Brandywine GLOBAL
A LEGG MASON COMPANY

2Q 2019 | Product Commentary

BRANDYWINEGLOBAL - GLOBAL UNCONSTRAINED BOND FUND*

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Portfolio Managers

Average annual total returns and fund expenses (%)

as of June 30, 2019

	3-mo	1-yr	5-yr	10-yr	Since Incept.*	Expenses Gross	Expenses Net
Class A Excluding sales charges	1.48	1.68	1.30	N/A	2.68	1.25	1.20
Class A Including effects of maximum sales charges	-0.77	-0.64	0.85	N/A	2.39	1.25	1.20
Class IS	1.56	2.12	1.76	N/A	1.63	-	-
FTSE 3-Month U.S. Treasury Bill Index	0.61	2.30	0.84	N/A	N/A	-	-

Performance shown represents past performance and is no guarantee of future results. *Current performance may be higher or lower than the performance shown. Investment return and principal value will fluctuate, so shares, when redeemed, may be worth more or less than the original cost. Class A shares reflect the deduction of a maximum front-end sales charge of 2.25%. If sales charges were included, performance shown would be lower. Total returns assume the reinvestment of all distributions at net asset value and the deduction of all Fund expenses. Total return figures are based on the NAV per share applied to shareholder subscriptions and redemptions, which may differ from the NAV per share disclosed in Fund shareholder reports. Performance would have been lower if fees had not been waived and/or reimbursed in various periods. Returns for less than one year are cumulative. Performance for other share classes will vary. For the most recent month-end information, please visit www.leggmason.com.*

Effective September 1, 2017, the Fund changed its security pricing methodology to now use the mean value of the bid and ask prices (of underlying fund holdings) to calculate the NAV. Funds may show a one-time increase of the NAV, which is due to this change in pricing methodology.

*The inception date for Class A is February 28, 2011. The inception date for Class IS is March 1, 2013.

Gross expenses are the Fund's total annual operating expenses for the share class(es) shown.

Net expenses are the Fund's total annual operating expenses for the share classes indicated and would reflect contractual fee waivers and/or reimbursements, where these reductions reduce the Fund's gross expenses. These arrangements cannot be terminated prior to December 31, 2020 without the Board's consent. In periods of market volatility, assets may decline significantly, causing total annual Fund operating expenses to become higher than the numbers shown in the table above. Index definition under Definitions page.

Shaking up the Global Paradigm

The investment outlook these days has investors shaking their heads as they try to rewire the process of assessing tail risks that seem to be coming from all directions: the U.S.-Iran cyberwar; icy U.S.-China trade and technology relations, Taiwan and the South China Sea, Brexit, European populism, North Korean missile tests, Hong Kong riots, and the U.S.-Russia retreat from the 1987 Intermediate-Range Nuclear Forces Treaty—to name a few. There are a lot of distractions and it is easy to lose perspective on the big picture. Needless to say, handicapping or modeling all of these moving parts is challenging. Among these risks, we believe assessing a 25% tariff on all U.S. imports from China could tip the world economy into a recession.

In our opinion, global liquidity is still the major driver of risk because of its effect on growth rates and market returns, both of which were in retreat in 2018 and spilled into international markets, dampening global liquidity and strengthening the dollar. At the midway point of 2019, the manufacturing slowdown may be on the precipice of turning into a manufacturing recession. Global growth has continued to slow, but the June global Purchasing Manager Index (PMI) data are about as bad as it gets without a major recession. Importantly, a Federal Reserve ("Fed") policy pivot has continued to gain traction, which would support liquidity and eventually growth.

*Prior to December 29, 2017, this fund was known as Legg Mason BW Absolute Return Opportunities Fund.

INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE

The Fed and European Central Bank (ECB) have abandoned normalization and turned dovish. China continues to dial up more policy stimulus. Central banks in Australia, Chile, India, Malaysia, the Philippines and Russia have cut rates. Money supply measures are basing out in most regions of the world. We expect more to come. The bull market in the dollar has been checked—at least for now—with the broad dollar index roughly where it was last November. The trade war between the U.S. and China seems to be on hold, possibly until the U.S. general elections.

Many investors see the divergence in U.S. equities and bond yields as a macro inconsistency: one suggests recession, the other an extension of the global business cycle. The latter interpretation suggests that markets anticipate a soft landing. The equity risk premium is rising. The natural consequence of lower inflation and lower bond yields is higher equity multiples. The key to ensure this outcome is that policymakers move far and fast enough to validate expectations, or the global economy starts looking up.

We've Seen This Before

The current global slump is the third since the G20 first took policy action to propel the global economy out of the Great Financial Crisis (GFC) in 2009. All three down episodes since that time have been triggered by policy:

1. The first post-GFC slump centered on the European sovereign debt crisis in 2011-2012 and was triggered by the Trichet-led ECB's mistaken decision to raise rates.
2. The second slump in 2014-15 was caused by China's attempts to deleverage its economy, which produced the biggest commodity bust in decades.
3. The slump since early 2018 is a by-product of multiple policy decisions: the Fed tightened too much last year, the "sugar high" of the combined effect of the U.S. fiscal thrust and tax cuts, Chinese authorities hit the fiscal brakes too soon, and protectionist rhetoric and tariffs undermined trade and corporate spending.

The misjudgement reflected in all these policy decisions was the belief that the post-GFC period of subdued growth, below-target inflation, and lackluster credit creation would finally be put to rest once enough time had passed and conditions could "re-normalize" back to something that looked more like pre-2008. Unfortunately, the above trifecta put a damper on global growth, and we believe that swift and prescriptive action from the Fed and Chinese authorities may be able to stabilize growth. Policy stimulus counter-measures managed to reverse the first two slumps.

1. The 2012 slump ended with America's open-ended quantitative easing, Draghi's "Do what it takes" approach in Europe, and Abenomics in Japan.
2. The 2015 commodity bust ended with China's aggressive fiscal stimulus and the Fed decision to postpone raising rates.

Now, for a third time, policymakers are beginning to swing toward stimulative countermeasures, or at least end their restraint.

The Fed—Behind the Curve, Time to Catch Up

In hindsight, the wisdom of appointing a lawyer to run U.S. monetary policy begs the question whether the justice system would be as well served by installing an economist on the Supreme Court. Humiliated by markets at the end of last year, Fed Chair Jerome Powell abandoned plans to normalize interest rates back to a neutral rate he mistakenly judged to be much higher. In addition, what was to be a mechanical unwinding of the balance sheet will now end sooner than planned. Even after these changes, the unambiguous message from the inverted yield curve is that the Fed is behind the curve and needs to catch up. We agree.

Historically, the Fed ultimately has always behaved rationally. We doubt this time will be different, and we anticipate that easing actions lie ahead. The Fed stayed put at the June meeting, with Powell claiming the central bank wants more time to assess the data. From our perspective, he runs the risk of increasing the probability of a recession—which has already been flagged by some leading indicators—while waiting for lagging indicators to slow. Currently, we believe that U.S. real gross domestic product (GDP) growth has moderated back below 2%, roughly in line with the Fed's view, which may explain the Board's more sanguine stance than the message from the yield curve. However, non-financial corporate profits contracted in the first quarter based on the national income accounts, and gross domestic income is running significantly slower than GDP. The June payrolls report was better than the weaker ADP data, but wage and price inflation trends have been unambiguously soft. In addition, the level of the Conference Board's Consumer Confidence Index ended last year near historic highs but has since retreated on a rate of change basis this year to below zero in June, which nevertheless is in sharp contrast to the large decline in business confidence. A spillover into general consumer

confidence would radically and quickly alter the Fed's current outlook.

China—Successive Approximation, No Big Reflation

China's slowdown has been an important driver of the slump in global economic growth—along with the related trade and tariff issues—since early 2018. The cause of this slowdown was a retreat from fiscal stimulus to restraint and an all-out attack on shadow bank lending; growth in the latter has plunged from a peak of 20% to -10% currently.

Reversing the economic slowdown has been the goal of policymakers since-mid 2018; however, China's leaders remain steadfast in their opposition to the kind of full-bore fiscal/credit reflation which re-energized the local and global economy in 2009, and again in 2016. The reason why is because China's leaders don't want to boost leverage.

Instead, a range of measures have been taken to stabilize growth including:

- Increased infrastructure investment spending—which is where last year's fiscal retreat was concentrated.
- Lowered interest rates, reserve requirements and taxes.
- Increased bank directives to lend to the small and medium-size enterprises where productivity is the greatest but access to capital the poorest.

Chinese officials have also reformed the tax system with income tax cuts and reducing the business value-added tax, which are long-tailed growth initiatives. The results have been mixed. The fiscal impulse is gradually building but the monetary data have yet to stage much of a reversal. Positives include the Organization for Economic Cooperation and Development (OECD) Leading Economic Indicators (LEI) for China, which have been rising all year, and the Shanghai Composite, which is well off last year's lows. The latest NBS manufacturing PMIs remain unchanged for June and off the recent lows. Although Markit PMI export orders are in a clear uptrend, they remain within a narrow range just below their historic averages.

The Trade War—Escalation on Hold

We don't think it is a coincidence that last year's growth slump seemed to intensify around the same time that the U.S. put a ban on selling components to China's ZTE corporation in April 2018. Relations with China have cooled on many fronts since then. The levying of tariffs and threat of protectionism has affected business confidence and willingness to invest in China, and it has limited corporate capital spending around the world. By some metrics, global trade is already in recession, and May/June economic data lurched lower as the trade rhetoric heated up.

At the June G20 meeting in Osaka, the two protagonists called a temporary truce. China and the U.S. agreed to re-engage in trade discussions and avoid any new tariffs without reversing existing tariffs. The absence of a negative is a positive. The Trump Administration has focused on where it considers China to be engaging unfairly with the U.S. and has been using tariffs regulations as incentives for achieving compliance. These dispute points are unlikely to be resolved anytime soon but President Trump also wants to win the next election. He needs a strong economy and financial markets to achieve that goal. So, a window of stability in the global trade wars seems likely to prevail for the next year or so.

Emerging Markets Step Up

To sum up: the Fed has ended tightening and is expected to ease, China's leaders will add incremental stimulus if needed, and the trade war is on pause for now. The policy pivot is moving in the right direction. The real issue is that the scale of counter-stimulus seems slight in comparison with previous episodes. Central banks are globally trying to assess the risk of the manufacturing slump spilling over into other sectors of the economy. Simply stated, central banks do not want the manufacturing PMIs to descend into the mid-40s. The Fed is still balking. China wants to avoid a big credit push. And the temporary agreement between the U.S. and China was to defer extra tariffs, not unwind the old ones. Meanwhile, Europe is embarking on another policy initiative to stabilize the surprising growth slump in the region. We believe the bottoming-out process is under way in order to stabilize the slowdown in global growth and eventually provide a soft landing.

One important development in global data trends is the relative outperformance of emerging countries outside of China. The OECD LEI for member countries plus the six major non-member economies is slowly turning on a rate of change basis while the G7 measures continue to retreat. In addition, emerging market manufacturing PMIs have been relatively flat since early 2018 and persistently above 50 while the same metric for advanced economies has trended to just below 50. The reason for this relative performance is not perfectly clear. The collection of countries that have actually cut rates in recent weeks has been mainly emerging markets and there is considerable latitude for more easing, given steadily falling

inflation and stable currencies. In addition, there is anecdotal evidence of companies reconsidering production in other countries outside of China. Stimulus and growth from the emerging area of the world could turn out to be a major component of the soft landing outlook which seems embedded in asset prices.

Risk and Some Very Long-Term Thoughts

It is rare for the Fed not to cut interest rates when commodity prices are weak. The near-term risk in the outlook is that policymakers do not do enough. If policy changes are too slow, too, in response or not by enough, volatility will pick up.

Unfortunately, central banks in the major economies are still the only game in town when it comes to counter-cyclical economic policy. Fiscal policy is tapped out: budget deficits are already big in the U.S. and China and neither Europe nor Japan want their deficits bigger. Credit ratings agencies encourage emerging countries to balance their budgets. But central banks do not have much ammunition left, and many, including the Bank for International Settlements, warn that further rate cuts are counterproductive.

The result could be that policy impotence drives politics toward increasingly radical attempts to stir up economic activity. There are plenty of signs of this pressure building. Populist uprisings in Europe are tilting toward better growth at the expense of balanced budgets. Musings about firing the Fed Chairman is more than simple presidential exasperation with the stance of monetary policy. It is a sign of increased political pressure to drive growth. Institutional roadblocks are the biggest barriers for radical change. The nominations of Waller and Shelton bring two more doves to the Federal Open Market Committee. Christine Lagarde's nomination for ECB President—another lawyer—opens the door for more creative measures to stimulate. The rebirth of Modern Monetary Theory (MMT) could be a big step in a more radical direction for central bank policy. Central banks usually only buy bonds to affect growth by manipulating interest rates and the time value of money. The focus provided by MMT has the central bank effectively funding anything the government wants. If radical policy implementation were to occur down the line, it could foster radical investment and economic outcomes in the distant future.

Performance

The Fund Class A (excluding sales charges) and Class IS shares outperformed the FTSE 3-Month U.S. Treasury Bill Index for the quarter. Positive performance was attributable to bond positions for the period; however, the very different mix of bond holdings in the portfolio created some divergent returns statistics. Substantial positive performance came from Mexican bonos, which was a large holding within the portfolio. In contrast, negative performance came from a short position in European interest rate futures. Core- and peripheral-European government bonds rallied strongly to negative yield levels during the second quarter. Negative nominal yielding sovereign bonds are not our definition of good value, which is why we have maintained short positions in them. The global bond market rallied during the second quarter, including most developed market sovereign bonds across the duration spectrum, as investors sought safety and anticipated easier monetary policy. Investor angst was compounded by trade uncertainty and rising geopolitical tensions. On the currency front, the main source of the negative incremental performance came from the yen, where we maintained a short position as the currency rallied.

Positioning in regional European currencies produced mixed performance. Positive gains from exposure to the Norwegian krone and Polish zloty were offset by an underweight in the euro—which failed to fully capture the currency's rally—as well as weakness emanating from our Swedish krona exposure. The fluid Brexit negotiations were a drag on the British pound, and our exposure detracted from performance. Despite a host of constructive factors, unresolved risks regarding global trade and the Chinese economy weighed on the Australian dollar; our exposure detracted from performance.

Our exposure to both emerging market bonds and currencies generated strong absolute returns for the period. Positive developments regarding pension reform—including the suggested quantified savings from the changes—provided support for the Brazilian real; the expected improvements to the country's fiscal position also sparked a rally in the government bonds. Exposure to Brazilian assets, as well as Colombian government bonds, Peruvian sovereign bonds, and the Chilean peso all contributed to performance, given the benign backdrop in these countries. Exposure to the Russian ruble was accretive, as the currency made gains during the quarter when foreign capital flowed into the economy despite weaker energy prices. The Indonesian rupiah benefitted from weaker crude oil prices that helped the country's net energy import position, though the currency's rally was muted, given the significant trade relationship with China. A position in Malaysian government bonds was also additive to absolute performance.

Positioning

There have been a few adjustments heading into the second half of the year, but overall the portfolio retains the same essential characteristics: significant duration in Treasurys and select emerging market sovereign bonds—especially Mexican Bonos—and lower exposure to the U.S. dollar. Treasury duration was reduced slightly during the quarter on the back of the rally. A position in U.S. dollars was rotated into the New Zealand dollar, Korean won and Czech koruna.

Treasury yields have been melting on the back of slower nominal income growth. Valuations have swung from price opportunity to building risk as a result of the price appreciation. The macro story embedded in this rally has been a swing from economic optimism fueled by tax cuts to more pessimism fueled by the global slowdown. We suspect that the rally may be nearing an end point based on our outlook for a global soft landing, which is why we clipped a year of duration across most portfolios during the second quarter. However, the global macro pulse remains weak enough to sustain a significant Treasury holding for the time being.

The Mexican bonos position has been and remains the second-largest bond position in the portfolio. These bonds have rallied steadily since the end of last November and broke out in June to levels that existed prior to the election of President Andrés Manuel López Obrador. The power of the rally is noteworthy, given the volatility surrounding the peso and President Trump's threat to impose tariffs if the Mexican government did not take greater action on America's southern border. In addition, the ability of the market to rally despite concerns about the Pemex corporate downgrades that could in turn affect Mexico's sovereign credit rating is further testimony for the bull market. One of the major support factors behind the rally has been the stubborn stance of the central bank. The economy is probably entering recession, yet the central bank has maintained its resolve to sustain monetary pressure in the face of stubborn core inflation stuck around 4%. Inflation looks like it is ready to fall, and a reduction of the 8.25% overnight interbank interest rate to closer to 7% is part of our forecast for the balance of the year. More specifically, we expect this rate decline to occur when Powell moves on its rate policy at one of the remaining 2019 Fed meetings.

We held few dollars for some time, a stance which hurt our portfolios in 2018, owing to the scale of the dollar uptrend. We view last year's move as a counter-trend that developed on the back of the unusual divergence between tax-cut fueled strong U.S. economic growth and a China-led deceleration that spilled into the rest of the global economy. In addition, there is some empirical evidence relating last year's dollar strength to the contraction in the Fed's balance sheet.

The growth divergence between the U.S. and rest of world no longer exists. Based on front-leading indicators, the U.S. economy has ratcheted down in line with the rest of the world economy. We advanced the hypothesis some time ago that the U.S. might trade places with the rest of the world this year and into next—the U.S. softening, while the rest of the world picks up. Signs of stabilization in China along with relative outperformance in the emerging economies support this thesis. In addition, the U.S. monetary base is scheduled to stop contracting by the end of this quarter, which lifts a scarcity factor supporting the dollar. A range of metrics imply that the dollar is overvalued and the U.S. balance of trade in goods and services has been gradually deteriorating over the past two years—all these factors support the reduction of dollars in your portfolio.

During the quarter we reduced our dollar weighting. As discussed earlier, we rounded up existing positions and evaluated them before redeploying U.S. dollars and yen into new positions in the won and koruna. We boosted our Australian dollar weight. The Australian dollar story is a compelling one. The currency is undervalued based on our metrics and on Australia's terms of trade. The bull market in coal and iron prices would imply an Australian dollar's fair value is closer to $0.76, other things being equal. In addition, the government is proposing tax cuts, interest rates have been cut twice to bolster the economy, and macro-prudential measures aimed at containing household debt are gearing up to reverse in order to stabilize property prices. Early reports are that real estate prices have stopped falling in the major cities.

Conclusion

For the framework of our forecast to play out, the reflation trade must be renewed and seep into the manufacturing sector, which will need support as a new rate-cutting cycle begins around the world and plays out throughout the balance of 2019. While a weaker U.S. dollar will be a key factor in reviving global liquidity to support a longer global growth cycle, policymakers—namely the Fed and Chinese officials—will determine whether we see a global soft landing later this year.

We thank you for your continued support.

Definitions:

Brexit is an abbreviation of "British exit," which refers to the June 23, 2016 referendum by British voters to exit the European Union.
FTSE 3-Month U.S. Treasury Bill Index represents monthly return equivalents of yield averages of the last 3-month Treasury Bill issues. Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Duration is an estimated measure of the price sensitivity of a bond to a change in interest rates.

The **Group of Seven (G-7)** is a forum of the seven countries with the world's largest developed economies—France, Germany, Italy, Japan, the United States, the United Kingdom, and Canada—whose government leaders meet annually on international economic and monetary issues.
Gross domestic product (GDP) is an economic statistic that measures the market value of all final goods and services produced within a country in a given period of time.

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

The **Group of 20, also called the G20,** is a group of finance ministers and central bank governors from 19 of the world's largest economies, including those of many developing nations, along with the European Union.
JP Morgan Emerging Markets Currency Index is a tradable benchmark for emerging markets currencies vs. the US Dollar (USD). Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

The **Institute for Supply Management's composite PMI Index** (formerly the National Association of Purchasing Managers Index) is based on a survey of purchasing executives who buy the raw materials for manufacturing at more than 350 companies. It offers an early reading on the health of the manufacturing sector. Please note that an investor cannot invest directly in an index.

Modern Monetary Theory (MMT) is a heterodox macroeconomic framework that says monetarily sovereign countries like the U.S., U.K., Japan and Canada are not operationally constrained by revenues when it comes to federal government spending.

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

Top 10 fixed income holdings (%)	
UNITED STATES TREASURY FLOATIN 2.2270% Mat 10/31/2020	5.7
COLOMBIAN TES 6.0000% Mat 04/28/2028	4.9
MEX BONOS DESARR FIX RT 7.7500% Mat 11/13/2042	4.6
UNITED STATES TREASURY FLOATIN 2.3210% Mat 04/30/2021	4.6
GOLDMAN SACHS GROUP INC SR UNS 3.2735% Mat 02/23/2023	4.3
MEX BONOS DESARR FIX RT 8.5000% Mat 11/18/2038	3.3
MEXICAN BONOS 8.5000% Mat 05/31/2029	3.3
INDONESIA TREASURY BOND 9.0000% Mat 03/15/2029	2.9
GENERAL MOTORS FINL CO COMPANY 3.5267% Mat 04/13/2020	2.9
REPUBLIC OF POLAND GOVERNMENT 1.5000% Mat 04/25/2020	2.8

Top 10 countries (%)	
United States	38.4
Mexico	13.6
Malaysia	6.9
Poland	6.3
Colombia	5.0
Brazil	5.0
South Africa	4.8
Indonesia	4.1
Australia	4.0
Germany	3.7

Top currency allocation (%)	
US Dollar	33.2
Japanese Yen	-16.7
Mexican Peso	13.7
Norwegian Krone	9.9
Swedish Krona	8.7
Australian Dollar	7.9
Malaysian Ringgit	6.9
Chilean Peso	6.6
Polish Zloty	5.5
Singapore Dollar	-5.2
Indonesian Rupiah	5.1
Colombian Peso	5.0
Brazilian Real	5.0
New Zealand Dollar	4.0
South Korean Won	4.0

Percentages are based on total portfolio as of quarter end and are subject to change at any time. For informational purposes only and not to be considered a recommendation to purchase or sell any security.

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What should I know before investing?

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. High-yield bonds are subject to greater price volatility, illiquidity and possibility of default. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. Short selling is a speculative strategy. Unlike the possible loss on a security that is purchased, there is no limit on the amount of loss on an appreciating security that is sold short. Derivatives, such as options and futures, can be illiquid, may disproportionately increase losses, and have a potentially large impact on Fund performance. As a non-diversified fund, the Fund is permitted to invest a higher percentage of its assets in any one issuer than a diversified fund, which may magnify the Fund's losses from events affecting a particular issuer. The portfolio manager does not attempt to keep the portfolio structure or the Fund's performance consistent with any designated stock, bond or market index, and during times of market rallies, the Fund may not perform as well as other funds that seek to outperform an index. Leverage may increase volatility and possibility of loss. Active management does not ensure gains or protect against market declines.

A general rise in interest rates may lead to increased portfolio volatility.

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

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