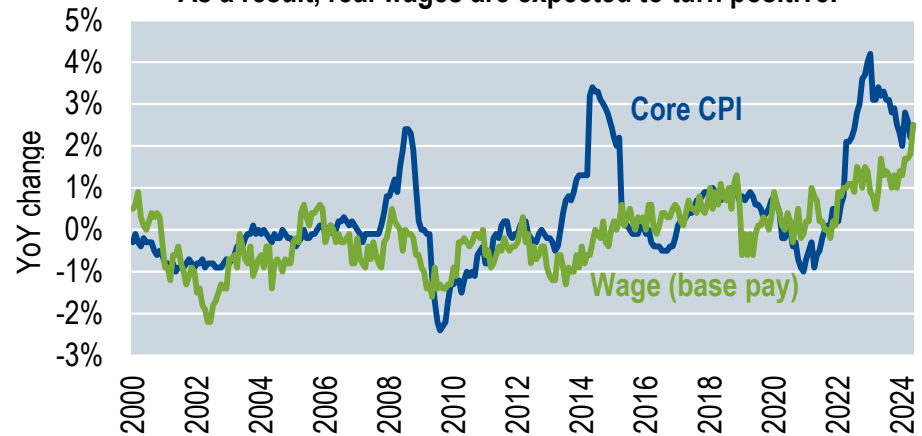
Labor Market

Structural labor shortage



Source: Datastream. As of 15 May 24

Wages are expected to rise to around 3.0-3.5% Y/Y over this summer due to the strong results of the spring labor negotiation. As a result, real wages are expected to turn positive.



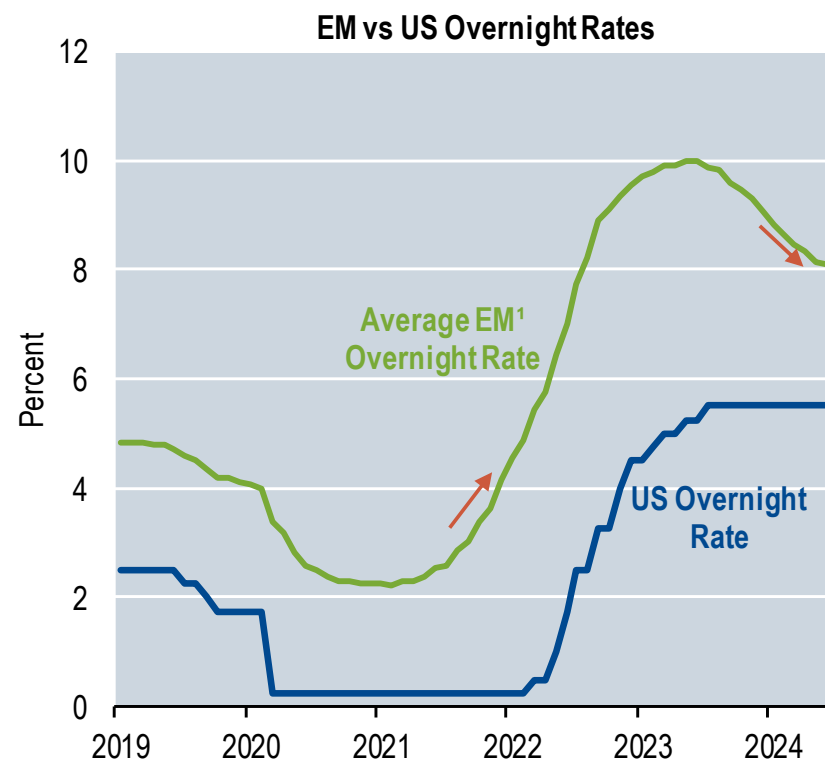
Source: Bloomberg. As of 31 May 24

EM Central Banks Have Been Ahead of the Curve

EM policymakers tightened policy aggressively, starting in early 2021 well in front of the Fed.

With both EM and DM inflation having peaked, EM central banks have already started to cut rates despite the Fed indicating no cuts in the US until late 2024.

EM central banks' response to the recent inflation scenario has provided stability for EM FX and the opportunity for investors to benefit from attractive local yields.

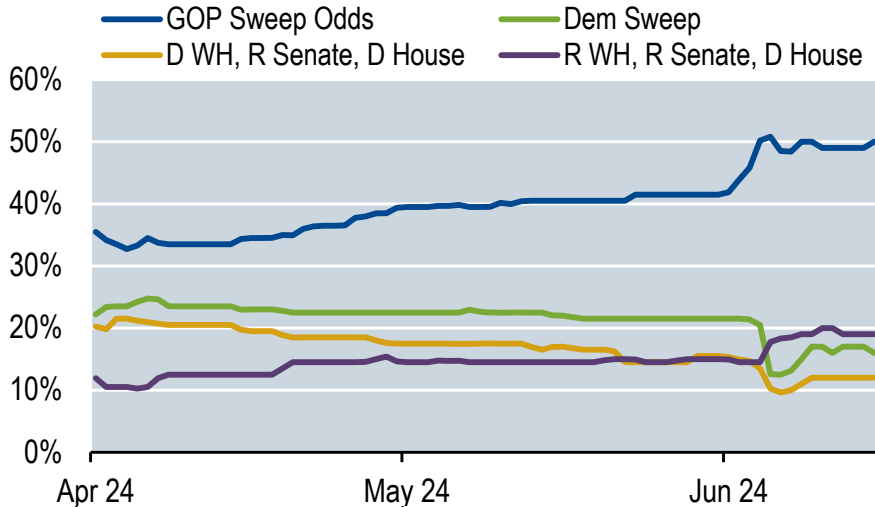


Source: Western Asset. As of 28 Jun 24

¹EM = Brazil, Mexico, Colombia, Hungary, Chile, South Africa, India, Indonesia and Poland

US Election...Difficult to Predict and Potential Market Impact

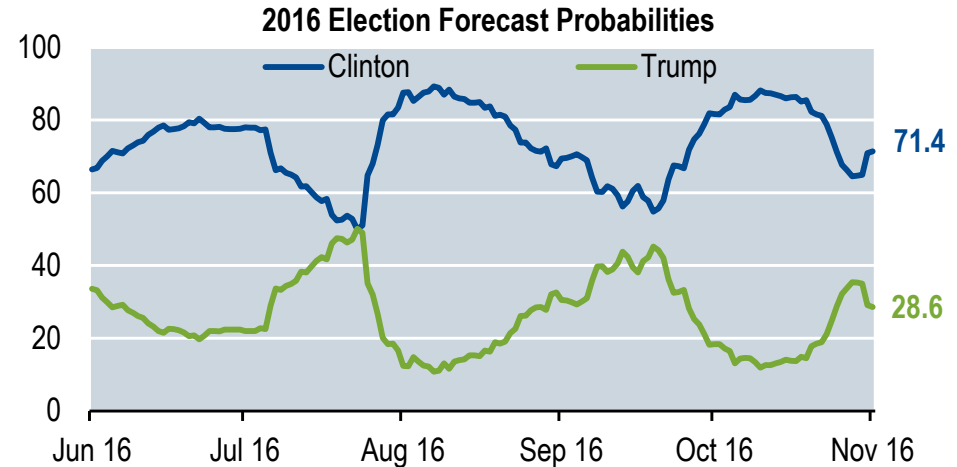
Betting Odds: 2024 Balance of Power (Polymarket)



Source: Strategas Securities. As of 09 Jul 24

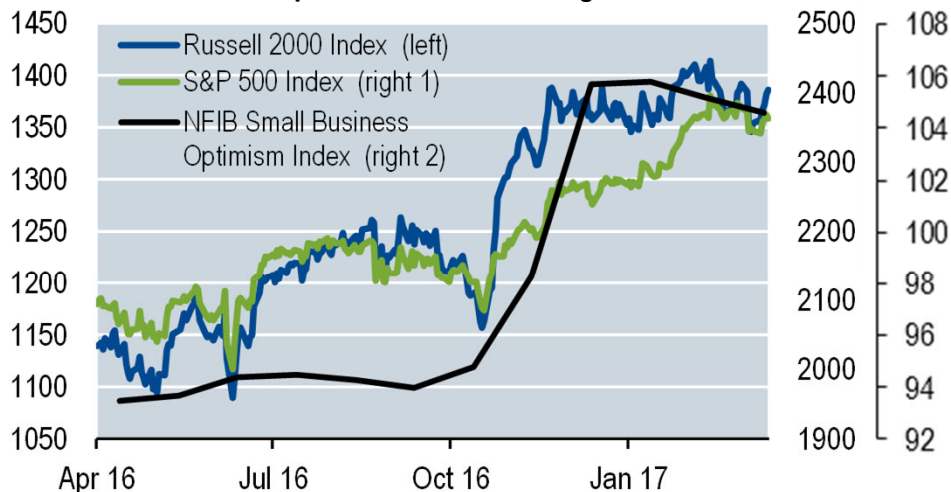
Election surprises have been the norm this year...France, India, South Africa, Mexico

Don't Forget 2016



Source: Strategas Securities. As of 09 Jul 24

Trump Would Push for Deregulation

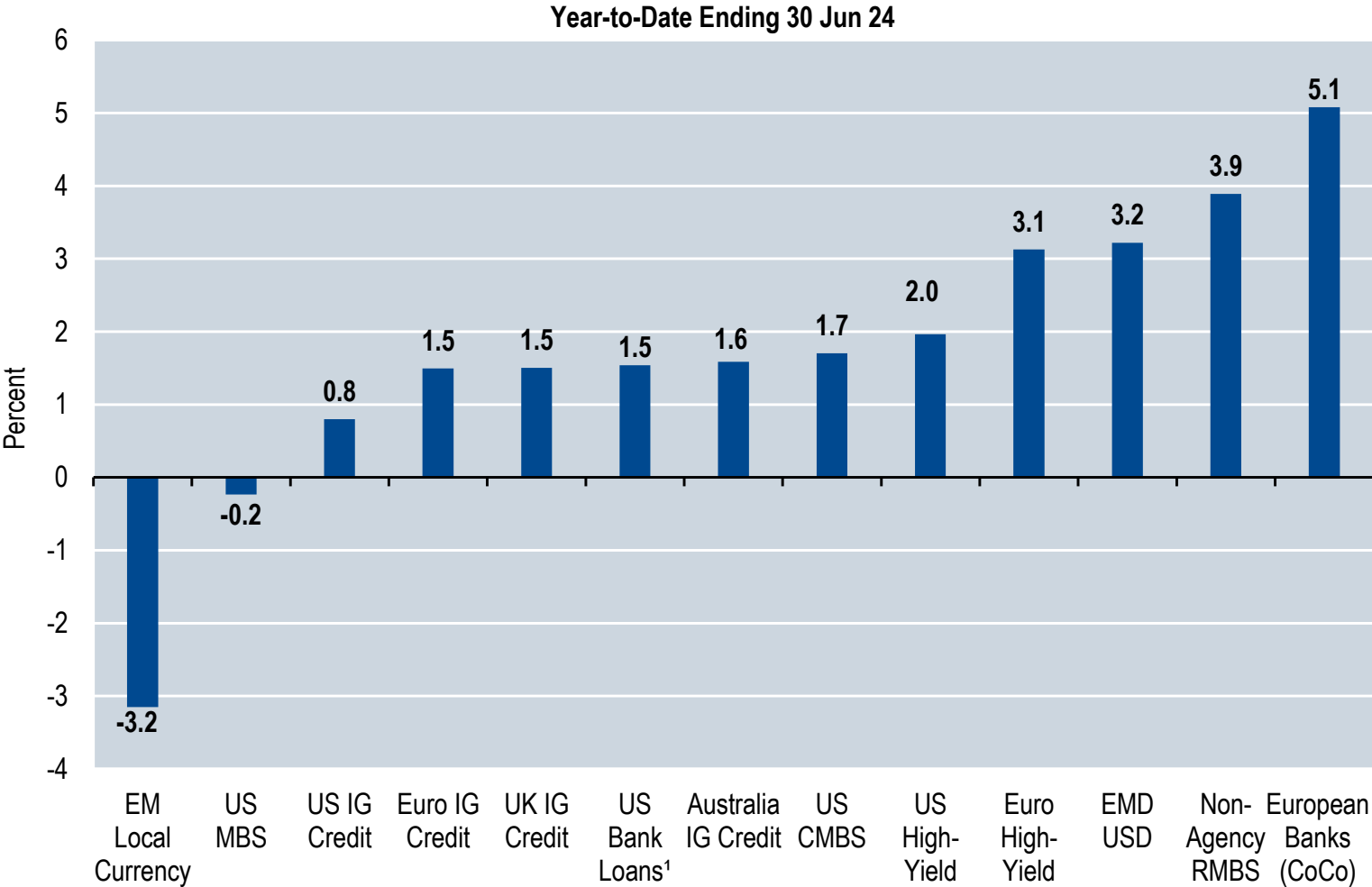


Source: Bloomberg. As of 31 Mar 17

Trump and the Stock Market

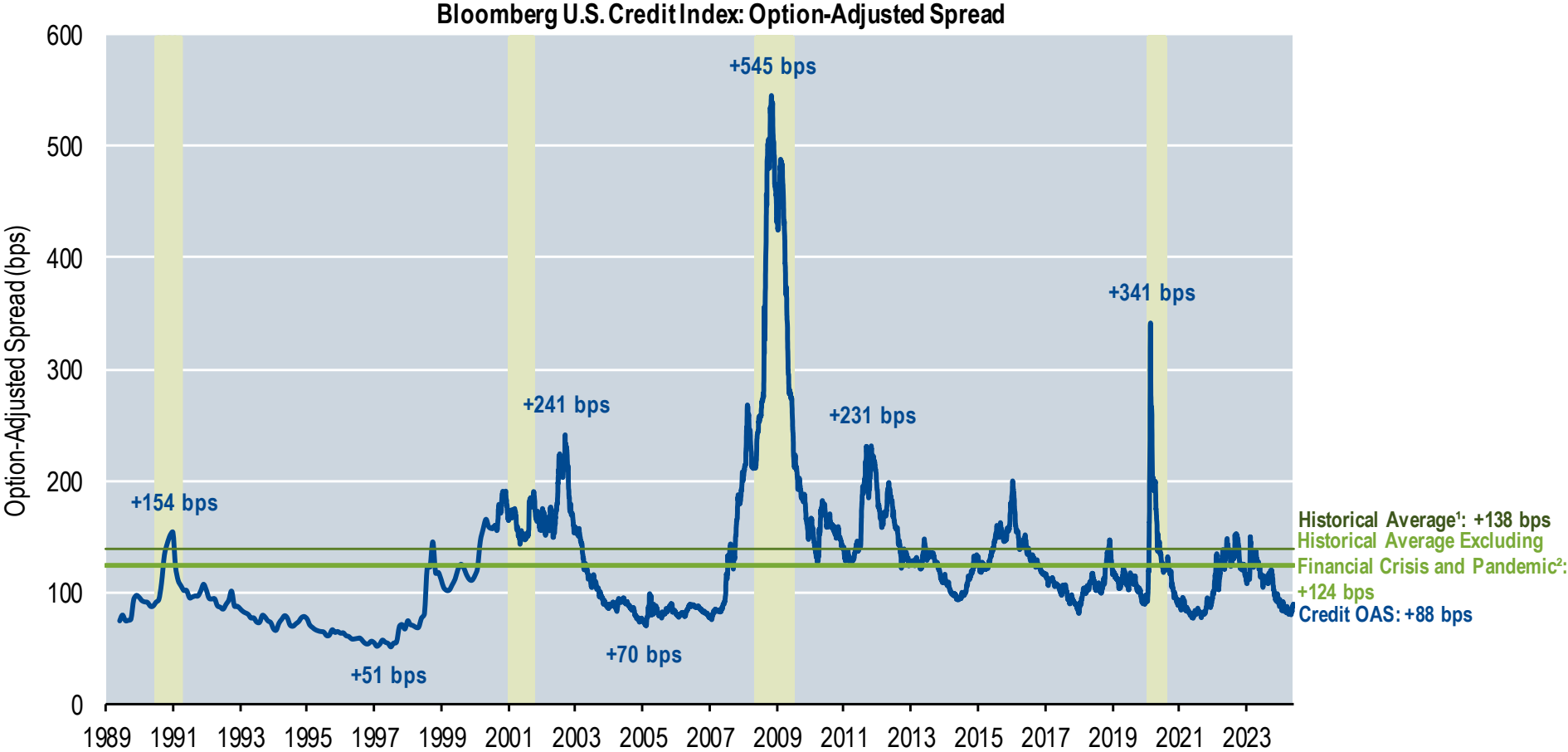
"But the reason our stock market is so successful is because of me. I've always been great with money, I've always been great with jobs, that's what I do. And I've done it well, I've done it really well, much better than people understand and they understand I've done well."

Spread Sector Excess Returns



Source: Bloomberg, Citi, J.P. Morgan, Morningstar LSTA, Western Asset. As of 30 Jun 24
¹Morningstar LSTA US Leveraged Loan Total Return Index excess return vs. SOFR - Secured Overnight Financing Rate USD Unhedged Index.
 Past performance is not a reliable indicator of future results.

Valuation: US Credit at +88 OAS, “Richly Valued”



Source: Bloomberg. As of 28 Jun 24
 Periods of recession highlighted in yellow
 ¹Average based on monthly data from 30 Jun 89 – 31 Jul 00, and daily end of business days from 15 Aug 00 to current
 ²Excludes data from 01 Dec 07 – 30 Jun 09, 01 Feb 20 – 31 Aug

The Two Tiers of the US Banking System

We prefer large US banks over regionals

	Regulatory Scrutiny	Balance Sheet Strength	Deposit Mix	Interest Rate Risk	Vulnerability to Confidence Erosion
Large US Banks	High	Very High	Diversified, Low Risk	Low	Low
Regional US Banks	Moderate	Moderate	Narrow, Medium Risk	Medium	High

Expectations:

- Large banks will get stronger while weaker regionals will consolidate
- Regulation (and issuance) will increase for regional banks
- Regional bank ratings will come under pressure

Source: Western Asset. The above reflects current opinions of Western Asset and are subject to change with market conditions.

Energy Companies

2022 About Deleveraging, 2023/2024 Capital Discipline, Upgrades and Mergers

Issuer	2022 Debt (\$mm)	2022 Change in Index Debt (\$mm)	Upgraded in 2023/ Positive Outlook
IG Energy Index Change in Debt Outstanding 2022		-42,408	
BP PLC	25,539	-5,000	Upgraded
Chevron Corp	14,687	-4,700	
Exxon Mobil Corp	29,500	-4,000	
Energy Transfer Partners LP	32,611	-2,643	Upgraded
Valero Energy Corp	7,598	-2,602	
TotalEnergies SE	11,850	-2,000	
Conoco Inc	12,860	-1,768	
Sabine Pass Liquefaction LLC	10,350	-1,468	Upgraded
Enterprise Products Operating LLC	25,975	-1,250	Upgraded 2x
Halliburton Company	7,600	-1,200	
Plains All American Pipeline LP	7,033	-1,100	Upgraded
Phillips 66	11,741	-1,032	
Canadian Natural Resources	7,250	-1,000	
Shell PLC	30,750	-1,000	
ONEOK	11,885	-925	Upgraded
Kinder Morgan Inc	24,168	-725	
TC Energy Corp	14,625	-625	
Williams Cos Inc	21,058	900	
Enbridge Inc	15,150	900	
MPLX LP	19,057	1,011	
IG Bond Index Change in Debt Outstanding 2022		321,300	

Source: J.P. Morgan, Bloomberg Finance L.P., Western Asset. As of 30 Nov 23

BB Energy Issuers and Change in Index Debt Outstanding 2022

Issuer	2022 Debt (\$mm)	2022 Change in Index Debt (\$mm)	Upgraded in 2023/ Positive Outlook
BB Energy Change in Debt Outstanding 2022		-13,537	
Occidental Petroleum	19,937	-8,126	Upgraded
Apache	5,037	-1,310	Upgraded
Petrofac Ltd	600	-600	Positive Outlook
Antero Resources	1,120	-979	Positive Outlook
Southwestern Energy	4,161	-573	Positive Outlook
Western Midstream Operating	6,256	-502	Upgraded
TechnipFMC plc	203	-430	
MEG Energy Corp.	1,971	-225	Upgraded
DCP Midstream Operating	4,275	-350	Upgraded
Murphy Oil Corp	2,044	-442	Upgraded

Source: J.P. Morgan, Western Asset. As of 30 Nov 23

The information provided is not a recommendation to purchase, sell, or hold any particular security and should not be construed as an endorsement of or affiliation with Franklin Templeton or Western Asset.

Mergers in 2023-2024

Acquiring Company	Target	Size (\$bn)	Date Announced
Phillips 66	DCP	3.8	Jan 2023
Targa Resources	Grand Prix	1.1	Jan 2023
Energy Transfer	Lotus Midstream	1.5	Mar 2023
Ovintiv	Multiple Targets	4.3	Apr 2023
Chevron	PDC Energy	7.9	May 2023
Conoco	Total-Surmont	3.0	May 2023
ONEOK	Magellan	18.9	May 2023
Patterson-UTI	NexTier	2.1	Jun 2023
Exxon Mobil	Pioneer Natural Resources	68.0	October 2023
Chevron	Hess	60.0	October 2023
Occidental Petroleum	CrownRock	12.0	December 2023
Chesapeake Energy	Southwestern Energy	11.5	January 2024
APA Corp	Callon Petroleum Company	4.5	January 2024
Diamondback Energy	Endeavor Energy Resources	25.9	February 2024
EQT Corporation	Equitrans Midstream	12.9	March 2024
Energy Transfer	WTG Midstream	3.3	May 2024
ConocoPhillips	Marathon Oil	22.5	May 2024
Total		263.2	

Source: Bloomberg. As of 31 May 24

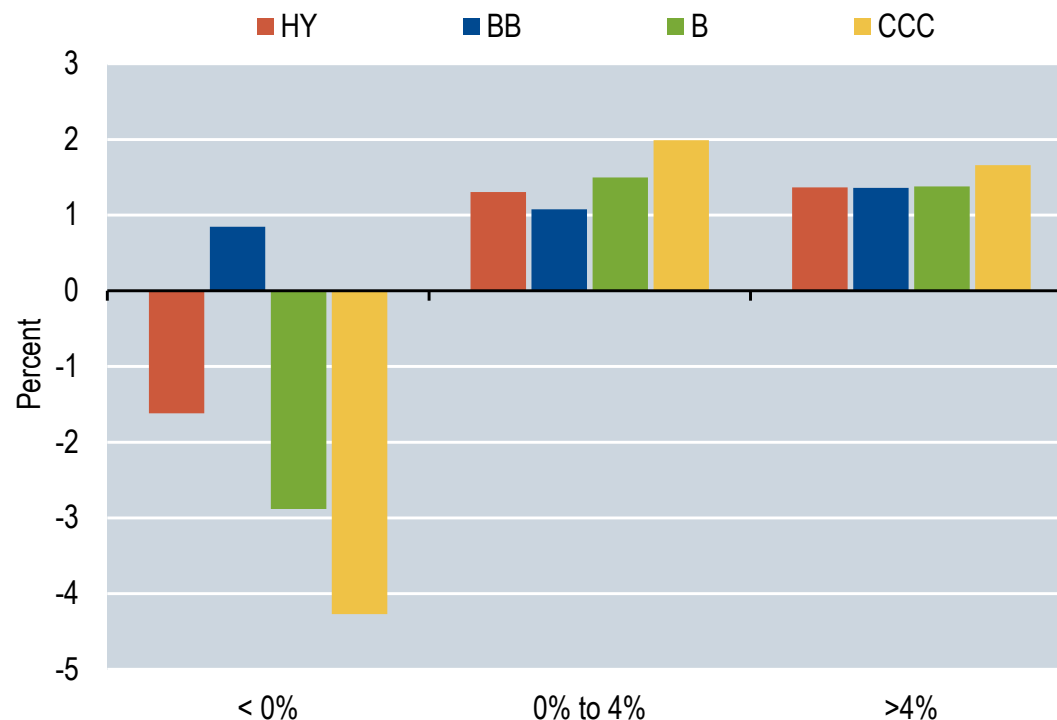
Moderate Growth Is the Sweet Spot for High Yield

In high growth periods or economic recoveries (>4% real GDP) is typically good for high yield, but it can sometimes be better for equity

Moderate growth (0-4%) can be the sweet spot, where high yield excess returns are strong, but you may see less shareholder friendly M&A at the expense of lenders

Low growth and recessions are typically bad for high yield as defaults pick-up, especially with lower quality credits

Median High-Yield Index Excess Returns by GDP Bucket

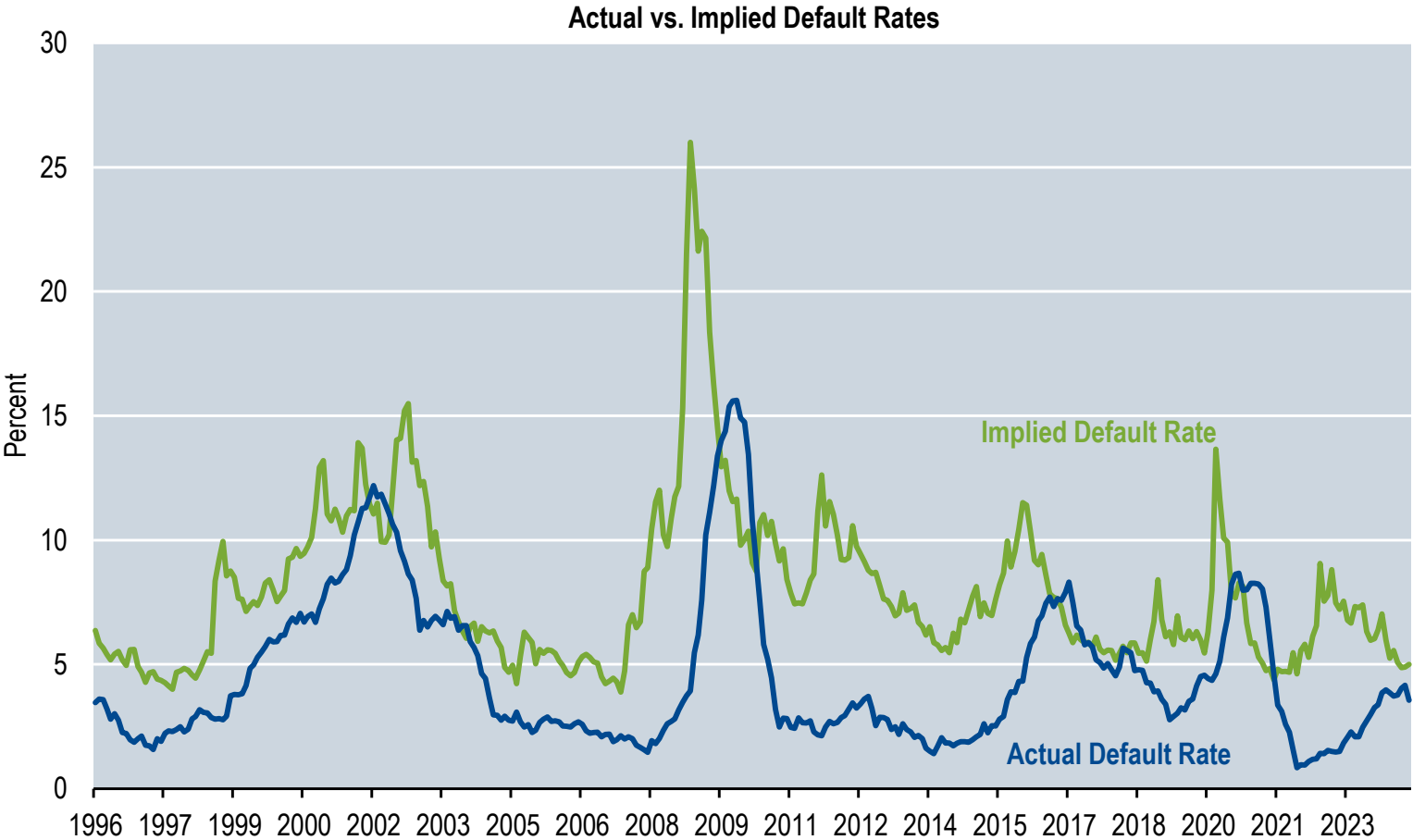


Source: Bloomberg, U.S. Bureau of Economic Analysis. As of 31 Dec 23

Past results are not indicative of future investment results.

Note: High-yield return data dates back to 31 Dec 92, GDP data dates back to 31 Dec 92

High-Yield Default Rate Off Record Lows

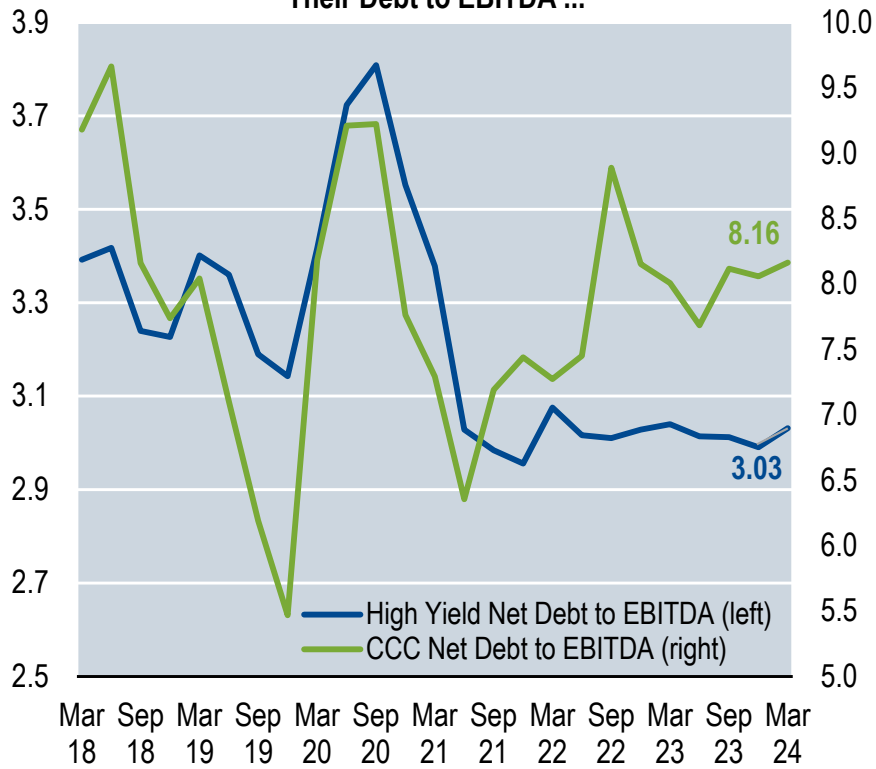


Source: Bloomberg, Western Asset. As of 31 May 24
Assumes 40% recovery rate

Fundamental Dispersion in High-Yield Supports an Active Approach

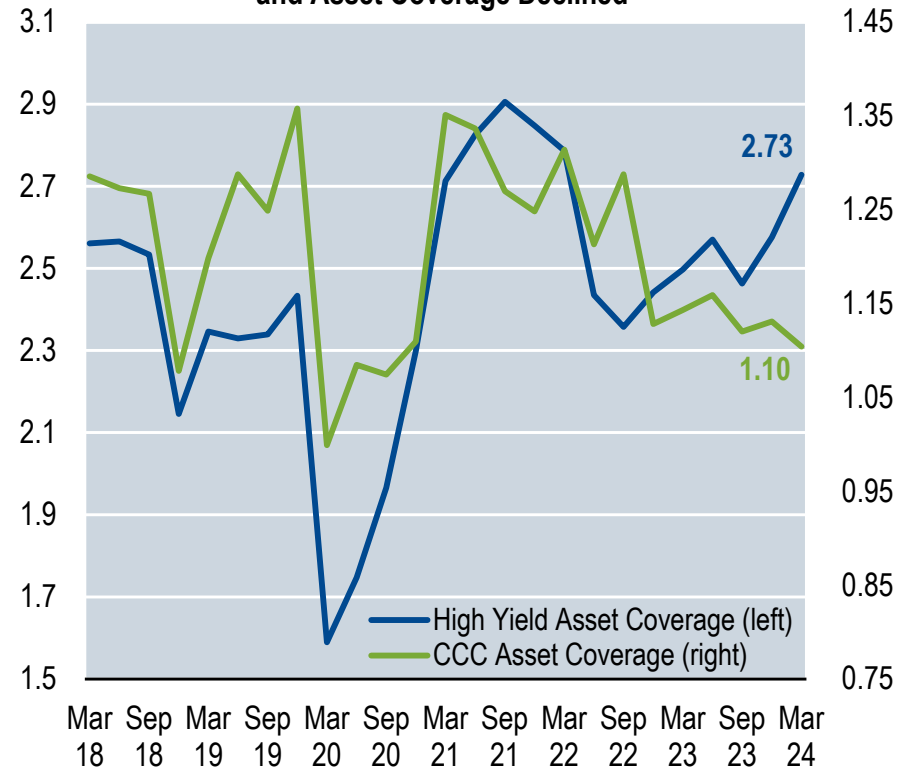
Fundamentals remain supportive on average, but not for the most levered CCCs

Many Companies Have Maintained Discipline With Their Debt to EBITDA ...



Source: Morgan Stanley. As of 31 Mar 24

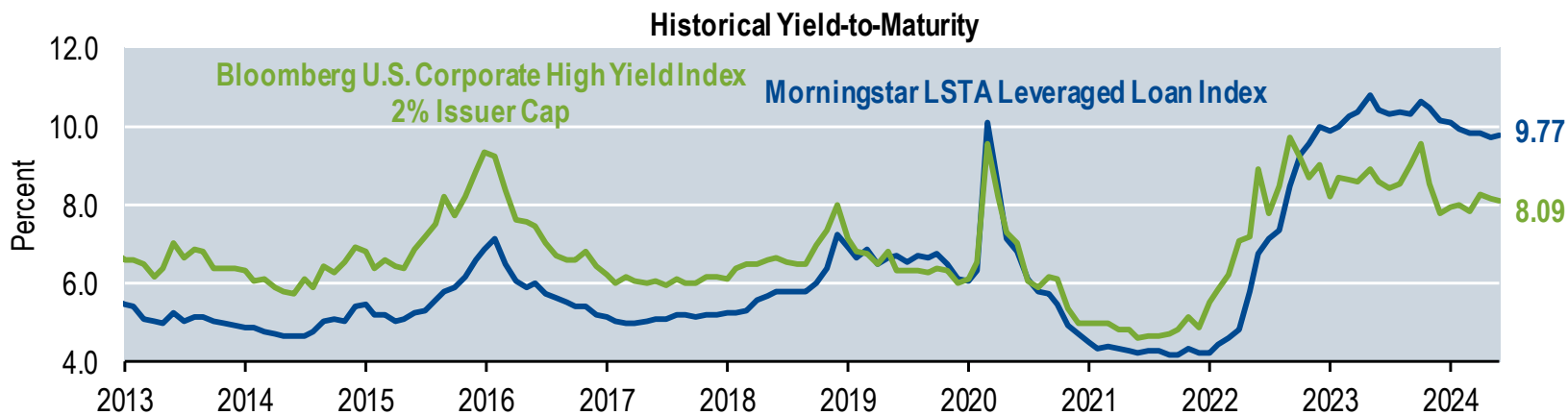
...However, CCC Companies Leverage Rose and Asset Coverage Declined



Source: Morgan Stanley. As of 31 Mar 24

Bank Loan Valuations Remain Compelling for Higher Quality Loans

Senior secured bank loans in the higher quality segment of the market exhibit attractive relative value and stable fundamentals with ample credit metrics. We continue to target BB credit profiles and select single-B credit profiles with moderate capital structures and strong fundamental profiles.



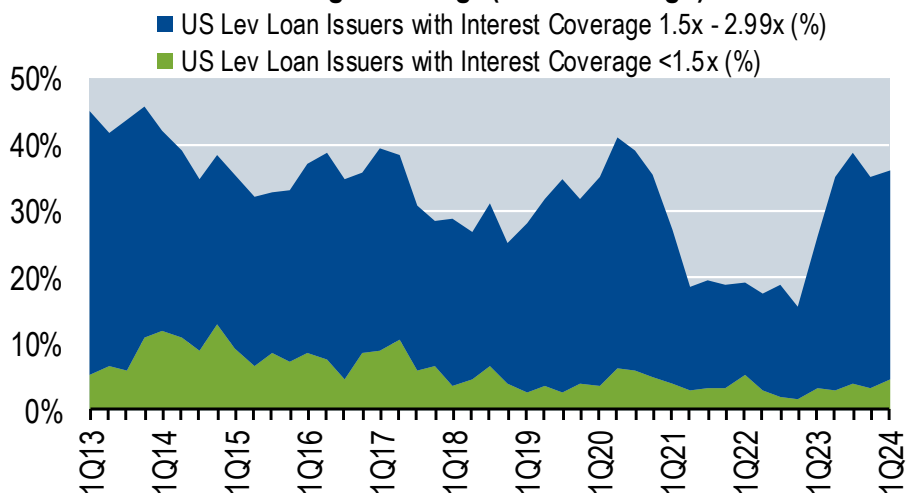
Coverage by Rating

By Rating	Coverage (EBITDA/Net Interest Expense)						
	1Q24	4Q23	1Q23	Q/Q change	Q/Q % change	Y/Y change	Y/Y % change
BB	4.25x	4.40x	4.89x	-0.14x	-3.30%	-0.64x	-13.00%
B1/B2	2.23x	2.26x	2.70x	-0.03x	-1.30%	-0.48x	-17.60%
B3	1.88x	1.80x	2.41x	0.09x	5.00%	-0.52x	-21.70%
CCC	1.84x	1.69x	1.56x	0.16x	9.20%	0.28x	18.20%

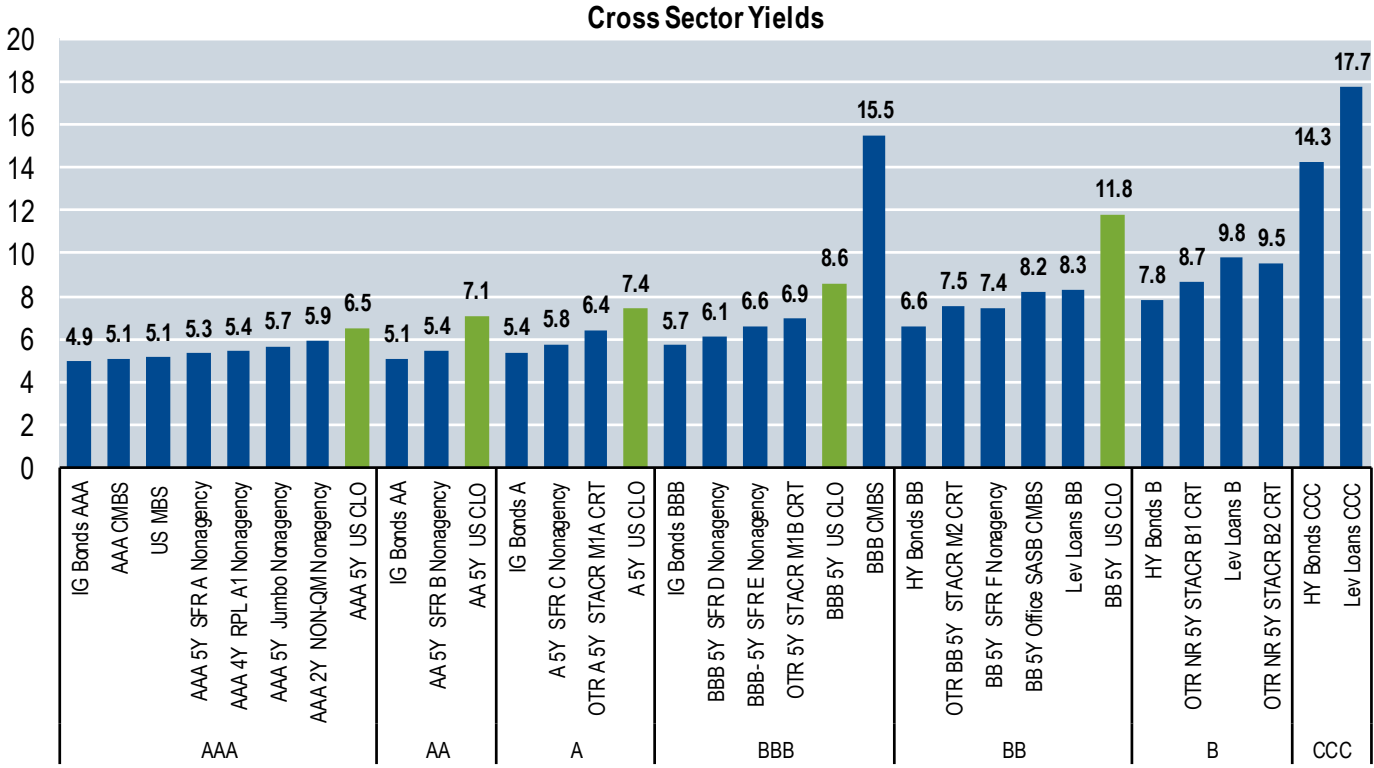
Sources: J.P. Morgan; Capital IQ; Bixby Research and Analytics Inc. As of 31 Mar 24

Note: Issuer ratings are computed based on Moody's tranche ratings. BB includes loans rated Ba1, Ba2, or Ba3 and CCC includes loans rated Caa1, Caa2, or Caa3.

Borrowers with High Leverage (<1.5x Coverage) Remains Low



CLO Capital Structure Yields Remain Attractive

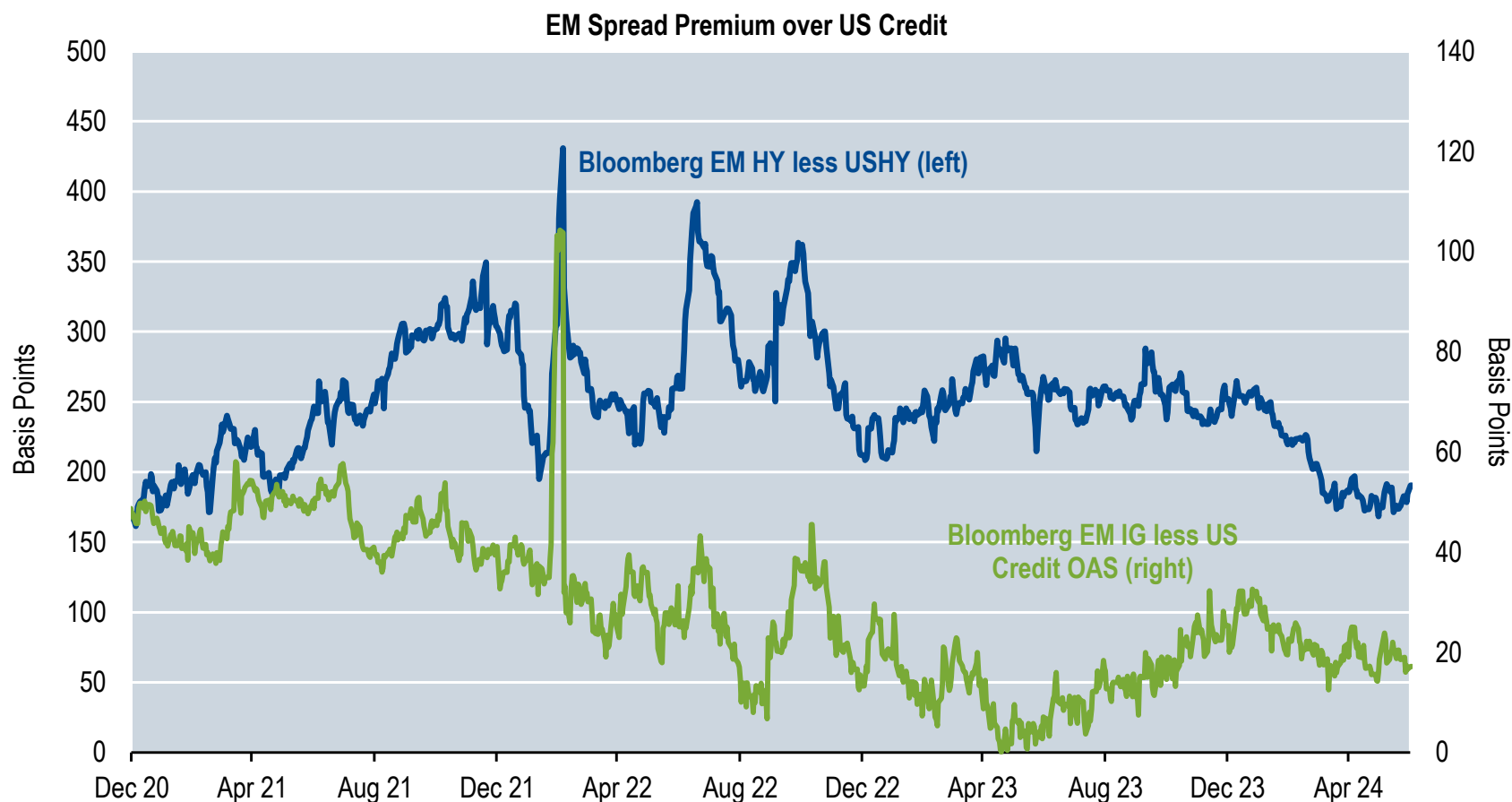


Source: BofA Global Research, Palmer Square CLO Indices, Bloomberg. As of 28 Jun 24

EM vs. DM Credit Relative Value

Investment-grade EM bond valuations screen as comparatively tight versus US investment-grade due to differences in ratings composition and technicals.

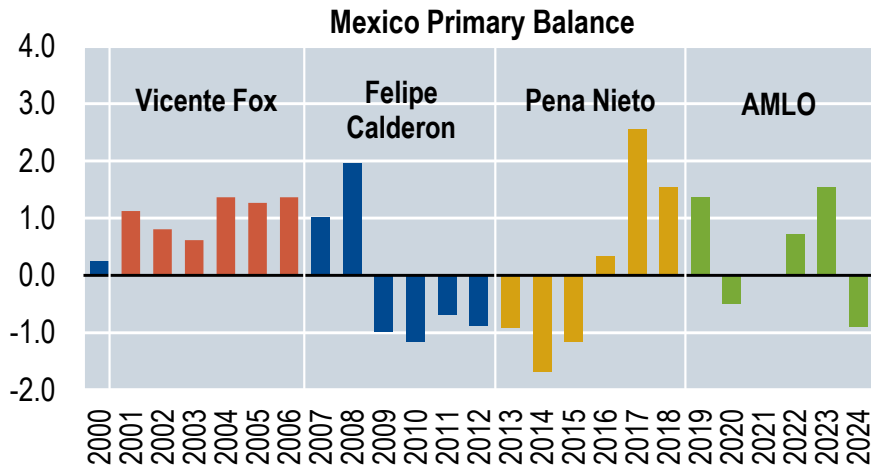
EM high-yield bonds, particularly those issued by Frontier sovereigns, have performed well year-to-date 2024 and continue to offer value given high carry and limited interest rate duration.



Source: Bloomberg. As of 30 Jun 24

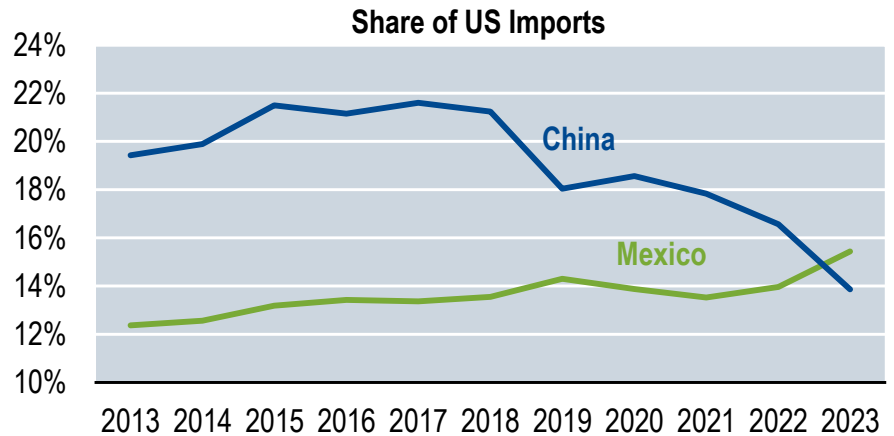
Mexico Local – Attributes of an Attractive Carry Trade

Tight Fiscal: AMLO ran reasonably tight fiscal accounts even through Covid and Claudia has signaled a similar approach...



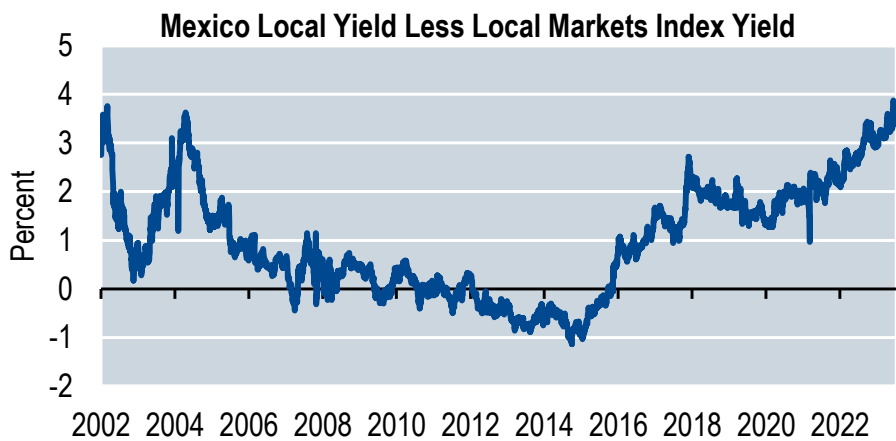
Source: IMF WEO April 2024

Beneficiary of Geopolitical Trends: Mexico likely to benefit further from nearshoring trends...



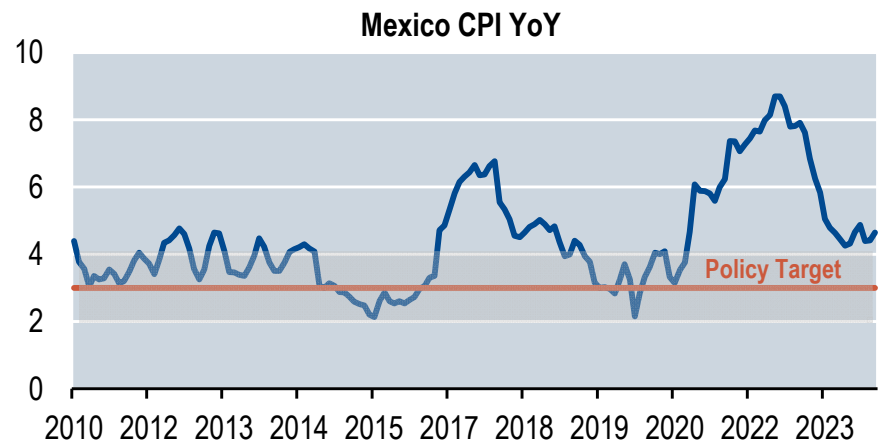
Source: International Trade Administration June 2024

Attractive Yields: Mexico nominal yields are historically high...



Source: Bloomberg, J.P. Morgan. As of 08 Jul 24

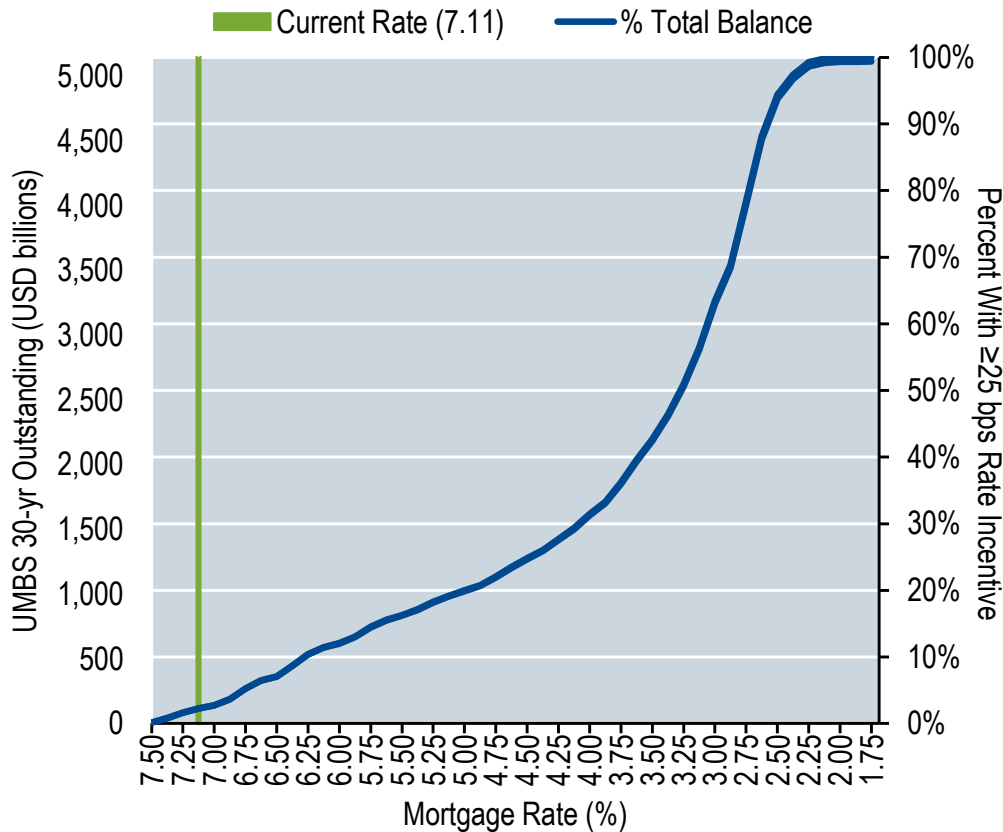
Inflation Near Target: Disinflationary process well under way...



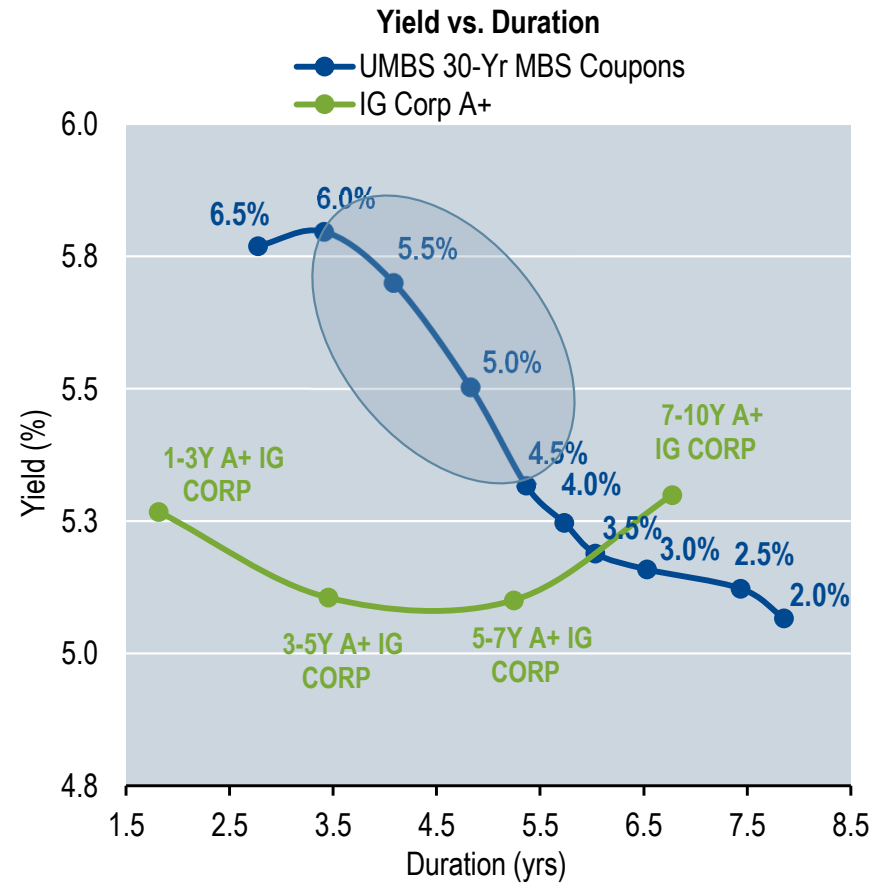
Source: Bloomberg. As of 30 Apr 24

Agency MBS Are Attractive With Low Prepayment Risk and No Credit Risk

- With current mortgage rates at 7% and the average borrower locked into a sub 4% rate, prepayment risk is low
- Agency MBS offer yield pick over A+ Corporates in higher coupons



Source: CPRCDR, Mortgage Bankers Association, Western Asset. As of 30 Jun 24



Source: Bloomberg. As of 30 Jun 24

Mortgage Credit Offers Attractive Relative Value

- While real estate prices are expected to cool from the record increases, market spreads are elevated with increased risk premiums
- During the housing boom of Covid, lending stayed conservative and single-family markets remain well supported by long-term fundamentals
- Commercial real estate sector has largely been able to pass on the cost of higher interest rates in rents at hotels, apartments and industrial properties, while the office sector faces continued headwinds from Covid

Spreads	Representative RMBS CRT Below IG*	BAML RMBS Legacy Below IG	Bloomberg Non-Agency CMBS BBB	Bloomberg US IG Corporate	Bloomberg US High Yield
31 Jan 20	178	123	306	102	390
28 Jun 24	218	202	813	94	309
Difference Since 31 Jan 20	40	78	506	-8	-81
31 Dec 18	246	127	367	153	526
28 Jun 24	218	202	813	94	309
Difference Since 31 Dec 18	-28	75	446	-59	-217

Source: Bloomberg, Bank of America, Western Asset. As of 28 Jun 24

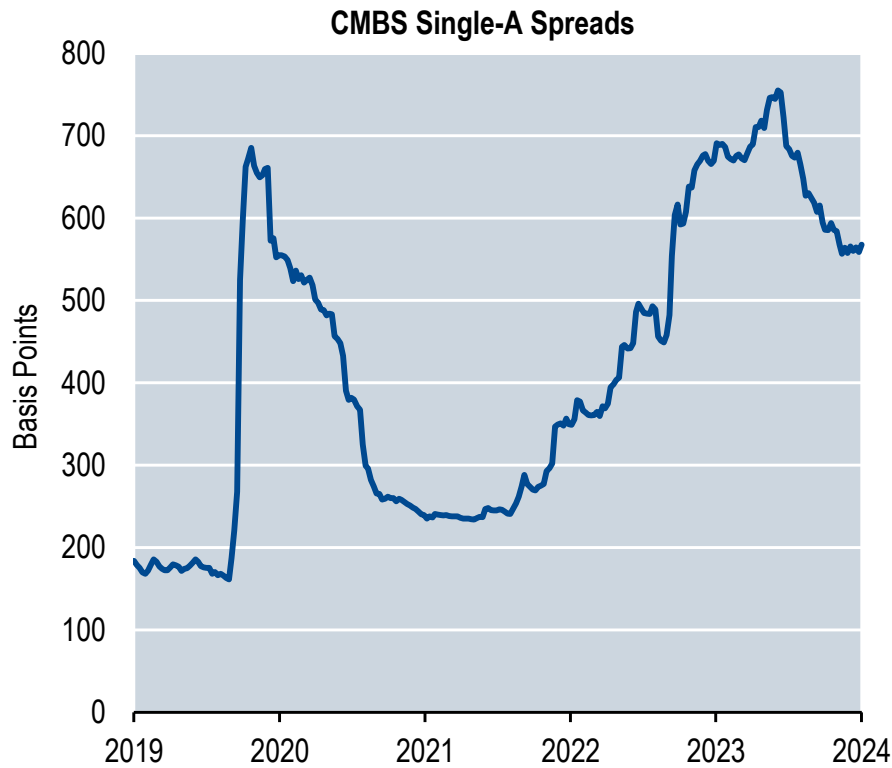
Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situations or needs of investors.

*Representative RMBS CRT Below IG: On-the-run speed adjust spread for below investment-grade rated CRT cohort

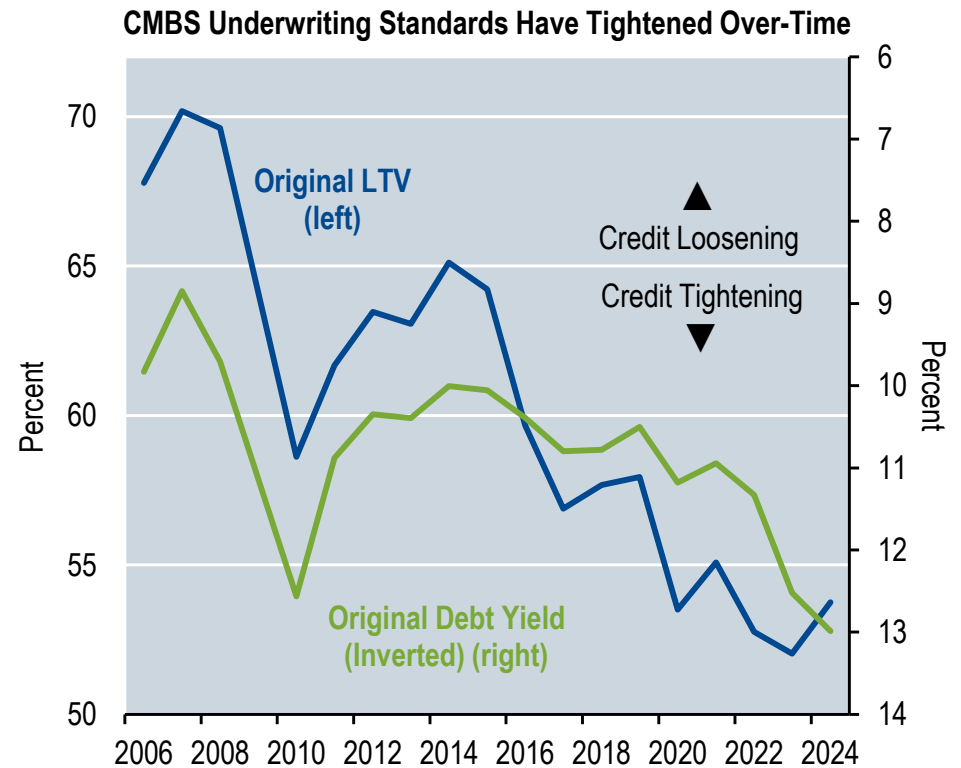
Past performance is not a reliable indicator of future results.

CMBS Market Recovery Is Underway

- CMBS spreads have outperformed to start the year but the credit curve remains steep to historical norms
- Underwriting standards have tightened, exhibiting among the lowest LTVs and highest debt yields in market history
- YTD 2024 CMBS issuance exceeds YTD 2023 by > 200% and is on pace with the trailing 15-year average



Source: JP Morgan. As of 28 Jun 24



Source: Trepp. As of 28 Jun 24



Thank you.

Risk Disclosure

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