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GLOBAL ASSET MANAGEMENT

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GLOBAL BOND REVIEW AND OUTLOOK

Markets rally as Europe unveils stimulus

- Global growth should improve mildly in 2015, helped by accommodative monetary policies
- Global inflationary pressures remain very subdued
- The European Central Bank unveiled a much-expected Quantitative Easing program
- The pace of US rate increases is likely to be very slow and gradual
- Global bond markets enjoyed a strong start to 2015 although volatility remained at elevated levels

JAN 2015

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 US economy, global activity remains subpar giving little reason to question a 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 are likely to be negatively impacted but, overall, we believe, global growth should 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 Federal Reserve's (Fed) dual mandate of full employment and price stability. Western Asset expects the 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. Western Asset's 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, even though a sustained rise in long-term U.S. bond yields is unlikely while inflation remains subdued, short-dated bond valuations appear more attractive in the event that growth disappoints.

Europe and Japan

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 has added sovereign debt to its asset purchase policy in an attempt to stave off further deflationary forces. Western Asset believes that it is unlikely that monetary policy alone will be successful in repairing the broken credit mechanism, so it might have to be complemented by fiscal stimulus. The divergent growth and policy stance versus the U.S. may facilitate further euro weakness and support peripheral European bond spreads relative to Germany, despite the risks from a standoff over Greece's debts. Western Asset doesn't view the euro favourably but has a positive outlook on Italian government bonds.

Japan's economy remains in a fragile state as negative real wages continue to dampen demand. Long-term market inflation expectations remain depressed. The Bank of Japan (BoJ) has responded with an aggressive increase in liquidity provision and further stimulus is expected as lower oil prices drag inflation lower. Although the weaker yen and energy prices should boost growth near-term, the divergence of policy between the BoJ and the Fed should place further downward pressure on the Japanese yen.

China

The Chinese economy is slowing but should still grow at a rate of around 7% in 2015. 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 model. There seems to be 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. Western Asset believes China is expected to continue to contribute significantly to the ongoing global recovery.

With the recent commodity price declines, some EM countries face a more challenging environment in 2015. Longer term, and despite near-term challenges, EM economies will likely 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.

Corporate bonds

Western Asset maintains a favourable view on corporate bonds where the fundamental outlook and management of companies remain 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. We believe, the decline in these sectors, and in some individual securities in particular, should 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.

> U.S. short-dated bond valuations appear more attractive in the event that domestic growth disappoints.
>
> Western Asset

MARKET
REVIEW

Figure 1: Bond sector total returns[1]

	1 Month	12 Months
Barclays European Treasury Index	2.3	13.3
Barclays European Corporate Index	0.9	7.9
Barclays Pan-European High Yield (Euro) Index	1.1	6.2
Barclays Sterling Gilts Index	4.9	17.7
Barclays Sterling Corporate Index	5.1	15.8
Barclays Pan-European High Yield (Sterling) Index	2.2	6.2
Barclays U.S. Treasury Index	2.6	6.3
Barclays U.S. Agency Mortgage Backed Securities (MBS) Index	0.9	5.3
Barclays U.S. Corporate Index	3.0	8.8
Barclays U.S. High Yield Index	0.7	2.4
JPMorgan Emerging Markets Bond Index Plus (EMBI+)	0.6	8.5
JPMorgan Corporate Emerging Market Bond Index (CEMBI) Broad Composite	0.2	3.5
JPMorgan Government Bond Index — Emerging Market (GBI-EM) Global Diversified Composite	0.3	-0.8

Source: Bloomberg, as of January 31, 2015. **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.

Global bond markets enjoyed a strong start to 2015 although volatility remained at elevated levels.

Major government bond markets and the U.S. dollar were the main beneficiaries of investor flows in January. Disappointing global economic data, falling oil prices, significant shifts in central bank policies and geopolitical tensions all served to keep demand strong for safe-haven assets with yields plumbing record lows in many markets.

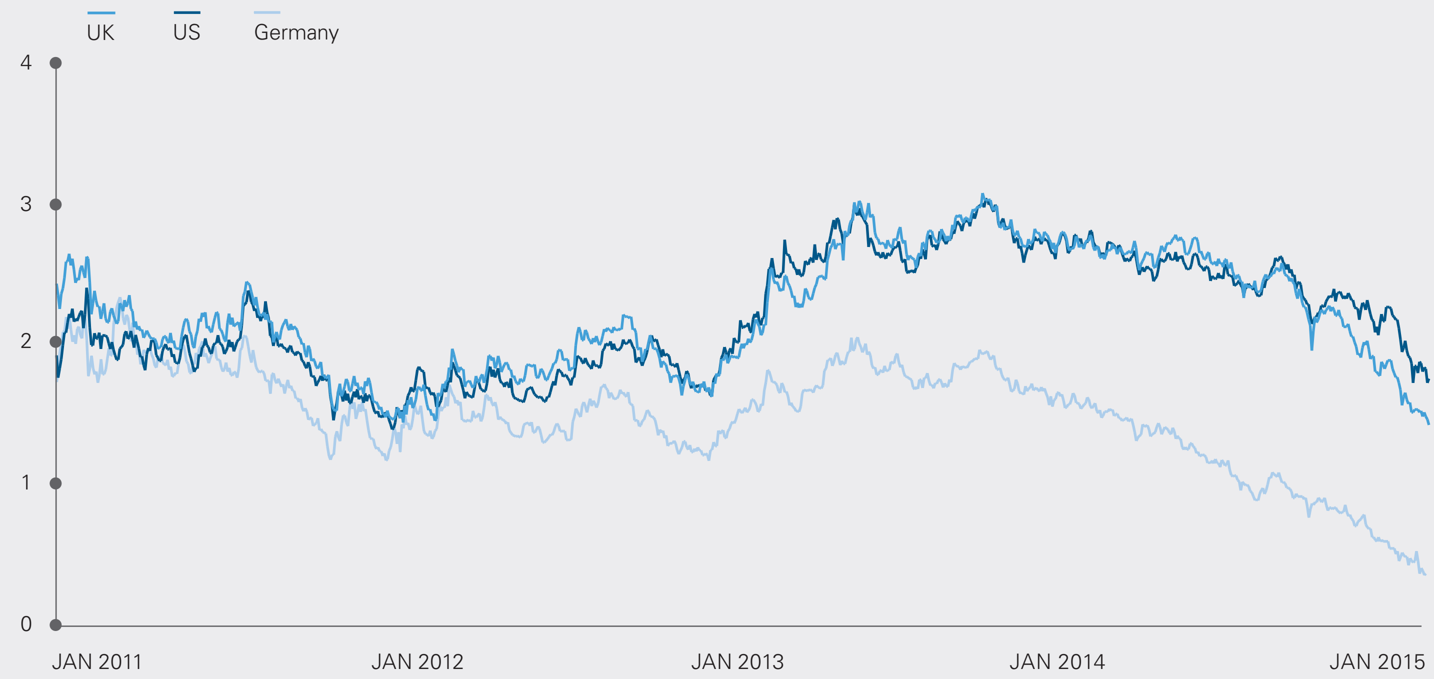
Investment-grade credit sector returns broadly kept up with equivalent-duration government securities but high-yield corporates and external EM debt lagged. Local currency EM bonds, however, posted strong gains as yields declined sharply.

Currency markets were particularly volatile in the wake of the surprise decision by the Swiss National Bank to stop supporting its peg to the euro and the announcement by the ECB to add sovereign bonds to its asset purchase policy. The Swiss franc appreciated by 15% versus the euro, which in turn weakened by 7% versus the U.S. dollar in reaction to the ECB's plan to purchase €60 billion of sovereign and private-sector debt monthly until inflation trends closer to its 2% target.

The unprecedented policy shift saw German 10-year yields drop to a record low of 0.3% and other core European government yields move to negative yields for maturities up to five years. Peripheral European markets were initially buoyed by the ECB's move to sovereign Quantitative Easing (QE) but the election of the anti-austerity party in Greece's general elections renewed anxieties over the stability of the eurozone and spreads to Germany widened from four-year lows. UK yields also declined sharply as inflation fell and the Bank of England signalled rates would stay on hold. With oil prices dropping below the $50 per barrel level, and China's economy posting its slowest annual growth since 1990, most EMs and commodity-related currencies remained under pressure.

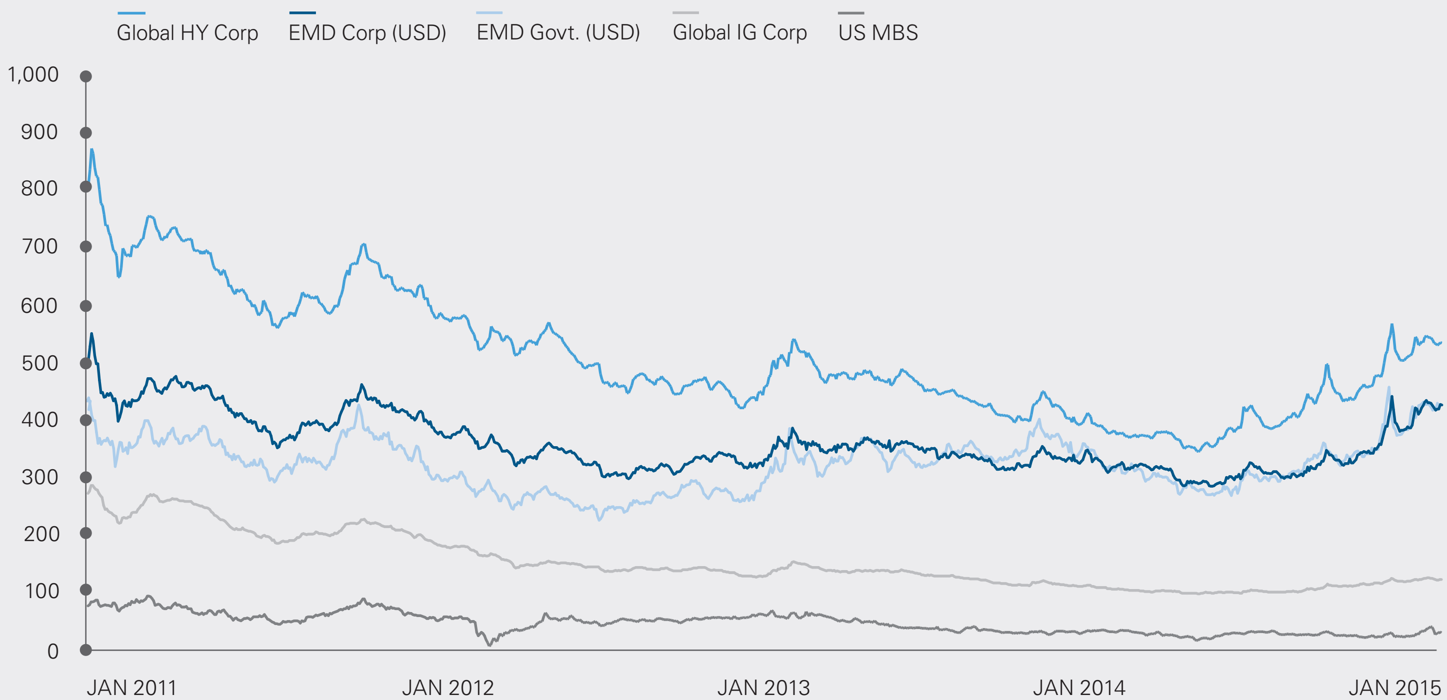
Despite both the World Bank and the International Monetary Fund lowering their global growth forecasts for 2015, the outlook for the U.S. economy remained more robust than in most other regions. US. Gross Domestic Product increased by 2.6% in 4Q14 and by 2.4% for 2014: robust hiring and improving consumption (helped by the windfall from lower gasoline prices) offset weaker net exports. Despite the Federal Reserve up¬grading its confidence in the solid pace of economic expansion, the fall in headline inflation to below 1% and the ECB's announcement of sovereign QE led to investors delaying their expectations of when official rates would rise to late in 2015. Ten and 30-year yields fell sharply to 1.64% and 2.22% (a record low), respectively.

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



Source: Bloomberg, as of January 31, 2015. **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 January 31, 2015. **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.

Past performance is no guarantee of future results. An investor cannot invest directly in an index. **Yields represent past performance and there is no guarantee they will continue to be paid.**

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.

Mortgage-backed securities involve additional risk over more traditional fixed-income investments, including: interest rate risk, implied call and extension risks; and the possibility of premature return of principal due to mortgage prepayment, which can reduce expected yield and lead to price volatility.

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.

Quantitative easing (QE) refers to a monetary policy implemented by a central bank in which it increases the excess reserves of the banking system through the direct purchase of debt securities.

Tapering refers to the Fed's announced approach to reduce the pace of its monthly asset purchases gradually instead of ending the purchases all at once.

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* As of December 31, 2014.