WESTERN ASSET
A LEGG MASON COMPANY

2Q 2019 | Product Commentary

WIA - WESTERN ASSET INFLATION-LINKED INCOME FUND

Team-managed

Average annual total returns (%)
as of June 30, 2019

	3-mo	YTD	1-yr	3-yr	5-yr	10-yr	Since Incept. (9/26/03)
NAV	4.18	9.73	6.60	3.87	2.36	3.98	3.61
Market Price	4.88	12.06	5.79	4.14	2.55	3.35	2.85

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 sold, may be worth more or less than the original cost. Returns are based on Market Price or NAV and assume the reinvestment of all distributions at the Dividend Reinvestment Plan Price or NAV, respectively. All returns include the deduction of management fees, operating expenses and all other Fund expenses, and do not reflect the deduction of brokerage commissions or taxes that investors may pay on distributions or the sale of shares. Performance data of less than one year are cumulative figures and are not annualized. For current month-end performance, visit www.lmcef.com.*

Executive summary

- Both short- and long-term Treasury yields declined during the second quarter, as the Federal Reserve Board ("Fed") indicated it may soon lower interest rates.
- The overall taxable bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, gained 3.08% during the second quarter. The spread sectors also moved higher over the quarter.
- U.S. Treasury Inflation-Protected Securities ("TIPS"), as measured by the Bloomberg Barclays U.S. TIPS Index, returned 2.86% during the second quarter.
- The Fund generated a strong return at NAV during the second quarter.
- Western Asset Management ("Western") expects global growth to remain resilient on the back of steady U.S. growth, improving domestic conditions in Europe, and signs that sustained monetary and fiscal stimuli across Asia are gaining traction.
- Western acknowledges that trade friction will be an ongoing drag on investor and business confidence, but central banks globally have become much more explicit in their commitment to unleash additional policy accommodation to truncate downside risks.

Market recap

U.S. Treasurys generated a positive return during the second quarter, as both short- and long-term yields declined (yields and prices move in the opposite direction). The spread sectors (non-U.S. Treasurys) also rallied over the quarter. After yields generally moved higher in April, trade concerns dominated May and led to a risk-off environment for much of the month. Yields then moved sharply lower as the Federal Reserve Board ("Fed") indicated it was getting closer to lowering interest rates. Similar accommodative messaging by the European Central Bank (ECB) also contributed to falling global bond yields.

Looking at the U.S. economy, according to the Commerce Department, first quarter 2019 gross domestic product (GDP) 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.

The labor market remained tight during the second quarter. The unemployment rate was 3.6% in both April and May—equaling the lowest rate since December 1969. The unemployment rate then ticked up to 3.7%. However, this was partially due to an increase in the workforce participation rate, as it rose from 62.8% in May to 62.9% in June.

The manufacturing sector continued to expand, but the pace moderated during the second quarter. According to the Institute for Supply Management's Purchasing Managers Index (PMI), the manufacturing sector expanded for the 34th consecutive month in June, with a reading of 51.7, versus 52.8 in April. (A reading

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below 50 indicates a contraction, while a reading above 50 indicates an expansion.) Twelve of the 18 industries measured by the PMI expanded in June.

According to the National Association of Realtors (NAR), existing-home sales rose 2.5% on a seasonally adjusted basis in May versus the previous month's sales. The NAR also reported that the median existing-home price for all housing types was $277,700 in May 2019, up 4.8% from May 2018. Finally, the inventory of homes available for sale in May was at a 4.3-month supply at the current sales pace. In contrast, there was a 4.2-month supply the previous month.

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."

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.

The overall taxable bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, gained 3.08% during the second quarter. The spread sectors also moved higher, as the Fed and a number of other central banks leaned toward introducing more accommodative monetary policies. In addition, signs of moderating global growth and uncertainties over U.S.-China trade negotiations triggered several flights to quality. Higher-yielding spread sectors also generated positive results during the quarter. The Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Cap Index returned 2.50%, whereas the emerging market debt asset class, as represented by the JPMorgan Emerging Markets Bond Index Global (EMBI Global), gained 3.76%. Finally, U.S. Treasury Inflation-Protected Securities ("TIPS"), as measured by the Bloomberg Barclays U.S. TIPS Index, returned 2.86% during the second quarter.

Fund overview

The Fund generated a strong return during the second quarter. Our exposure to U.S. dollar-denominated emerging market sovereigns was beneficial, as they performed well as spreads tightened. The Fund's Treasury allocation was rewarded as yields moved sharply lower over the period.

Foreign exchange (FX) positioning was also additive. During the quarter, we held a diversified mix of currency exposures across a number of countries.

An allocation to non-agency residential mortgage-backed securities contributed to returns, as did our duration positioning. Finally, our TIPS exposure was also a modest tailwind for results.

On the downside, yield curve positioning detracted from performance.

Outlook

Global growth concerns have intensified since last quarter, as an initial trade spat between the U.S. and China has morphed into a broader conflict, with the risk of expanding on new fronts. Markets have also been rattled by the prospect of a U.S. recession, a sustained slowdown in eurozone growth, and higher oil price volatility on escalating tensions in the Middle East. Despite these concerns, we expect global growth to remain resilient on the back of steady U.S. growth, improving domestic conditions in Europe, and signs that sustained monetary and fiscal stimuli across Asia are gaining traction. We acknowledge that trade friction will be an ongoing drag on investor and business confidence, but central banks globally have become much more explicit in their commitment to unleash additional policy accommodation to truncate downside risks.

Yields and dividends represent past performance, and they can fluctuate, and there is no guarantee they will continue to be paid. Past performance is no guarantee of future results.

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Glossary

Spread refers to the difference between Treasury securities and non-Treasury securities of similar maturity but different credit quality.

Credit quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. The credit ratings discussed are based on a security's rating as provided by Standard & Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd., and they typically range from AAA (highest) to D (lowest), or an equivalent and/or similar rating. 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 that the closed-end funds have not been rated by an independent rating agency. Investment-grade bonds are bonds that are rated Aaa, Aa, A and Baa by Moody’s Investors Service and AAA, AA, A and BBB by Standard & Poor’s Ratings Service, or that have an equivalent rating by a nationally recognized statistical rating organization or are determined by the manager to be of equivalent quality. A below-investment-grade bond or a high-yield security has a rating of BB or lower; it pays a higher yield to compensate for its greater risk.

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.

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.

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.

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.

An investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

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What should I know before investing?

All investments are subject to risk, including possible loss of principal. 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. The Fund is subject to the additional risks associated with inflation-linked securities, including liquidity risk, prepayment risk, extension risk and deflation risk. 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. Currency transactions are subject to price volatility, liquidity and counterparty risk. Derivatives, such as options and futures, can be illiquid, may disproportionately increase losses, and have a potentially large impact on Fund performance. To the extent that the Fund invests in commodity-linked derivatives, these investments are subject to additional risks, such as commodity index volatility, investor speculation, interest rates, or factors such as drought, floods, weather, livestock disease, and political and regulatory developments. To the extent that the Fund invests in asset-backed, mortgage-backed or mortgage-related securities, these investments are subject to additional risks, such as prepayment and extension risks. Leverage may result in greater volatility of NAV and the market price of common shares and increases a shareholder's risk of loss.

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