WESTERN ASSET

First Quarter 2021

GLOBAL OUTLOOK

Western Asset's base case outlook is for a U-shaped global economic recovery, with an expectation that short-term growth challenges will be followed by a continuation of the global rebound thereafter. The recent sharp increase in new COVID-19 cases has led to tighter restrictions in many countries and this is likely to weigh on growth in the near term. However, recent regulatory approvals of various vaccines and an acceleration of the rollout in many countries together with significant ongoing policy support should boost growth in 2H21. Given this backdrop, we expect central banks to remain extraordinarily accommodative, especially given ongoing subdued inflation pressures, a recognition that global growth remains fragile and the persistence of downside risks. Here, we provide a summary of the key drivers behind our global outlook and describe where we see value across global fixed-income markets.

Executive Summary

- We expect central banks to remain extraordinarily accommodative, especially given ongoing subdued inflation pressures, a recognition that global growth remains fragile and the persistence of downside risks.
- In the US, growth has slowed from the spectacular pace of 2020, but that is only to be expected as activity in most sectors re-approach pre-COVID-19 levels and activity in other sectors continues to be restrained by sustained strictures on businesses and by consumer fears.
- We expect Europe to rebound in 2021, albeit subject to large cross-country variation as a result of very different recovery potentials, different speeds of vaccine rollout, but also due to the discretionary deployment of fiscal policy.
- In China, we expect the 2H20 economic rebound to extend over the next several years as the economy resumes its structural transition away from low-end manufacturing and investments toward consumption, services and the information technology sectors.

Key Drivers

US: Recovery Proceeding, but COVID-19 Resurgence Induces Shutdowns of Some Sectors

For the most part, economic recovery has continued in the US in recent months, and we expect that to be the case in the months to come. Growth has slowed from the spectacular pace seen last year, but that is only to be expected as activity in most sectors re-approach pre-COVID-19 levels and activity in other sectors continues to be restrained by sustained strictures on businesses and by consumer fears.

Aggregate demand has regained or surpassed pre-COVID-19 levels in most goods-producing and construction sectors. Output and employment in these sectors have not yet recovered as fully, but are in the process of doing so. In those sectors still operating under ongoing strictures—as well as the renewed shutdowns imposed in recent weeks—recovery has been more problematic, and a more robust pace of recovery there is not likely to emerge until a large proportion of the population has been vaccinated and something resembling herd immunity has been attained.

In the meantime, Federal Reserve (Fed) policy will likely remain very accommodative. There is little reason to argue or believe that current woes are monetary in nature or that monetary policy can help assuage them. However, that is not likely to sway the Fed's hand. Meanwhile, we take some solace in the fact that Fed actions in 2020 look to have been about as inconsequential for growth and inflation as those of 2008 and after. In other words, there is no indication that any Fed excesses seen in 2020 or at present are working to generate inflation pressures. However, among financial market participants, inflation expectations do appear to have risen.

> *There is no indication that any Fed excesses seen in 2020 or at present are working to generate inflation pressures.*

The Democratic sweep of the US presidency and both houses of Congress will give incoming President Biden a relatively free hand in legislating for the next year or so. However, COVID-19 concerns are likely to hold center stage in Washington, and it also has never been clear to us that tax increases were a major legislative aim of his campaign (apart from being used to energize portions of his base). The more likely fiscal action from Washington this year would be a package of infrastructure projects. We doubt that these will work to stimulate economic growth—or raise interest rates—as much as some corners appear to believe.

Europe: A Rebound With Large Cross-Country Variation

After a steep recession in 2020, we expect Europe to rebound in 2021, albeit subject to large cross-country variation. The distinct recovery paths are a result of very different recovery potentials, different speeds of vaccine rollout, but also the discretionary deployment of fiscal policy—some countries still plan on running significant fiscal deficits, others are already turning a bit more cautious. Taken as a whole, we expect Europe to recover to pre-crisis activity levels not before the end of 2022. The Next Generation EU (NGEU) recovery fund will not play a major role in 2021 outcomes as disbursements will be modest and back-loaded, but the prioritization effort will prove useful over the next few years. A key question in this context will be which countries will take advantage of the NGEU loans (in addition to the grants) as additional debt-financed spending can boost the recovery but could be tripped up by political concerns.

Inflation in the eurozone is likely to remain muted for an extended period abstracting from significant base effects in 2021 due to tax changes. This will allow the European Central Bank (ECB) to focus its interventions on ensuring favorable financing conditions, in line with its commitment last December. Assuming no major shocks, we don't believe that the ECB will spend the full resource envelope available for asset purchases. Similarly to

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Key Drivers

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2020, European yield curves (including German bunds) will be partly driven by issuance versus ECB absorption, as sovereign yields are part of the ECB's concern around financing conditions. We expect that yields will drift higher, in line with other developed market government bonds as the recovery in global activity firms up. More fiscal stimulus in specific countries might reinforce that dynamic.

Focusing on Italy, the country's outlook is similar to that of other large economies in Europe, subject to a couple of additional considerations. First, the use of supranational loans—namely, the European Stability Mechanism (ESM), but also the NGEU—seems to be more politically charged than elsewhere, with implications for fiscal accounts and the growth trajectory. Second, the glue in the governing coalition seems to have become weaker. With parliamentary elections ruled out by the constitution in the six months ahead of the presidential elections in early 2022, we see the first half of 2021 as a potential window for political risk to flare up. Aside from the potential risk element, we expect spreads to stay around current levels or grind marginally tighter as the ECB serves as a backstop and investors seek higher/positive yields. But, this is subject to more political uncertainty than elsewhere.

The UK should also rebound in 2021, together with the rest of Europe—and has a lot of room to do so—but the trajectory is subject to additional uncertainty. The "skinny" trade deal achieved late last year is certainly better than no deal, but it is too early to assess the economic fallout from Brexit. The UK is also further advanced in the vaccine rollout, with fiscal and especially monetary policy having room to act if needed. But, the economic damage in 2020 has been substantial and the reasons are hard to disentangle given the pandemic, Brexit and domestic factors such as the relatively heavy reliance on services.

China: A Path to Recovery Remains Intact

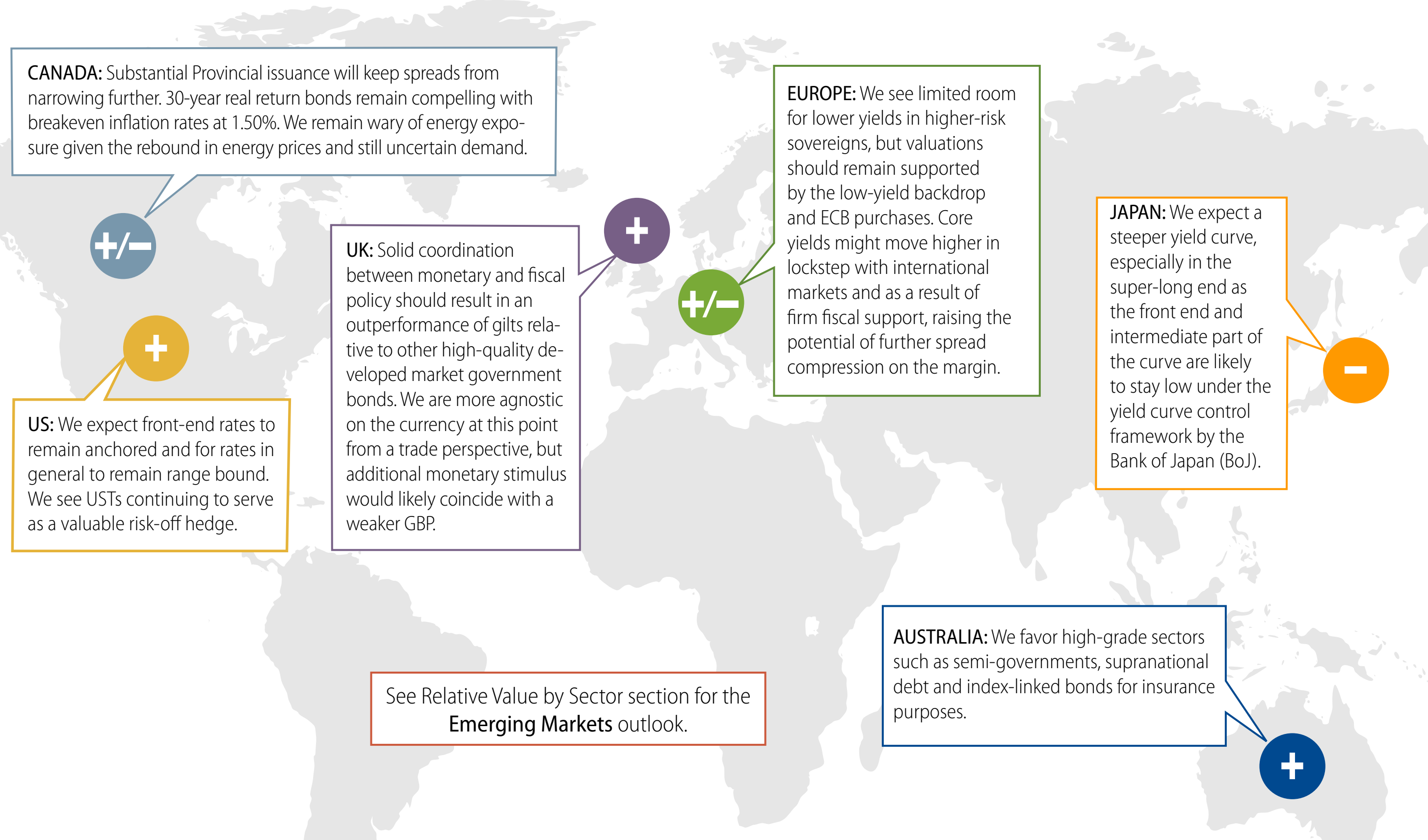
China successfully contained the COVID-19 outbreak soon after it was first detected in Wuhan in January 2020. The strong implementation of non-pharmaceutical interventions such as quarantines, mass patient testing and contact tracing has been effective in curbing initial and subsequent viral outbreaks. This has allowed China's business activity in both the manufacturing and service sectors to resume to pre-COVID-19 levels faster than in most countries. On the external front, despite tariffs and US-China tensions, Chinese export growth has been strong due to overseas demand for medical and pharmaceutical products, as well as for electronic goods, due to work-from-home restrictions.

> *China's successful containment of COVID-19 has allowed business activity to resume to pre-pandemic levels faster than in most countries.*

Prior to the outbreak, it was anticipated that China would enjoy a healthy 5.5% to 6.0% annual growth rate. While the viral outbreak at the start of the year resulted in a significant disruption to China's economy, it is a temporary shock due to successful containment. China's sharp economic rebound in 2H20 is likely to resume and we anticipate China's gross domestic product (GDP) will continue its 5% to 6% annual growth rate over the next several years as the economy resumes its structural transition away from low-end manufacturing and investments toward consumption, services and the information technology sectors. The journey will undoubtedly be bumpy; headline growth indicators may at times be weak, but in our opinion, the probability of a sustained China slowdown remains low as China's per-capita GDP is still at emerging market levels and the government continues to have considerable fiscal and monetary policy levers to boost economic growth. China's contribution to the world's economy, in our view, will grow and remain highly significant.

The Big Picture

Developed Market Rates: Relative Value by Region



US	Economic recovery has continued in the US in recent months, and we expect it to remain intact in the months to come. In the meantime, Fed policy is going to remain accommodative; there is no indication that any Fed excesses seen in 2020 are working to generate inflation pressures.
Canada	The Canadian economic recovery trajectory is slightly behind that of the US, reflecting the lagging rebound in the energy sector. While household income support and the upswing in real estate demand will keep the recovery on track despite the resurgence in infection rates around the turn of the year. The stronger Canadian dollar will dampen any inflationary pressures and keep the Bank of Canada on hold alongside the US.
Europe	Strong fiscal and monetary support helped the continent contain the damage in 2020 and will support the 2021 rebound, together with vaccination progress. Divergent fiscal stances at the national level are likely to have an impact on the speed of recovery since progress on the supranational recovery fund is somewhat slower than expected. That said, EU-level borrowing will still expand markedly right away, increasing the pool of supranational safe-haven assets. The ECB is, for now, in a wait-and-see position after its commitment to favorable financing conditions.
UK	As the UK enters renewed tighter COVID-19 restrictions, we expect more support from fiscal and monetary policy to limit the damage to the economy. While it is too early to assess the fallout from the new post-Brexit trade regime, their head start on the vaccine rollout is undoubtedly positive for the economy.
Japan	We expect that the Japanese economy will continue to recover on the back of an unprecedented policy response and the recent progress on COVID-19 vaccines. The Japanese government is likely to keep the current flexible fiscal stance to support the recovery. Also, the BoJ is likely to keep interest rates very low for a long period of time with a steepening bias in the yield curve.
Australia	The Reserve Bank of Australia (RBA) recently reduced the cash rate to 10 basis points (bps) and also embarked on its first real quantitative easing (QE) program with the purchasing of government and semi-government bonds alongside the current yield curve control program. The RBA's focus is now on realized forecasted inflation and unemployment levels as well as maintaining very easy monetary conditions for at least three years.

Relative Value by Sector

Investment-Grade (IG) Corporate Credit	Outlook		Relative Value
US	We are optimistic on credit fundamentals, but with multiple vaccination programs already in progress and more to come, the left tail has been truncated. The path forward now partly rests with how quickly economic activity is allowed to resume and on how companies handle the war chest of liquidity they've raised thus far. While favorable technicals endure, valuations have already returned to pre-COVID-19 levels for many sectors.	+/–	With overall valuations near full recovery, our bias now is to sell into further strength for those sectors where valuations have returned to pre-COVID-19 levels.
Europe	After a year of discipline and caution by investment-grade management teams, credit profiles are generally in solid shape. We expect this to continue, but believe Mergers and Acquisitions (M&A) appetite and shareholder returns may be more emphasized this year.	–	We expect continued demand for investment-grade bonds on the back of low yields and ECB purchases. However, valuations are no longer compelling given prevailing spread levels.
Australia	Credit market fundamentals remain well supported by the further easing of monetary policy, the reopening of the economy and stimulatory fiscal support. Primary markets remain active. Real Estate Investment Trusts (REITs) were the best performing sector with industrials coming in next and utilities following.	+	We favor the investment-grade sector.
High-Yield (HY) Corporate Credit			
US	4Q20 was another strong quarter for the high-yield market as the risk-on trade was in full-swing, with spreads tightening by 157 bps. During the quarter, we continued to take advantage of our ability to help structure certain high-quality secured transactions largely in cyclical sectors and anticipate this continuing.	+	We remain positive on certain cyclical sectors (airlines, cruise lines and retail) complemented by a higher quality bias in those less cyclical subsectors, providing ballast in the portfolios.
Europe	Corporate liquidity should remain in focus, as well as balance sheet sustainability and longer-term deleveraging potential. Supply has been concentrated on higher-rated BB companies and use of proceeds mainly for bolstering liquidity. We anticipate 2021 supply to pivot toward refinancing. It is possible that M&A-related issuance picks up in 2021.	+	We currently favor BBs and B rated credits. Our focus is on defensive industries (such as pharma) and certain cyclical sectors, such as media. We remain selective on consumer-related companies.
Bank Loans			
US	The loan market is expected to continue marching higher, driven primarily by a strong technical environment: attractive cost of financing for Collateralized loan obligations (CLOs), significant CLO formation during the quarter with over 100 CLO warehouses currently open and higher-than-expected loan repayments and amortization at the end of 4Q20, resulting in high cash balances that need to be reinvested in the secondary market.	+	We believe outperformance will come from significant interest carry, missing the COVID-19-impacted names that will run out of runway in 2021, and owning select names where the fundamentals and liquidity remain intact and there is still real price convexity in the credit.
Collateralized Loan Obligations (CLOs)			
US	1Q21 projections for primary issuance is very high across new issues, resets and refinancings. Rumors of Japanese and US banks coming back with renewed appetite for CLOs would be a very strong tailwind for demand and a catalyst for additional supply.	+	We retain our view that AAAs will continue to perform well in either a bearish or bullish scenario. We move to more of a neutral stance for lower-rated CLOs following the rally in 4Q20 and based on the heavy supply picture for January.
Structured Credit			
Agency MBS	We are neutral on mortgages based on current valuations and continued support from Fed purchases.	+/–	We favor TBA in production coupons and specified pools in higher coupons.
Non-Agency Residential MBS (NARMBS)	While uncertainty surrounding the COVID-19 crisis remains, housing was in a strong position going into the crisis. The response from regulators and the Fed has been swift and effective at preventing a spike in foreclosures and keeping capital flowing into the housing market.	+	We are positive on legacy NARMBS/new-issue re-performing loan deals as many of these borrowers have already withstood similar disruptions (e.g., global financial crisis and hurricanes) and are proven performers.
Non-Agency Commercial MBS (CMBS)	While the commercial sector remains further behind in terms of recovery, momentum is building. In the near term, we remain cautious as it is uncertain how long it will take for the commercial sector to recover from the negative impacts of the pandemic. We expect the fundamental outlook to be uneven across property types and markets as the impact of COVID-19 on each property type and geography varies.	+/–	We are positive on short-duration, well-structured single-borrower securitizations and loans. We remain selective and prefer bonds that can better withstand a period of reduced operating income and forbearance and provide good risk/reward.
Asset-Backed Securities (ABS)	We are cautious on consumer fundamentals. ABS sectors remain hostage to the pandemic and uncertain pace of recovery.	+/–	We favor well-protected senior ABS classes from high-quality sectors with low COVID-19 disruption impact.

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Relative Value by Sector

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Inflation-Linked	Outlook		Relative Value
US	TIPS have benefited from strong inflows as investors are concerned about possible inflation in the new fiscal, monetary and trade-restricted world. While we would not rule out inflation reaching or exceeding the Fed's 2.0% target in future years, the world remains disinflationary through 2021 and likely longer. Energy prices now have downside risk given still-significant inventories and the need to increase production and revenue on the part of oil producers.	+	TIPS are more likely to perform well only as long as US economic activity is outperforming expectations. The top in breakeven inflation rates over the last few years is only 20 bps higher than the current 2.00%. These levels are likely to prove the peak in relative performance, even with the economic recovery, as long as inflation remains below Fed targets.
Europe	In 2021, European inflation will be very lumpy with many base effects dominating the near-term picture. Despite our low expectations for inflation, breakevens remain cheap and we are monitoring the supply-side-led rise in survey input and output prices which could support inflation in the near term.	+	In index-linked and global portfolios, we favor French and Italian real yields and breakeven inflation spreads.
Japan	We believe that Japanese inflation-linked bonds are significantly undervalued, assuming the expected recovery of Japanese economy. Buybacks by the Ministry of Finance and BoJ would support a correction of the undervaluation.	+	We prefer Japanese real yields against nominal yields.
Municipals			
US	We expect the muni market to still benefit from the $900 billion bill passed through Congress at the end of 2020. As we have received additional clarity surrounding the US elections, we believe the increased prospects for higher tax rates and additional stimulus measures will lend support to the asset class in 1Q21.	+	We continue to favor revenue-backed securities versus general obligation-backed liens.
Emerging Market (EM) Debt			
EM Sovereigns (USD)	We anticipate US dollar sovereign issuance to be robust as EM countries continue to take advantage of lower rates to fund fiscal programs and mitigate ongoing economic damage induced by the pandemic. EM countries continue to be constrained in implementing significant monetary and fiscal programs versus developed market countries, and we believe the crisis may linger longer in EM countries.	+/–	We continue to favor select investment-grade-rated EM USD-denominated sovereigns from both a carry and total return standpoint, and exercise caution toward debt issued by lower-rated frontier sovereign countries that face an uphill road ahead.
EM Local Currency	The real rate differential between the US and EM countries is a dynamic that should benefit prospective EM capital and portfolio flows. Many EM central banks continue to be in accommodative mode, while EM FX continues to exhibit volatility driven by ongoing developments related to the pandemic, vaccine and US/China tensions.	+	We continue to find local rates relatively attractive given high real yields and a more favorable risk/reward profile. We maintain a thoughtful and opportunistic approach to EM currencies, seeking to avoid currencies that are susceptible to virus-induced growth setbacks, given EM currencies' higher volatility and role as a pressure relief valve.
EM Corporates	EM corporates are comparatively defensive within the global credit universe; however, deteriorating global and sovereign-level growth weigh on fundamentals. EM corporates have relatively clean maturity schedules and liquidity positions, which companies have been bolstering with cost cuts, revolver borrowings and opportunistic new issuance.	+	EM corporates offer a compelling investment opportunity. As the market continues to recover, we are taking advantage of primary issuance from investment-grade and BB rated corporates, while monitoring potential 2021 risks from fears of central bank tightening and vaccine delays.

Definitions

COVID-19 is the World Health Organization's official designation of the current novel coronavirus disease. The virus causing the novel coronavirus disease is known as SARSCoV-2.

A **U-shaped recovery** is a type of economic recession and recovery that resembles a U shape when charted. A U-shaped recovery represents the shape of the chart of certain economic measures, such as employment, GDP, and industrial output. This shape occurs when the economy experiences a sharp decline in these metrics without a clearly defined trough but instead a period of stagnation followed by a relatively healthy rise back to its previous peak.

Herd immunity occurs when a large portion of a community (the herd) becomes immune to a disease, making the spread of disease from person to person unlikely. As a result, the whole community becomes protected — not just those who are immune.

In July 2020, the European Council agreed to a massive **recovery fund** of 750 billion € branded **Next Generation EU (NGEU)** in order to support member states hit by the COVID-19 pandemic.

A **bund** is a debt instrument issued by Germany's federal government to finance outgoing expenditures.

Sovereign yield is the interest rate paid to the buyer of the bond by the government, or sovereign entity, issuing that debt instrument.

Supranational refers to debt of international organizations or unions such as the World Bank, the International Monetary Fund, Eurozone, regional multilateral development banks, etc. European Stability Mechanism

Provincial bonds are issued by the provincial government and are among the most secure investments available. They are backed by the full faith and credit of the provincial government and timely payment of the principal and interest is guaranteed.

U.S. Treasuries (UST) are direct debt obligations issued and backed by the "full faith and credit" of the U.S. government. The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity.

A **gilt** is a **UK** Government liability in sterling, issued by the Treasury and listed on the London Stock Exchange.

Risk-on risk-off refers to changes in investment activity in response to global economic patterns. During periods when risk is perceived as low, the risk-on risk-off theory states that investors tend to engage in higher-risk investments.

Hedging refers to making an investment to reduce the risk of adverse price movements in another asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Yield curve control involves targeting a longer-term interest rate by a central bank, then buying or selling as many bonds as necessary to hit that rate target.

An **index-linked bond** is a bond in which payment of interest income on the principal is related to a specific price index, usually the Consumer Price Index (CPI).

A **safe haven** is an investment that is expected to retain or increase in value during times of market turbulence. Safe havens are sought by investors to limit their exposure to losses in the event of market downturns.

"AAA" and "AA" (high credit quality) and "A" and "BBB" (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ("BB," "B," "CCC," etc.) are considered low credit quality, and are commonly referred to as "junk bonds."

To be announced (TBA) serves as a contract to purchase or sell a mortgage-backed security on a specific date, but it does not include information regarding the pool number, number of pools, or the exact amount that will be included in the transaction.

U.S. Treasury inflation protected securities (TIPS) are a special type of Treasury note or bond that offers protection from inflation. Like other Treasuries, an inflation-indexed security pays interest six months and pays the principal when the security matures. The difference is that the coupon payments and underlying principal are automatically increased to compensate for inflation as measured by the CPI. Also referred to as "Treasury inflation-indexed securities."

The **nominal yield** is the amount of income earned from a fixed-income security divided by the security's par value, expressed as a percentage.

Britain clinched a last-minute **skinny trade deal** with the European Union that will preserve its zero-tariff and zero-quota access to the bloc's single market of 450 million consumers. But it is a thin deal that will not prevent economic pain and disruption for the United Kingdom or for EU member states, and many aspects of Britain's future relationship with the EU remain to be hammered out, possibly over years.

WHAT ARE THE RISKS?

Past performance is no guarantee of future results. Please note that an investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

Equity securities are subject to price fluctuation and possible loss of principal. **Fixed-income** securities involve interest rate, credit, inflation and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed income securities falls. **International investments** are subject to special risks including currency fluctuations, social, economic and political uncertainties, which could increase volatility. These risks are magnified in **emerging markets**. **Commodities** and **currencies** contain heightened risk that include market, political, regulatory, and natural conditions and may not be suitable for all investors.

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