FIRST QUARTER 2025

WESTERN ASSET
A Franklin Templeton Company

The Big Picture

Western Asset's latest insights on economic drivers and credit markets for fixed-income investors

Michael Buchanan, CFA

Chief Investment Officer

"We anticipate a strong year for fixed-income markets, driven by attractive yields and opportunities in select spread sectors. We see value in certain DM government bonds, including those in Australia, the UK and broader Europe. We also see opportunities in certain credit investments, including structured credit, especially commercial real estate and CLO tranches, as well as higher-rated bank loans. Potential volatility, particularly with the new US administration, highlights the importance of active management."

1Q25 HIGHLIGHTS

- We are optimistic about fixed-income returns in 2025 given the prevalence of higher available yields.
- While global growth is downshifting, we expect it to remain positive. US growth should continue to outpace most other developed markets.
- Inflation globally is now very close to central bank targets, although there are inter-country discrepancies, such as stubborn inflation in the US (an outlier among DM economies). The overall trend gives central banks room to cut policy rates.
- Spread sector fundamentals should remain supportive, and current valuations reflect this.
- We see opportunities to hold duration in select developed markets such as Australia, the UK and in core Europe, as well as in short-dated USTs.
- Select parts of the securitized and corporate bond markets offer attractive return potential.

OVERVIEW

Global growth has slowed, and inflation rates have declined markedly across both developed market (DM) and emerging market (EM) economies. Our base case calls for these trends to persist. Goods price inflation is running modestly below pre-pandemic levels and, with ongoing deflationary pressures from Asia, it's hard to envision a meaningful persistent uptick. Services inflation should continue to slow as wage pressures abate with the softening jobs market and slower demand in the service sector. The inflation backdrop has generally allowed key DM central banks to begin reducing policy rates at a time when the growth backdrop is calling for less restrictive policy; however, the US remains an outlier among DM economies with its stubbornly higher inflation. The global growth trajectory, however, is highly dependent on US government policy outcomes. We remain overweight to interest-rate duration, particularly given the recent rise in yields. We see value in Australia, the UK and in core Europe, as well as in short-dated US Treasuries (USTs) that are less susceptible to the uncertain outlook for US fiscal policy. Spread sectors have performed well, and we expect this to continue. However, valuations are trading at or through historical averages. We see value in select sectors and names. EM debt appears to remain fundamentally attractive, but both internal and external political risks have hampered performance in some countries.

Richard A. Booth

Portfolio Manager

"Economic activity in the UK has been subdued, and the BoE is expected to continue gradually easing policy restrictions. Inflation is expected to fall back to target by 2Q25, driven by declining services inflation. The ECB is likely to reduce policy rates to 1.75% by year-end. We maintain a modestly overweight duration position in both the UK and core-European bonds and an underweight in the euro."

KEY DRIVERS AND RELATIVE VALUE BY REGION

US: Soft Landing on Track

+	The US economy should expand near trend well into 2025, buoyed by housing and consumer demand. Core inflation should continue to run near the Federal Reserve (Fed) target level of 2%. US bond yields remain high relative to pre-pandemic growth and inflation levels. Market uncertainty about Trump administration policy changes could lead to market volatility in early 2025.	

EUROPE: Lacklustre Growth as Inflation Returns to Target in 1H25

+	Prospects for economic growth in the eurozone remain challenged. We expect inflation to fall back to target in Q2 led by falling services inflation. The European Central Bank (ECB) is expected to reduce policy rates to 1.75% by year-end. We remain modestly overweight duration via both nominal and real yields while maintaining a small underweight in the euro.	

UK: Gradual Removal of Policy Restraint to Continue

+	Recent economic activity has missed expectations and is likely to remain subdued. While the Bank of England (BoE) will have to monitor the impact of October's budget, surveys suggest that the passthrough to prices is likely to be modest while the labour market should further weaken. This would allow the BoE to continue to gradually remove restrictive policy.	

CANADA: Data Tug of War Continues

+/−	With core inflation running at target and a near-neutral policy rate, the Bank of Canada is likely to pause further action. Slowly improving indicators should reduce slack in the economy, and a modest bottoming out in residential real estate is already apparent. However, domestic political uncertainty must now contend with US trade restrictions as major obstacles for the economy and Canadian dollar.	

AUSTRALIA: Gradual Removal of Policy Restraint to Begin Soon

+	The Reserve Bank of Australia (RBA) rhetoric had been hawkish up until December 2024. Although core inflation continues to show progress toward the RBA's target, the RBA now appears to be showing some concern that the higher rates are taking a toll. Our portfolios are moderately long duration as we expect yields to move lower as the RBA cautiously eases; however, market volatility is likely to keep this position active.	

JAPAN: Higher Rates Ahead

+/−	We expect Japan's economy to grow 1.5% in the first half of 2025, led by the recovery in private consumption and strong business investments. Inflation is likely to remain above 2%. As such, we expect the Bank of Japan to raise policy rates at a cautious pace. This should result in higher Japanese government bond yields and yield-curve flattening.	

CHINA: Structural Challenges Persist; Policymakers Responsive

+/−	Recent measures by the Chinese government signal attempts to revive investor sentiment and consumer confidence. However, there is no shift from the structural goals of limiting leverage growth and de-risking the property sector. Although deflationary pressures persist and confidence is weak, policymakers appear ready to do more, albeit still in a moderate form.	

MEXICO: Awaiting Trump 2.0

+	Market sentiment continues to be dominated by the country's fiscal challenges and the uncertainty surrounding US trade policy under Trump. We remain biased toward local rates over FX, as Banxico is expected to proceed with its easing cycle given the high real rate environment, ongoing disinflation trends and the potential for additional easing by the Fed.	

INDIA: Fundamentals, Valuations and Technicals Favor Indian Bonds

+	While GDP growth forecasts were lowered to the mid-6% range for FY25, these levels are still trending higher than regional peers on average. With Consumer Price Index (CPI) inflation moderating, the bias is for looser monetary policy. Despite recent portfolio outflows, India is backed by substantial FX reserves. Bonds are expected to outperform given attractive carry and tailwinds from EM bond index inclusion.	

BRAZIL: Facing More Fiscal Pressure

+	The Brazilian real has already factored in several pessimistic elements, which we anticipate will correct over time. However, the absence of sustainable fiscal policy measures will continue to weigh on the currency despite tighter monetary policy by the central bank over the coming months.	

Ryan J. Kohan

Head of Bank Loans

"We believe companies that issue bank loans will benefit from a stable fundamental backdrop and lower interest costs. With this backdrop, we continue to favor BB rated bank loans for stable, carry-driven returns. We also will target single-B rated loans in select sectors for compelling interest carry and total return potential. For more total-return-focused mandates, we continue to favor BBB rated CLOs."

WESTERN ASSET SECTOR THEMES	
Investment-Grade (IG) Corporate Credit	
In the US, fundamentals remain strong for IG corporates as balance sheets are positioned to withstand economic uncertainty and management teams continue to exercise caution. Demand for IG corporates has kept pace with robust supply. We expect this trend to continue for the next quarter as the rates market has priced in more attractive yields for corporates. Given strong fundamentals and positive technicals, valuations appear fairly priced.	+
In Europe, IG fundamentals are more challenged in some sectors, such as autos, but bank balance sheets remain strong. Spreads continue to look relatively tight, but we see value in European banks and utilities. We are more selective on real estate issuers given strong performance during 2024. Record levels of supply are being absorbed by ongoing inflows into the asset class.	+/–
In Australia, fundamentals remain sound despite the economy slowing due to defensive balance sheet positioning. We maintain an overweight in credit, particularly in short-dated holdings, with a preference for select REITs and utility/infrastructure assets that have regulated resets. We also favor senior unsecured major bank and foreign national champion bank issuance.	+
High-Yield (HY) Corporate Credit	
In the US, HY credit spreads reflect balance sheet strength, the prudent behavior of management teams and supportive demand for higher yielding securities relative to supply. We continue to see some opportunity in service-related sectors that are still recovering from the pandemic-era recession, and in energy (E&P) and potential rising stars. We are more cautious on consumer products, retailers and home construction.	+
In Europe, corporate fundamentals remain fairly sound. Primary issuance continues to be dominated by refinancing activity. We remain selective with a BB/B rating focus as spreads remain tight and rangebound.	+/–
Bank Loans	
Bank loan yields remain particularly attractive relative to fixed coupon alternatives, and we anticipate further spread compression by year-end. We continue to expect a stable (i.e., 5%-6%) coupon-driven return from BB loans with strong underlying credit quality. We believe stable value will come from well-capitalized companies in industrials, while we are finding total return opportunities in select areas of health care, media and technology sectors.	+
Collateralized Loan Obligations (CLOs)	
We see more opportunity in AAA, BBB and select BB rated debt tranches of CLOs that are invested in broadly syndicated bank loans. We believe that AAAs and BBBs should continue to perform well in either bullish or bearish bank-loan-spread environments, given strong structural protections. BB CLO spreads are close to their 5-year tights, but all-in yields on select BBs remain attractive at 10%-11% given a higher 3-month SOFR base rate.	+
Mortgage and Consumer Credit	
Agency mortgage-backed securities (MBS) offer attractive spread valuations with low prepayment risk. We favor 30- and 20-year over 15-year MBS, higher coupons and non-benchmark sectors, focusing on security selection to enhance yield and convexity profiles.	+
Non-agency residential MBS (NARMBS) had strong performance in 2024 amid elevated new-issue volumes and credit spreads closing the year at the tight end of the range. Residential housing fundamentals remain supportive of securitization as existing and new home supply is expected to remain low for the coming year. We like new-issue deals at the top of the credit stack as well as seasoned credit bonds with ratings upgrade potential as deals continue to de-lever.	+
Commercial MBS (CMBS) rallied back strongly in 2024, outperforming most credit sectors; however, spreads down the capital structure remain wide relative to post-GFC averages. CRE prices have bottomed out, and capital is being deployed to take advantage of the reset valuations in both debt and equity markets. Seasoned bonds priced at a discount also offer intriguing total-return opportunities for short, event-driven trades.	+
We expect tighter lending standards to lead to stable consumer performance, and still favor higher-quality consumer credit amid tighter spreads. We are constructive on select esoteric sectors such as aircraft lease, digital infrastructure and whole-business ABS across A and BBB rated tranches. Senior spreads are in the mid- to high-100s and mezzanine spreads are in the mid-200s. Spreads, while at two-year tights, provide attractive carry relative to IG credit.	+

WESTERN ASSET SECTOR THEMES *continued*

Inflation-Linked	
US Treasury Inflation-Protected Securities (TIPS) real yields remain attractive at near-two-decade highs, though breakeven inflation (BEI) levels are near the highest levels seen over the past year. While there is substantial uncertainty over the impact of Trump administration policies on inflation, we doubt there will be a long-term impact. We see better opportunities to buy TIPS versus nominals, though portfolios remain long TIPS on a real-yield basis.	+
European inflation expectations (via 5-year swaps) are around 2.0%. This rate is consistent with the ECB achieving its inflation mandate. Risks are currently balanced, with potential downsides from our expected near-term path for inflation (dipping below target in H2) and prospective US tariffs (should unsold export goods need domestic discounting), coupled with upsides from a weaker euro and energy, weather and geopolitical volatility.	+/–
In Japan, the CPI remains above 2% and wage growth is gaining momentum due to a structural labor shortage. We maintain an overweight to Japanese real yields versus nominal yields as the current BEI rate is still below 2%.	+/–
Municipals	
Navigating the municipal market in early 2025 will require careful active management. New-issue supply is likely to exceed $450 billion, with retail demand being crucial as institutional demand remains subdued, potentially increasing rate volatility. We are closely monitoring how potential policy changes may affect sectors like energy, manufacturing, health care and transportation. Better opportunities reside in lower coupon bonds, shorter call structures, lower-end IG and specific below-IG issues.	+/–
Emerging Market (EM) Debt	
We believe that frontier market sovereigns continue to represent a compelling carry and total return opportunity, given still-wide valuations and key idiosyncratic credit stories. IG-rated EM sovereigns remain tight and can be considered a source of cash for trades with better relative value across EM and other sectors.	+
A stronger-than-expected US dollar has weighed on EM FX performance, while expectations of fewer rate cuts by the Fed could augur fewer rate cuts across EM. Given high real yields, we currently favor Latin American local rates, while Asian local currency bonds appear unattractive given historically low yields relative to USTs. We are monitoring US growth exceptionalism and the post-election trade friction as risks to EM FX going forward.	+/–
EM corporates continue to maintain strong balance sheets, especially compared to their DM peers. With sector spreads at historically tight levels, we are seeking value in the primary market and in shorter-dated HY corporates.	+/–

Suzanne M. Trepp, CFA

Research Analyst

"Western Asset continues to favor the transportation sector, anticipating growth in global air travel demand in 2025. Despite rising labor and maintenance costs as well as increased airport fees, large legacy carriers benefit from increased demand for premium fares and have strengthened their balance sheets, maintaining substantial liquidity."

WESTERN ASSET INDUSTRY THEMES

Industry	Key Observations
Auto & Related	We favor a neutral sector positioning with a bias toward US auto manufacturers as they are stronger and pragmatic about EV market prospects and profitability. We are closely monitoring potential credit impacts due to higher tariffs and/or trade impacts from President Trump's proposed policies.
Banks	We are maintaining a large overweight for top-quality global banks due to their resilient performance, as banks have lower risk profiles due to stringent regulations, heightened oversight and improved risk management following the GFC.
Energy	Continued management conservatism and positive FCF generation provides stability; excess FCF returned to shareholders, M&A ongoing for scale. Cautious about increasing energy exposure given the aggressive move tighter in valuations last year.
Food & Beverage	Entering 2025, the food sector is carefully following the potential regulatory uncertainty created by the nomination of health-conscious Robert F. Kennedy, Jr. as the head of Health & Human Services. Most food companies have conservative balance sheets and maintain good liquidity that provides financial flexibility in an uncertain demand and regulatory environment.

WESTERN ASSET INDUSTRY THEMES *continued*	
Gaming	The US gaming sector's fundamentals remain intact, and we expect modest growth opportunities to take hold throughout FYE 2025. Outside the US, we continue to believe in the long-term growth story in Singapore and Macau with a preference for the latter.
Health Care	We are maintaining an underweight in IG health care due to the cyclical and secular decline in credit quality, rich valuations and negative event risks.
Metals & Mining	We remain overweight the sector with a bias toward copper producers. All eyes remain on China—its economic policy, reform agendas and subsequent execution, given its role as the largest consumer of commodities.
Pharmaceuticals	We are underweight IG pharmaceuticals on continued sector headwinds. Lower-rated specialty pharma is expected to pursue aggressive liability management this year.
Retailing	Discretionary consumer spending is expected to be mixed in 2025 as the low-income consumer is supported by jobs and real wage gains, while the high-income consumer is supported by rising wealth effects. Potential new tariffs represent a headwind for both retailers and consumers, who will absorb a portion of any additional tariffs that will have the greatest impact.
Telecommunications & Media	Our view remains fundamentally constructive, despite the maturing market and increased competitive intensity, as the leading operators continue to grow free cash flow and remain focused on their balance sheets. We remain selective within media given the secular shift from linear TV to streaming.
Transportation	Demand for global air travel should continue to grow in 2025 as consumers continue to prioritize experiences over things, and as corporate travel has almost fully recovered. The large legacy carriers are also benefiting from the structural rise in demand for premium fares. Most of the airlines have repaired their balance sheets over the past several years, and continue to maintain large liquidity cushions.
Utilities	We remain focused on first mortgage bonds and transmission & distribution assets. The industry continues to generate material negative free cash flow with large and growing capital budgets. The regulatory environment and ability to recover costs remains key to company assessments.

RISK DISCLOSURES

© Western Asset Management Company, LLC 2025. The information contained in these materials ("the materials") is intended for the exclusive use of the designated recipient ("the recipient"). This information is proprietary and confidential and may contain commercially sensitive information, and may not be copied, reproduced or republished, in whole or in part, without the prior written consent of Western Asset Management Company ("Western Asset").

Past performance does not predict future returns. These materials should not be deemed to be a prediction or projection of future performance.

These materials are intended for investment professionals including professional clients, eligible counterparties, and qualified investors only.

These materials have been produced for illustrative and informational purposes only. These materials contain Western Asset's opinions and beliefs as of the date designated on the materials; these views are subject to change and may not reflect real-time market developments and investment views.

Third party data may be used throughout the materials, and this data is believed to be accurate to the best of Western Asset's knowledge at the time of publication, but cannot be guaranteed. These materials may also contain strategy or product awards or rankings from independent third parties or industry publications which are based on unbiased quantitative and/or qualitative information determined independently by each third party or publication. In some cases, Western Asset may subscribe to these third party's standard industry services or publications. These standard subscriptions and services are available to all asset managers and do not influence rankings or awards in any way.

Investment strategies or products discussed herein may involve a high degree of risk, including the loss of some or all capital. Investments in any products or strategies described in these materials may be volatile, and investors should have the financial ability and willingness to accept such risks.

Unless otherwise noted, investment performance contained in these materials is reflective of a strategy composite. All other strategy data and information included in these materials reflects a representative portfolio which is an account in the composite that Western Asset believes most closely reflects the current portfolio management style of the strategy. Performance is not a consideration in the selection of the representative portfolio. The characteristics of the representative portfolio shown may differ from other accounts in the composite. Information regarding the representative portfolio and the other accounts in the composite are available upon request.

Statements in these materials should not be considered investment advice. References, either general or specific, to securities and/or issuers in the materials are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendation to purchase or sell such securities. Employees and/or clients of Western Asset may have a position in the securities or issuers mentioned.

These materials are not intended to provide, and should not be relied on for, accounting, legal, tax, investment or other advice. The recipient should consult its own counsel, accountant, investment, tax, and any other advisers for this advice, including economic risks and merits, related to making an investment with Western Asset. The recipient is responsible for observing the applicable laws and regulations of their country of residence.

Founded in 1971, Western Asset Management Company is a global fixed-income investment manager with offices in Pasadena, New York, London, Singapore, Tokyo, Melbourne, São Paulo, Hong Kong, and Zürich. Western Asset is a wholly owned subsidiary of Franklin Resources, Inc. but operates autonomously. Western Asset is comprised of six legal entities across the globe, each with distinct regional registrations: Western Asset Management Company, LLC, a registered Investment Adviser with the Securities and Exchange Commission; Western Asset Management Company Distribuidora de Títulos e Valores Mobiliários Limitada is authorized and regulated by Comissão de Valores Mobiliários and Brazilian Central Bank; Western Asset Management Company Pty Ltd ABN 41 117 767 923 is the holder of the Australian Financial Services License 303160; Western Asset Management Company Pte. Ltd. Co. Reg. No. 200007692R is a holder of a Capital Markets Services License for fund management and regulated by the Monetary Authority of Singapore; Western Asset Management Company Ltd, a registered Financial Instruments Business Operator and regulated by the Financial Services Agency of Japan; and Western Asset Management Company Limited is authorised and regulated by the Financial Conduct Authority ("FCA") (FRN 145930). This communication is intended for distribution to Professional Clients only if deemed to be a financial promotion in the UK as defined by the FCA. This communication may also be intended for certain EEA countries where Western Asset has been granted permission to do so. For the current list of the approved EEA countries please contact Western Asset at +44 (0)20 7422 3000.

WESTERN ASSET
A Franklin Templeton Company