

TOPIC OF FOCUS: ECONOMY

A GLOBAL CREDIT CYCLE BUILT FOR ENDURANCE

The expansion phase of the current global credit cycle has been ongoing for the last ten years, making it one of the longest in history. While many have been calling for it to falter, we take a different view. Within the greater cycle are smaller “mini-cycles” and the indicators that may flash warning signs are more nuanced than those of past cycles. Here we explain our assessment of the current cycle in detail and conclude that we do not yet see any near-term catalysts about to trigger its end.



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KEY TAKEAWAYS

- We maintain our long-standing view that the underpinnings of the current credit cycle are more nuanced than those of prior cycles.
- Today’s cycle is benefiting from a slow recovery in risk-taking behavior and an unprecedented level of central bank activism.
- Portfolio positioning largely rests on one’s view of where we are in the global credit cycle, assessments of “fair value” for each credit sector and portfolio risk tolerance.
- Contrary to conventional wisdom, we believe portfolios should maintain a healthy allocation to corporate credit at this stage of the cycle.
- Barring a full-blown trade war or tail-risk event, the combined weight of resilient global growth, low rates and stable credit fundamentals suggests credit market performance could improve beyond current market expectations.
- Note that a copy of our *Relative Value By Sector* analysis, as published in our recent Third Quarter Global Outlook, is included at the end of this paper.

A GLOBAL CREDIT CYCLE BUILT FOR ENDURANCE

By Michael Buchanan and Robert Abad

"...differences in various countries' economic cycles, fiscal policies and central bank policies lead to very different cycle phases across global credit markets and their subsectors."

Investors continue to debate where we are in the global credit cycle and wonder if the party is about to end. After all, credit spreads have ground tighter over the past few years even as corporate sector leverage has crept higher and as global growth has softened on the back of trade-related uncertainty. This is a potentially worrisome mix, many would argue. We recognize that there are a number of signs in credit markets that warrant caution. Still, we maintain our long-standing view that the underpinnings of this cycle are more nuanced than those of prior cycles, and that credit market performance could improve beyond current market expectations. This paper delves a bit deeper into our views, market concerns and implications for portfolio positioning.

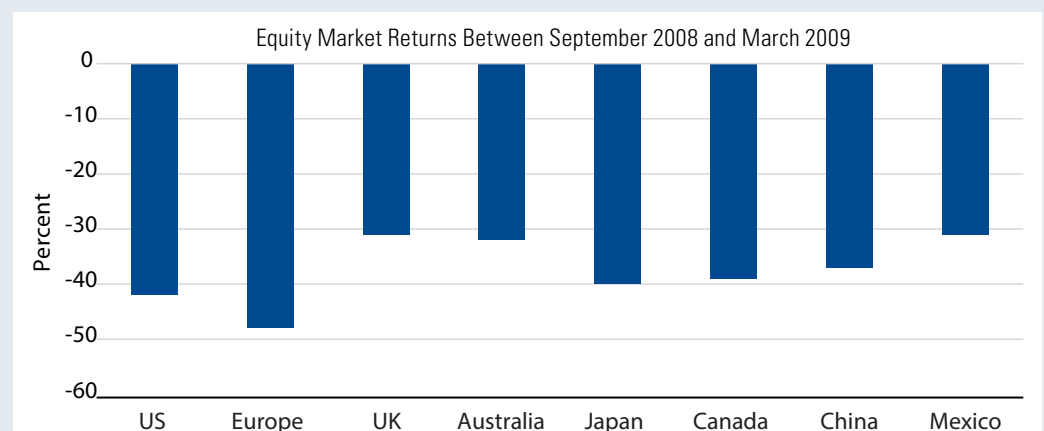
Drivers of the Latest Credit Cycle

Credit cycles are typically characterized as having four distinct phases: early (recovery), mid (expansion), late (downturn) and recession (repair). In fact, sometimes the credit cycle is depicted as a "clock" with sectors moving across all four quadrants simultaneously or with each phase having the same duration. While this framework helps simplify a complex subject, reality is much messier. The length and strength of any credit cycle is driven by a variety of factors, both top-down and bottom-up. For example, differences in various countries' economic cycles, fiscal policies and central bank policies lead to very different cycle phases across global credit markets and their subsectors.

In the aftermath of the 2008 global financial crisis, three themes helped shape our view that the ensuing credit cycle would likely exceed the duration of all previous cycles:

1. **The global financial crisis (GFC) disproportionately impacted developed markets.** The crisis had severely dented global wealth and critically damaged market psychology, specifically risk-taking behavior, among individuals, corporations and governments. We expected certain areas of the global economy to rebound sharply, most notably emerging markets (EM), which were not a focal point of the crisis. However, we felt it would take much longer for the developed world to recover.

Exhibit 1: Global Crisis Impact



Source: MSCI Total Return Indices. As of 31 Mar 09. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.



“...not all credit markets or their respective subsectors are the same, and it follows that a crisis in one market may not necessarily be a harbinger of a broader crisis.”

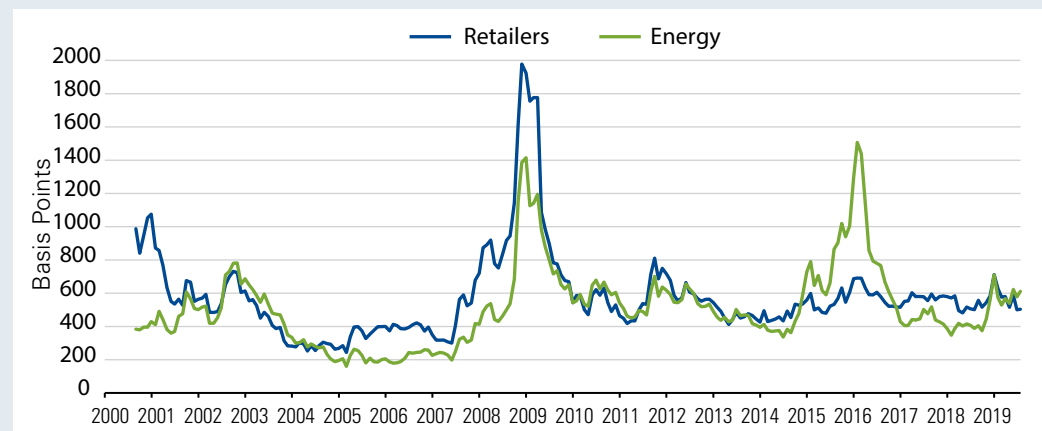
2. **Central banks initiated extraordinary measures.** During the depth of the crisis, the major central banks united in an unprecedented way to enact extraordinary policy measures. This “whatever it takes” posture signaled that central banks understood the urgency of preserving the integrity of the financial system and repairing market sentiment.
3. **Financial regulators made beneficial changes.** Across different countries, financial regulators were advocating significant legislative and regulatory changes with the aim of capping leverage (especially for financials), repairing balance sheets and improving liquidity. These new regulations would have the effect of adding ballast to the ensuing economic expansion and function as a strong tailwind for risk assets.

The Role of “Mini-Cycles”

As we alluded to earlier, not all credit markets or their respective subsectors are the same, and it follows that a crisis in one market may not necessarily be a harbinger of a broader crisis. Markets that are mature, deep and well trafficked by all investor types globally enjoy extra resilience when hiccups occur. Consider the US corporate credit versus European or EM credit markets, which are still broadening and deepening.

As an example, investors grew quite concerned a few years ago with the entire US high-yield (HY) market. In 2014, the success of technological innovation (i.e., fracking) greatly enhanced the ability of exploration and production (E&P) companies in the US to extract a greater amount of crude oil; this upset the supply/demand dynamic throughout the global energy sector and contributed to a severe downturn a year later. On top of that, the retail sector in 2015 experienced turbulence as investors realized the scale of the disruptive impact that online retailers were having on the business model of brick-and-mortar retailers.

Exhibit 2: High-Yield Energy and Retail Sector Spreads



Source: Bloomberg Barclays. As of 30 Jun 19. **Past performance is no guarantee of future results.** Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

These specific sector dislocations engendered many alarmist headlines, not just about the state of the US High Yield (HY) market, but also about the potential end of the credit cycle. Ultimately, none of these episodes had a lasting impact; if anything, these “mini-cycles” reduced market excesses, restored corporate discipline and boosted investor confidence, all of which added more fuel to the broader credit cycle.

Areas of Concern

All that stated, our research analysts have seen some signs of late-stage cycle behavior. These include weaker covenant packages in underlying securities that expose investors to increased risk, questionable use of lines of credit (revolvers) and a growing preoccupation with shareholder returns. Most equity-sponsored deals, for

“We acknowledge the risk that an unforeseen catalyst could precipitate a wave of downgrades...however... we see no reason for panic.”

example, allow generous use of the restricted payment basket and an increase in allowable “add-backs” to arrive at adjusted earnings before interest, taxes, depreciation and amortization (EBITDA).

Other areas of concern include increasing debt-financed Mergers and Acquisition (M&A) activity and leverage creep, which are closely tied to the rapid growth of the BBB rated segment of the credit market. We acknowledge the risk that an unforeseen catalyst could precipitate a wave of downgrades (fallen angels), which would ultimately overwhelm the HY market. However, when looking more closely at the drivers, we see no reason for panic. The growth of BBBs as a proportion of the investment-grade (IG) market over the past decade—from 32% to 46%—has largely been observed within three subsectors: banking, healthcare & pharmaceuticals and autos, all of which have very different trajectories.*

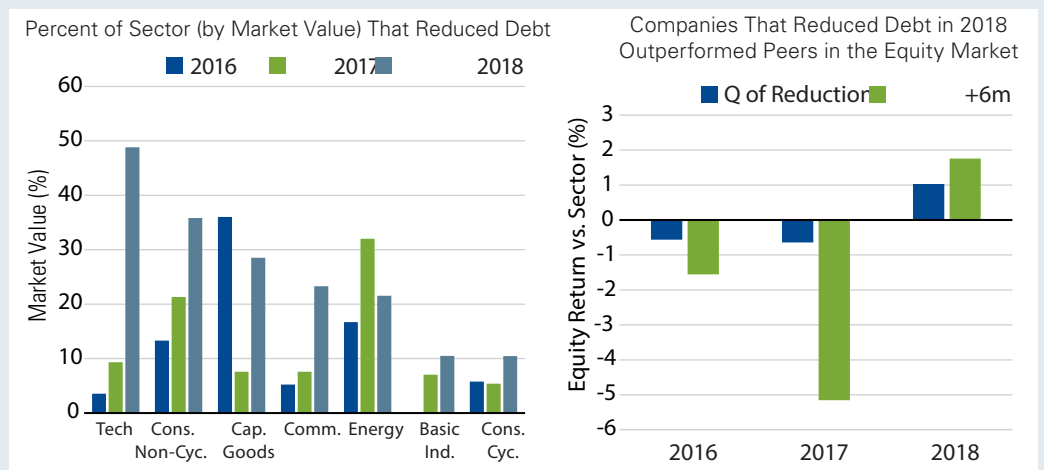
For instance, the US banking industry was downgraded en masse in the aftermath of the financial crisis but record earnings, higher capital ratios and improving asset quality over the past decade have this sector on an improving ratings trend. While European banks are behind their US counterparts in terms of balance sheet repair, they are also heading in the right direction and in a much stronger position than they were pre-crisis.

The healthcare & pharmaceuticals industry, on the other hand, has gone through a secular fundamental decline. What used to be an AA/A industry has settled in at A/BBB as a result of deteriorating margins, weak product pipelines and generic competition. To combat these forces, industry consolidation was necessary, but management teams have generally been committed to IG ratings. A somewhat reassuring factor is that the industry is non-cyclical; therefore, it is less vulnerable to a dramatic revenue downturn in recessionary environments.

Meanwhile, original equipment manufacturers in the auto industry have been on a ratings roller coaster over the past couple of decades, but the most recent turn has been upward. This area of the market has drawn increased concern as companies have been subject to forces beyond their control (e.g., peak sales, China slowdown and tariffs). However, we credit management teams with addressing legacy issues (debt load, underfunded pensions and labor contracts) and understand they have no intention of giving up their hard-fought IG ratings.

Regarding BBB issuer risk more broadly, it’s important to bear in mind that corporate managements have been wrestling with the trade-off between meeting the “higher standards” required for a single A rating, improving their weighted-average cost of capital, especially in the current low-rate environment, and maintaining flexibility in order to execute the corporate strategy. As a result, some have settled into the mindset that the optimal capital structure should include more leverage.

Exhibit 3: Company Deleveraging Continues



Source: Bloomberg Barclays. As of 31 Dec 18, **Past performance is no guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.



“Given the heightened level of uncertainty in today’s market, investors are right to question what type of credit exposure is currently appropriate in their portfolios.”

That stated, some of the largest issuers (of the IG credit index) have been actively reducing leverage. In Exhibit 3, the chart on the left shows the deleveraging trend gaining momentum in key sectors such as technology, consumer non-cyclicals and communications. The chart on the right shows the equity performance of companies that reduced debt relative to their sector peers during the quarter they deleveraged and six months later (when this activity was disclosed to the public). In the 2016-2017 period, equity investors penalized corporations that paid down debt. This shifted in 2018 with equity investors rewarding those companies that made tangible progress with deleveraging.

Thoughts About Credit Sector Positioning*

Given the heightened level of uncertainty in today’s market, investors are right to question what type of credit exposure is currently appropriate in their portfolios. The answer largely rests on one’s view of where we are in the global credit cycle, assessments of “fair value” for each credit sector and portfolio risk tolerance.

Exhibit 4 provides our summary view of what high-level asset allocations might generally look like during each phase of the cycle, taking into consideration differing portfolio styles (e.g., benchmarked, unconstrained and multi-asset credit). Green represents having a constructive view (more aggressive exposure), yellow represents exercising some degree of caution (more conservative exposure) and red represents having a less constructive view (minimal or zero exposure).

Note that these asset allocations relate more to macro conditions and timing. From a bottom-up valuation perspective, we would argue that the best time to own higher beta credit such as HY and EM is during the depths of a down cycle (i.e., the recession period) when valuations become extreme. For example, in late 2008, credit fundamentals were under duress and defaults spiked a year later, but that was the time to put money to work. This speaks, once again, to the need for active management in fixed-income to identify and exploit value opportunities as they present themselves.

In the recovery phase of a cycle, it makes sense to have diversified exposure across corporate and structured credit in a broad market portfolio (e.g., a Core Plus type mandate). These sectors typically perform strongly in an environment of loose monetary conditions and earnings expansion. In an environment of improving global macro prospects and healthier market sentiment (what we observed in the years following the 2008 crisis), EM debt also offers attractive total return potential.

Exhibit 4: Credit Cycle Asset Allocations

	Early (Recovery)	Mid (Expansion)	Late (Downturn)	Recession (Repair)
Cycle Stage Characteristics	Free cash flow generation, improving credit metrics, deleveraging underway	Easy lending standards, availability of capital, increased borrowing, rising leverage metrics	Lending standards tighten, more shareholder friendly behavior, borrowing costs rising, liquidity diminishes	Operating environment bottoming balance sheet stabilization, cost cutting, asset sales to raise liquidity
Asset Allocations				
IG Corporates	●	●	●	●
HY Corporates	●	●	●	●
Bank Loans	●	●	●	●
EM Debt	●	●	●	●
Structured Credit	●	●	●	●
Governments	●	●	●	●

● = Strategic (overweight) allocations in Core Plus, Unconstrained and Multi-Asset Credit portfolios
 ● = Tactical (or marketweight) allocations in Core Plus, Unconstrained and Multi-Asset Credit portfolios
 ● = Opportunistic allocations depending on portfolio return objective and risk tolerance

Source: Western Asset. As of 31 Jul 19. **Past performance is no guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

*Diversification and asset allocation do not guarantee a profit or protect against a loss.

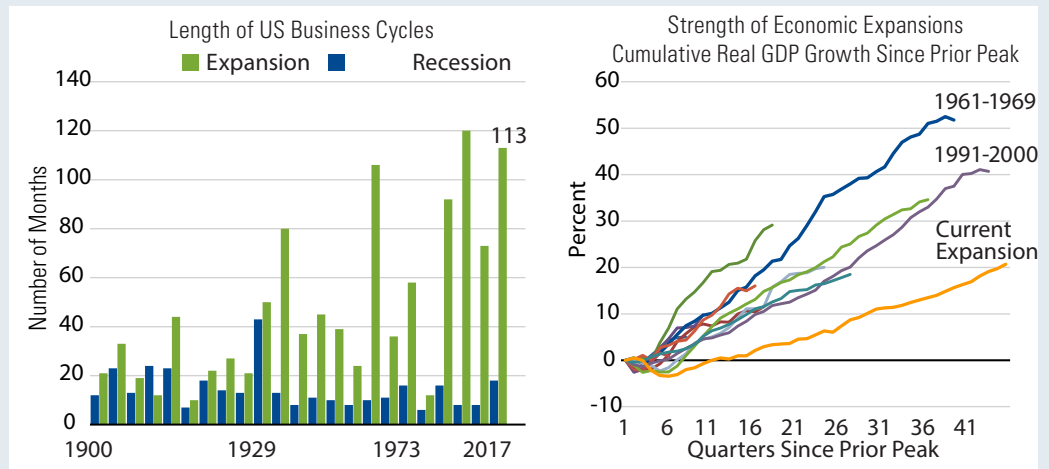
Conversely, as external macro and/or domestic conditions begin to deteriorate for a particular credit market (or sub-sector), it would be prudent—especially for investors in benchmarked portfolios—to exercise caution. This entails recalibrating credit risk exposure by either moving up in credit quality (i.e., going underweight lower-rated issuers and overweight higher-rated issuers) or shifting proceeds to more defensive sectors (e.g., global government bonds) to mitigate potential spikes in tracking error volatility. Note that portfolios that are unconstrained or not managed versus a benchmark, such as multi-asset credit strategies, have much greater investment and risk management latitude than their benchmarked counterparts. A manager is not tethered to an index and can tactically rotate from one sector to another to find value in down cycles.

At present, there is a growing market consensus that we are in the late stage of the credit cycle. Conventional wisdom says that, in such an environment, a broad market portfolio should have a minimal amount of exposure to higher beta sectors. We believe this assessment misses the mark due to unique top-down and bottom-up dynamics.

Consider the growing activism of central banks over the past decade. Unconventional monetary policy, which was used during the crisis to rescue economies from a downward spiral, has in fact become conventional policy with central bankers. This is true in both developed markets and EM as policymakers seek to sustain their recoveries. For example, the current US expansion has clearly lagged past expansions in terms of magnitude, despite extraordinary

“Conventional wisdom says that, in such an environment, a broad market portfolio should have a minimal amount of exposure to higher beta sectors. We believe this assessment misses the mark...”

Exhibit 5: History of Economic Expansions (and Recessions)

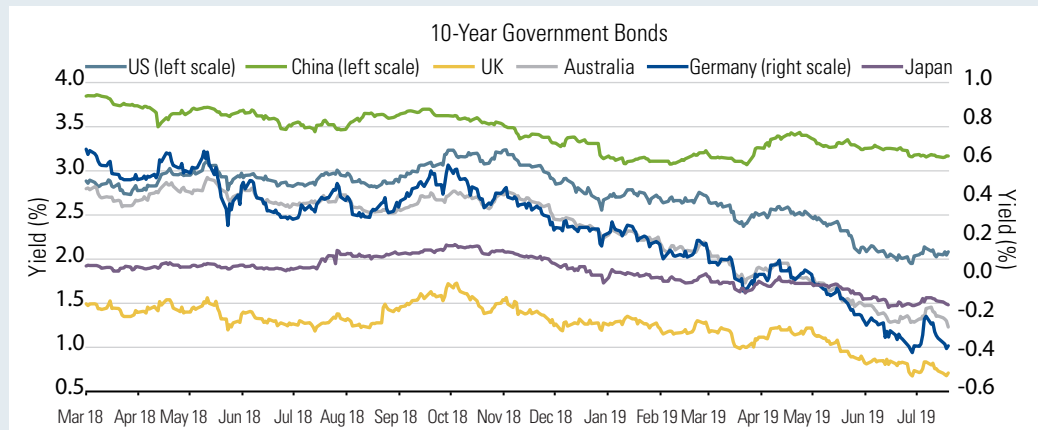


Source: J.P. Morgan, National Bureau of Economic Research, and Bureau of Economic Analysis. Left chart as of 30 Nov 18. Right chart as of 31 Jan 19. **Past performance is no guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

policy accommodation by the Federal Reserve (Fed). A similar dynamic is occurring in Europe, Japan and elsewhere. Weaker global growth expectations—exacerbated by protracted uncertainty around Brexit and US-China trade tensions—have had the effect of pushing both inflation expectations and global government bond yields lower as investors price in the probability of additional stimulus.

The net result is a period of low borrowing costs for the foreseeable future, which should allow issuers both in the US and abroad to continue to refinance and extend their obligations at cheaper levels and longer maturities. This, combined with stable credit fundamental indicators that do not suggest imminent decay, allays our concern of an IG credit-driven liquidity crisis or a scenario of widespread default risk in the HY market. Indeed, when looking at HY credit spreads through the lens of historical and expected default rates, we believe concerns around “tight” valuations may be overdone with more room to run.

Exhibit 6: Key Benchmark Rates Continue to Drift Lower

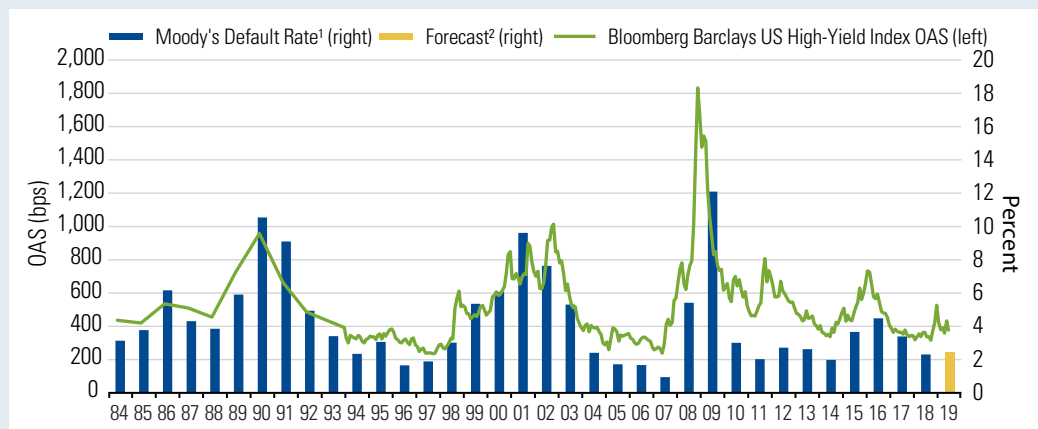


Source: Bloomberg Barclays. As of 25 Jul 19. **Past performance is no guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

With this in mind, we believe investors should have a healthy allocation to both US and European IG and HY corporate credit. Spreads across these markets have widened as of late due to a number of market concerns, but the world of “yield starvation” is back in play. Indeed, the amount of negative-yielding debt globally now stands at a record high of \$13+ trillion.* Interest rates of 2%+ in the US are high by comparison and yield spreads across credit markets are also the most generous. We believe these data points along with the Fed and the European Central Bank’s aggressive accommodative posture position corporate credit as a compelling “carry” trade for both benchmarked and unconstrained portfolios.

“...we believe concerns around ‘tight’ valuations may be overdone with more room to run.”

Exhibit 7: High-Yield Default Rates vs. Spreads



Source: Moody's, Bloomberg Barclays, Western Asset. As of 30 Jun 19
¹Moody's Trailing 12-Month Issuer-Weighted Spec-Grade Default Rate ²Moody's baseline forecast for 31 Dec 19 as of 30 Jun 19
Past performance is no guarantee of future results. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

The subsectors we see as currently offering attractive relative value and, more importantly, that exhibit a lower sensitivity to tariffs are financials (with an emphasis on the strongest US and European banks across the capital structure), energy (mainly higher-rated, US oil-directed Exploration and Production (E&P) as well as pipeline and midstream credits) and basic industries, specifically metals & mining (e.g., copper-related credits). Our emphasis is also on higher quality issuers such as “rising stars,” which are BB rated credits that have the potential to move up to IG over the next 12-18 months.

Exhibit 8: Growing Universe of Negative Yielding Debt



Source: Bloomberg Barclays. As of 30 Jun 19. **Past performance is no guarantee of future results.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

“Looking ahead, a more dovish Fed and signs of slowing US growth outperformance are constructive for EM financial conditions and flows.”

We also believe a tactical allocation to EM (with an eye on idiosyncratic risk across countries) can make sense as U.S. dollar (USD)-denominated sovereign and corporate issuers continue to recover from the commodity price collapse and marked slowdown in Chinese economic activity during 2014-2016. Looking ahead, a more dovish Fed and signs of slowing US growth outperformance are constructive for EM financial conditions and flows. More importantly, these factors take the pressure off EM central banks to tighten policy, which bodes well for the fundamental outlook of the asset class.

Structured credit—both mortgage and consumer credit—should also be considered at this time given the investment team’s view that the sector is sitting between the early and middle phase of the credit cycle. Since the financial crisis, increased transparency and improved risk measures have resulted in better underwriting standards (e.g., mandatory income verification and more equity in the property) and improved loan quality, resulting in a higher quality asset class. From a macro standpoint, structured credit is well supported by the continuation of the deleveraging trend observed in consumer and household debt. From a relative value standpoint, structured credit offers attractive yield potential and, perhaps more importantly, diversification benefits given the low correlation that non-agency residential and commercial mortgage-backed securities (MBS) have to corporate credit.

On the margin—and keeping in mind that markets may become more volatile in the coming months—we favor an allocation to bank loans. Despite concerns over the state of the leveraged loan market, we continue to see attractive underlying fundamentals and expect moderate growth in the coming quarters for corporates. We also favor an allocation to collateralized loan obligations (CLOs) with an emphasis on the highest quality (AAA rated) tranches given their history of resilience during periods of severe market dislocation and compelling carry profile relative to other credit markets, such as similarly rated IG corporate credit and commercial mortgage-backed securities (CMBS).

Last, but not least—and given prevailing market concerns over trade tensions and Brexit—we feel it is prudent to hold an allocation to US Treasuries as they remain the best diversifying hedge against broader market risks.

Looking Ahead

There have been three credit cycle downturns in the past 30 years, and each was associated with either a sharp tightening in global financial conditions (precipitated by the bursting of a market bubble) or a protracted economic downturn during which time corporate default rates rose sharply. We do not see any near-term catalysts that could trigger such scenarios. Barring a full-blown trade war or a tail-risk event, we remain optimistic that the combined weight of resilient global growth, low inflation, central bank activism (resulting in interest rates remaining “low for longer”) and stable credit fundamentals should continue to extend the life of the global credit cycle for the foreseeable future.

Relative Value By Sector

IG Corporate Credit	Outlook	Relative Value
US	US IG credit index spreads have drifted wider; dovish central bank policies globally support holding risk near term. We remain cautious on the food & beverage, healthcare/pharmaceuticals and automotive sectors.	+/- We remain focused on banking, energy, and metals & mining as they exhibit the least sensitivity to tariff-related risk and are poised for further uplift from the ratings agencies.
Europe	European IG credit fundamentals remain solid but are susceptible to growth and tariff pressures. We are watching for near term regional growth risks and on an industry basis the autos/retails sectors. The euro market feels fairly well supported in terms of overseas and local demand but valuations are less attractive than at the start of the year.	+ Bias to financials over non-financials given strong balance sheets and spread pick-up available.
Australia	Fundamentals remain strong as management retains a conservative attitude to balance sheets alongside solid profitability. Limited issuance and maturities in 2019 should also assist on the technical front.	+ Overweight to sector but holding a short duration focus to manage spread risk. Sector biases remain in financials, REITS and regulated utilities.

High-Yield (HY) Corporate Credit

US	Further spread tightening on stable corporate fundamentals and positive technicals has driven current valuations closer to fair value. Looming risks warrant caution. Opportunities remain in higher quality issuers that continue to delever and have access to capital.	+ We remain underweight CCCs given valuations and the late stage credit cycle; we are overweight metals & mining (e.g., copper), consumer cyclical services, financials and rising star candidates.
Europe	Market volatility has increased as sentiment fluctuates, impacting liquidity. This has caused more issuer specific dispersion. Technicals are fairly supportive, new issues generally in the BB and high B ratings bracket, but there is a lack of new issue premium.	+/- The weak regional growth backdrop, trade and Brexit-related uncertainties give us cause to take a more opportunistic/cautious approach to new issues and secondary market opportunities.

Bank Loans

US	Borrowers continue to show moderate growth and ample cash flow coverage; lower short-term rates could further improve cash flow. We expect CLO formation to drive demand; however, a lower rate backdrop will likely cause moderate outflows from retail accounts. Loans remain attractive as a carry trade.	+ With CLO demand driving the secondary bid, we expect demand to be strongest in names irrespective of underlying fundamentals. We have been able to extract significant value and drive tighter structures in recent new-issue deals, a positive trend demonstrating attractive opportunities in new issuance.
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Collateralized Loan Obligations (CLOs)

US	CLO supply remains robust. While fundamentals and relative value are strong, we expect that supply technicals may keep CLO spreads range-bound over the next quarter. In the BBB and BB CLO space we expect there to be modest widening should supply turn out to be overwhelming; we would look to exploit this.	+ Front end AAAs and 1- to 2-year seasoned AAAs are most attractive. Within lower mezzanine tranches (BBB/BB) there are pockets of opportunity from structurally/fundamentally sound deals.
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Structured Credit

Agency MBS	We are constructive on mortgages due to locally wide spread levels, attractive hedge adjusted carry and the expectation that central banks will remain accommodative. Concerns regarding GSE reform and refinance risk warrant some caution.	+/- We are positive on MBS vs. U.S. Treasuries (USTs) and favor lower coupons and agency commercial MBS.
Non-Agency Residential MBS (RMBS)	We are constructive on housing fundamentals and expect modest home price growth over the coming years, with limited downside risks as housing appears reasonably valued and supported. Credit underwriting standards are historically high, making the quality of new loan production strong.	+ We are positive on the credit risk of government-sponsored enterprises (Fannie Mae and Freddie Mac) and recently issued non-agency loans as well as re-performing loans and securities.
Non-Agency Commercial MBS (CMBS)	We remain constructive on the CMBS market, due to broadly positive commercial real estate fundamentals and a favorable economic outlook; we expect the fundamental outlook to be uneven across property types and markets.	+ We are positive on short-duration, well-structured single-borrower securitizations and loans; in conduit deals we see better value in AAA rated bonds.
Asset-Backed Securities (ABS)	We remain constructive on consumer fundamentals and the current state of leverage; we expect opportunities exist in well-protected, off-the-run sectors, which offer attractive risk/return profiles.	+/- We are constructive on off-the-run senior high-quality ABS sectors, such as FFELP student loans, auto floor-plan and rental car.

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Inflation-Linked	Outlook	Relative Value
US	The level of breakeven inflation spreads are below Fed targets and are good long-term value in our base case scenario. However, poor carry over the near-term and risks pointing to lower inflation are unlikely to attract substantial inflows nor push longer-term inflation expectations higher.	+/- In the near term, we prefer to maintain an overweight in US real yields combined with tactical positioning in nominal bonds to manage overall duration exposure
Europe	European breakeven spreads have recently fallen sharply discounting the rebound in oil prices which has benefitted other index-linked markets. We expect headline inflation to average 1.20% in 2019, which is higher than the level priced in the swap and cash markets. Thus we expect some gradual catch up to oil prices and fundamentals going forward.	+/- In index-linked accounts we remain short both nominal and real yields.

Municipals

US	We continue to see good fundamentals in the overall municipal market due to a number of factors, including strong market technicals, low unemployment, improving tax revenues and modest budgetary spending proposals; adjusted for ratings, municipal bonds are attractive versus their taxable counterparts for maturities of five years and greater.	+ We remain focused on idiosyncratic risks over “market beta;” we favor revenue bonds over general obligation debt with an emphasis on industrial development revenue bonds and the transportation sectors.
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EM Debt

EM Sovereigns (USD)	Despite uncertainty about global growth conditions, the Fed’s recent dovish pivot and signs of slowing US growth outperformance are constructive for EM financial conditions and flows. From a technical standpoint, EM remains underrepresented in global bond indices. In this regard, the progressive inclusion of sizable markets, notably China and Gulf Cooperation Council (GCC) countries, will increase the sector’s visibility and investor appetite.	+ Select IG and HY-rated EM USD-denominated sovereigns remain attractive from both carry and total return standpoints. We are currently looking to add exposure to lower-risk GCC countries and attractively priced Frontier sovereigns, while BBB rated sovereigns appear more fully valued.
EM Local Currency	A dovish Fed and stable to strengthening EM currencies have taken pressure off EM central banks to tighten policy. EM real yields and differentials versus developed-market (DM) are supportive of the asset class and have scope to compress. Diminishing impact of US fiscal stimulus, and the re-introduction of stimulus in China augur well for the end of US growth exceptionalism. In our view, these factors should be positive for EM local currency debt.	+ We currently find local rates to be the most attractive part of the EM local currency universe given high real yields and a more dovish outlook for EM central banks. We favor the local bonds of stable countries with moderate inflation, including Indonesia, India, Brazil and Russia.
EM Corporates	EM corporates continue to benefit from a combination of resilient fundamentals and conservative balance sheet management. Unlike US corporates, EM companies have less of a focus on share buybacks/M&A and have continued to reduce debt after 2014-2016 commodity price and political crises. While the overall market shows robust bond issuance, EM corporate net issuance ex-China remains very low, creating positive technicals for the asset class.	+ We view crossover-rated bonds as being the best way to allocate to the EM corporate sector given both fundamentals and valuation. In terms of issuer selection, we prefer companies aligned with their sovereigns and those generating revenues in hard currency. For higher quality mandates, EM IG corporates are an attractive complement to US investment-grade allocations given higher spreads, shorter duration and more favorable issuance/BBB technicals.

Definitions:

A collateralized loan obligation (CLO) is a security backed by a pool of debt, often low-rated corporate loans.

A Mortgage-Backed Security (MBS) is a type of asset-backed security that is secured by a mortgage or collection of mortgages.

Residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) are forms of asset-backed securities, holding pools of residential or commercial mortgages (respectively) used as collateral for the securities.

Revolving credit (revolvers) refers to a line of credit where the customer pays a commitment fee and is then allowed to use the funds when they are needed. It is usually used for operating purposes, fluctuating each month depending on the customer's current cash flow needs.

"Brexit" is a shorthand term referring to the UK vote to exit the European Union.

A **CCC** rating is assigned to fairly speculative debt instruments; indicates the issuer is at greater risk of default than a B-rated issue and less than a CC-rated issue if business, financial, or economic conditions change measurably.

A **BBB** rating is the lowest investment-grade rating; it reflects an opinion that the issuer has the current capacity to meet its debt obligations but faces more solvency risk than A-, AA- or AAA-rated issues.

Add-back refers to an adjustment intended to raise a specified accounting figure in order to meet requirements of an existing loan agreement.

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.

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.

Investment-grade bonds are those rated Aaa, Aa, A and Baa by Moody's Investors Service and AAA, AA, A and BBB by Standard & Poor's Ratings Service, or that have an equivalent rating by a nationally recognized statistical rating organization or are determined by the manager to be of equivalent quality.

Mergers and acquisitions (M&A) is a general term used to refer to the consolidation of companies. A merger is a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed.

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.

Break-even inflation is the difference between the nominal yield on a fixed-rate investment and the real yield (fixed spread) on an inflation-linked investment of similar maturity and credit quality.

The Federal National Mortgage Association (FNMA), also known as Fannie Mae, is a government-sponsored enterprise (GSE) founded in 1938. Its purpose is to expand the secondary mortgage market by securitizing mortgages in the form of mortgage-backed securities (MBS), allowing lenders to reinvest their assets into more lending.

The Federal Home Loan Mortgage Corp (FHLMC), also known as Freddie Mac is government-sponsored enterprise (GSE) chartered by Congress in 1970 to keep money flowing to mortgage lenders in support of homeownership and rental housing for middle income Americans. The FHLMC purchases, guarantees and securitizes mortgages to form mortgage-backed securities.

An asset-backed security (ABS) is a financial instrument backed by a loan, lease or receivables against assets other than real estate and mortgage-backed securities.

The Gulf Cooperation Council (GCC) is a political and economic alliance of six countries in the Arabian Peninsula: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

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All investments involve risk, including possible loss of principal.

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