WESTERN ASSET
A LEGG MASON COMPANY

2Q 2019 | Product Commentary

WESTERN ASSET MUNICIPAL HIGH INCOME FUND

Team-managed

Average annual total returns and fund expenses (%)

as of June 30, 2019

Class A	3-mo	1-yr	5-yr	10-yr	Since Incept. (11/06/92)	Expenses Gross	Expenses Net
Excluding sales charges	2.23	5.79	4.08	5.88	4.96	0.82	0.82
Including effects of maximum sales charges	-2.08	1.32	3.18	5.42	4.79	0.82	0.82
Bloomberg Barclays Municipal Bond Index	2.14	6.71	3.64	4.72	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 4.25%.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.*

Gross expenses are the Fund's total annual operating expenses for the share class(es) shown. Because the Fund does not currently have fee waivers or reimbursements, gross and net expense ratios are the same. Please see the prospectus for more details on fees, expenses and expense limitation arrangements, if any. 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.

The **Bloomberg Barclays Municipal Bond Index** is a broad measure of the municipal bond market with maturities of at least one year. 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 posted a positive return, but it lagged its taxable counterpart during the second quarter.
- As was the case with the taxable bond market, falling interest rates were supportive for muni market returns.
- From a sector perspective, an overweight and security selection to industrial revenue along with security selection in lease, water & sewer, education, housing and state general obligation bonds contributed to performance. The Fund's quality biases were also additive for returns.
- Having a shorter duration than that of the benchmark detracted from performance, as rates declined during the quarter. An underweight to state general obligation bonds and security selection of local general obligation bonds were also headwinds for results.
- Western continues to see good fundamentals in the overall municipal market due to a number of factors, including strong market supply/demand technicals, low unemployment, improving tax revenues and modest budgetary spending proposals.
- Adjusted for credit quality ratings, Western believes municipal bonds are attractive versus their taxable counterparts for maturities five years and greater.

Market overview

U.S. Treasurys generated a positive return during the second quarter of 2019, as did the spread sectors (non-U.S. Treasurys). Both short- and long-term U.S. Treasury yields fell sharply during the quarter (yields and prices move in the opposite direction). This was partially driven by indications that the Federal Reserve Board ("Fed")[1] was getting closer to lowering interest rates, coupled with concerns over moderating global growth and modest inflation.

Looking at the U.S. economy, according to the Commerce Department, first quarter 2019 gross domestic product (GDP)[2] annualized growth was 3.1%. In contrast, the economy expanded 2.2% during the fourth quarter of 2018. The acceleration in GDP growth during the first quarter of 2019 was attributed to positive contributions from exports, personal consumption expenditures, nonresidential fixed investment, private inventory investment, and state and local government spending. These movements were slightly offset by a negative contribution from residential fixed investment. Imports, which are a subtraction in the calculation of GDP, decreased.[3]

The Fed kept its target rate unchanged in a range between 2.25% and 2.50% during the second quarter. However, at its meeting in June the Fed said, "The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes, but uncertainties about this outlook have increased." In his press conference after the meeting Fed Chair Powell stated, "The case for somewhat more accommodative policy has strengthened."[4]

Both short-term and longer-term Treasury yields fell sharply during the second quarter. When the period began, the yield on the two-year Treasury was 2.27%, and it ended the quarter at 1.75%. Its low for the period of 1.71% occurred on June 25, and it rose as high as 2.41%, on April 16. The yield on the 10-year Treasury began at 2.41% and it ended the quarter at 2.00%, equaling its low for the period. Its peak of 2.60% occurred on April 16.[5]

The municipal ("muni") market posted a solid gain, but it underperformed the overall taxable bond market during the second quarter. As was the case with taxable bond market, munis were supported by falling interest rates. All told, the Bloomberg Barclays Municipal Bond Index[6] returned 2.14% during the second quarter, whereas the overall taxable bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index,[7] gained 3.08%.[8]

Contributors/detractors

From a sector perspective, an overweight and security selection to industrial revenue along with security selection in lease, water & sewer, education, housing and state general obligation bonds[9] contributed to performance. The Fund's quality biases were also additive for returns. In particular, overweights to securities rated BBB and below contributed to performance, as did underweights to securities rated AA and AAA. On the downside, having a shorter duration than that of the benchmark detracted from performance, as rates declined during the quarter. An underweight to state general obligation bonds and security selection of local general obligation bonds were also headwinds for results.

The Fund's duration was increased during the quarter, but it remained shorter than that of the benchmark. From a sector positioning perspective, we increased the Fund's allocations to state general obligation bonds, industrial revenue and water & sewer, while paring its exposure to transportation. We also reduced the Fund's allocation to pre-refunded securities, both from sales and the maturing of certain positions.

Outlook

We continue to see good fundamentals in the overall municipal market, driven by a number of factors. These include strong market supply/demand technicals, low unemployment, improving tax revenues and modest budgetary spending proposals. Adjusted for ratings, municipal bonds are attractive versus their taxable counterparts for maturities five years and greater. We remain focused on idiosyncratic risks over market risk. In terms of positioning, we continue to favor

[1] 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.

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

[3] Source of data in this paragraph: Bloomberg, 7/19.

[4] Source of data in this paragraph: Bloomberg, 6/19.

[5] Source of data in this paragraph: Bloomberg, 7/19.

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

[7] 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.

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

[9] 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.

revenue bonds[10] over general obligation bonds, with an emphasis on the industrial revenue and transportation sectors.

Sector allocation (%)	
Industrial Revenue	26.4
Education	11.9
Pre refunded / Escrowed to Maturity	11.7
Transportation	10.2
Health Care	9.6
Water & Sewer	6.6
Local	5.6
Special Tax Obligation	4.9
State	4.8
Lease Backed	2.5
Housing	2.5
Other	1.3
Solid Waste/Res Recovery	1.0
Power	0.7
Other Cash	0.0
Government	0.0
Cash & Cash Equivalents	0.2

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.

[10] A revenue bond is a municipal bond supported by the revenue from a specific project, such as a toll bridge, highway or local stadium.

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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. Derivatives, such as options and futures, can be illiquid, may disproportionately increase losses, and have a potentially large impact on Fund performance. An investor may be subject to the federal Alternative Minimum Tax, and state and local taxes may apply. Capital gains, if any, are fully taxable.

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Portfolio holdings and sector allocations may not be representative of the portfolio manager's current or future investment and are subject to change at any time.

Credit quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. The credit ratings shown are based on each portfolio security's rating as provided by Standard and Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd. and typically range from AAA (highest) to D (lowest), or an equivalent and/or similar rating. For this purpose, if two or more of the agencies have assigned differing ratings to a security, the highest rating is used. Securities that are unrated by all three agencies are reflected as such. The credit quality of the investments in the Fund's portfolio does not apply to the stability or safety of the Fund. **These ratings are updated monthly and may change over time. Please note, the Fund itself has not been rated by an independent rating agency.**

U.S. Treasurys 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. Treasurys when the securities are held to maturity.

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