Executive Summary

- We expect that global growth will prove to be resilient, even in the face of interconnected risks that include trade tensions, slowdowns in Europe and China, and a potential hard Brexit.
- Our estimate for US growth in 2019 is between 2.0% and 2.25%. We’re encouraged by a recent rebound in consumer spending and a tentative improvement in manufacturing data.
- We see nothing in Fed policy nor in the ongoing growth rates of nominal GDP that would suggest any inflation spikes over the near to mid term.
- For the eurozone, we recently downgraded our growth expectations to about 1.0% for 2019 given recent data prints.
- On US-China trade tensions, we do not expect to see a quick permanent turnaround in the near term as neither country appears keen to concede ground.
- In line with other DMs, growth has slowed in Australia and we now expect growth of 2.0%-2.5% in 2019.
- While oil prices over the short term are expected to be in the $55 to $62 per barrel range given the recent drone strikes in Saudi Arabia, we expect an eventual return to our $50 to $55 per barrel range.

Global growth prospects remain clouded by a number of interconnected risks: a sustained decline in global manufacturing activity due to ongoing global trade tensions, a more pronounced slowdown in Europe and China, the possibility of policy missteps by the Fed and ECB as they look to enact additional stimulus measures, and fear of an imminent hard-Brexit scenario due to political chaos and newer flashpoints in Hong Kong and Saudi Arabia, with ramifications that remain unknown at this time. While downside risks have risen this year, we believe global growth should prove to be resilient. We remain encouraged by the ongoing strength of the consumer globally and the enormous amount of monetary stimulus supplied by both developed (DM) and emerging market (EM) central banks—the combined weight of these two forces should truncate downside growth risks as we move closer to 2020. Here we provide a summary of the key drivers behind our global outlook, how we’re positioned in broad market portfolios and a more detailed description of where we see value in today’s markets.
US: Economic Growth Continues to Hold Up Well

At present, we are estimating US growth between 2.0% and 2.25% for 2019. Earlier in the year, an apparent sputter in consumer spending and income growth had caused us to reduce our forecast, but both indicators have rebounded over recent months making a low 2%‐handle outcome most likely. This rebound in consumer spending and a tentative recent improvement in US manufacturing sector data make the chances of recession even lower now than they were a few months ago when we were expecting slightly slower 2019 growth. While various elements of the US economy are showing slower growth than was the case over 2017‐2018, nowhere is there actual weakness or any indication of an ongoing deceleration that would raise the threat of recession.

Constant news of tariffs—and retaliatory tariffs—between the US and China have caused some to fear the downside implications of this ongoing spat for the US economy. At present, however, we see no tangible evidence that trade wars are adversely affecting US economic aggregates. If anything, the US trade balance has improved slightly relative to trend so far this year, implying a slight boost to GDP growth, rather than the drag some profess to see. Developments in capital spending by US corporations also show some recent improvement, if anything, contrary to claims that trade fears are restraining capital expenditures. While core inflation measures have also rebounded a bit in recent months, the upswing merely offsets some of the especially low inflation seen earlier in 2019. All in all, then, inflation looks to be holding below the Fed’s 2% target. We see nothing in Fed policy nor in the ongoing growth rates of nominal GDP that would suggest any meaningful upside pressure on inflation.

Europe: Growth Sturdy, Risks Rising, All Eyes on Brexit

We revise down our growth expectations for the eurozone in 2019 on the margin given recent data prints, but still believe that growth will come in around 1.0%. The slowdown in global trade has taken an outsized toll on German growth, while political risk earlier in the year is likely to have brought Italy to an economic standstill. We also view issues in the German car manufacturing and chemical industries as having contributed to the slowdown after four years of above‐potential growth, but we see those hindrances becoming less important over time.

Looking ahead to 2020, we also revise our growth expectations lower somewhat on the back of recent disappointments in soft data including service PMIs, but, on aggregate, we still see a small pickup over 2019 to around 1.2% on the back of Germany and Italy doing better. We expect the German economy to accelerate next year and grow around potential, partly due to base effects and partly as the result of the supply‐side constraints mentioned earlier becoming less binding. Abating political noise in Italy should be conducive to growth rebounding there as well. Other large eurozone countries, on the other hand, could slow somewhat but are likely to grow roughly at potential, supported by accommodative monetary and fiscal policies across the continent. Risks around this baseline for 2019, but especially for 2020, are skewed to the downside, in particular if the service sector weakness in soft data becomes more pronounced and starts showing up increasingly in hard data. Other key risks next year include a disorderly Brexit, higher crude prices, further trade escalation and renewed political risk in Italy.

Regarding the UK, we are of the view that the recent Supreme Court ruling has substantially reduced the chances of a “no‐deal” Brexit this year as it has strengthened the role of Parliament in the process. Instead, we expect that either (1) Parliament approves a deal before October 19 that is perceived as a marginal improvement to the one negotiated by former Prime Minister Theresa May or (2) the current Prime Minister Boris Johnson—or a caretaker government—requests an extension before the end of October, followed by a general election. While the narrative keeps shifting, we are marginally more hopeful that a “deal” will come to pass before the end of October as there seems to be a more concerted effort from the UK to make meaningful proposals on how to resolve the outstanding issues around the Irish backstop.

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Our 2020 growth outlook for the UK comprises, therefore, an unusually large degree of uncertainty. Inflation, similarly, depends significantly on the levels of the exchange rate and the introduction of tariffs and transaction costs, but we think that in the case of a “no-deal” Brexit, the Bank of England will look through a temporary rise in inflation and cut rates to support the economy.

China's economy is slowing for both structural and cyclical reasons at a time when the global economy is softening. Facing this backdrop, Chinese policymakers have judged that giving their domestic producers breathing room with a currency devaluation makes sense. However, the key challenge for small and micro enterprises remains financing availability, as banks continue to be cautious in lending. The People's Bank of China's 2019 monetary policy report maintained continued accommodative monetary policy, though in reality it would mean more of the same, with the overarching aim of preventing further froth in property markets.

On US-China trade tensions, we do not expect to see a quick permanent turnaround in the near term, as neither the US nor China appear keen to concede ground. Seemingly intractable positions at least from a domestic political perspective look set to persist. In the extreme event of a further hardening in US stance, global markets could see further deterioration. This underpins the uncertain policy environment in developed markets, which is detrimental for investment. Looking ahead, escalating tensions and uncertainty will continue to weigh on sentiment leading to further drags on capital expenditure and consumer confidence.

Growth has slowed in Australia in line with other DMs and we now expect growth of 2.0%-2.5% in 2019. Although a reluctant cutter, the Reserve Bank of Australia (RBA) reduced rates three times since June after almost three years on the sidelines and has maintained an explicit easing bias. The market has brought forward expectations for the next rate cut, perceiving a greater likelihood of one more cut before the year-end and the possibility of further easing in 2020.

There are indications that the housing market has bottomed with a few months of rising prices after almost two years of declines. The wealth effect from a turnaround in housing may help improve the lackluster contribution to GDP growth from the consumer over the past year or so. Although very strong, jobs growth has failed to keep pace with record labour force participation over the past year, resulting in a small rise in the unemployment rate, one of the key indicators the RBA has explicitly targeted in its rate-setting deliberations. Together with the firm dovish tone from the RBA, this would point to another cut in the near term.

A series of drone strikes against the world's largest petroleum processing facility in Saudi Arabia resulted in the loss of 5.7 million barrels per day of Saudi oil production. This amount represents a little more than 5% of global supply and has the potential to destabilize the oil market's supply/demand balance. Before this event, we believed WTI oil prices were range-bound at $50 to $55 per barrel, consistent with management and industry budget setting.

From a fundamental perspective, the crude market in 2019 is considered relatively balanced—resilient oil demand growth, US production growth, OPEC and Russia's compliance with target quotas, supply disruptions and geopolitical risk support the argument. In recent times, these factors were seen to be moderating into 2020 with concerns over trade tensions and weaker economic growth, hence demand. The Saudi event has only served to highlight the prospect that geopolitical risk may not be fully incorporated into prices and focus has returned to the region, including the Strait of Hormuz, which is a potential chokepoint.

While WTI prices over the short term are expected to be elevated in the $55 to $62 per barrel range given the supply-side impact and questions over production restoration, we could see a return to our $50 to $55 per barrel range over the medium to long term given lower demand growth from slowing forward economic activity.
The Big Picture

Developed Market Rates: Relative Value by Region

**Canada:** We do not see the Fed hiking rates until realized inflation is above its 2% target for a sustained period of time. Until then, the Fed will likely maintain an accommodative posture for an extended period. We are maintaining a long duration position with an overweight to longer-dated bonds, which can also act as ballast against spread risk.

**US:** We currently look for US growth between 2.0% and 2.25% in 2019. Equipment investment, exports and inventories have slowed; however, none of them are outright weak, certainly not enough to threaten recession. Even for homebuilding, the roughly 10% drop seen there in 2018 pales against the declines seen over 2006-2008. So, at this time, again, we project slower growth in 2019 than what was experienced over 2017-2018, but we do not see recession risk as being more than slight.

**Europe:** We continue to expect eurozone growth to be around 1% this year and next—not spectacular but only slightly below estimates of the region’s potential annual growth rate after five consecutive years of above-potential growth. While there are many downside risks and some countries might be at the brink of a technical recession, we feel that the market has become too pessimistic. In addition, the ECB has restarted its asset purchase program (APP), linking its duration explicitly to inflation outcomes.

**UK:** We maintain a constructive view on the Japanese economy, driven by consumer spending and business investment. The negative effect of a consumption tax increase is expected to be limited due to some mitigating fiscal measures. On monetary policy, we expect the BoJ to maintain its accommodative monetary policy for some time to meet its 2% inflation goal. No further easing is our base case scenario.

**Japan:** We now expect growth of 2.0%-2.5% in 2019 as there are indications that the housing market has bottomed. Although very strong, jobs growth has failed to keep pace with record labour force participation over the past year, resulting in a small rise in the unemployment rate, one of the key indicators the RBA has explicitly targeted in its rate-setting deliberations. This would point to at least another cut in the near term, most likely this year.

**Australia:** We hold a neutral position relative to benchmarks; at present with a 10s/30s flattening position. External risks may remain protracted and potentially add to the RBA’s case for further easing. Long-dated bonds continue to look attractive versus those of other DMs as we believe the curve is likely to flatten if global markets destabilise due to trade and geopolitical events.

See Relative Value by Sector section for the Emerging Markets outlook.

**EUROPE:** We view the ECB’s APP re-engagement as renewed impetus for the yield compression trade in Europe. That said, the lower intensity (at €20 billion per month) implies that the downward pull for bond yields is less strong than in previous iterations. While the growth picture is worsening on the margin, we still view global bonds as overvalued.

**UK:** We do not see the Fed hiking rates until realized inflation is above its 2% target for a sustained period of time. Until then, the Fed will likely maintain an accommodative posture for an extended period. We are maintaining a long duration position with an overweight to longer-dated bonds, which can also act as ballast against spread risk.

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**Canada:** Real estate risks have fallen down the list, with all but Vancouver doing pretty well. National sales data bottomed and are rebounding. Household debt levels are a problem for the outlook, though by themselves do not make the case for a policy response either way (neither high enough to reduce the incentive to take on debt nor low enough to offset any yet-to-be-seen drag).

**Europe:** We continue to expect eurozone growth to be around 1% this year and next—not spectacular but only slightly below estimates of the region’s potential annual growth rate after five consecutive years of above-potential growth. While there are many downside risks and some countries might be at the brink of a technical recession, we feel that the market has become too pessimistic. In addition, the ECB has restarted its asset purchase program (APP), linking its duration explicitly to inflation outcomes.

**UK:** The Bank of England continues to signal its preference for a slow tightening in the case of an orderly Brexit given the robust labor market and an expected firming of investment and domestic demand growth. The Supreme Court’s ruling has significantly reduced the probability of an “accidental” disorderly Brexit by the end of October. The alternative scenarios—a deal or an extension combined with elections—are both “softer” outcomes. While an extension does not rule out a disorderly Brexit later on, the outcome of the elections could reshuffle the cards in a significant way.

**Japan:** We maintain a constructive view on the Japanese economy, driven by consumer spending and business investment. The negative effect of a consumption tax increase is expected to be limited due to some mitigating fiscal measures. On monetary policy, we expect the BoJ to maintain its accommodative monetary policy for some time to meet its 2% inflation goal. No further easing is our base case scenario.

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**UK:** UK gilts have rallied in line with the government debt of other developed markets, though at a lesser extent than US Treasuries over the last few months. Should the UK and European Union reach some form of agreement on Brexit, we expect higher gilt yields and a stronger GBP. The gilt curve could steepen markedly in the case that the current opposition wins the elections and engages in expansionary fiscal policies.

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**Canada:** The Canadian yield curve is flatter than that of the US, limiting interest on an unhedged basis, but the Canadian dollar appears to have priced in the worst of the Canadian oil discount. Longer-dated bonds look attractive relative to the front end and the US.

**Europe:** We view the ECB’s APP re-engagement as renewed impetus for the yield compression trade in Europe. That said, the lower intensity (at €20 billion per month) implies that the downward pull for bond yields is less strong than in previous iterations. While the growth picture is worsening on the margin, we still view global bonds as overvalued.

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### Relative Value by Sector

<table>
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<tr>
<th>IG Corporate Credit</th>
<th>Outlook</th>
<th>Relative Value</th>
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<tbody>
<tr>
<td>US</td>
<td>We remain a better holder of risk going into year-end given continued accommodative central bank policies and prevalent negative yields around the world. US investment-grade (IG) credit index spreads reached the tight of 102 bps at the end of July, but drifted wider once more in August due to intensified trade tensions. We maintain a cautious bias toward sectors such as food &amp; beverage, healthcare/pharmaceuticals and automotive.</td>
<td>+/- Our focus continues to be on banking, energy and metals &amp; mining; these are sectors where positive fundamental trends remain intact, which exhibit the least sensitivity to tariff-related risks and where we are likely to see further uplift from the ratings agencies.</td>
</tr>
<tr>
<td>Europe</td>
<td>European IG credit fundamentals are reasonably solid and still improving for banks. The negative yield backdrop and re-start of corporate bond purchases by the ECB have led to a healthy demand for IG euro credit. This has been met with a surge in new-issue supply, in particular from US issuers. Valuations are compelling given the low rate backdrop but still look tight on a historical basis.</td>
<td>+/- Cautious positioning overall. Prefer financials and REITs over utilities and cyclical names.</td>
</tr>
<tr>
<td>Australia</td>
<td>Fundamentals remain strong as management retains a conservative attitude to balance sheets alongside solid profitability. Limited issuance and maturities expected for the remainder of the year should also assist on the technical front.</td>
<td>+ Overweight to the sector but holding a short duration focus to manage spread risk. Sector biases remain in financials, REITs and regulated utilities.</td>
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### High-Yield (HY) Corporate Credit

| US                  | Given the positive fundamental backdrop, strong technical picture and supportive Fed, HY spreads continue to compress and are broadly approaching fair value. We remain cautious on the lower quality segment of the market due to concerns over global growth, trade and weaker primary market technicals. | +/- We see value in asset rich subsectors and companies with clear access to capital. We are selectively participating in the primary market where positive catalysts are apparent. We remain underweight CCCs and below-rated paper. |
| Europe              | A weaker European economic backdrop is beginning to impact fundamentals. Technicals remain supportive given negative rates, however valuations are less compelling. Primary issuance is mainly focused on refinancing and BBB/B rated deals. We expect this trend to continue, resulting in less CCC issuance. | +/- Increasingly, more companies are being assigned a negative credit rating outlook and issuer dispersion is continuing. Therefore we remain opportunistic to new issues and secondary market opportunities. |

### Bank Loans

| US                  | CLO formation will continue to be the primary driver for the loan asset class, resulting in a strong bid for higher quality names. Rates stability or a more dovish Fed should drive additional retail flows to the asset class. Loans offer attractive carry with market value upside driven by ramping CLO vehicles, retail flows and a light supply calendar. | + Strong single-B new issuance should create further opportunities to add at attractive levels over the quarter. Despite recent headlines of an expected robust pipeline of new issuance, actual translation into deals will be lighter than expected, driving secondary levels higher. |

### Collateralized Loan Obligations (CLOs)

| US                  | CLO supply technicals will likely continue to keep spreads range-bound; overwhelming market consensus of high supply may actually lead to the exact opposite as investors’ patience will translate into slower CLO creation and a challenging arbitrage environment for issuers; AAA and AA CLOs continue to trade into strong demand; the entire CLO capital structure screens cheap relative to comparably rated products, even after adjusting for the forward curve. | + We prefer front-end AAAs and favor a slight barbell against longer spread duration newer-issue AAAs with price convexity. Within lower mezzanine tranches (BBB/BB) there are pockets of opportunities in the short end of the curve. |

### Structured Credit

| Agency MBS          | We are constructive on mortgages due to locally wide spread levels, attractive hedge-adjusted carry and the expectation that central banks will remain accommodative. Concerns regarding government-sponsored enterprise (GSE) reform and refinace risk warrant some caution. | +/- We are positive on MBS versus US Treasuries (USTs) and favor lower coupons and agency CMBS. |
| Non-Agency          | We are constructive on housing fundamentals and expect modest home price growth over the coming years, with limited downside risk as housing appears reasonably valued and supported. Credit underwriting standards are historically high, making the quality of new loan production strong. | + We are positive on the credit risk of GSEs (Fannie Mae and Freddie Mac) and recently issued non-agency loans as well as re-performing loans and securities. |
| Residential MBS     | We are constructive on the CMBS market, due to broadly positive commercial real estate fundamentals and a favorable economic outlook; we expect the fundamental outlook to be uneven across property types and markets. | + We are positive on short-duration, well-structured single-borrower securitizations and loans; in conduit deals we see better value in AAA rated bonds. |
| RMBS                | We remain constructive on consumer fundamentals and the current state of leverage; opportunities remain in well-protected, off-the-run sectors, which offer attractive risk/return. | +/- We are constructive on off-the-run senior high-quality ABS sectors, such as FFELP student loans, auto floor-plan and rental car. |
| Non-Agency Commercial MBS (CMBS) | | | |
| Asset-Backed Securities (ABS) | | | |
## Relative Value by Sector

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<table>
<thead>
<tr>
<th>Inflation-Linked</th>
<th>Outlook</th>
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<tr>
<td><strong>US</strong></td>
<td>The level of breakeven inflation spreads are below Fed targets, representing good long-term value in our base case scenario. However, poor carry over the near-term and risks pointing to lower inflation are unlikely to attract substantial inflows nor push longer-term inflation expectations higher.</td>
<td>+/- In the near term, we prefer to maintain an overweight in US real yields combined with tactical positioning in nominal bonds to manage overall duration exposure.</td>
</tr>
<tr>
<td><strong>Europe</strong></td>
<td>European breakeven spreads remain at low levels, alongside most developed market breakeven spreads. We expect headline inflation to average 1.20% in 2019 which is higher than the level priced in the swap and cash markets. At the margin, ECB purchases on index-linked bonds should be supportive.</td>
<td>+ In index-linked and global portfolios we are long French and Italian breakeven spreads.</td>
</tr>
<tr>
<td><strong>Japan</strong></td>
<td>Japanese breakeven inflation spreads have fallen to around 0.1%, which is even below the floor option values. We expect inflation in Japan to rise gradually toward 1% in 2020 on the back of the tight labor market. Therefore, we believe that Japanese inflation-linked bonds are significantly undervalued.</td>
<td>+ We maintain an overweight in Japanese real yields against nominal yields.</td>
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### Municipals

| **US** | We continue to see good fundamentals in the overall municipal market due to a number of factors, including strong market technicals, low unemployment, improving tax revenues and modest budgetary spending proposals. We see valuations as fair to full value at the short end of the curve while better value can be found in the intermediate and longer maturity range. In credit, we see lower investment-grade as still providing a reasonable pickup over the muni investment-grade index. | + Our strategy seeks to benefit from income, with an emphasis on lower investment-grade issuers within transportation, industrial development, and water & sewer sectors, an opportunistic eye to below-investment-grade issuers, and our curve position, which remains centered on intermediate and longer maturities. |

### EM Debt

| **EM Sovereigns (USD)** | Despite uncertainty about global growth conditions, the Fed’s recent dovish pivot and signs of slowing US growth outperformance are constructive for EM financial conditions and flows. From a technical standpoint, EM remains underrepresented in global bond indices. In this regard, the progressive inclusion of sizable markets, notably China and Gulf Cooperation Council (GCC) countries, will increase the sector’s visibility and investor appetite. | + Select IG- and HY-rated EM USD-denominated sovereigns remain attractive from both carry and total return standpoints. We are currently looking to add exposure to lower-risk GCC countries and attractively priced Frontier sovereigns, while BBB rated sovereigns appear more fully valued. |
| **EM Local Currency**  | A dovish Fed/ECB combined with decreasing inflation within many EM countries is allowing their respective central banks to lower rates and support economic activity. EM real yields and differentials versus those of DMs are supportive of the asset class and have scope to compress. Diminishing impact of US fiscal stimulus, and the re-introduction of stimulus in China augur well for the end of US growth exceptionalism. In our view, these factors should be positive for EM local currency debt. | + We currently find local rates to be the most attractive part of the EM local currency universe given high real yields and a more dovish outlook for EM central banks. We favor the local bonds of stable countries with moderate inflation, including Indonesia, India, Brazil and Russia. |
| **EM Corporates**      | Our neutral rating reflects a more balanced risk/reward tradeoff in EM, rather than explicit deterioration in the sector's resilient fundamentals, conservative balance sheet management, and strong technicals. While the overall market shows robust bond issuance, EM corporate net issuance ex-China remains very low, creating positive technicals for the asset class. | +/- For higher-quality mandates, EM IG corporates are an attractive complement to US IG allocations given higher spreads, shorter duration and more favorable technicals. For HY corporates, we have a preference for BBs in less financing-sensitive sovereigns and those generating revenues in hard currency. |
Definitions

A collateralized loan obligation (CLO) is a security backed by a pool of debt, often low-rated corporate loans.

A Mortgage-Backed Security (MBS) is a type of asset-backed security that is secured by a mortgage or collection of mortgages.

Residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) are forms of asset-backed securities, holding pools of residential or commercial mortgages (respectively) used as collateral for the securities.

The yield curve shows the relationship between yields and maturity dates for a similar class of bonds.

Inverted yield curve refers to a market condition when yields for longer-maturity bonds have yields which are lower than shorter-maturity issues.

“Bunds” refers to bonds issued by Germany’s federal government. Bunds are available in 10- and 30-year maturities.

The Federal Reserve Board (“Fed”) is responsible for the formulation of U.S. policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

The Personal Consumption Expenditures (PCE) Price Index is a measure of price changes in consumer goods and services; the measure includes data pertaining to durables, non-durables and services. This index takes consumers’ changing consumption due to prices into account, whereas the Consumer Price Index uses a fixed basket of goods with weightings that do not change over time. Core PCE excludes food & energy prices.

“Barbell” refers to a portfolio with heavier weightings in short-duration and long-duration debt than in the rest of the portfolio.

The Organization of the Petroleum Exporting Countries (OPEC) is a permanent intergovernmental organization of 12 oil-exporting developing nations that coordinates and unifies the petroleum policies of its member countries.

Emerging markets (EM) are nations with social or business activity in the process of rapid growth and industrialization. These nations are sometimes also referred to as developing or less developed countries.

“Brexit” is a shorthand term referring to the UK vote to exit the European Union.

An Asset-Backed Security (ABS) is a financial security backed by a loan, lease or receivables against assets other than real estate and mortgage-backed securities.

Real Estate Investment Trusts (REITs) invest in real estate or loans secured by real estate and issue shares in such investments, which can be illiquid.

A CCC rating is assigned to fairly speculative debt instruments; indicates the issuer is at greater risk of default than a B-rated issue and less than a C-rated issue if business, financial, or economic conditions change measurably.

Carry trade refers to a strategy in which an investor sells a certain currency with a relatively low interest rate and uses the funds to purchase a different currency yielding a higher interest rate. A trader using this strategy attempts to capture the difference between the rates, which can often be substantial, depending on the amount of leverage used.

The Federal Family Education Loan Program (FFELP) is also referred to as the federally-guaranteed student loan program. It includes Stafford Loans, Unsubsidized Stafford Loans, Federal PLUS Loans, and Federal Consolidation Loans.

Mezzanine debt financing is a hybrid of debt and equity financing that is basically debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full.

A mezzanine tranche is the portion of a company’s financing which is made up of mezzanine debt.

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All investments involve risk, including possible loss of principal.

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