Western Asset Management July 2014

GLOBAL FIXED INCOME REVIEW

MARKET REVIEW

Eurozone inflation fell further to 0.4% year-over-year, but the European Central Bank (ECB) provided no new policy signals ahead of its targeted longer-term refinancing operations (T-LTROs) in mid-September. Problems at Portugal's second biggest bank failed to trigger renewed eurozone systemic concerns and all eurozone government bond markets posted strong positive returns, with peripheral markets continuing to outperform ahead of the summer lull in supply. The euro weakened moderately versus the US dollar. US data economic releases were mixed with forward-looking survey data that were generally stronger than hard data, such as housing starts, industrial production and retail sales. 1Q14 US GDP's decline was revised higher to -2.1% and the initial reading of 2Q14 GDP came in at a much higher-than-expected rate of 4.0%. Testimony from US Federal Reserve (Fed) Chair Janet Yellen remained dovish but acknowledged that better data would bring forward the timing of rate hikes and that inflation was moving closer to target. US Treasury (UST) yields ended the month higher in shorter tenors but the strong outperformance in 30-year tenors continued, with yields declining modestly. In the UK, inflation picked up marginally but UK gilts posted positive returns. In Japan, the central bank remained confident that it would meet its higher inflation target in fiscal year 2015 despite the softer post-consumption tax economic data. Japanese yields fell marginally, and the yen weakened moderately. Investment-grade bonds performed in line with UST but mortgage-backed securities (MBS) lagged as market volatility moved a little higher. Exposure to US high-yield corporate bonds was reduced during the month, and they underperformed as investors sought higher compensation for risk after the Fed chair warned that valuations “appear stretched.” Emerging market (EM) bonds were mixed as Mexico and Turkey local-currency debt underperformed UST even as Poland and Brazil outperformed. The US dollar gained versus the euro and the Japanese yen but EM currency returns were on the weak side. The Russian ruble and Polish zloty led declines on growing tensions over Ukraine. Meanwhile, the Brazilian real fell on concerns over Argentina's default at month-end.

OUTLOOK

We continue to believe the global economy will expand at a moderate pace and inflation will remain benign. We expect core bond yields to stay within recent trading ranges, anchored by very low official rates. Despite the Fed reducing quantitative easing, monetary policy is expected to stay highly accommodative in all major economies throughout 2014, as highlighted by the plethora of additional liquidity measures recently announced by the ECB. As such, global central banks should continue to provide support to the global economy.

The US should benefit from a lower fiscal drag and firmer domestic consumption, but growth is not expected to accelerate significantly despite the sharp recovery from the weather-induced slowdown at the start of the year. Although the Fed unwind of emergency policy will be complete by year-end, given the ongoing slack in the labor market, modest wage growth and low inflation, policy rates are likely to stay low. Moderate growth and low inflation should also contain a meaningful rise in longer-dated UST yields. Over time, we expect a flatter UST yield curve as the Fed gradually removes policy accommodation. Portfolios remain biased to overweight US duration, predominantly in longer maturities. Tactically, overall duration has been reduced after the significant fall in intermediate maturity yields and exposure to shorter-dated bonds has increased. With 10-year yields close to our fair value of 2.5%, further meaningful yield declines would be dependent on weaker economic growth.

In Europe, growth remains fragile and banks continue to deleverage ahead of the ECB's Asset Quality Review and Stress Test. With inflation persistently low, the ECB has eased policy significantly and stands ready to implement additional liquidity measures should inflation or growth fail to recover. This backdrop, combined with systemic risk fears abating, supports our overweight to Italy, which has a healthy primary fiscal position and improving political dynamics. Japan is showing some signs of recovery, but the 3% consumption tax increase imposed on April 1 has seen consumption slow sharply, placing more of the burden on the Bank of Japan to keep policy loose. Deeper structural reforms are needed to boost competitiveness as absent these reforms, wages and net exports are unlikely to improve, hurting Japan's prospects to exit deflation and return to sustainable growth. We remain underweight longer-dated bonds given their poor relative value. China is likely to succeed in engineering a soft landing of around 7% to 7.5% in 2014. We believe China's economy will continue to have an important impact on other EM and commodity-exporting economies as it seeks to rebalance growth toward domestic demand, while also liberalizing its financial markets and reining in credit excesses.

An environment of positive real growth and globally accommodative monetary policy remains supportive of corporate earnings and should help keep spreads broadly stable. Today's valuations are no longer demonstrably cheap but we remain constructive on the debt of financial issuers where the complementary processes of deleveraging, capital build and regulatory constraint continue to be credit positive. With strong underlying fundamentals, low default rates and supportive supply and demand conditions, high-yield corporate bonds remain attractive relative to higher-quality bonds. Near term, however, we have reduced exposure modestly as valuations offer less compensation for market and illiquidity risk.

We maintain our core conviction that EM economies are likely to see improving growth over the longer term despite near-term challenges. If momentum in developed economies' recoveries continues, net exports should benefit from significantly more-competitive currencies. Nevertheless, scrutiny is warranted on the nature and pace of reforms undertaken by individual EM policymakers to support long-term competitiveness, especially for countries with external deficits. We remain positioned to benefit from global diversification and the risk premiums in EM bonds. Where permitted, we maintain exposure to Mexican, Brazilian, Polish and South African government bonds with a more modest and actively managed EM currency exposure.

Our currency strategy is driven by our outlook for growth, interest-rate differentials and relative central bank policy. Our conviction for a weaker euro and Japanese yen versus the US dollar is partially based on the contrasting central bank policy stances as well as the stronger relative growth momentum of the US. The yen is also likely to weaken further over time given Japan's loose monetary policy, tight fiscal policy and deteriorating trade balance.

Market volatility has declined over the past few years. This is most likely due to the slow but ongoing global economic recovery, low inflationary pressures and very accommodative major central bank policy, which is resulting in a gradual normalization of asset prices as systemic risk recedes. We expect this environment to persist for some time, but with markets now expecting a continuation of low volatility, there is greater risk from an unexpected shock to market expectations.

The key risks to our outlook are predicated on the strength or weakness of the US economy and/or unexpected economic developments in China or other EM economies. Stronger US growth should support spread sectors and underpin EM recoveries, but could push UST yields higher. Weaker data may pressure profit margins and employment and result in further volatility in EM economies and currencies. We will continue to manage portfolio duration on a tactical basis with a bias to be overweight as a ballast against credit and other spread sectors.

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