Executive Summary

- The municipal ("muni") bond market posted a small negative return and underperformed its taxable counterpart during the third quarter.

- As was the case with the taxable bond market, rising interest rates were a headwind for muni market returns.

- The Fund’s positioning in a number of sectors was additive for performance, as was its quality biases.

- Yield curve positioning, along with an overweight to the industrial revenue sector, detracted from performance.

- In the short term, Western Asset Management (Western) expects muni valuations will be driven mostly by the balance between supply and demand, as they expect fundamentals will remain generally solid and unchanged.

- Western continues to favor revenue bonds over general obligation bonds, particularly essential service revenue bonds.²

Market overview

The overall U.S. bond market was largely flat during the third quarter and the spread sectors (non-U.S. Treasuries) generally outperformed equal duration Treasuries. The U.S. Treasury yield curve flattened during the period, as short-term yields

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¹A 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.

²Revenue bonds are municipal bonds that finance income-producing projects and are secured by a specified revenue source.

INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE
rose more than their longer-term counterparts (yields and prices move in the opposite direction).

Looking at the U.S. economy, the Commerce Department reported that second quarter 2018 gross domestic product (GDP)\(^3\) annualized growth was 4.2%. This represented the strongest pace since the third quarter of 2014. In contrast, the economy expanded 2.2% during the first quarter. The acceleration in GDP growth reflected positive contributions from personal consumption expenditures (“PCE”), exports, federal government spending and state and local government spending, along with a smaller decrease in residential fixed investment. These were partly offset by a downturn in private inventory investment and a deceleration in nonresidential fixed investment. Imports decreased after increasing in the first quarter of 2018. The initial estimate for third quarter GDP will be released on October 26.\(^4\)

After holding steady at its meeting in August, the Federal Reserve Board ("Fed")\(^5\) raised rates 0.25% at its meeting in September. This pushed the Fed's target rate to a range between 2.00% and 2.25%. The increase marked the Fed's eighth rate hike since December 2015, and the Fed currently anticipates raising rates one more time during the year. In a statement following its September meeting the Fed said, “In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective.”\(^6\)

The municipal ("muni") market posted a small negative return and underperformed the overall taxable bond market during the third quarter. As was the case with taxable bond market, munis were negatively impacted by rising interest rates. All told, the Bloomberg Barclays Municipal Bond Index (the "Index") returned -0.15% during the third quarter, whereas the overall taxable bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index,\(^7\) gained 0.02%\(^8\).

Contributors/detractors

\(^3\) Gross domestic product ("GDP") is the market value of all final goods and services produced within a country in a given period of time.

\(^4\) Source of data in this paragraph: Bloomberg, 9/18.

\(^5\) 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.

\(^6\) Source of data in this paragraph: Bloomberg, 10/18.

\(^7\) The Bloomberg Barclays Municipal Bond Index is a market value weighted index of investment grade municipal bonds with maturities of one year or more.

\(^8\) 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.

\(^9\) Source of data in this paragraph: Bloomberg, 10/18.

\(^10\) 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.
<table>
<thead>
<tr>
<th>Sector allocation (%)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial Revenue</td>
<td>25.5</td>
</tr>
<tr>
<td>Pre refunded / Escrowed to Maturity</td>
<td>15.4</td>
</tr>
<tr>
<td>Education</td>
<td>12.0</td>
</tr>
<tr>
<td>Health Care</td>
<td>11.8</td>
</tr>
<tr>
<td>Transportation</td>
<td>11.5</td>
</tr>
<tr>
<td>Water &amp; Sewer</td>
<td>6.0</td>
</tr>
<tr>
<td>Local</td>
<td>5.0</td>
</tr>
<tr>
<td>Special Tax Obligation</td>
<td>3.8</td>
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<tr>
<td>State</td>
<td>2.1</td>
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<tr>
<td>Housing</td>
<td>1.9</td>
</tr>
<tr>
<td>Lease Backed</td>
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<tr>
<td>Solid Waste/Res Recovery</td>
<td>1.2</td>
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<tr>
<td>Other</td>
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<tr>
<td>Power</td>
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</tr>
<tr>
<td>Cash &amp; Cash Equivalents</td>
<td>0.6</td>
</tr>
</tbody>
</table>

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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*Please note, the Fund itself has not been rated by an independent rating agency.*

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