2Q 2019 | Product Commentary

XWAMX - WESTERN ASSET MIDDLE MARKET DEBT FUND INC.

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

	3-mo	YTD	1-yr	3-yr	5-yr	10-yr	Since Incept. (12/20/12)
NAV	1.59	8.32	4.89	9.35	2.87	-	4.33

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 NAV and assume the reinvestment of all distributions at NAV. 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

- The U.S. high-yield bond market, as measured by the Bloomberg Barclays U.S. High Yield 2% Issuer Cap Index, gained 2.50% during the second quarter.
- For comparison purposes, the overall taxable bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, returned 3.08% during the quarter.
- In Western Asset Management's ("Western") view, the high-yield bond market continues to offer an attractive risk/reward profile, and even more so given the pullback in May.
- Western remains mindful that tariff tensions (among other risks) could resurface and weigh on investor sentiment.
- In Western's view, the Fund is well-positioned to take advantage of both up and down markets.

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 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 U.S. high-yield bond market, as measured by the Bloomberg Barclays U.S. High Yield 2% Issuer Cap Index, gained 2.50% during the second quarter.

Fund overview

During the second quarter, Western Asset Middle Market Debt Fund returned 1.59%, versus the 0.20% return of the stated benchmark, the Bloomberg Barclays U.S. High Yield Caa ex Hybrids 2% Issuer-Constrained Index.

In terms of Fund-specific performance, the selection of industry sectors and securities was, as in previous periods, a primary driver of returns. A key driver of performance was the Fund's allocation to the consumer cyclical and consumer non-cyclical industry sectors. These were the largest two sectors of the Fund's exposure and together accounted for approximately 48% of the portfolio.

Another meaningful contributor to returns was a position in Neovia notes. The company completed a refinancing and the notes moved from a significant discount to par to being called at par. Another positive contributor was a position in BioScrip, which continued to increase in value based on company results and the approaching reverse merger expected to close in August 2019. Elsewhere, continuing its positive performance in the prior quarter, the Fund's position in U.S. Concrete notes was additive for returns. The company provides ready-mixed and precast concrete, concrete block, aggregate and concrete building materials.

On the downside, the Fund's position in natural gas producer Montage Resources common shares, which entered the portfolio via the restructuring of Magnum Hunter notes, detracted from results. Equities in the U.S. natural gas sector are out of favor based on current low natural gas prices. A second security detracting from the Fund's overall positive performance in the quarter was a small position in Murray Energy, which was originally purchased at a significant discount to par.

Toward the end of the second quarter, the Fund increased its leverage to approximately 16%. This reflects our evolving view around the environment for market support from monetary policy and the expected healthy earning results for companies in the portfolio. With this leverage, the Fund retains considerable "dry powder" in case the market experiences an increase in volatility.

For the quarter as a whole and the year-to-date period, the Fund experienced no defaults. The Fund's distribution decreased during the quarter. This was partially attributable to using less leverage for the quarter as a whole, as well as having a significant number of high-yielding investments called away in the first and second quarters of 2019.

Finally, the eight-year life of the Fund comes at the end of December 2020. With roughly 18 months of Fund life remaining, the maturity date has a slight influence on portfolio positions. In particular, we are avoiding acutely illiquid investments and favoring more liquid notes and term loan investments, as well as debt instruments that mature before December 2020. We expect to continue to use the full 20% allocation to non-middle market issuers to add high-yield bonds that have in general been historically more liquid than middle market investments.

Outlook

In our view, high yield continues to offer an attractive risk/reward profile. The U.S. high-yield default rate is low, and it's expected to remain so as we progress through 2019. Corporate earnings remain solid and leverage is still moderate. The fundamentals of the U.S. economy continue to hold up, and absent a full-blown global trade war, which is not our base case, we see no imminent threat to a continuation of the credit cycle. From an industry perspective we remain overweight select cyclicals (services, lodging), metals (copper) and financials. Our ratings positioning is on the conservative side, with an underweight to CCC-rated securities and an opportunistic exposure to investment-grade bonds. We believe our strategy is well positioned to take advantage of both up and down markets.

Credit Quality Allocation (%):

BB	4.61
B	51.32
CCC	30.88
CC	1.70
D	0.40
Not Rated	11.09

Past performance is no guarantee of future results. Opinions shared in this commentary are current as of July 30, 2019 and are subject to change based on markets and other conditions. These opinions do not constitute, and should not be construed as, investment advice or recommendations. The opinions expressed are those of the portfolio managers indicated and may differ from the views of other managers or the firm as a whole. And they are not intended to be a forecast of future events or a guarantee of future results. Discussions of individual securities are intended to inform shareholders as to the basis (in whole or in part) for previously made decisions by a portfolio manager to buy, sell or hold a security in a portfolio. References to specific securities are not intended, and should not be relied upon, as the basis for anyone to buy, sell or hold any security. Investors seeking financial advice regarding the appropriateness of investing in any securities or investment strategies should consult their financial professional. Forecasts are inherently limited and should not be relied upon as an indication of actual or future performance.

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Legg Mason Partners Fund Advisor, LLC (LMPFA) is the Fund’s manager, and it has delegated the day-to-day portfolio management of the Fund to Western Asset.

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). For this purpose, if two or more of the agencies have assigned differing ratings to a security, the lowest 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 that the Fund itself has not been rated by an independent rating agency.**

For more information about any of our closed-end funds, including long-term performance, risks, expenses and fund objectives, please visit www.lmcef.com.

Glossary

High-yield bonds possess greater price volatility, illiquidity and possibility of default.

Investment-grade bonds are generally rated BBB and above.

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

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. High Yield 2% Issuer Capped Bond Index** is a component of the U.S. Corporate High-Yield Bond Index, which covers the universe of fixed-rate, non-investment-grade corporate debt of issuers in non-emerging market countries. It is not market capitalization-weighted; each issuer is capped at 2% of the index.

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?

An investment in the Fund involves a high degree of risk. The Fund should be considered an illiquid investment. The Fund does not intend to apply for an exchange listing, and it is highly unlikely that a secondary market will exist for the purchase and sale of the Fund's shares. You could lose some or all of your investment. An investment in the Fund is not appropriate for all investors and is not intended to be a complete investment program. The Fund is designed as a long-term investment for investors who are prepared to hold the Fund's Common Stock until the expiration of its term, and it is not a trading vehicle. All investments are subject to risk, including possible loss of principal. Fixed income securities are subject to numerous risks, including but not limited to credit, inflation, income, prepayment and interest rates risks. As interest rates rise, the value of fixed income securities falls. Middle market companies have additional risks due to their limited operating histories, limited financial resources, less predictable operating results, narrower product lines and other factors. Securities of middle market issuers are typically considered high-yield. "High-yield" refers to below-investment-grade quality (also commonly referred to as "junk bonds"). High-yield fixed income securities of below-investment-grade quality are regarded as having predominantly speculative characteristics with respect to the issuer's capacity to pay interest and repay principal. High-yield bonds are subject to higher credit risk and a greater risk of default. The Fund may invest all or a portion of its Managed Assets in illiquid securities. The Fund may make significant investments in securities for which there are no observable market prices; the prices must be estimated by Western Asset. Investments in foreign securities involve risks, including the possibility of losses due to changes in currency exchange rates and negative developments in the political, economic or regulatory structure of specific countries or regions. These risks are greater in emerging markets. Leverage may result in greater volatility of the net asset value of common shares and increases a shareholder's risk of loss. Derivative instruments can be illiquid, may disproportionately increase losses, and have a potentially large impact on Fund performance.

Distributions are not guaranteed and are subject to change.