Second Quarter 2020

GLOBAL OUTLOOK

Following the sharpest monthly decline in risk assets on record, which occurred due to the unexpected COVID-19 pandemic and oil price shock, Western Asset's base case outlook is for a longer, U-shaped global economic recovery. This is premised on the view that near-term growth will be severely impacted, but that this shortfall will prove to be largely transitory as policymakers push to resuscitate economic activity. On this front, significant central bank policy easing, extensive liquidity provisions and enhanced fiscal stimulus are already underway. Together, they should help temper the negative impact of restrictive social distancing policies on global economies and enable markets to function more smoothly. As the actual timing of any eventual recovery will be tied to the length and severity of the pandemic—a key uncertainty at this point—our portfolios are positioned to withstand further market volatility, yet remain flexible enough to capture exceptional value opportunities as they appear. Here, we provide a summary of the key drivers behind our global outlook and describe where we see value across global fixed-income markets.

Executive Summary

- Western Asset's base case outlook is for a longer, U-shaped global economic recovery. This is premised on the view that near-term growth will be severely impacted, but that this shortfall will prove to be largely transitory as policymakers push to resuscitate economic activity.
- Possible declines in US GDP growth could be much more severe than even what was observed during the late stages of the global financial crisis. However, we believe that the economic bounce-back can be strong and relatively quick.
- We currently expect the eurozone to contract by around 6% this year, but the contraction will become more pronounced with every week that restrictive measures are necessary to contain the viral outbreak.
- The heterogeneity of Asian economies will continue to reflect the divergence in growth between economies more closely linked to China's consumption and the Asian tech supply chain, as well as those that are more endogenously driven.

GLOBALOUTLOOK

Key Drivers

US: Economic Momentum Disrupted

The rapid spread of not just the coronavirus, but also of radical economic measures intended to slow it down have significantly changed the economic environment from what it was just a month ago. Previous recessions have invariably started in manufacturing or construction markets and spread from there to the rest of the economy. In contrast, the economic response to the virus started in the leisure-oriented service industries, and these will likely remain the hardest hit. Meanwhile, it seems the virus has spread into the industrial sectors of the economy and consumer demand for big-ticket items is understandably depressed.

Economic weakness at present is largely coming from the supply side, as those services are simply not available, and as a range of important merchandise has disappeared from store shelves. However, as shutdown-forced layoffs spread, resulting in sustained income losses, there is also the risk of sharply reduced demand for a range of goods and services beyond big-ticket items.

Given the enforced measures of supply disruptions and their prevalence in cyclically insensitive services industries, possible declines in US GDP growth could be much more severe than even what was observed during the late stages of the global financial crisis (GFC). The unknowns are how severe such shutdowns will become across the whole country and how long the economy will remain at such low levels of utilization. This, of course, will depend partly on the arc of infections. However, it will also depend on the state of consumer and business demand when and as the virus has subsided, and return-to-work advisories are provided by the government to households and businesses.

Considering the very healthy financial shape of both businesses and households on the eve of the crisis (we disagree with claims that businesses were highly leveraged and households were clearly not so), and given the breadth and timeliness of government and central bank measures to sustain private-sector finances, we believe that the economic bounce-back can be strong and relatively quick. Also, we believe that central bank efforts to intervene directly in credit markets—with capital backing from the government—will be successful in forestalling widespread bankruptcies, so that firms will be able to survive and participate in the recovery. Finally, we are also inclined to think that the impact of the virus on national health and national health systems will be much less severe than some are predicting.

Of course, even if we are correct in these assumptions, the challenge will be in sustaining investment positions through what might be very rough times in the weeks and months ahead before a more hospitable market environment returns.

Europe: In the Middle of a Massive Downturn

For 2020, we have slashed our growth forecasts in response to the COVID-19 pandemic. We currently expect the eurozone to contract by around 6%-8% this year, but the contraction will become more pronounced with every week that restrictive measures continue in the effort to contain the viral outbreak. For many countries in Europe, this will be the worst recession since WW2.

2021 is likely to see a moderate recovery, but the size and distribution across countries will depend crucially on the longer-term policy support measures implemented at this time at the national and supranational levels, including the Recovery Fund still under discussion by the eurogroup. Other outcomes of these discussions just before Easter included a larger resource envelope for the European Investment Bank (EIB) to lend to small and medium-sized enterprises (SMEs) and midcap corporates across Europe, a centrally financed back-up for national short-time work programs, as well as countries' access to precautionary European Stability Mechanism (ESM) lending of up to 2% of GDP with very little conditionality (although the stigma remains).

At a national level, fiscal responses have ranged from almost zero in very few countries to very large support schemes. These have amounted to 20%+ of GDP across households, the self-employed and corporations of all

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Key Drivers

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sizes. At the upper end of the range, Germany's supplementary budget of specific measures was the equivalent of 4.5% of its 2019 GDP, whereas the guarantee portion of the support program is substantially larger. Two critical elements of some programs have been government support schemes aimed at keeping employees in their current positions to limit the increase in unemployment and enable a faster rebound along with government guarantees to facilitate corporate borrowing where market conditions would not allow. This implies that the true fiscal cost of this crisis will not be known for a long time.

Regarding monetary policy, the European Central Bank (ECB) refrained from cutting rates but has stepped up its support in most other directions. In addition to more favorable refinancing conditions in the form of targeted longer-term refinancing operations (TLTROs), the central bank increased its bond purchasing program twice. First it added a new €120 billion envelope to the existing asset purchase program (APP), totaling now around €300 billion for the rest of the year. Second, the ECB introduced the Pandemic Emergency Purchase Program (PEPP) geared at ensuring proper transmission of monetary policy in light of the recent market dislocations. The PEPP is sized at €750 billion to be spent by year-end across the same buckets as the APP and can be increased if deemed necessary. The main difference between the PEPP and the APP lies in the PEPP's additional flexibility as the ECB's self-imposed constraints regarding issuer and issuance limits do not apply. Early indications are that the ECB is frontloading purchases under both programs. Meanwhile, the ECB's strategic review has been extended from end-2020 to mid-2021.

In the UK, developments have been broadly similar to those on the continent, including the rapid economic deterioration. On the monetary policy side, the Bank of England (BoE) cut rates in two steps to the new 325-year low of 0.1% in addition to restarting its quantitative easing (QE) program. The fiscal stimulus measures are among the largest (as share of GDP) across the countries in Europe.

Asia: Not Yet Out of the Woods

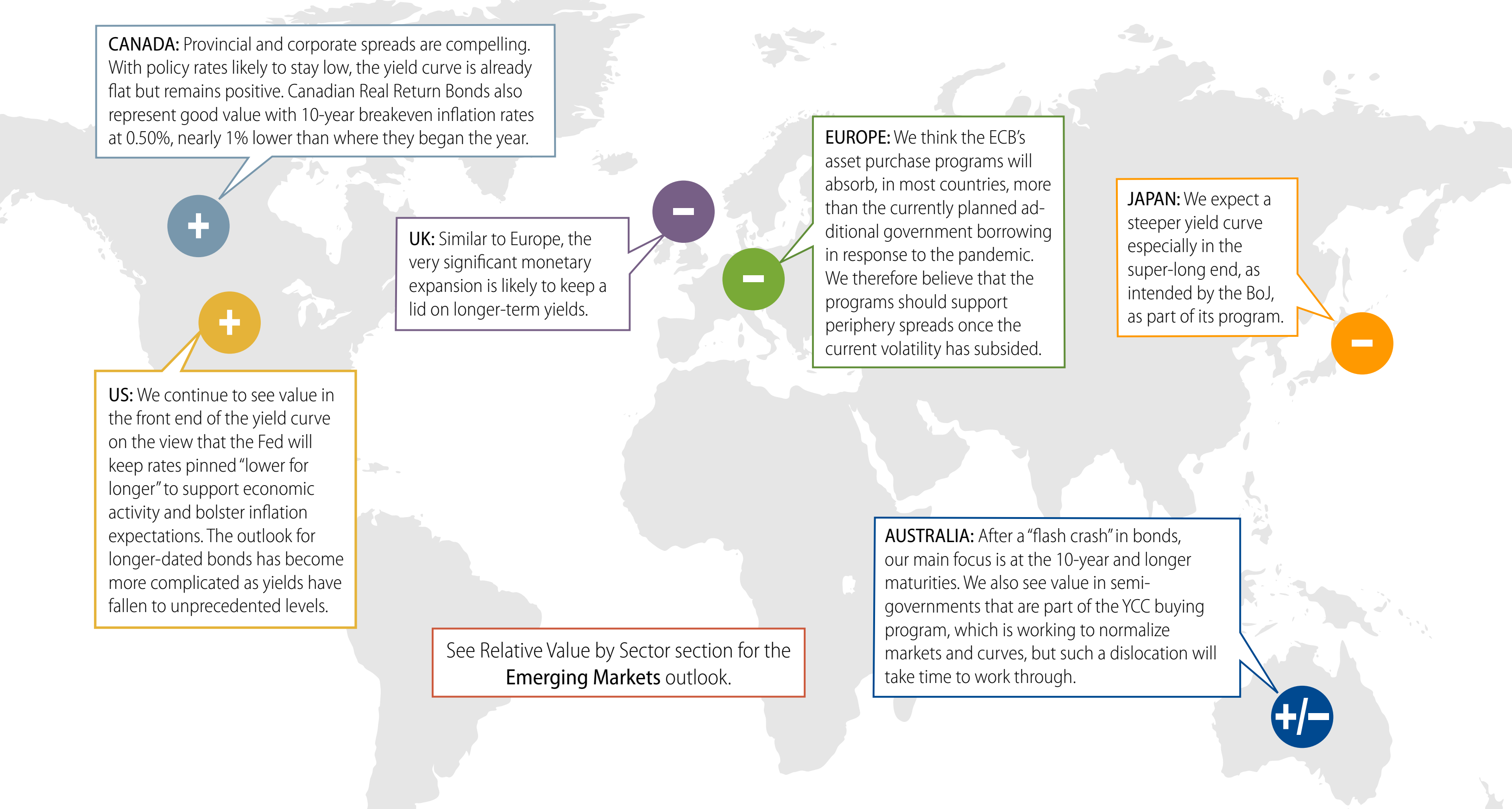
The epicenter of the crisis has clearly shifted out of China where it began. For most other parts of the world, the situation remains critical and a test of medical infrastructure quality, as well as the quality of governance and social capital. China is on a quick recovery track and near-term numbers will demonstrate the effect of extreme containment and centralized control, as will the first wave of recoveries in North Asian economies such as South Korea, Taiwan, and Hong Kong. Since the viral outbreak, the Chinese government has launched a slew of supportive measures worth ¥3 trillion, representing 2.9% of GDP in 2019. Policy support is inevitable as unemployment remains a risk with the official unemployment rate in China rising to 6.2% in February; poverty elimination remains a key policy goal in 2020. However, beyond the immediate recovery, demand shocks will weigh on the outlook as exogenous demand beyond backorders declines.

For emerging market (EM) economies in Asia (the second wave of countries infected), the near-term outlook is weak, especially for Malaysia, Thailand, the Philippines and Indonesia, as the risks of an extended lockdown are material to both households due to the effect of income as well as corporates that are dependent on discretionary consumption among other factors. The actual impact of a sustained epidemic on tourism, consumption and industrial output due to supply chain disruptions will weigh significantly on growth, and demand extreme support from all levers available to governments. These are also countries that are most at risk from an uncontrolled outbreak due to weak medical infrastructure.

The heterogeneity of Asian economies will continue to reflect the divergence in growth between economies more closely linked to China's consumption and the Asian tech supply chain as well as those that are more endogenously driven. What is consistent is that Asian economies have the policy space, the political stability and the populace support to deal with the vicissitudes of an uncertain economic environment. With this in mind, our base case for the region remains cautiously optimistic. We expect continued monetary and fiscal accommodation where needed in the year ahead.

The Big Picture

Developed Market Rates: Relative Value by Region



US	Given the enforced "social distancing" measures causing supply disruptions and their prevalence in cyclically insensitive services industries, declines in US GDP growth could be much more severe than what was observed during the late stages of the GFC. The unknowns are how severe such shutdowns will become across the whole country and how long the economy will remain at such low levels of utilization.
Canada	To support the Canadian economy, the Bank of Canada cut its policy rate to 0.25% and initiated QE for the first time ever. Fiscal policy at both the federal and provincial levels, including a wage relief program for distressed industries should help. However, the collapse in global oil markets has taken a particular toll on Western Canadian oil prices and production, with its ability to recover over the next year or two unclear.
Europe	For 2020, we expect a marked recession, followed by a moderate rebound in 2021. Given its hesitance so far, we continue to believe that the ECB is unlikely to cut interest rates, but the focus is really on the various asset purchase programs. In particular, the activation of precautionary ESM programs essentially implies that countries willing to borrow from the ESM are eligible for further ECB support beyond currently active purchase programs (i.e., Outright Monetary Purchases, OMT).
UK	We still expect the Brexit transition period to come to a close at the end of this year. The outlook for monetary policy is now wide open, but it is hard to see the BoE become structurally more accommodating given that it has eased on all fronts and also reengaged in purchasing corporate bonds.
Japan	We expect negative growth for 2020 followed by a rebound given the magnitude of both fiscal and monetary policies globally in place. On monetary policy, we expect the Bank of Japan (BoJ) to maintain its very accommodative policy with a focus on the supply of liquidity and the reduction of risk premium.
Australia	The Reserve Bank of Australia (RBA) cut its cash rate to 0.25% and instituted "Yield Curve Control" (YCC) that targets the 3-year bond at 0.25% while supporting the yield curve with unlimited fire power. Monetary policy is now complete as the RBA has stipulated that it is not pursuing a negative rate policy. It will support lending to SMEs and ensure that overnight settlement balances and currency swap markets remain efficient.

Relative Value by Sector

Investment-Grade (IG) Corporate Credit	Outlook		Relative Value
US	The Fed is now directly engaged in supporting the corporate bond market and liquidity imbalances; this should help to support continued spread compression against a backdrop of massive new issue supply.	+	Our bias in the near term is on high-quality issuers with robust franchises and longer-dated new issues of infrequent borrowers offering generous spread concessions.
Europe	Central bank purchases will likely support spreads and the liquidity of IG markets moving forward. We expect a number of sectors to demonstrate resilience while others face downgrade pressure. Companies are reaching for liquidity, bringing elevated supply despite a quiet M&A picture.	+/–	We have added to euro-denominated IG and continue to do so. We think flat credit curves should normalize over time. We prefer financials and REITs over credits in sectors more directly impacted by the COVID-19 outbreak.
Australia	The fundamentals were strong in IG credit coming into this crisis. Spreads are now sharply wider across the board, with airlines, airports and REITS feeling much of the pain due to the lockdown. Banks have started to trade but the market remains largely illiquid as price discovery is slow.	–	We are overweight the sector, but holding exposure mainly in short-dated credit. Spreads will take some time to recover without a dedicated program from the RBA to assist market functioning.
High-Yield (HY) Corporate Credit			
US	Support from the Fed and Congress are welcome, but may not be enough to limit default risk in subsectors most impacted by COVID-19. Regardless of the timing and slope of the eventual recovery, remaining defensive with regard to issue, industry and credit quality appears to be the prudent path for now.	+	We remain overweight consumers, health care and communications. New issuance may provide significant investment opportunities as terms will be extremely favorable. Issue selection is crucial at this time.
Europe	Credit ratings are under downward pressure. Spreads have adjusted accordingly, with levels not seen since the eurozone crisis. Affected sectors include retail, autos and transportation whereas telecoms and utilities are seen as less impacted.	+	We see European HY as offering value now. Better risk/reward is in more resilient industries, and in the secured debt and subordinated hybrid securities of IG companies.
Bank Loans			
US	Higher risk credits have already accessed capital markets for liquidity. If this trend continues, we should see significant additional demand for risk (as default risk declines) against a backdrop of limited new issuance. Ongoing market volatility will provide highly attractive entry points into defensive names within the loan market.	+	While defensive industries have recovered more than cyclical sectors, we believe industries like consumer staple, health care and communication offer a better risk/return profile given the uncertainty of the economic shutdown.
Collateralized Loan Obligations (CLOs)			
US	Until we see clarity on the earnings front, lower-rated CLOs may continue to trade at levels that reflect a somewhat draconian set of outcomes on the broader loan market.	+	AAA CLOs at +300 bps are attractive; single A and BBBs in the \$80s price range also compelling; BB CLOs have upside at the \$50-\$60 price level if default risk recedes.
Structured Credit			
Agency MBS	We are moderately constructive on mortgages based on current valuations and continued support from Fed purchases.	+	We are positive on MBS versus USTs and favor securities with stable prepayment profiles.
Non-Agency Residential MBS (NARMBS)	Valuations reflect GFC levels, which we believe are not justified. Borrowers have equity in their properties, underlying mortgages are significantly better underwritten and delinquencies are at record lows.	+	We prefer legacy NARMBS/new-issue re-performing loan deals as many of these borrowers have already withstood similar disruptions.
Non-Agency Commercial MBS (CMBS)	We view CMBS valuations favorably relative to fundamentals. We are mindful of affected areas, e.g. hotels and retail properties. Our focus is on Class A properties with well-capitalized sponsors.	+	We prefer short-duration, well-structured single-asset single-borrower securitizations; in conduit deals we see better value in AAA rated bonds.
Asset-Backed Securities (ABS)	US consumer fundamentals entered the crisis in solid shape. Reduced travel is expected to have a negative impact on restaurants and auto sales.	+/–	We prefer senior ABS classes from sectors of TALF-eligible collateral such as auto, cards, equipment and student loans.

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Relative Value by Sector

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Inflation-Linked	Outlook		Relative Value
US	While near-term deflation may persist into year-end, the decline in forward inflation expectations appears overdone. The Fed is intent on keeping inflation expectations near target, while the sharp GDP drop may cause less deflation this time given the temporary and service-industry-oriented nature of the declines. 5-year forward inflation expectations are still 50 bps lower than 2019 year-end levels.	+	TIPS seem attractive to nominal USTs across the curve. We are focused on longer-dated breakeven trades. Headline inflation will suffer from weakness in energy and non-energy components over the remainder of 2020, but will not impact next year's headline inflation to the same degree.
Europe	Inflation may remain subdued relative to historical levels but should move above the levels implied by the current very low breakeven inflation rates once it becomes apparent that economic recovery has begun. ECB purchases of index-linked bonds should provide support in the near term.	+	In index-linked and global portfolios, we have added to French and Italian real yields and breakeven inflation spreads.
Japan	Japanese breakeven inflation spreads have fallen below 0%. Considering the embedded floor options, Japanese inflation-linked bonds are significantly undervalued. We believe that the undervaluation would be gradually corrected since the Ministry of Finance as well as the BoJ have increased the buyback in addition to the reduction of the issuance.	+	We maintain an overweight in Japanese real yields against nominal yields.
Municipals			
US	State and local municipalities will be on the front lines of addressing COVID-19, requiring additional spending for services while grappling with revenue challenges and longer-term economic uncertainty. Most, but not all, states and local governments are entering the crisis in a stronger position than they did the prior recession. We expect isolated credit headlines and an increase in downgrades against a backdrop of weak market liquidity to contribute to continued market volatility over the medium term.	+	We are navigating the higher-beta transportation and industrial development sectors, focusing on issuers that can withstand near-term economic stress. As demand deterioration subsides, we believe the sound issuers within these sectors will normalize to their fundamental value and provide above average levels of tax-exempt income.
Emerging Market (EM) Debt			
EM Sovereigns (USD)	Compared to the developed market (DM) world, EM constraints limit the degree to which authorities can use monetary and fiscal levers to respond to crises and oil price shocks, suggesting a more challenging experience for EM. We anticipate an eventual meaningful uptick to USD-denominated sovereign supply as sovereign balance sheets are used to absorb fallout from fiscal stimulus and bail out the private sector.	+/–	We view select IG-rated EM USD-denominated sovereigns attractive from both a carry and total return standpoint, but we remain vigilant about the potential for fallen angels. HY-rated and frontier sovereigns are faced with additional downgrades and concerns over access to markets.
EM Local Currency	EM central banks have historically been constrained in their ability to cut rates in the face of currency weakness; however, the uniqueness of this dual shock of the pandemic and oil price rout has enabled "cautious" rate cuts by most EM central banks.	+/–	We currently view local rates as carry rather than total return opportunities given high real rates; EM currencies remain vulnerable to weak virus-induced growth, both absolute and relative to DMs.
EM Corporates	EM corporates have outperformed many other asset classes year to date, based on conservative balance sheets and lower spread duration. Price dislocations and overlap with other credit asset classes have presented a myriad of attractive opportunities to exploit, but a heavy emphasis on credit differentiation is paramount.	+	We find value in front-end EM corporate bonds as well as high-quality longer-dated paper; we view EM corporates as being defensive within the global credit universe given low leverage and conservative balance sheet management.