Western Asset Management

January 2017

GLOBAL FIXED INCOME REVIEW

- Global bonds posted mixed returns.
- Spread sectors continued to outperform.
- We continue to believe that the optimistic growth scenario currently priced into markets may be overdone.
- Spread sectors are expected to continue to outperform government bonds over the longer term.

MARKET REVIEW

Optimism over a pro-growth, pro-business agenda under the new US administration spilled over into the new year with US equities and credit markets grinding higher. Longer-dated US bonds and the US dollar, however, were pressured by increasing uncertainty over the new administration's trade policies (specifically, the future role of the US in the Trans-Pacific Partnership and the North American Free Trade Agreement); confusion over its immigration policies, which sparked a domestic and global political backlash; and rhetoric from over the valuation of the US dollar, which precipitated a broad-based rally across global currency markets. While emerging markets (EMs) such as Mexico were initially impacted by these developments, the asset class as a whole recovered into month-end. Meanwhile, stronger growth and inflation data and increased political uncertainty pushed European government bond yields sharply higher, especially in Italy and in France.

MARKET OUTLOOK

Markets have priced in the expectation of an imminent and radical shift in US growth. While we don't dismiss this possibility, we also recognize that disappointment would prove painful. In our opinion, the current steady but unspectacular global growth and low inflation backdrop have not materially changed. Our working premise has been a trend growth rate of roughly 1.5% for the US and 3% for the global economy. We believe global growth of around 3% is sustainable, but high debt loads and other headwinds, including low productivity and aging populations, continue to flash a cautionary sign in many economies. We expect that any improvement in the global recovery is going to continue to take time as well as require ongoing policy support. While we have modestly reconfigured global portfolio positioning to reflect a stronger US growth scenario, we also recognize that the optimistic scenario reflected in current market pricing is likely to be gradual and may be overdone in the near term.

In the US, fiscal stimulus and the withdrawal of anti-growth regulations is expected to provide a more favorable climate for business and growth. If anti-globalization and foreign policy missteps are avoided, the addition of meaningful fiscal stimulus to a substantially closed economy such as that of the US—which is already operating near full employment—could become a game changer. Growth could accelerate and the Federal Reserve (Fed) could tighten more meaningfully. Additionally, the disinflation backdrop could reverse, helping to boost interest rates. Igniting US growth in the context of a very weak global environment, however, has proven exceedingly difficult. The implications of labeling China a currency manipulator and the erection of trade barriers may reinforce the global risk-off episodes we have seen intermittently over the last five years. Most importantly, the market's optimistic growth expectation is based on policies that may come over the next 12 months, but the bond market has already raised interest rates today. We continue to believe the Fed will remain cautious, especially in the first half of 2017, mindful of the many unknowns surrounding the new administration's policies. We continue to hold a long US duration position in global portfolios with a bias towards 30-year US maturities, and remain tactical with respect to yield curve positioning. We maintain an allocation to US TIPS as a hedge to any unexpected rise in inflation and maintain short duration positions in core European bonds and Japan.

We expect the eurozone to grow at around 1.7%-2% in 2017, notwithstanding the uncertainty caused by the UK's decision to leave the EU and an increase in anti-establishment politics across the eurozone. In the UK, we believe Brexit-induced uncertainty is likely to slow growth to around 1.5% in 2017 as companies defer spending plans until there is more clarity over the UK's future relationship with the EU. Consumer confidence is also likely to be hit, further impacting the growth outlook. Against this, ongoing policy support by the Bank of England (BoE) should cushion the downturn and the depreciation in sterling on a trade-weighted basis over the last 18 months should support the export sector. The direct exposure in global portfolios to UK assets remains low, with investments focused primarily in financial sector issuers. While the headwinds for the UK bank and insurance sectors have increased post the Brexit vote, and we expect further pressure on profitability, capital ratios remain solid and we are comfortable with the issuers we hold.

In Japan, we expect growth to improve to around 1% in the context of the current fiscal and monetary policy mix and the delay in the consumption tax increase. Inflation is expected to remain negligible, but should increase gradually due to a tighter labor market and the recent rise in oil prices. With 10-year nominal yields capped at 0% by the Bank of Japan (BoJ), we expect real yields to decline further and maintain exposure to Japanese inflation-linked bonds.

We continue to believe that the divergence of growth and interest rate differentials between the US and Europe/Japan combined with the continued expansion of the European Central Bank's (ECB's) and BoJ's balance sheets should continue to push the yen and euro weaker versus the US dollar.

US policy moving towards a looser fiscal and regulatory landscape that should be more business-friendly should also be supportive for credit markets. The technical tailwinds for credit also remain positive with strong investor inflows in search of higher-yielding assets and ongoing ECB, BoJ and BoE corporate bond purchases. After many years of supply increasing year-over-year, expectations are for a deceleration in the pace of new issues as we head further into 2017. While we remain vigilant that concerns over growth in China and US trade policies may reemerge, our base case view is for credit spreads to tighten further in the short to medium term.

The outlook for EM countries remains uncertain given the potential for a diminution in global trade under the new Trump administration. The recent improvement in commodity prices should, however, provide some support to commodity producing EM countries. We believe that valuations in select EM countries remain attractive with currencies such as the Mexican peso having the potential to rebound sharply as technically driven pressure abates. In Poland, decent (albeit slowing) growth and continued weak inflation make Polish rates attractive, especially relative to core eurozone yields.

Global portfolios remain positioned with an overweight to spread sectors, in particular to investment-grade corporate bonds and select EM bonds, to take advantage of attractive valuations. With volatility likely to remain elevated, we continue to look for opportunities to benefit from market anomalies. Our focus remains on longer-term fundamentals with diversified strategies to manage risk.

Brandywine Global
Clarion Partners
ClearBridge Investments
EnTrustPermal
Martin Currie
QS Investors
RARE Infrastructure
Royce & Associates
Western Asset Management

Legg Mason is a leading global investment company committed to helping clients reach their financial goals through long term, actively managed investment strategies.

- Over US$710 billion* in assets invested worldwide in a broad mix of equities, fixed income, alternatives and cash strategies
- A diverse family of specialized investment managers, each with its own independent approach to research and analysis
- Over a century of experience in identifying opportunities and delivering astute investment solutions to clients

* As of 31 December 2016.

IMPORTANT INFORMATION

Source: Western Asset Management. This document is issued by Legg Mason Asset Management Hong Kong Limited in Hong Kong and Macau, and by Legg Mason Asset Management Singapore Pte. Limited in Singapore (**"Legg Mason"**). This document is for information only and does not constitute an offer or invitation to the public to purchase any shares in any fund in Hong Kong, Macau or Singapore.

If this document is distributed in Macau, this may not be used other than by the Distributors.

This document is for information only and is not intended to provide investment advice. All data, opinions, estimates and other information are provided as of the date of this document and may be subject to change without notice. Where past performance is quoted, such figures are not indicative of future performance. Investors intending to subscribe for any units or shares of a fund should refer to the Fund's most current offering document. **INVESTMENT INVOLVES RISKS**. Please refer to the offering documents for further details, including the risk factors. Although information has been obtained from sources that Legg Mason believes to be reliable, no guarantee can be given as to its accuracy and such information may be incomplete or condensed and may be subject to change at any time without notice.

Any views expressed are opinions of the respective investment affiliates as of the date of this document and are subject to change based on market and other conditions without notice and may differ from other investment affiliates or of the firm as a whole. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. The mention of any individual securities/ funds should neither constitute nor be construed as a recommendation to purchase or sell securities, and the information provided regarding such individual securities/funds is not a sufficient basis upon which to make an investment decision. Portfolio allocations, holdings and characteristics are subject to change at any time. Legg Mason, its affiliates, officers or directors, may have an interest in the acquisition or disposal of the securities mentioned herein. Distribution of this document may be restricted in jurisdictions, other than Hong Kong, Macau and Singapore. Any person coming into possession of this document should seek advice for details of, and observe such restrictions (if any).

Issuer in Hong Kong and Macau:
Legg Mason Asset Management Hong Kong Limited.

This document has not been reviewed by the Securities and Futures Commission in Hong Kong or Monetary Authority of Macao in Macau.

Issuer in Singapore:
Legg Mason Asset Management Singapore Pte. Limited is the legal representative of Legg Mason, Inc. in Singapore. (Registration Number (UEN): 200007942R)

FOR PUBLIC IN SINGAPORE AND HONG KONG AND DISTRIBUTORS IN MACAU USE ONLY.