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GLOBAL BOND REVIEW AND OUTLOOK

Global recovery to remain slow in 2015

- The balance of global growth risks are skewed to the downside as we enter 2015
- Long-term U.S. bond yields are unlikely to rise substantially even as the Fed increases overnight interest rates
- Bond markets were volatile in December amid falling oil prices and heightened geopolitical risk
- The U.S. yield curve flattened further with five-year yields rising but 30-year yields declining to only 2.75%
- Fears of eurozone deflation increased and the U.S. dollar continued to strengthen

DEC 2014

MARKET OUTLOOK

Western Asset has long been of the view that the pace of this global recovery will be slow relative to past economic cycles. Despite intermittent periods of optimism, mostly emanating from the U.S. economy, global activity remains subpar giving us little reason to revise our cautious stance on global growth.

Indeed, geopolitical risks, evidence of a protracted slowdown in Europe and Japan, and a managed slowdown in China suggest the balance of global growth risks are skewed to the downside as we enter 2015. Global inflationary pressures remain very subdued, and the recent sharp decline in commodity prices suggests an even weaker global inflation outcome in 2015. Lower oil prices should be supportive of global growth by increasing real consumer incomes and corporate earnings in economies such as the U.S. that have a higher propensity to spend. Moreover, for oil-importing Emerging Market (EM) countries, lower inflation may provide more flexibility for policymakers to stimulate growth. Clearly, countries that are heavily dependent on oil revenues will be negatively impacted but, overall, Western Asset expects global growth to improve mildly in 2015 helped by accommodative monetary policies. The U.S. is the bright spot among the developed market economies. U.S. labor market conditions continue to improve and although current inflation remains low, both remain consistent with the Fed's dual mandate of full employment and price stability. Western Asset expects the U.S. Federal Reserve (Fed) to initiate policy normalization in the second half of 2015, although the pace of rate increases is likely to be very slow and gradual. Our reasoning is that while the Fed wants to shift its policy away from emergency settings, it also wants to avoid tightening U.S. financial conditions. As a result, long-term U.S. bond yields are unlikely to rise substantially even as the Fed increases overnight interest rates.

Europe

In Europe, bank lending continues to contract and growth remains stagnant. The European Central Bank (ECB) is targeting an aggressive expansion of its balance sheet via targeted longer-term refinancing operations and purchases of private assets in an attempt to stave off further deflationary forces. Western Asset thinks it is unlikely that these measures alone will be successful in repairing the broken credit mechanism, and further Quantitative Easing (QE) via the purchase of sovereign bonds is likely in early 2015.

Western Asset believes this will facilitate further euro weakness versus the U.S. dollar and tighter peripheral European bond spreads relative to Germany. We do not favour the euro, but have a positive view on Italian government bonds

Asia

Japan's economy remains in a fragile state following the 3% consumption tax increase in April 2014 and as negative real wages continue to dampen demand. Long-term market inflation expectations have continued to decline. The Bank of Japan (BoJ) has responded with an aggressive increase in liquidity provision and the government has delayed the next consumer tax increase. The divergence of policy between the BoJ and the Fed should place further downward pressure on the Japanese yen.

The Chinese economy is slowing down, but it may still grow at a rate of around 7% in 2015. Western Asset feels this controlled and manageable slowdown is a necessary consequence of the ongoing shift from an investment and export-led growth model to a more sustainable consumption and service-based one. Western Asset sees little evidence in data to suggest a more severe downturn is imminent and the authorities recently demonstrated their ongoing willingness to ease policy to support growth if required. Western Asset believes China will continue to contribute significantly to the ongoing global recovery.

Emerging markets

With the recent commodity price declines, some EM countries face a more challenging environment in 2015. Longer term, Western Asset's view is that despite near-term challenges, EM economies will benefit from the recovery in global growth and that most of these countries will retain their credit ratings. The spreads between EM and developed market yields have widened and may present opportunities to add value in 2015.

Western Asset favours corporate bonds where it is believed that the fundamental outlook and management of companies remains positive, particularly in the U.S. financial sector. There has been a marked difference in performance across the credit sectors with higher-yielding, energy-related and EM credits underperforming in the second half of 2014. The decline in these sectors, and in some individual securities in particular, may offer attractive valuations with many companies expected to remain strong with energy prices at current levels, or even lower.

Heightened geopolitical risks mean the global outlook remains uncertain. At the same time, there is a clear "de-synchronization" of the U.S. and European and Japanese economic cycles. This suggests that we are entering a new phase of this global economic recovery, one in which the world's major central banks are moving monetary policy in different directions. This phase is unlikely to pass without increased volatility, although market dislocations in some sectors may create opportunities for active fixed-income managers. Western Asset remains focused on longer term fundamentals with diversified strategies to manage risk.

> In Europe, further QE via the purchase of sovereign bonds is likely in early 2015.
>
> Western Asset

MARKET REVIEW

Figure 1: Bond sector total returns[1]

	1 Month	12 Months
Barclays European Treasury Index	1.1	13.1
Barclays European Corporate Index	0.6	8.4
Barclays Pan-European High Yield (Euro) Index	-0.2	5.8
Barclays Sterling Gilts Index	1.8	14.6
Barclays Sterling Corporate Index	1.4	12.5
Barclays Pan-European High Yield (Sterling) Index	0.2	4.9
Barclays U.S. Treasury Index	0.1	5.1
Barclays U.S. Agency Mortgage Backed Securities (MBS) Index	0.2	6.1
Barclays U.S. Corporate Index	0.1	7.5
Barclays U.S. High Yield Index	-1.5	2.5
JPMorgan Emerging Markets Bond Index Plus (EMBI+)	-2.5	6.2
JPMorgan Corporate Emerging Market Bond Index (CEMBI) Broad Composite	-2.5	3.6
JPMorgan Government Bond Index — Emerging Market (GBI-EM) Global Diversified Composite	-5.9	-5.7

Source: Bloomberg, as of December 31, 2014. **Past performance is not a guarantee of future results**. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges.

[1] The **Barclays European Treasury Index** is the Treasury component of the Euro Government index, which is part of the Barclays Euro-Aggregate Index. The Barclays Euro-Aggregate Index consists of bonds issued in the euro or the legacy currencies of the 16 sovereign countries participating in the European Monetary Union (EMU). All issues must be investment grade rated, fixed-rate securities with at least one year remaining to maturity. The Euro-Aggregate Index excludes convertible securities, floating rate notes, perpetual notes, warrants, linked bonds, and structured products. German Schuldscheine (quasi-loan securities) are also excluded because of their trading restrictions and unlisted status, which results in illiquidity. The country of issue is not an index criterion, and securities of issuers from outside the Eurozone are included if they meet the index criteria.

The **Barclays European Corporate Index** is the Corporates component of the Euro-Aggregate Credit index, which is part of the Barclays Euro-Aggregate Index.

The **Barclays Pan-European High Yield (Euro) Index** covers the universe of fixed-rate, sub-investment-grade debt denominated in euros or other European currencies (except Swiss francs). This index includes only euro-and sterling-denominated bonds, because no issues in the other European currencies now meet all the index requirements. To be included, the bonds must be rated high-yield (Ba1/BB+ or lower) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be high-yield. Bonds must have at least one year to maturity and an outstanding par value of at least EUR50 million. The index does not include non-rated bonds, and it excludes debt from entities in countries that are designated as emerging markets.

The **Barclays Sterling Gilts Index** is the Gilts component of the Barclays Sterling Aggregate Bond Index. The Sterling Aggregate Index contains fixed-rate, investment-grade Sterling-denominated securities. Inclusion is based on the currency of the issue, and not the domicile of the issuer. The principal asset classes in the index are Treasuries (Gilts), Corporates, Government Related and Securitized. Securities in the index are all eligible for the Pan- European Aggregate and Global Aggregate indices.

The **Barclays Sterling Corporate Index** is the Corporates component of the Barclays Sterling Aggregate Bond Index.

The **Barclays Pan-European High Yield (Sterling) Index** is the sterling component of the Pan-European High Yield Index.

The **Barclays U.S. Treasury Index** is the U.S. Treasury component of the U.S. Government index, which is part of the Barclays U.S. Aggregate Bond Index. The Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

The **Barclays U.S. Agency Mortgage Backed Securities (MBS) Index** is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The **Barclays U.S. Corporate Index** is the corporate component of the U.S. Credit index, which is part of the Barclays U.S. Aggregate Bond Index.

The **Barclays U.S. High Yield Index** covers the universe of fixed rate, non-investment grade debt, including corporate and non-corporate sectors. Pay-in-kind (PIK) bonds, Eurobonds, and debt issues from countries designated as emerging markets are excluded, but Canadian and global bonds (SEC registered) of issuers in non-emerging market countries are included. Original issue zero coupon bonds, step-up coupon structures, and 144-As are also included.

The **JPMorgan Emerging Markets Bond Index Plus (EMBI+)** is a total return index that tracks the traded market for U.S. dollar-denominated Brady and other similar sovereign restructured bonds traded in the emerging markets. Please note an investor cannot invest directly in an index.

The **JPMorgan Corporate Emerging Market Bond Index (CEMBI) Broad Composite** tracks USD denominated debt issued by emerging market corporations.

The **JPMorgan Government Bond Index — Emerging Market (GBI-EM) Global Diversified Composite** tracks local currency bonds issued by Emerging Market governments.

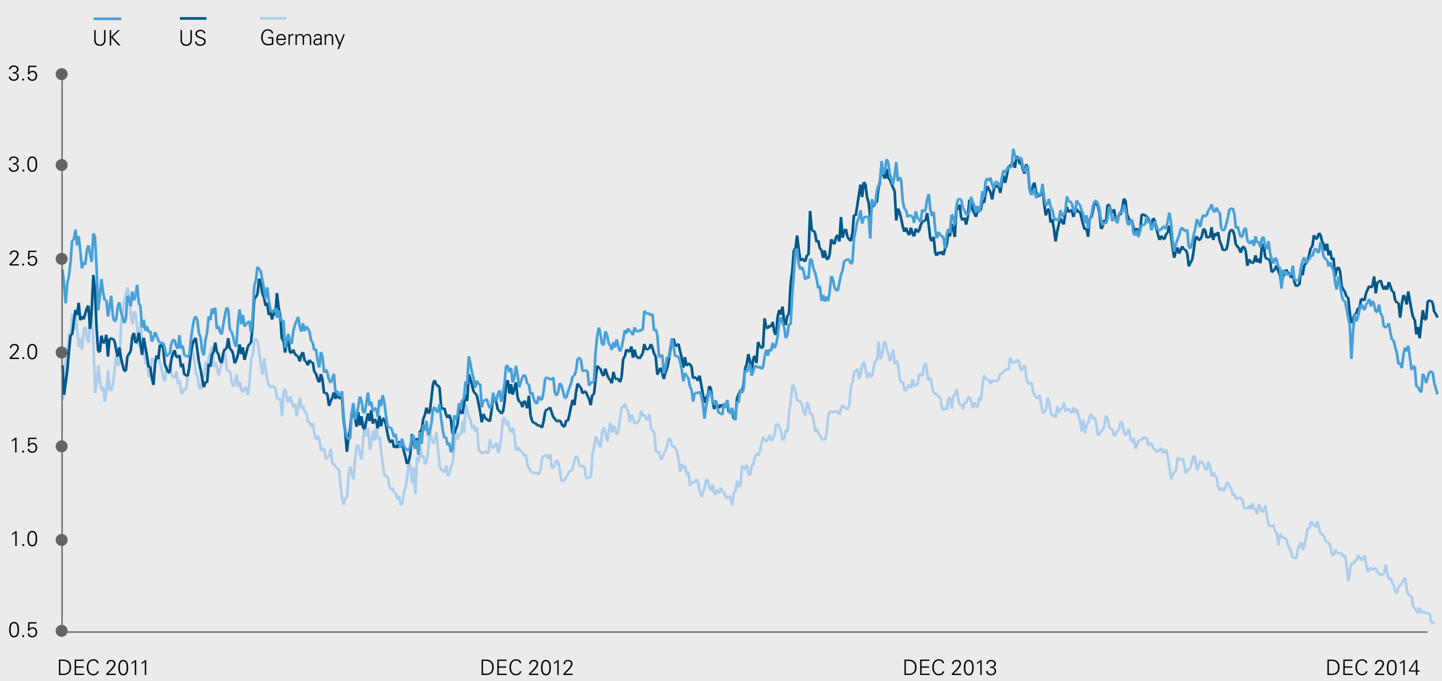
December was a very volatile month for global bond market and currencies

Instead of the traditional quiet end to the year, December was a very volatile month for global bond markets and currencies. The recent downshift in global growth expectations and ongoing geopolitical tensions resulted in positive returns in all major government bond markets.

Heightened uncertainty (particularly over the situation in Russia/Ukraine), the sharp fall in the oil price to below US$60 per barrel and reduced market liquidity with dealers reluctant to hold inventory ahead of year-end, resulted in significant stress in many energy-related and higher-yielding securities. Emerging market assets and commodity-related currencies were also negatively impacted and investment-grade credit spreads widened. Following an effective devaluation of the Russian ruble intra-month, the central bank raised rates by 6.5% to 17%, which alleviated the fall in Russian assets and contributed to a stabilization in other markets.

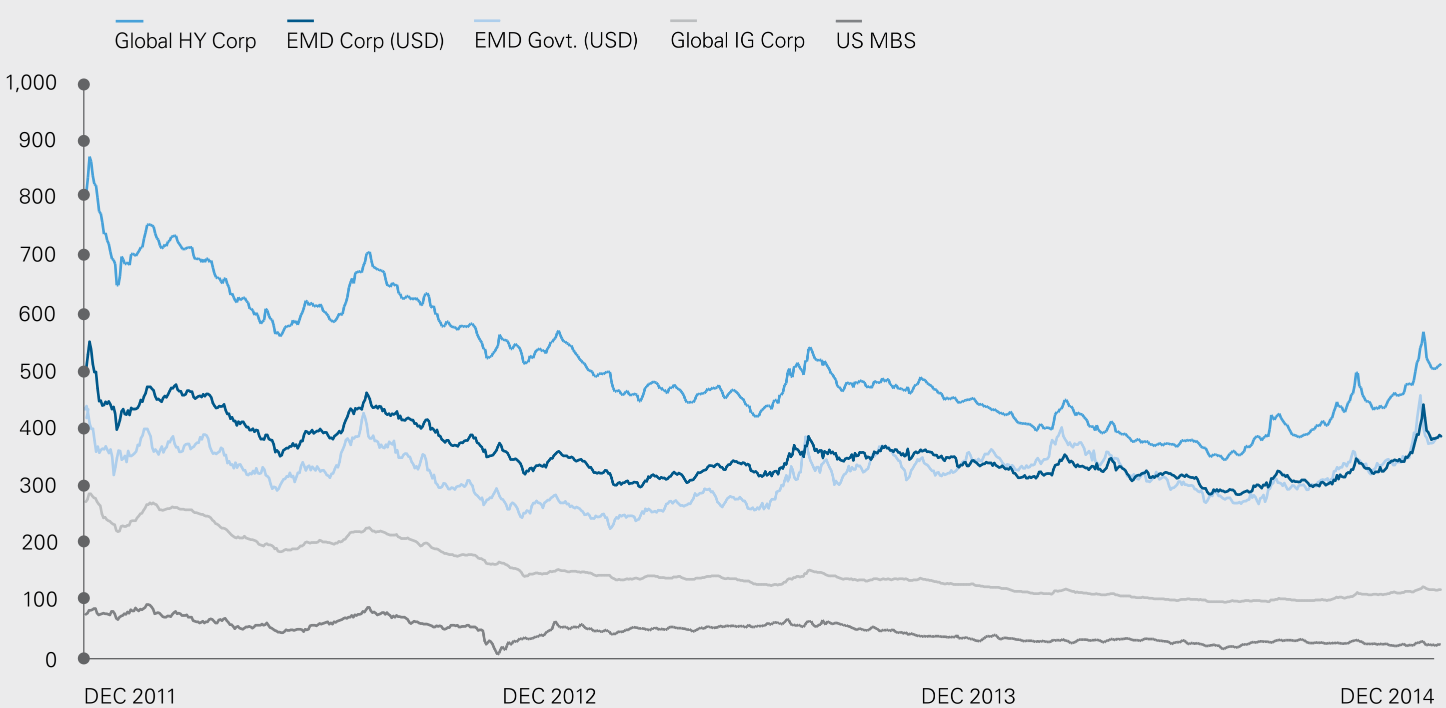
In the U.S., with lower energy prices expected to provide a boost to growth but also to result in lower inflation, the yield curve flattened further with five-year yields rising but 30-year yields declining to only 2.75%. The Federal Reserve remained relatively dovish, highlighting that it would remain patient and use a balanced approach to remove policy accommodation. In Japan, Prime Minister Shinzo Abe achieved a significant majority in a snap election, solidifying support for his government's plans to boost growth by enacting structural reforms. Ten-year Japanese yields fell to only 0.33%. Despite the announcement of an early election in Greece, peripheral eurozone spreads ended the month much unchanged, with Spain outperforming. Fears of eurozone deflation increased, which resulted in increased expectations for the European Central Bank to announce additional QE measures via purchases of sovereign securities in early 2015. Core eurozone yields continued to decline with 10-year bund yields falling to new lows at only 0.59%. The U.S. dollar continued to strengthen.

Figure 2: Government bond yields (%) 10-year



Source: Bloomberg, as of December 31, 2014. **Past performance is not a guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Figure 3: Sector spreads[2] (bps)[3]



Source: Bloomberg, as of December 31, 2014. **Past performance is not a guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

2 A **spread** is the difference in yield between two different types of fixed income securities with similar maturities.

3 A **basis point (bps)** is one one-hundredth of one percent (1/100% or 0.01%).

Investment risks

The opinions and views expressed herein are subject to change and are not intended to be relied upon as a prediction or forecast of actual future events or performance, or a guarantee of future results, or investment advice.

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Fixed income securities are subject to interest rate and credit risk, which is a possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. As interest rates rise, the price 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.

U.S. Treasuries 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. Unlike U.S. Treasury securities, debt securities issued by the federal agencies and instrumentalities and related investments may or may not be backed by the full faith and credit of the U.S. government. Even when the U.S. government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.

Currencies and commodities contain heightened risk that include market, political, regulatory, and natural conditions and may not be suitable for all investors.

A credit rating is a measure of an issuer's ability to repay interest and principal in a timely manner. The credit ratings provided by Standard and Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd. typically range from AAA (highest) to D (lowest). Please see www.standardandpoors.com, www.moodys.com, or www.fitchratings.com for details.

High yield bonds are subject to increased risk of default and greater volatility due to the lower credit quality of the issues.

Active Management does not ensure gains or protect against market declines.

Outperformance does not imply positive results.

Definitions

The **Federal Open Market Committee (FOMC)** is a policy-making body of the Federal Reserve System responsible for the formulation of a policy designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

The **Federal Reserve Board ("Fed")** is responsible for the formulation of U.S. policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

Gross Domestic Product ("GDP") is an economic statistic which measures the market value of all final goods and services produced within a country in a given period of time.

Emerging markets (EM) are nations with social or business activity in the process of rapid growth and industrialization. These nations are sometimes also referred to as developing or less developed countries.

The **European Central Bank (ECB)** is responsible for the monetary system of the European Union (EU) and the euro currency.

Liquidity refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price.

Deleveraging refers to decreasing financial leverage; most often via paying off existing debt.

The **federal funds rate** is the interest rate that banks with excess reserves at a U.S. Federal Reserve district bank charge other banks that need overnight loans.

Forward interest rates are rates that express how the market is feeling about the future movements of interest rates.

The **overnight rate** is the interest rate at which a depository institution lends funds to another depository institution (short-term), or the interest rate the central bank charges a financial institution to borrow money overnight. The overnight rate is the lowest available interest rate, and as such, it is only available to the most creditworthy institutions.

A **yield curve** shows the relationship between yields and maturity dates for a similar class of bonds.

The **yield to worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

A **spread** is the difference in yield between two different types of fixed income securities.

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* As of December 31, 2014.