1Q 2021 | Product Commentary

WESTERN ASSET INTERMEDIATE-TERM MUNICIPALS FUND

Team-managed

Average annual total returns and fund expenses (%)

as of March 31, 2021

Class A	3-mo	1-yr	5-yr	10-yr	Since Incept. (11/28/88)	Expenses Gross	Expenses Net
Excluding sales charges	0.25	7.57	2.69	3.77	4.71	0.60	0.60
Including effects of maximum sales charges	-2.00	5.20	2.23	3.54	4.64	0.60	0.60
Bloomberg Barclays Municipal 1-15 Year Bond Index	-0.32	4.92	3.03	3.72	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 have a maximum front-end sales charge of 2.25%. 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 in various periods. Returns for less than one year are cumulative. For the most recent month-end information, please visit www.leggmason.com/individualinvestors.*

Gross expenses are the Fund's total annual operating expenses for the share class(es) shown. **Net expenses** for Class A reflects contractual fee waivers and/or reimbursements, where these reductions reduce the Fund's gross expenses, which cannot be terminated prior to Dec 31, 2021 without Board consent.

The Bloomberg Barclays Municipal 1-15 Year Bond Index is a market value-weighted index of investment-grade fixed-rate municipal bonds with maturities of 1-15 years. Investors cannot invest directly in an index and unmanaged index returns do not reflect any fees, expenses or sales charges.

Executive Summary

- The municipal ("muni") bond market generated a modest negative return, but outperformed its taxable bond counterpart during the first quarter.
- The overall fixed income market was negatively impacted by rising interest rates.
- The Fund's ratings biases were the largest contributors to performance over the quarter.
- Having a duration that was longer than the benchmark detracted from returns.
- State and local governments received direct stimulus funding, as Congress passed the $1.9 trillion American Rescue Plan Act
- Despite the recent upward move in Treasury rates, Western Asset ("Western") believes long term structural employment levels and Fed policy will keep long-term rates anchored.

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 trigged 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,

[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.

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."[3]

Looking at the U.S. economy, fourth quarter 2020 gross domestic product (GDP) [4] 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). According to the Commerce Department, "The [fourth quarter] increase in real GDP reflected increases in exports, nonresidential fixed investment, personal consumption expenditures, residential fixed investment, and private inventory investment, that were partly offset by decreases in state and local government spending as well as federal government spending. Imports, which are a subtraction in the calculation of GDP, increased." The initial estimate for first quarter 2021 GDP will be released on April 29, 2021.[5]

The labor market continued to improve over the first quarter. The unemployment rate fell from 6.7% in December 2020 to 6.3% in January 2021 and 6.2% in February. March's 6.0% unemployment rate was the lowest since the pandemic escalated in April 2020. The workforce participation rate was unchanged overall and ended the first quarter at 61.5%.[6]

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 the Fed's meeting in March it said, "Following a moderation in the pace of the recovery, indicators of economic activity and employment have turned up recently, although the sectors most adversely affected by the pandemic remain weak." 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."[7]

Two-year Treasury yields moved modestly higher ended 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%.[8]

The overall municipal ("muni") bond market posted a modest negative return, but outperformed the overall taxable bond market during the quarter. Over that time, the Bloomberg Barclays Municipal Bond Index[9] and the Bloomberg Barclays U.S. Aggregate Index[10] returned -0.35% and -3.37%, respectively. The overall fixed income market was negatively impacted by rising interest rates.[11]

Contributors/detractors

The Fund's ratings biases were the largest contributors to performance over the quarter. In particular, an overweight to securities rated BBB was rewarded, as was an opportunistic exposure to high-yield muni securities. In terms of security selection, our holdings in the leasing and state general obligation bond[12] sectors were the most additive for results. Looking at sector allocation, an overweight to transportation was rewarded. On the downside, having a duration[13] that was longer than the benchmark detracted from returns. From a yield curve[14] perspective, an overweight to the 10-year portion of the curve was a headwind for performance.

A number of adjustments were made to the portfolio during the quarter. We increased the Fund's duration over the period. From a sector positioning perspective, we increased our allocations to special tax and state general obligation bonds, while reducing our exposures to water & sewer and hospitals. In terms of quality positioning, we increased our allocations to securities rated below-investment-grade, while reducing our exposures to securities rated A and AA. Finally, looking at the Fund's positioning among states, we increased its allocation in New York, as well as the

[3] Source of data in this paragraph: Bloomberg, 3/21.

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

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

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

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

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

[9] The Bloomberg Barclays Municipal Bond Index is a market value weighted index of investment grade municipal bonds with maturities of one year or more.

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

[11] Source of data in this paragraph: Bloomberg, 4/20.

[12] A general obligation bond ("GO") is a municipal bond backed by the credit and taxing power of the issuing jurisdiction rather than the revenue from a given project.

[13] 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.

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

Commonwealth of Puerto Rico, while reducing its exposures to Michigan and Georgia.

Outlook

Despite the recent upward move in Treasury rates, we believe that long term structural employment levels and the Fed's stated willingness to let short term inflation rise above the stated 2.0% bound will keep long-term rates anchored and is constructive on duration over the long term. In addition, our duration positioning is used as a hedge to potential volatility that could arise from any challenges to the global growth outlook. From a technical standpoint, we anticipate near term muni demand could soften amid concerns of higher rates, along with the tendency for high net worth individuals to fund tax bills from muni allocations in March into May (given the extended tax filing deadline). From a supply perspective, we could see elevated new issuance amid the current rate volatility, and we remain focused on the progress of federal infrastructure policy and how that can shape tax-exempt and taxable issuance composition.

State and local governments finally received their hotly contested direct stimulus funding, as Congress passed the $1.9 trillion American Rescue Plan Act relief package, which provides $350 billion of direct aid to states and local municipalities. States will receive $195.3 billion and local governments will receive $130.2 billion. The majority of state funds will be distributed based on the overall share of unemployment. From the local government perspective, counties will receive $65.1 billion, metropolitan cities will receive $45.6 billion, and small cities will receive $19.5 billion. Other municipal revenue sectors will also stand to benefit, as the overall stimulus package targets the health care, transportation, education and housing sectors. While revenues proved better than initially feared, not all states are impacted by the pandemic equally and budget stress is still evident in the declining state and local payroll figures. State and local employment is still down 1.4 million from pre-pandemic highs, which should continue to constrain domestic and regional growth.

We believe that while some entities will receive more aid than needed, the package will be supportive of lower-grade municipalities that face longer-term structural challenges. Rating agencies are also taking note, as the state of Illinois once again avoided a high-yield rating downgrade, with Moody's affirming its BBB- rating while removing a negative watch, and Fitch affirming its BBB-/negative rating, citing that the state's revenues have exceeded enacted budget expectations and stimulus measures that "may provide an immediate boost to state's fiscal resilience."

Sector allocation (%)	
Transportation	22.1
Industrial Revenue	14.2
Special Tax Obligation	11.7
Lease Backed	8.2
Local	7.3
Water & Sewer	6.8
Health Care	6.0
Education	5.7
Power	5.5
State	4.6
Other	1.5
Housing	0.9
Pre refunded / Escrowed to Maturity	0.9
Solid Waste/Res Recovery	0.1
Undefined	0.0
Other Cash	-0.3
Commercial Mortgage Backed	0.3
Equity	0.0
Cash & Cash Equivalents	4.2

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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