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Post-Election, Fixed Income Markets Have Risen "Too Far, Too Fast"

Despite Initial Surge, Western Asset Deputy CIO Believes Investors Should Judge Opportunities by Fundamentals and Expect Challenges

(Pasadena, CA, December 20, 2016) – The election of Donald J. Trump sent bond yields higher and prices down sharply. The President-elect's strong pro-growth policies were interpreted by the markets as accelerating economic growth and inflation, which likely will result in the U.S. Federal Reserve raising rates faster and higher.

In a recent webcast to discuss these developments, the Deputy Chief Investment Officer of Legg Mason-affiliate Western Asset Management, Michael C. Buchanan, declared, "Our conclusion is that the markets have moved too far, too fast."

"The obvious shift has been in rates and valuations overall, but in reality, when you look at the fundamental landscape, things haven't really changed that much," Mr. Buchanan reported.

"You see it most clearly in rates: the yield on 10-year U.S. Treasury bonds is up 67 basis points since the election."

"We think the notion that rates will move radically higher in the near term is somewhat flawed."

"Their agenda is certainly pro-growth," he said. "It includes a lot of pro-growth policies and initiatives, and the net impact from our perspective is going to be economic positive."

"However, when you think about the implementation of these policies and these initiatives, it's unclear whether they'll have success on all of these. It's unclear how robust they'll actually be to the overall economy. We should also expect some challenges to these policies along the way."

Watch the replay from December 14 from the Western Asset webcast, "Finding Opportunity Amidst Hope, Doubt, and a New U.S. Administration," here: https://engage.vevent.com/rt/westernasset~121416

On election night, when the result of the presidential election was close to being decided, Mr. Buchanan believes the market was concerned that trade and immigration – hallmark issues of the Trump campaign – would overwhelm the economic impact of pro-growth policies. As it became apparent on election night that Mr. Trump was going to win, S&P futures traded off aggressively, over 100 points, with ultra-long bond futures up over four points.

"That initial risk-off movement was in response to the fear that surrounds trade barriers and perhaps restrictive immigration policies," he observed. "But when Trump gave what most believed to be a conciliatory acceptance speech, the market began to dampen those concerns."

Putting it all together, what does it mean for managing a diversified fixed-income portfolio?

“Rates have moved too far, too fast,” Mr. Buchanan said. “We don't argue that longer term, we should expect higher rates. But given the rapid move recently, we've probably overshot a little bit. We want to have duration bias in our portfolios, not only from a valuation perspective in and of its own right, but also the way it works within the context of a diversified portfolio.”

“If we're going to take select risk in certain spread markets, duration has historically worked very well as a complement.”

Western Asset always considers diversified strategies and constructs portfolios with a number of strategies with complementary sources of tracking error, Mr. Buchanan reported. This requires thinking about blends of different strategies and risks that work well together in different economic environments. In the current market environment that means rates, long-duration bias and developed country corporate credit.

Mr. Buchanan noted that Western Asset is following “our most emphatic strategies right now.”
“We still like investment grade credit and continue to emphasize financials,” he said. “Everything we're seeing from the new administration suggests a marginally stronger environment for banks; higher short-term rates as the U.S. Federal Reserve hikes, a potentially steeper yield curve, and an emphasis on deregulation that should enhance profitability.”

“Keep in mind that regulations also come from sources outside the new administration. Capital requirements are determined by global banking standards in accordance with Basel III and this type of regulation will remain in place. From a bondholder perspective, this is positive as balance sheets will continue to have excess capital.

As for geographic choices, Mr. Buchanan and Western Asset “still favor U.S. versus non-U.S.”

“Post-election, our bias for U.S. is not as glaring for us. Some real opportunities are popping up in the European and U.K. markets. Still a slight bias towards U.S., but not as significant as where we were a couple months ago.”

They remain cautious on health care and pharmaceuticals: “In our minds, we're really not out of the woods in terms of top-line pressure. That continues to be an underweight for us.”
The high-yield sector received more positive mention.

“We still like high-yield quite a bit,” Mr. Buchanan said. “Valuations have improved significantly. It makes that determination to own high yield a little more challenging, but we always bring it back to the fundamental backdrop: very healthy, and we think defaults are going to remain low.”

“At-risk sectors like energy and commodity-related went through a fairly violent default mini-cycle the previous two years. A lot of the more vulnerable companies were flushed out. What's left is a very strong cohort. We have a bit of an overweight in energy and metals and mining. As much as they've performed this year, we still think there's more to go.”

As for bank loans, over the past few months Western Asset has gradually increased exposure.

“Even though our base case is that rates have overshot, there is a risk that you could see higher rates,” Mr. Buchanan said. “We don't want to dismiss that.”

“The idea of owning bank loans is two-fold. One, we get the benefit of that strong fundamental backdrop I mentioned. But two, if we're wrong, if rates continue to climb, we think there is a really good trade opportunity in loans. Not only will you benefit from the fundamentals, you will also obviously benefit from increasingly higher levels of LIBOR. You could even see a little bit of a technical tailwind there. So, we like bank loans a lot. We don't think you're giving up a lot of income to have exposure to that sector, hence our increasing allocations there.”

When considering emerging markets, Western Asset has been “a little more cautious.”

“We recognize the risk from rates potentially as well as trade protectionism,” Mr. Buchanan said. “We are favoring sovereigns and situations where the fundamentals are improving, and you also see some improvement in policy outlook, and economies that are a little less sensitive to U.S. trade policy, namely Brazil and Russia.”

Discussing mortgage-backed securities, Mr. Buchanan cited strong consumer and real estate fundamentals. “Though we’ve seen improving valuations for some time, we continue to believe there’s more room to perform particularly in non-agency residential mortgages.”

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About Michael C. Buchanan CFA
The Deputy Chief Investment Officer of Western Asset Management Co., Mike Buchanan is a specialist in high yield, having headed the Global Credit team. Prior to joining the firm in 2005, Mr. Buchanan served as Managing Director and Head of U.S. Credit Products at Credit Suisse Asset Management, and as Executive Vice President and Portfolio Manager at Janus Capital Management. He also worked at BlackRock Financial Management as a managing director and portfolio manager, and at Conseco Capital Management as a vice president and portfolio manager. A Certified Financial Analyst, Mr. Buchanan earned his B.A. from Brown University.

About Western Asset Management
Western Asset Management is one of the world's leading fixed-income managers with $444.5 billion in assets under management as of Sept. 30, 2016. The firm is a wholly owned, independently operated subsidiary of Legg Mason, Inc. From offices in Pasadena, Hong Kong, London, Melbourne, New York, São Paulo, Singapore, Tokyo and Dubai, the company provides long-term, value-oriented investment services for a wide variety of global clients, across an equally wide variety of mandates. To learn more about Western Asset Management, please visit www.westernasset.com.

About Legg Mason
Legg Mason is a global asset management firm with $707 billion in assets under management as of November 30, 2016. The Company provides active asset management in many major investment centers throughout the world. Legg Mason is headquartered in Baltimore, Maryland, and its common stock is listed on the New York Stock Exchange (symbol: LM). www.leggmason.com

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