Western Asset

Fourth Quarter 2021

GLOBAL OUTLOOK

Executive Summary

- Western Asset expects US and global growth to decelerate from their cyclically driven highs as we move into 2022.
- In the US, we expect growth in the service sectors to continue to disappoint relative to consensus expectations and that growth in manufacturing and construction sectors will be muted as the recovery there is already complete.
- While European growth momentum can continue well into 2022, the main risk to our outlook is shifting for now from new COVID-19 variants to bottlenecks creating additional supply-side disruptions.
- While near-term growth challenges likely will persist in China due to a cyclical slowdown and policy-induced pain, we do not expect full-blown economic destabilization.

Western Asset expects US and global growth to decelerate from their cyclically driven highs as we move into 2022. Contributing factors include a sharp reduction in global fiscal stimulus, a reduction in monetary accommodation by key central banks such as the US Federal Reserve (Fed) and the European Central Bank (ECB) and the persistence of secular-related headwinds that include rising global debt burdens, aging demographics and technology displacement. Inflation remains challenging for policymakers, but we expect the impact of supply-chain disruptions to ease meaningfully through the course of next year. While COVID-19 continues to bedevil global populations, we are optimistic that the worst is behind us, which bodes well for the continued recovery of reopening sectors and spread product performance. Here, we provide a summary of the key drivers behind our global outlook and describe where we see value across global fixed-income markets.

Key Drivers

US: Growth Still Falling Short of Consensus

The US economy in recent months has performed in line with our expectations. Growth has moderated in the manufacturing and construction sectors, now that these have achieved essentially complete recovery from the COVID-19-induced shutdown recession of 1Q20. Meanwhile, growth in the service sectors has been decent, but not spectacular and not suggestive of a quick return to pre-COVID-19 norms. Much of this relatively sluggish rebound in services reflects the fact that a general reopening of the service sectors has been occurring only in the spring months of 2021, with some of that reopening reversed as the latest, Delta-variant outbreak of COVID-19 cases emerged.

Within services, growth in the restaurant and medical care sectors was especially brisk earlier this year, but, as with manufacturing and construction, these sectors are largely fully recovered from the COVID-19 shutdown and so will see only minimal growth going forward. As a result of these factors, we expect growth in the service sectors to continue to disappoint relative to consensus expectations—especially so with respect to job growth, and that growth in manufacturing and construction sectors will be muted as the recovery there is already complete. There is enough slack remaining in service sectors to single-handedly drive annualized US GDP growth of 7% or so for several quarters yet. Instead, however, we expect growth in a 2% to 4% range: not bad, but, again, lower than at least what the Fed is looking for.

> *We expect growth in a 2% to 4% range: not bad, but lower than at least what the Fed is looking for.*

While market and media rhetoric are still trumpeting an inflation flare-up, we see most of the run-up in reported inflation in recent months as reflecting adverse comparisons to especially low Consumer Price Index (CPI) prints in April and May 2020, and to rebounds in prices of a number of services where reopening is occurring to some extent (and where prices are still well below pre-COVID-19 levels even with the recent run-up). Treasury markets have already reacted to these developments with rates moving higher from the summer lows. That stated, we expect rates to remain range-bound with the 10-year trading within 1.25% to 1.75%.

Europe: Growth Slowed by Bottlenecks, Inflation Peaking Soon

European growth has strengthened throughout this year, and we expect this to continue into year-end and 2022. Barring new variants, further lockdowns are unlikely given the advanced level of vaccinations at least in Western Europe, where some countries have fully vaccinated more than 80% of their respective populations. Employment has also rebounded but remains below pre-pandemic levels as workers currently on furlough and related schemes rejoin the labor market. Higher-frequency, forward-looking activity indicators have receded from recent peaks as emerging supply bottlenecks have slowed the economic rebound. The main risk to our outlook is shifting for now from new COVID-19 variants to bottlenecks creating additional supply-side disruptions. We believe the growth momentum can continue well into 2022 as we see high household savings accumulated during the pandemic waiting to be spent after concerns around the economic situation recede. In addition, the fiscal cliff risk is less pronounced in Europe compared to elsewhere and while the most profligate government coalitions are numerically impossible after the German elections, we expect a continuation of the expansionary fiscal stance to tackle climate change and digitalization, with a knock-on effect elsewhere on the continent. The Next Generation EU (NGEU) recovery fund has started to disburse funds, which will have a significant impact on growth starting next year.

Inflation in the eurozone should peak in Q4 and fall early next year. However, the speed of the decrease is now somewhat more in doubt compared to expectations just last quarter as supply disruptions have led to higher

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Key Drivers

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energy inflation, which will take time to normalize. Nevertheless, underlying inflation (excluding energy) in the eurozone is likely to remain muted over the medium term, as long as the current spikes do not cause second-round effects via indexation or wage negotiations. Moreover, inflation expectations are rising but still below target. In its December meeting, the ECB will have to outline its plans for asset purchases in 2022 as the pandemic-related facility is scheduled to terminate at the end of March, leaving only the standard, slightly more constrained Asset Purchase Program (APP).

Post-pandemic normalization in the UK is more advanced compared to the continent but Q4 will prove important in shaping the policy response going forward as the labor market support scheme came to an end. In this respect, we expect the autumn budget and the spending review in late October to define the UK's fiscal strategy for the next few years and reverse the current drift toward a historically high tax burden. While supply-side disruptions in the natural gas and gasoline market have been more pronounced than on the continent, they are likely to recede and not cause major setbacks. On the other hand, disagreements with the EU around the implications of the Northern Ireland protocol (in the context of the UK's Withdrawal Agreement with the EU) could potentially escalate before the end of the year. The Bank of England's (BoE) asset purchase program will come to an end in December and while senior policymakers have warned that interest rate decisions are not intrinsically linked to those purchases, we believe that the bank will wait to see the outcome of the labor market measures and the fiscal strategy.

China: No Pain, No Gain

While near-term growth challenges will persist in China due to a cyclical slowdown and policy-induced pain, we do not expect full-blown economic destabilization. A necessary default with sufficient pain inflicted on Evergrande investors is a clear warning to heavily indebted developers. Policymakers continue to want to rein in property bubbles and control credit supply for the property sector, a nationally strategic aim. This pressure will persist even as Evergrande goes about the monetizing of remaining assets and the resolution of its ongoing residential projects. Away from the property sector, production constraints due to energy-use targets are also having an impact on industrial activity. The National Development and Reform Commission (NDRC) issued ratings in mid-August showing nine provinces performing poorly based on H1 energy usage, and the NDRC reportedly intensified its efforts to bring underperformers into line in mid-September. Twenty provinces have implemented power cuts since mid-August, as China's carbon regulatory reset has collided with lackluster hydropower generation and an industrial boom amid the pandemic. China's overarching policy stance is one of placing social stability and broad welfare above economic growth and development. Weaker growth is acceptable to policymakers to achieve their long-term strategic objectives as long as weaker growth does not translate into significant job market weakness or financial instability.

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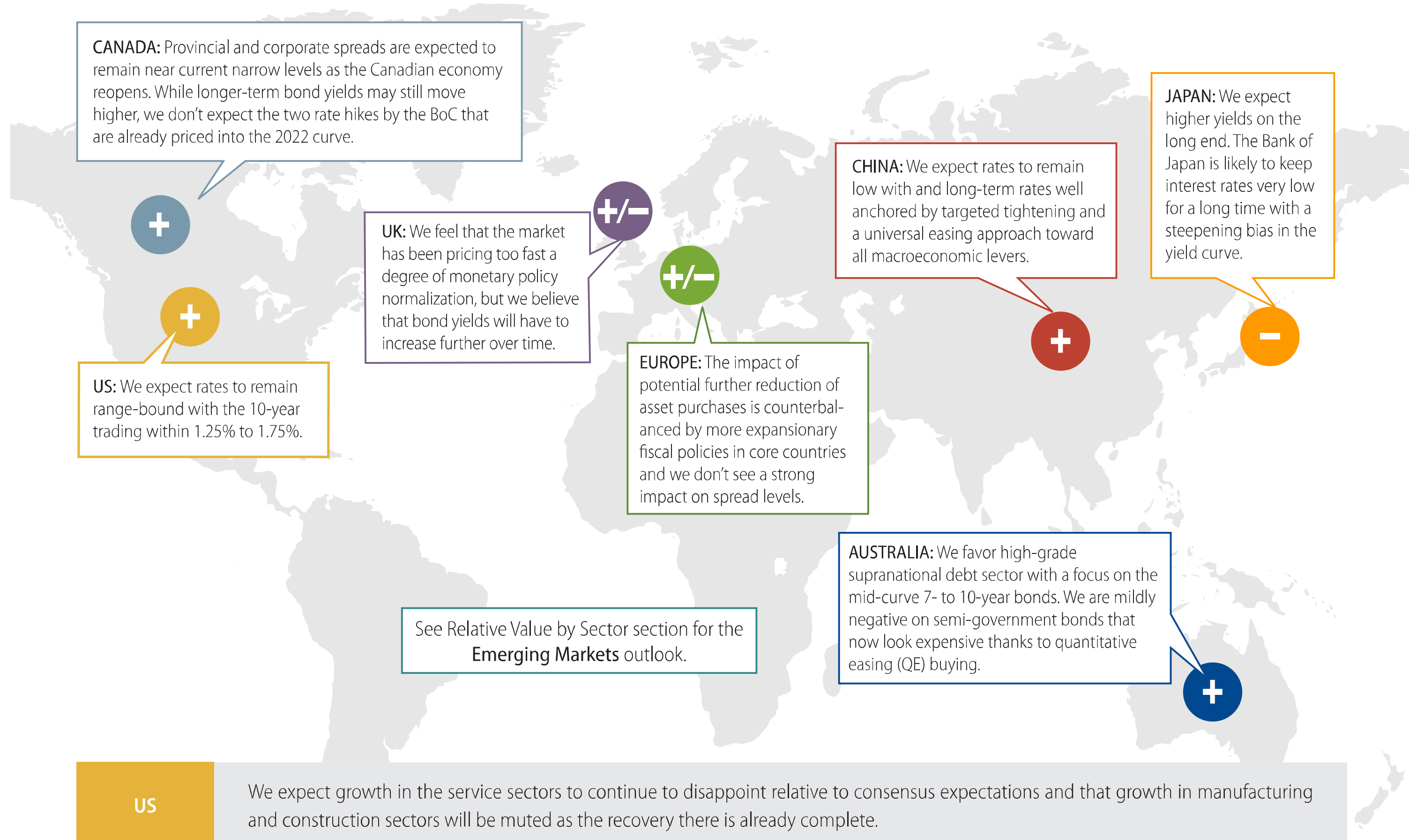
On the COVID-19 front, China's policymakers remain intent on keeping quarantines and border closures in place until at least after the Beijing Winter Olympics in February 2022. This should have a limited domestic impact on China growth as $250 billion of annual overseas spending would be kept at home, but we expect there will be negative spillover to countries dependent on Chinese tourism.

The Big Picture

Global Market Rates: Relative Value by Region



US	We expect growth in the service sectors to continue to disappoint relative to consensus expectations and that growth in manufacturing and construction sectors will be muted as the recovery there is already complete.
Canada	Rate hike expectations have been brought forward despite the mid-year COVID-19 setback. We remain optimistic that GDP growth continues to recover in Q4. While near-term growth and inflation justify some recalibration, we still believe we will get a cautious rate hike cycle by the Bank of Canada (BoC).
Europe	Strong growth and domestic fiscal support should keep the economic recovery going deep into 2022. The ECB is likely to gradually phase out its emergency measures, but will continue to strive for a very accommodative policy stance as inflation is likely to recede in early 2022.
UK	The UK is currently running into supply constraints that are likely to be temporary and should resolve during the course of Q4. The BoE is likely to raise rates at some point next year.
China	While near-term growth challenges will persist in China, we do not expect full-blown economic destabilization. Weaker growth is acceptable to policymakers to achieve their long-term strategic objectives as long as weaker growth does not translate into significant job market weakness or financial instability.
Japan	We expect that the Japanese economy will grow 2.5% in 2021 and 3% in 2022, rates that are slightly higher than consensus forecasts. We believe that new Prime Minister, Fumio Kishida, will continue the current expansive and supportive economic policies at least in the short run.
Australia	Lockdowns have delayed the recovery, but not derailed it, with Q4 expected to see a strong post-delta recovery; growth forecasts for 2022 have been upgraded as well. The Reserve Bank of Australia (RBA) "has a glass half-full view" on the recovery, but still remains very dovish, focused solely on getting inflation back to target levels of 2% to 3%.

Relative Value by Sector

Investment-Grade (IG) Corporate Credit	Outlook		Relative Value
US	We are constructive on the near-term path for credit fundamentals as COVID-19 appears to be waning while corporate managements continue to operate conservatively with their balance sheets. We remain vigilant of potential shareholder-friendly activity (e.g., leveraged buyouts and mergers and acquisitions) but against that, favorable technicals endure. Valuations, however, have already recovered to pre-COVID-19, and even pre-financial crisis, levels for many sectors.	+/–	We favor banking, select reopening industries and rising-star candidates where allowed.
Europe	Balance sheet discipline remains evident in European investment-grade for both banks and corporates. Supply chain and input cost issues are a theme in certain sectors and bring uncertainty. Valuations have held very steady but continue to look rich on a historical basis.	–	Low government bond yields and ECB corporate purchases continue to drive demand for investment-grade bonds. We find some opportunities in subordinated financials and real estate investment trusts (REITs).
Australia	Credit markets remained well supported due to the lack of new supply. Strong demand for yield continues as low underlying returns caused by yield-curve control and a cash rate that the RBA is steadfast on holding at record lows until 2024. Importantly, strong profitability reporting and conservative leverage positions remain supportive of investment-grade fundamentals.	+	We are positive on the investment-grade sector. REITs and infrastructure sectors still remain relatively more attractive than financials due to the RBA's funding program that limited supply in this sector and forced spreads in.
High-Yield (HY) Corporate Credit			
US	High-yield spreads remain relatively attractive given the economic growth and low default outlook. We continue to position for a "reopening trade" and rising stars. We favor certain cyclical sectors including airlines, cruise lines and select retail segments complemented by a higher quality bias in less cyclical subsectors.	+	Issue selection and asset class allocation remain the key drivers for portfolios. We will look to add selectively (away from LBO issuance and credits that aren't rising stars) for total return/spread compression given valuations.
Europe	Supply has increased, surpassing annual 2019/2020 levels, with a higher proportion of B rated issues and more M&A/LBO-related issuance. Some sectors are facing headwinds from higher input costs and supply chain disruption.	+/–	Spreads have been range-bound over the last quarter with some weakness recently. Further volatility in Q4 could provide more opportunities. We remain cautious on retail and auto suppliers.
Bank Loans			
US	Fundamentals remain healthy and minimal defaults are expected given the strong economic outlook. Issuance has been very robust, driven by LBO/M&A activity. That said, demand for higher-yielding floating-rate securities from retail, institutional clients and CLOs is expected to be robust.	+	We believe outperformance will come from carry and avoiding problem credits. We are focused on select names where fundamentals remain intact and prices are at discounts to their call price.
Collateralized Loan Obligations (CLOs)			
US	We see opportunity in CLO equity and select debt tranches given the valuations, fundamental outlook and supporting financing conditions. Returns to CLO equity should be supportive given the difference between borrowing and investment rates and low expected defaults. Spread widening in the sector is likely to be viewed as a buying opportunity, especially in light of relatively low hedging costs for Japanese and other foreign investors.	+	We retain our view that AAAs will continue to perform well in either bullish or bearish bank loan spread environments given strong technicals. We expect supply to remain heavy which will lead to opportunities to add lower-rated CLOs at attractive levels in the coming months.
Mortgage and Consumer Credit			
Agency mortgage-backed securities (MBS)	At current valuations, we believe there are more downside risks to spread-widening in agency MBS as supply remains elevated and convexity risk is unappealing.	–	We are negative on agency MBS production coupons relative to benchmarks, while favoring coupon and collateral selection.
Non-Agency Residential MBS (NARMBS)	Housing has performed strongly over the past year. Positive housing fundamentals continue to support further home price appreciation, albeit at a slower pace as supply and demand normalize.	+	We are positive on government sponsored enterprises (GSE) credit risk transfers as well as legacy non-agency and new-issue loan deals.
Non-Agency Commercial MBS (CMBS)	Fundamentals are widely improving but remain uneven across property types. Valuations are fair but a wide dispersion exists between the "haves" and "have-nots".	+/–	We are neutral up the capital stack and positive on select mezzanine and below-investment-grade credits.
Asset-Backed Securities (ABS)	While consumers are better positioned thanks to COVID-19 relief, we are cautious on consumer fundamentals and watchful of credit deterioration on consumer ABS sectors due to the reduction of direct aid and the long-term structural challenges.	+/–	We favor well-protected senior ABS classes from high-quality sectors with low COVID-19 disruption impact.

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Relative Value by Sector

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Inflation-Linked	Outlook		Relative Value
US	Longer lasting bottleneck price increases may lift near-term inflation but we still view downside risks to medium-term inflation expectations. Higher housing inflation next year will be offset by the decline in goods prices as shortages wane.	–	Our expectation is that short- and medium-maturity Treasury inflation-protected securities (TIPS) will underperform comparable nominal US Treasury bonds (USTs) in Q4.
Europe	In 4Q21 we expect a short-lived period of high inflation in the eurozone as VAT cuts drop out of the yearly numbers and the hump in goods prices overlaps with service sector price normalization. Recent increases in natural gas prices will add to this effect.	+/–	We are currently neutral in eurozone inflation-linked bonds. But we'd likely push against further strength.
Japan	We believe that inflation-linked Japanese government bonds (JGBs) remain undervalued as the 10-year breakeven inflation rate is well below the BoJ's inflation target. The balance between issuances and buybacks continues to be supportive.	+	We favor Japanese real yields against nominal yields.
Municipals			
US	Municipal credit will continue to be supported by improved fundamentals following strong revenue collections and robust direct federal aid measures that have led issuer cash balances to near pre-pandemic high levels. However, as valuations (spreads) have approached all-time tight levels, we remain cautious on credits that have not materially addressed structural budget challenges, particularly as any impact of federal aid subsidies.	+/–	We are positive on key higher-beta revenue sectors that would continue to benefit from an ongoing economic recovery, focusing on the transportation sector, health care sector and select high-yield issuers. However, we remain mindful of current valuations following a record municipal mutual fund inflow cycle.
Emerging Market (EM) Debt			
EM Sovereigns (USD)	As we gradually exit the pandemic-induced shock, our convictions continue to center on select EM countries with ample foreign exchange reserves, low external economic dependency, lower political uncertainty and effective policy executions.	+/–	We continue to favor select investment-grade-rated EM USD-denominated sovereigns while exercising caution toward lower-rated frontier sovereign debt.
EM Local Currency	EM local rates and flows should continue to benefit from the attractive real rate differential between the US and EM countries, a dynamic we believe will exist for the foreseeable future. By region, Asia stands to benefit given a resumption of global trade, while the currencies of weaker countries could be vulnerable to market swings.	+/–	We cannot overlook the risk that developed market (DM) countries may sharply accelerate policy tightening which will weigh heavily on EM. We remain biased toward but highly selective on local rates for their relatively attractive real yield.
EM Corporates	EM corporates have low leverage and conservative financial policies; technicals remain strong given a lack of net supply and increased investor interest in the asset class.	+	We continue to take advantage of primary issuance priced at a concession to secondary and DM levels, while monitoring potential risks from fears of central bank tightening and COVID-19 setbacks.

Definitions

"AAA" and **"AA"** (high credit quality) and **"A"** and **"BBB"** (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations (**"BB," "B," "CCC,"** etc.) are considered low credit quality, and are commonly referred to as "junk bonds."

Yield curve control involves targeting a longer-term interest rate by a central bank, then buying or selling as many bonds as necessary to hit that rate target.

A **rising star** is a business or a company that is relatively new to the debt capital markets, with little or no history of debt repayment.

A **floating-rate security** is an investment with interest payments that float or adjust periodically based upon a predetermined benchmark.

A pool of collateralized debt, such as mortgages and auto loans, may be subdivided into various **debt tranches** representing different levels of risk.

The **call price** is the price at which the issuer of a callable security has the right to buy back that security from an investor or creditor.

Quantitative easing (QE) refers to a monetary policy implemented by a central bank in which it increases the excess reserves of the banking system through the direct purchase of debt securities.

Convexity is a measure of the curvature in the relationship between bond prices and bond yields.

Spread is the difference between two prices (the bid and the ask) of a security or asset, or between two similar assets.

Beta measures the sensitivity of an investment to the movement of its benchmark.

U.S. Treasuries (UST) are direct debt obligations issued and backed by the "full faith and credit" of the U.S. government.

A **credit risk transfer** packages different tranches, or groups of loans, into one securitized package.

U.S. Treasury inflation protected securities (TIPS) are a special type of Treasury note or bond that offers protection from inflation.

A **leveraged buyout (LBO)** is the purchase of a company away from its outside equity shareholders by its management, financed by means of that company issuing a large amount of debt to cover the cost of the purchase.

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

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.

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

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Past performance is no guarantee of future results. Please note that an investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

Equity securities are subject to price fluctuation and 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. **International investments** are subject to special risks including currency fluctuations, social, economic and political uncertainties, which could increase volatility. These risks are magnified in **emerging markets. Commodities** and **currencies** contain heightened risk that include market, political, regulatory, and natural conditions and may not be suitable for all investors.

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