WESTERN ASSET ACTIVE BOND PORTFOLIOS

Market overview

The bond market weakened over the first quarter of 2021 as positive economic data, the rollout of the COVID-19 (coronavirus)[1] vaccines, and additional fiscal stimulus triggered expectations for improving growth and higher inflation. Despite the uptick in Treasury yields and concerns that the Federal Reserve Board ("Fed")[2] may remove its monetary accommodation sooner than previously expected, Fed Chair Jerome Powell repeatedly downplayed the latter. In March, Powell said, "Long term, we think that the inflation dynamics we've seen around the world for a quarter of a century are essentially intact…and we think those dynamics haven't gone away overnight and won't."

U.S. Treasuries, as measured by the Bloomberg Barclays U.S. Treasury Index,[3] returned -4.25% during the first quarter. Two-year Treasury yields moved modestly higher, while 10-year yields rose sharply (yields and prices move in the opposite direction). Most spread sectors (non-U.S. Treasuries) posted negative returns and produced mixed results versus similar-duration Treasuries.[4]

Looking at the U.S. economy, fourth-quarter 2020 gross domestic product (GDP)[5] annualized growth was 4.3%. This followed a 33.4% growth in the third quarter (the sharpest quarterly ascent on record) and a -31.4% reading during the second quarter (the steepest quarterly decline on record). The initial estimate for first-quarter 2021 GDP will be released on April 29, 2021.[6] The manufacturing sector continued to expand over the first quarter. According to the Institute for Supply Management's Purchasing Managers Index (PMI),[7] the manufacturing sector had a reading of 58.7 in January, 60.8 in February and 64.7 in March (the best reading since December 1983). (A reading below 50 indicates a contraction, while a reading above 50 indicates an expansion.) Seventeen of the 18 industries measured by the PMI expanded in March.[8]

The labor market largely improved over the first quarter. The unemployment rate fell from 6.7% in December 2020 to 6.0% in March 2021. The workforce participation rate was unchanged at 61.5% in March 2021, as it was in December 2020.[9]

On the inflation front, various price indices showed stable to higher price changes over the first quarter. Core Personal Consumption Expenditure (PCE)[10] inflation posted a 1.4% year-over-year increase in February 2021, while the Consumer Price Index (CPI)[11] increased from 1.4% to 1.7% year over year.[12]

[1] COVID-19 (coronavirus disease) is a new strain that was discovered in 2019 and has not been previously identified in humans.

[2] 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.

[3] The Bloomberg Barclays U.S. Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury.

[4] Source of data in this paragraph: Bloomberg, 4/21.

[5] Gross domestic product (GDP) is the market value of all final goods and services produced within a country in a given period of time.

[6] Source of data in this paragraph: Bloomberg, 4/21.

[7] 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 an investor cannot invest directly in an index.

[8] Source of data in this paragraph: Bloomberg, 4/21.

[9] Source of data in this paragraph: Bloomberg, 4/21.

[10] The Core Personal Consumption Expenditure Price Index (PCE) provides a measure of the prices paid by people for domestic purchases of goods and services, excluding the prices of food and energy. The core PCE is the Fed's preferred inflation measure.

[11] *The Consumer Price Index (CPI)* is a measure of the average change over time in the *prices* paid by urban *consumers* for a market basket of *consumer* goods and services.

[12] Source of data in this paragraph: Bloomberg, 4/21.

The Fed met twice during the first quarter and maintained its highly accommodative monetary policy stance. In the minutes from the Fed's January 2021 meeting, it said, "The path of the economy will depend significantly on the course of the virus, including progress on vaccinations. The ongoing public health crisis continues to weigh on economic activity, employment, and inflation, and poses considerable risks to the economic outlook." At its March meeting, the Fed increased its growth and inflation forecasts for 2021 to 6.5% and 2.4%, respectively, and lowered its unemployment forecast to 4.5%. The majority of members of the Federal Open Market Committee (FOMC)[13] did not change their forecasts for interest rates in 2023, maintaining the median forecast at zero hikes through December 2023. In his press conference following the March meeting, Fed Chairman Powell said, "...we could also see upward pressure on prices if spending rebounds quickly as the economy continues to reopen, particularly if supply bottlenecks limit how quickly production can respond in the near term. However, these one-time increases in prices are likely to have only transient effects on inflation."[14]

In terms of fiscal policy, a $1.9 trillion COVID-19 relief bill was approved by the U.S. Congress through the budget reconciliation process and was signed into law by President Biden in March 2021. On the last day of the quarter, the White House released its infrastructure plan that proposes roughly $2 trillion in spending over several years and a rise in the corporate tax rate.[15]

Two-year Treasury yields moved modestly higher, ending the first quarter at 0.16%. Meanwhile, signs of improving economic activity and inflationary concerns pushed 10-year yields sharply higher over the period. The yield on the 10-year Treasury began the quarter at 0.93% and it ended the quarter at 1.74%.[16]

Active Bond Portfolios

Annualized returns net and pure gross of fees - PRELIMINARY

(%) as of March 31, 2021

	QTR	YTD	1-yr	3-yr	5-yr	7-yr	10-yr
Active Bond Gov/Corp (net)	-4.37	-4.37	0.72	3.79	1.96	2.16	2.43
Active Bond Gov/Corp (gross)	-4.01	-4.01	2.23	5.34	3.48	3.69	3.97
Bloomberg Barclays U.S. Gov/Credit Index	-4.28	-4.28	0.86	4.99	3.36	3.48	3.70
FTSE 3-Month U.S. Treasury Bill Index	0.02	0.02	0.21	1.45	1.15	0.84	0.60
Active Bond Intermediate (net)	-2.32	-2.32	1.00	2.74	1.18	1.24	1.41
Active Bond Intermediate (gross)	-1.95	-1.95	2.51	4.28	2.70	2.75	2.93
Bloomberg Barclays U.S. Int. Gov/Credit Index	-1.86	-1.86	2.01	4.36	2.75	2.77	2.88
Active Bond Aggregate (net)	-4.05	-4.05	-0.31	2.96	1.47	1.73	1.90
Active Bond Aggregate (gross)	-3.69	-3.69	1.19	4.51	2.99	3.25	3.42
Bloomberg Barclays U.S. Aggregate Index (USD)	-3.37	-3.37	0.71	4.65	3.10	3.31	3.44

The strategy returns are preliminary composite returns, subject to future revision (downward or upward). Please visit www.leggmason.com for the latest performance figures. YTD numbers are not annualized.

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Fees: Gross returns are presented as pure gross of fee returns and do not reflect the deduction of investment management fees and certain transaction costs, which will reduce portfolio performance shown. Net performance includes the deduction of a 1.5% annual wrap fee, which is the maximum anticipated wrap fee for fixed income portfolios. Actual fees may vary. For fee schedules, contact your financial professional or, if you enter into an agreement directly with Legg Mason Private Portfolio Group, LLC (LMPPG), refer to LMPPG's Form ADV disclosure document. Returns reflect the reinvestment of dividends and other earnings. All performance is reported in US dollars.

Returns reflect the reinvestment of dividends and other earnings.

Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

[13] The Federal Open Market Committee (FOMC) is a committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

[14] Source of data in this paragraph: Bloomberg, 4/21.

[15] Source of data in this paragraph: Bloomberg, 4/21.

[16] Source of data in this paragraph: Bloomberg, 4/21.

Contributors and detractors

The Active Bond Intermediate Portfolio (gross of fees) modestly lagged its benchmark, the Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index, during the quarter. Duration[17] positioning was slightly beneficial for returns, as the Portfolio was modestly shorter than the benchmark. Yield-curve[18] positioning was a headwind for returns, due to an overweight to the 10-year portion of the curve. Sector allocation was additive for returns, driven by an overweight to agency securities. Security selection, overall, was a small detractor from results, due to the Portfolio's lack of exposure to more cyclical credits.

The Active Bond Government Corporate strategy (gross of fees) modestly outperformed its benchmark, the Bloomberg Barclays U.S. Government/Credit Index, during the quarter. Duration positioning was a slight headwind for returns, as the Portfolio was modestly longer than the benchmark. Yield-curve positioning was also a small detractor, driven by an overweight to the 30-year portion of the curve. Sector allocation was additive for returns, driven by an overweight to agency securities and the portfolio's U.S. Treasury Inflation Protected Securities (TIPS)[19] exposure. Security selection did not meaningfully impact returns over the quarter.

The Active Bond Aggregate strategy (gross of fees) modestly lagged its benchmark, the Bloomberg Barclays U.S. Aggregate Index, during the quarter. Duration positioning was a slight headwind for returns, as the Portfolio was modestly longer than the benchmark. Yield-curve positioning was also a small detractor, driven by an overweight to the 30-year portion of the curve. Sector allocation was additive for returns, driven by an overweight to agency securities and the portfolio's TIPS exposure. Security selection did not meaningfully impact returns over the quarter.

Outlook

We feel that the second half of the year should see very strong global growth as the world economy reopens. That said, we are cautious about extrapolating short-term cyclical boosts into a presumption of a higher secular trend rate of growth or inflation. The secular challenges that have kept U.S. and global growth to a moderate pace at best over the last several decades persist. These include the stagnation of Western societies' middle-class wages, aging demographics, and rising global debt burdens. Moreover, the small- and medium-sized business destruction in many countries not seen since the Great Depression may take years to replace. Given this backdrop, we expect central banks to remain extraordinarily accommodative for the foreseeable future.

[17] Duration is a measurement that signals how much the price of a bond is likely to fluctuate when there is a change in interest rates. The higher the duration number, the more sensitive a bond will be to interest rate changes.

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

[19] U.S. Treasury Inflation-Protected Securities (TIPS) are bonds that receive a fixed, stated rate of return, but they also increase their principal by the changes in the CPI-U (the non-seasonally adjusted U.S. city average of the all-item consumer price index for all urban consumers, published by the Bureau of Labor Statistics). TIPS, like most fixed income instruments with long maturities, are subject to price risk.

Important information

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Definitions and additional information

Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Professional money management may not be suitable for all investors.

The **Bloomberg Barclays U.S. Intermediate Government/Credit Index** is composed of all publicly issued, fixed-rate, non-convertible, domestic debt in three major classifications: industrial, utility and financial (as well as domestic debt of the U.S. government or any agency thereof). All corporate bonds have a minimum rating of Baa by Moody's and BBB by Standard & Poor's. This index has an average current maturity of 4.28 years (average maturity may vary over time).

The **Bloomberg Barclays U.S. Aggregate Index** is a broad-based bond index composed of government, corporate, mortgage and asset-backed issues rated investment grade or higher and having at least one year to maturity.

The **Bloomberg Barclays U.S. Government/Credit Index** includes the Barclays Government Bond Index and the Barclays Credit Bond index. The Government Index includes all public U.S. Treasury obligations and the debt of U.S. government agencies and quasi-federal corporations. The Credit Index includes corporates (industrial, utility and finance, including both U.S. and non-U.S. corporations) and non-corporates (sovereign, supranational, foreign agencies and foreign local governments).

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

The **FTSE 3-Month U.S. Treasury Bill Index** is an index based on the average monthly yield of the 90-day Treasury bills. U.S. Treasury bills are secured by the "full faith and credit" of the U.S. government and offer a fixed rate of return. The portfolio composition typically varies from that of the above-noted, unmanaged indices.

Institute for Supply Management (ISM), formerly known as the National Association for Purchasing Management, is an association representing more than 48,000 purchasing and supply management professionals. It conducts regular surveys of purchasing and supply managers to determine industry trends.

National Association of Realtors (NAR) is a national organization of real estate brokers. The National Association of Realtors was created to promote the real estate profession and foster professional behavior in its members.

Personal Consumption Expenditures (PCE, or the PCE Index) indicate price changes of consumer goods and services.

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

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What should I know before investing?

All investments involve risk, including loss of principal and there is no guarantee that investment objectives will be met.

Fixed income securities may be subject to extension risk, which is the risk that the issuer will repay their obligations more slowly than the market anticipates in the event market interest rates rise. Issuers also have the right to pay their payment obligations ahead of schedule in the event market interest rates fall, subjecting to prepayment risk. 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.

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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.

Investments may also be made in mortgage-backed, asset-backed securities and taxable municipal securities. Asset-backed securities generally decrease in value as a result of interest rate increases, but may benefit less than other fixed-income securities from declining interest rates, principally because of prepayments. 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.