1Q 2019 | Product Commentary

XWMFX - WESTERN ASSET MIDDLE MARKET INCOME FUND INC.

Average annual total returns (%)
as of March 31, 2019

	3-mo	YTD	1-yr	3-yr	5-yr	10-yr	Since Incept. (8/26/14)
NAV	6.44	6.44	7.51	14.62	-	-	3.88

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 7.26% during the first quarter.
- For comparison purposes, the overall taxable bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, gained 2.94% during the first quarter.
- In Western Asset Management's ("Western") 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 decline as the year progresses.
- Western believes 2019 is set to be a good year for high yield, but that headline-driven volatility is likely to remain.

Market recap

U.S. Treasurys generated a positive return during the first quarter of 2019, as did the spread sectors (non-U.S. Treasurys). Both short- and long-term U.S. Treasury yields declined during the quarter, driven by the "dovish pivot" by the Federal Reserve Board ("Fed"), signs of moderating global growth and tame inflation (yields and prices move in the opposite direction).

Looking at the U.S. economy, according to the Commerce Department, fourth-quarter 2018 gross domestic product (GDP) annualized growth was 2.2%, versus its previous estimate of 2.6%. In contrast, the economy expanded 3.4% during the third quarter. Moderating growth in the fourth quarter was attributed to decelerations in private inventory investment, personal consumption expenditures (PCE) and federal government spending, along with a downturn in state and local government spending. These factors were partly offset by an upturn in exports and an acceleration in nonresidential fixed investment. Furthermore, imports increased less in the fourth quarter than in the third quarter of 2018. The initial estimate for first-quarter 2019 GDP was 3.2%.

The labor market remained tight during the first quarter. The unemployment rate was 4.0% in January 2019. It then dipped to 3.8% in February, and it was unchanged in March. The workforce participation rate was little changed during the first quarter, as it moved from 63.2% in January to 63.0% in March.

After four increases in 2018, the Federal Reserve Board ("Fed") kept its target rate unchanged in a range between 2.25% and 2.50% during the first quarter. At its January meeting the Fed said, "In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate …." Then, at its March meeting, most Federal Open Market Committee members indicated that they did not feel additional rate hikes would be needed in 2019, and they anticipated only one increase in 2020. The Fed also provided additional guidance on the winding down of its balance sheet, explaining that it would be completed by September 2019.

After rising sharply in 2018, both short-term and longer-term Treasury yields declined during the first quarter of 2019. When the year began, the yield on the two-year Treasury was 2.48%, and it ended the quarter at 2.27%. Its low for the period of 2.22% occurred on March 27, and it rose as high as 2.62%, on January 18. The yield on the 10-year Treasury began the year at 2.69% and it ended the quarter at 2.41%. Its low for the period of 2.39% occurred on March 27, and it rose as high as 2.79%, on January 18.

The U.S. high-yield bond market, as measured by the Bloomberg Barclays U.S. High Yield-2% Issuer Cap Index, gained 7.26% during the first quarter. The high-yield market was supported by generally strong corporate earnings, accommodative central bank monetary policies, low defaults, supportive market supply/demand technicals, and rising oil prices. Collectively, this led to credit spread tightening and offset concerns over slowing global growth and a number of geopolitical issues. For comparison purposes, the overall taxable bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, gained 2.94% during the first quarter.

Fund overview

During the first quarter, Western Asset Middle Market Income Fund returned 6.44%, versus the 6.93% return of the stated benchmark, the Bloomberg Barclays U.S. High Yield CCC 2% Issuer-Constrained Index. Of note, the Fund was down less than the benchmark during the sell-off during the fourth quarter of 2018.[1]

In terms of Fund-specific performance, security selection was, as usual, a primary driver of returns. A key driver of performance was the Fund's allocation to the energy sector, as it benefited from sharply rising oil and commodity prices. In particular, the Fund's equity holding in Berry Petroleum (the majority of our equity exposure) was the largest contributor to results, as its common shares rose over 30% ($8.50 to $11.54). Given its strong results, we pared the Fund's exposure to Berry Petroleum during the quarter. Another meaningful contributor to returns was BioScrip, a public company in the at-home medical infusion business. Investor sentiment for the company was buoyed by the announcement of a reverse merger with Option Care. Elsewhere, U.S. Concrete was additive for returns. The company provides ready-mixed and precast concrete, concrete block, aggregate and concrete building materials. From a sector positioning perspective, holdings in consumer cyclicals and consumer non-cyclicals were beneficial for performance.

On the downside, a short position in XOP, an exchange-traded fund (ETF) focused on U.S. oil & gas exploration and production, detracted from results, given the strong results in this space. The Fund's short position was designed as a partial hedge against potentially falling oil prices. The Fund's position in Windstream, a provider of voice and data network communications, was also negative for returns. The company is headed to Chapter 11 after receiving an adverse verdict in litigation which surprised the financial markets. We subsequently sold our position. In addition to weak results in the communications sector, the electric utility sector was a slight headwind for returns.

During the quarter, we reduced the Fund's leverage to approximately 10%. We believe this was prudent, given narrowing spreads and less attractive valuations. This also gives us "dry powder" if the market experiences an increase in volatility.

In addition to those securities already mentioned, the Fund's position in ENMC 10.75% notes due in 2020 was called at par. Agiliti Health 7.625% notes due in 2020 were also called at par. Elsewhere, the Fund sold Silver Seas 7.25% notes due in 2025 at a premium, as the rating agencies upgraded the notes to an investment-grade rating.

For the quarter as a whole, the Fund experienced no defaults, versus nine for the JPM high-yield bond and loan index. The Fund's distribution decreased during the quarter. This was partially attributable to a one-time write-off of the accrued interest related to a distressed security held in the Fund.

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 decline as the year progresses. Corporate earnings remain strong, albeit with some companies calling for lower guidance, and the fundamentals of the U.S. and global economies remain sound. We see no imminent threat to a continuation of the credit cycle. While the risk of Federal Reserve Board overtightening has largely abated, we recognize that other risks, such as the U.S.-China trade spat and political developments in Europe, remain. However, there are signs that negotiations are proceeding toward an amicable conclusion. We believe 2019 is set to be a good year for high yield, but that headline-driven volatility is likely to remain.

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.

The WESTERN ASSET MIDDLE MARKET INCOME FUND is not publicly traded and is closed to new investors. The Fund has an anticipated 8-year term, with termination expected on December 30, 2022. The Fund's term may be longer, depending on market

[1] As of 3/31/19, the Fund estimates that the distributions will be paid from: 100.00% investment income; 0.00% realized capital gains; and 0.00% return of capital. These estimates are not for tax purposes and a 1099 will be issued following year end. The distribution rate is subject to change and is not a quotation of Fund performance. The board of directors may terminate or suspend the managed distribution policy at any time. Any such termination or suspension could have an adverse effect on the market price of the Fund's shares. A return of capital is not taxable and results in a reduction in the tax basis of a shareholder's investment. For more information about a distribution's composition, refer to the Fund's distribution press release or, if applicable, the Section 19 notice located in the press release section of our website.

conditions. If the Fund's board of directors determines that under then-current market conditions it is in the best interests of the Fund to do so, the Fund may extend the termination date for one year, to December 29, 2023, without a stockholder vote. The Fund's termination date can be further extended beyond December 29, 2023 by 75% of the directors and 75% of the outstanding voting securities of the Fund. The Fund anticipates making quarterly tender offers, at the sole discretion of the Fund, for up to 2.5% (or 10% annually) of Managed Assets, beginning 18 months after offering, in 2016. No exchange listing or liquid secondary market is expected to exist.

Diversification does not guarantee a profit or protect against market loss. Portfolio allocations, holdings and characteristics referenced in this commentary are as of March 31, 2019 and are subject to change at any time.

Credit Quality Allocation (%):

BB	4.36
B	41.29
CCC	38.15
C	0.04
D	0.53
Not Rated	15.64

Past performance is no guarantee of future results. Opinions shared in this commentary are current as of April 26, 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.

The closed-end funds are not sold or distributed by Legg Mason Investor Services, LLC (LMIS) or any affiliate of Legg Mason, Inc. Unlike open-end funds, shares are not continually offered. Like other public companies, closed-end funds have a one-time initial public offering. Share prices will fluctuate and, at the time of sale, they may be worth more or less than your original investment. **Net asset value (NAV)** is total assets less total liabilities divided by the number of shares outstanding. Investment return and net asset value will fluctuate with changes in market conditions. The Funds are subject to investment risks, including the possible loss of principal invested. Note that unlike other closed-end funds, Western Asset Middle Market Income Fund is not publicly traded and is closed to new investors. For more information, please call Investor Relations at 888-777-0102, or consult the Fund's website at www.lmcef.com.

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 & 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 Cap 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. Corporate High Yield—2% Issuer Cap CCC Component** is an index of the 2% Issuer Cap component of the broader Bloomberg Barclays U.S. Corporate High Yield Index and is comprised of the CCC-rated securities included in this 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 Common Stock. 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. High-yield bonds ("junk 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 of which must be estimated by the investment manager. 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 net asset value (NAV) 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.