



The Federal Reserve Drama Continues: Focus on the Big Picture

September 2023

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Investment Outlook

2023 Outlook

Disinflation ongoing but uneven

Fed tightening near end

Economy has remained resilient in part due to renewed fiscal stimulus

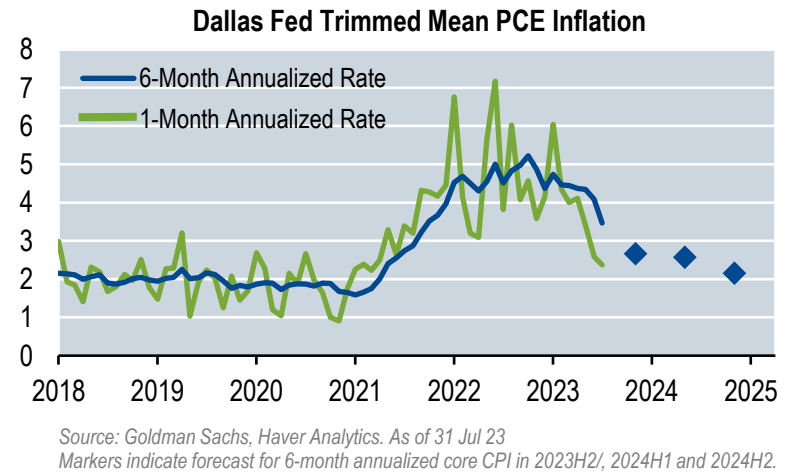
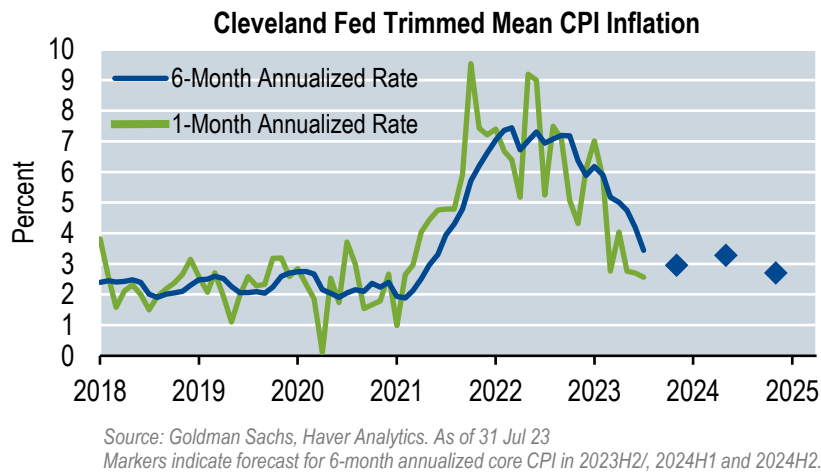
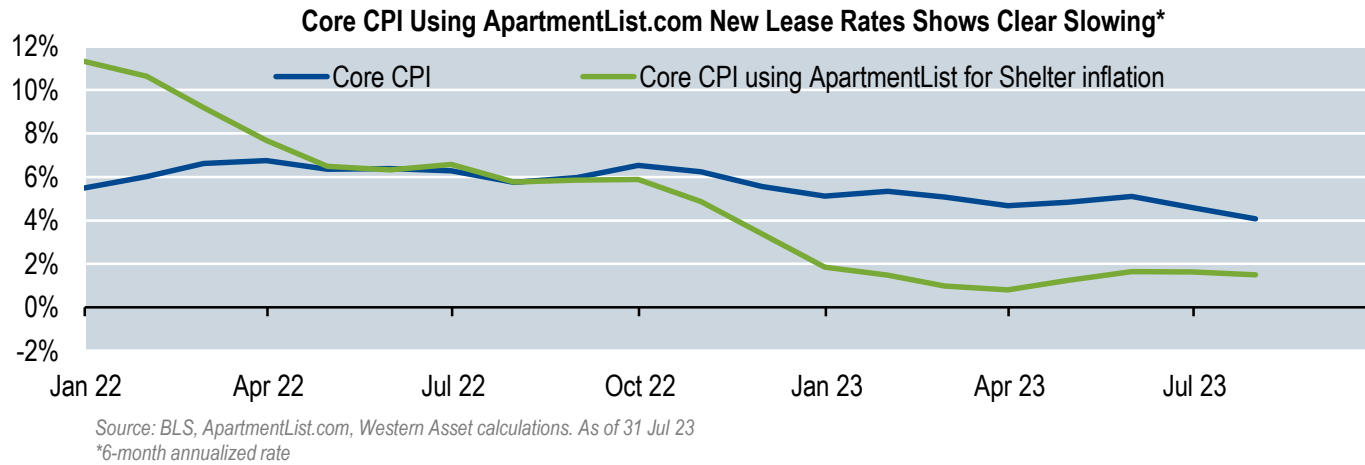
Current banking stress extremely complex but not systemic

Fixed-income outlook

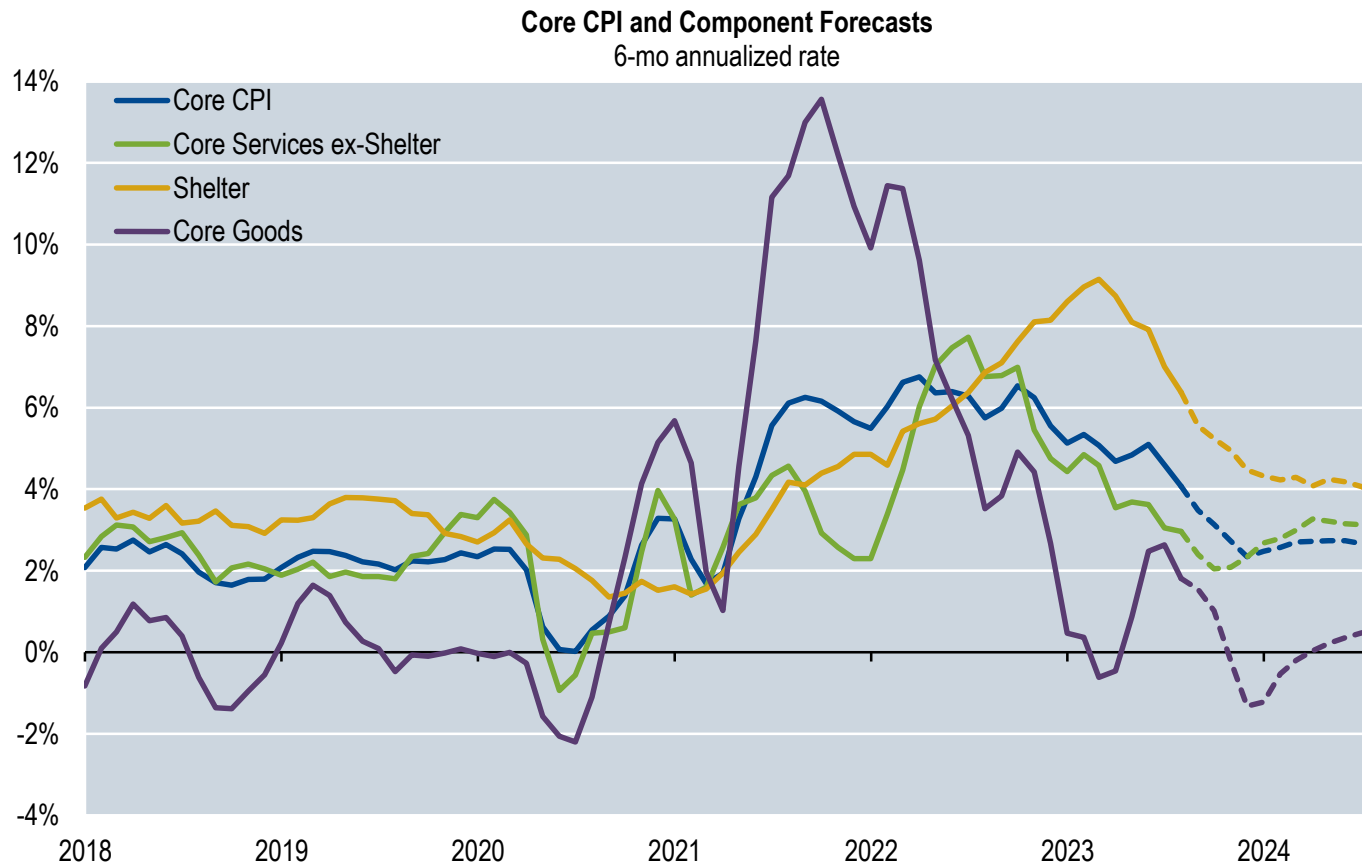
- US growth will slow but should avoid recession
- Global growth has downshifted and China is now a source of deflation
- Global inflation will continue to recede
- The dollar will weaken moderately
- Emerging markets—particularly in Latin America—should outperform
- Central bank overtightening is a meaningful risk
- Spread sectors are still attractive but the outlook is clouded by macro risk
- Geopolitical uncertainty continues to add to volatility

The above reflects current opinions of Western Asset and are subject to change with market conditions. As of 25 Aug 23

Inflation Trending Lower—Persistent but Uneven

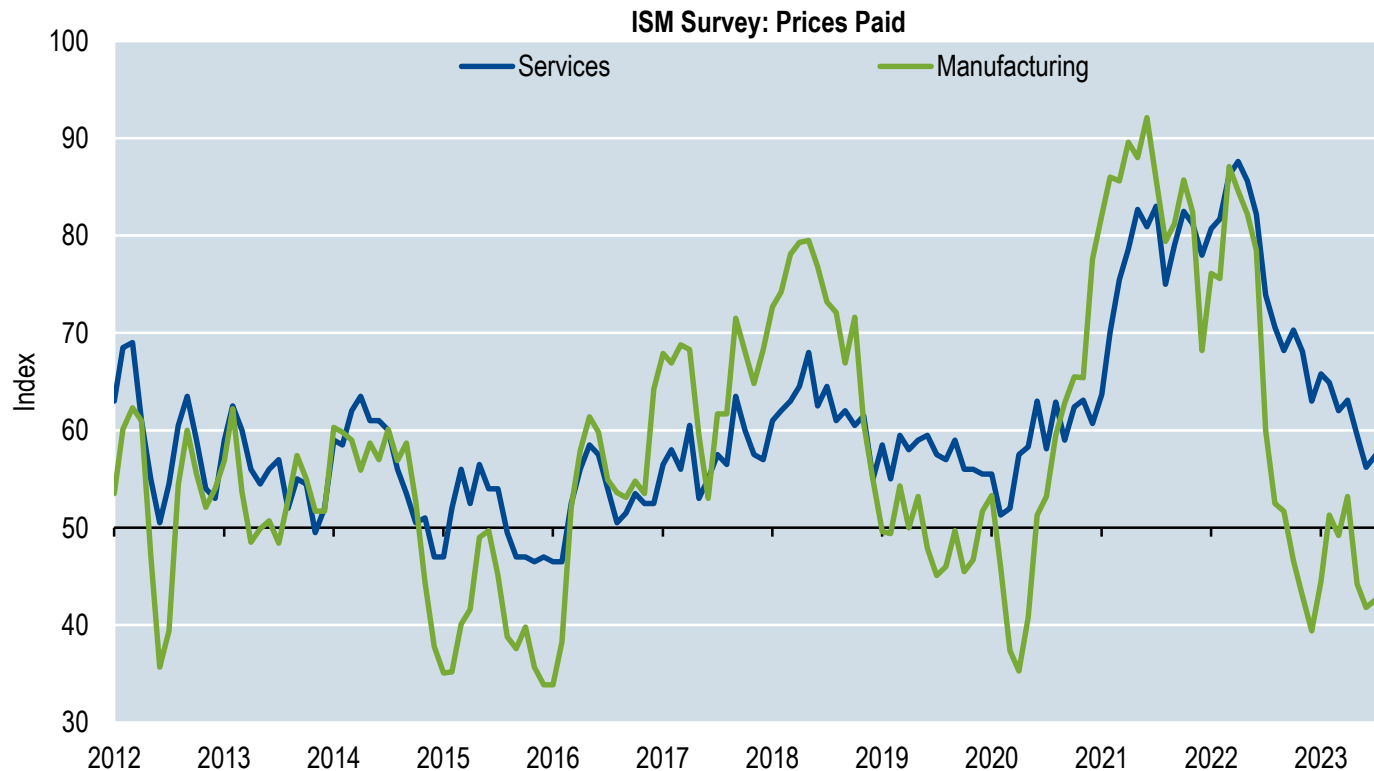


Disinflation Ongoing but Uneven



Source: Bureau of Labor Statistics, Western Asset. As of 31 Jul 23

Service Sector Inflation Is Also Turning Down



Source: Haver Analytics. As of 31 Jul 23
>50 Indicates Expansion

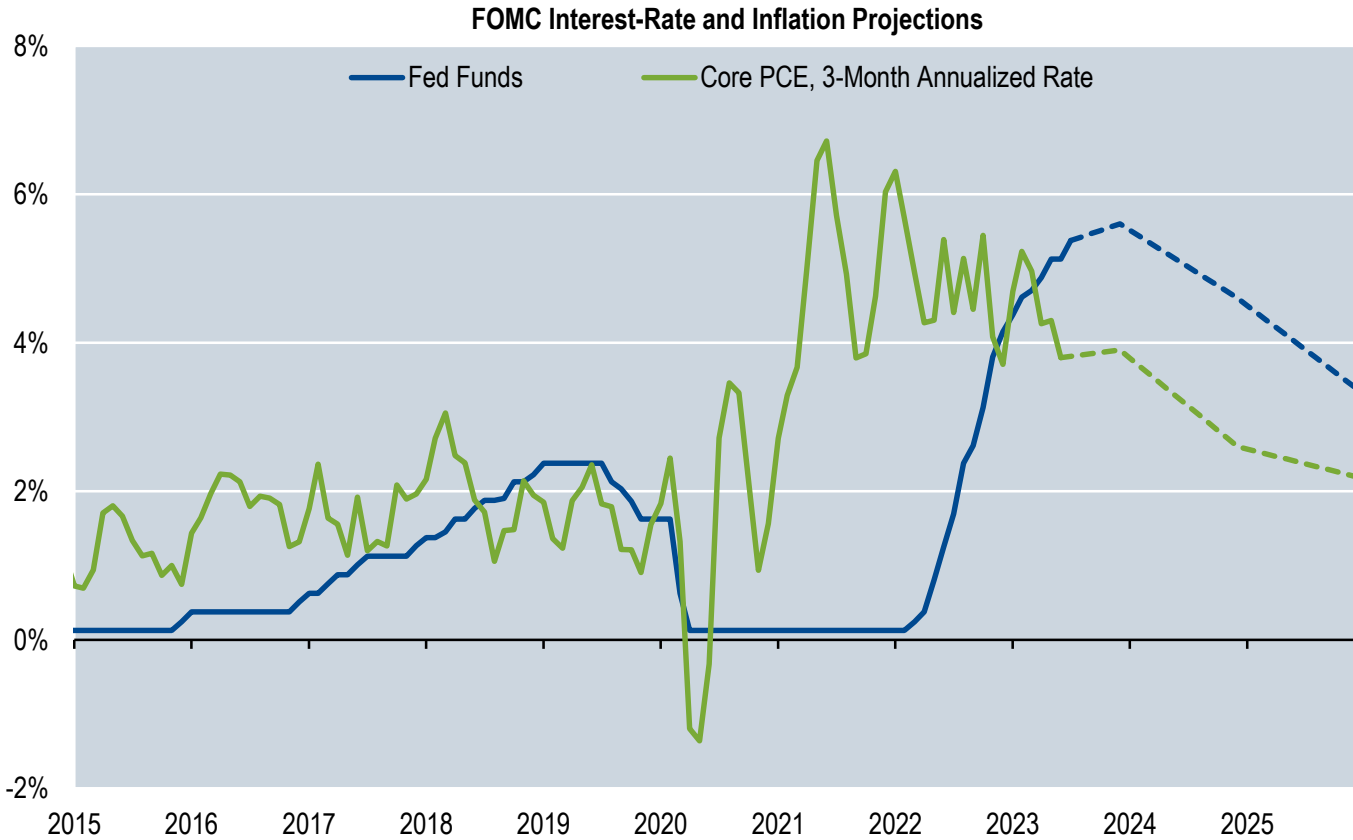
“What really was different this time was the series of unexpected and persistent supply shocks that featured in the inflation process.”

– Chair Powell, 19 May 23

Monetary Policy: Restrictive for an Extended Period

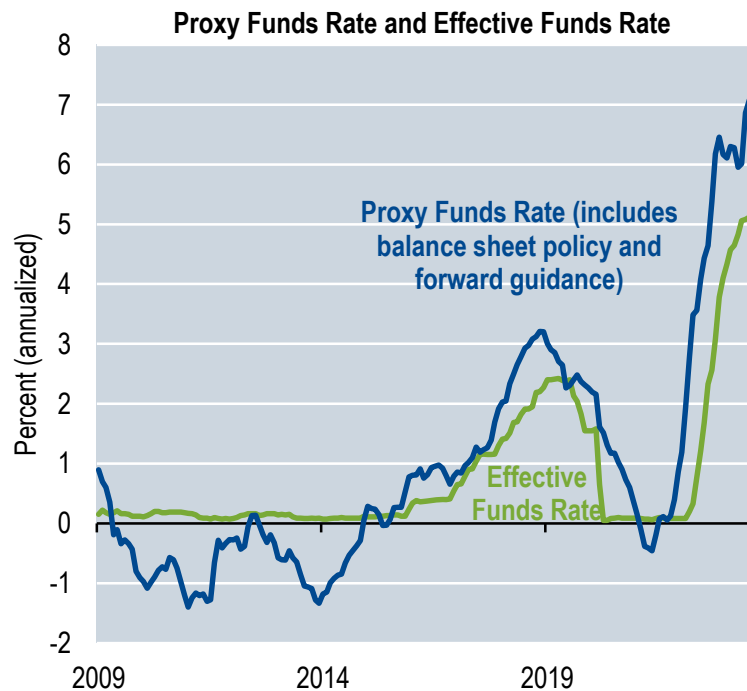
“We have come a long way in policy tightening, and the stance of policy is restrictive ... Having come this far, we can afford to look at the data and the evolving outlook and make careful assessments.”

– Chair Powell, May 19, 2023



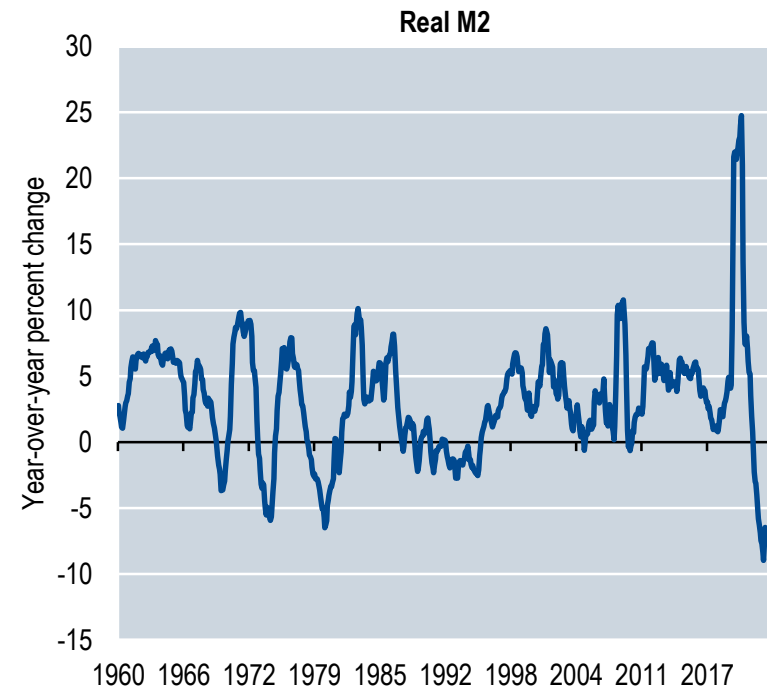
Source: Federal Reserve. As of 31 Jul 23

Monetary Policy Is Already Tighter Than It Looks



Source: Federal Reserve, Freddie Mac, The Bond Buyer, Moody's, Choi et al. (2022). As of 31 Jul 23

Proxy Funds Rates uses public and private borrowing rates and spreads to infer the broader stance of monetary policy. When the Federal Open Market Committee uses additional tools, such as forward guidance or changes in the balance sheet, these policy actions affect financial conditions, which the proxy rate translates into an analogous level of the federal funds rate.

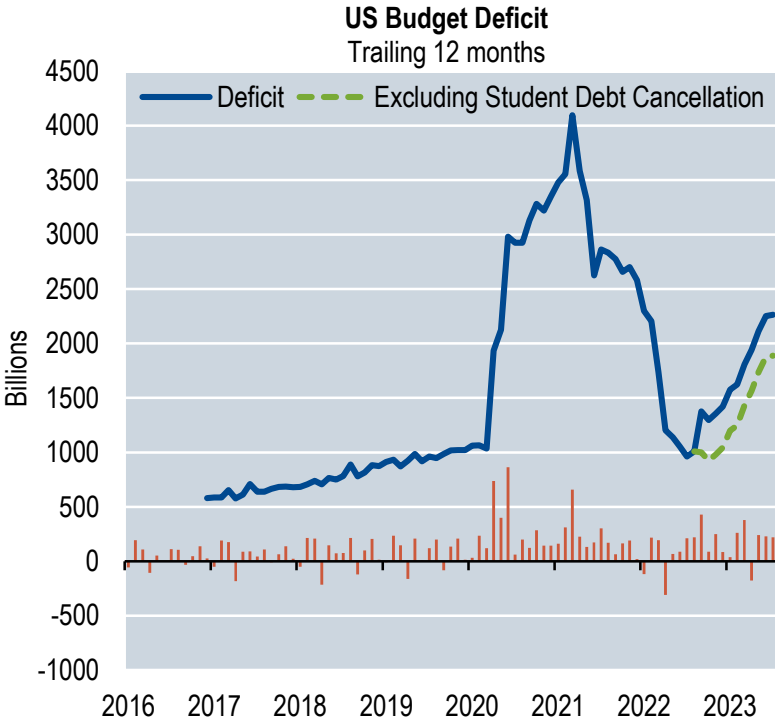


Source: Federal Reserve. As of 31 Jul 23

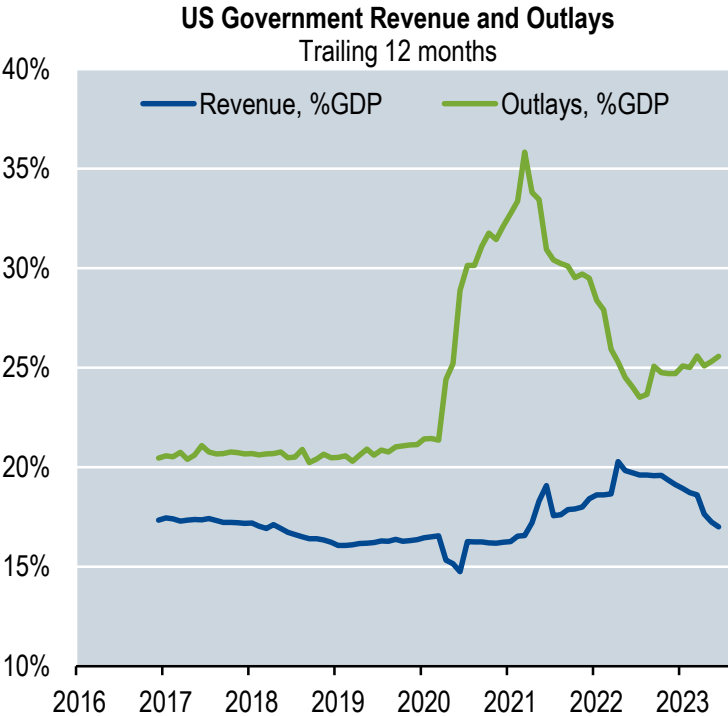
Fiscal Is a Concern

2023

- Inflation Reduction Act
- Student loan forgiveness
- Capital gains receipts



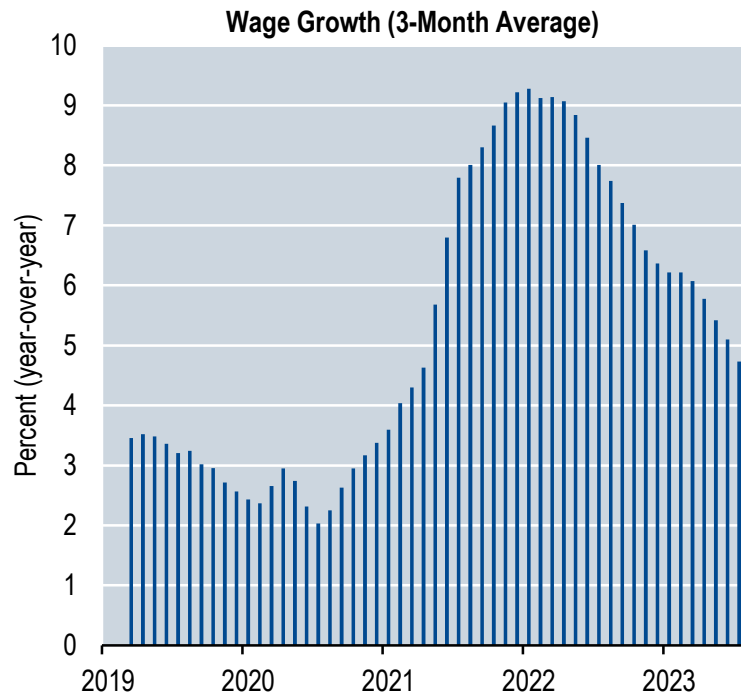
Source: U.S. Treasury, Haver Analytics. As of 31 Jul 23



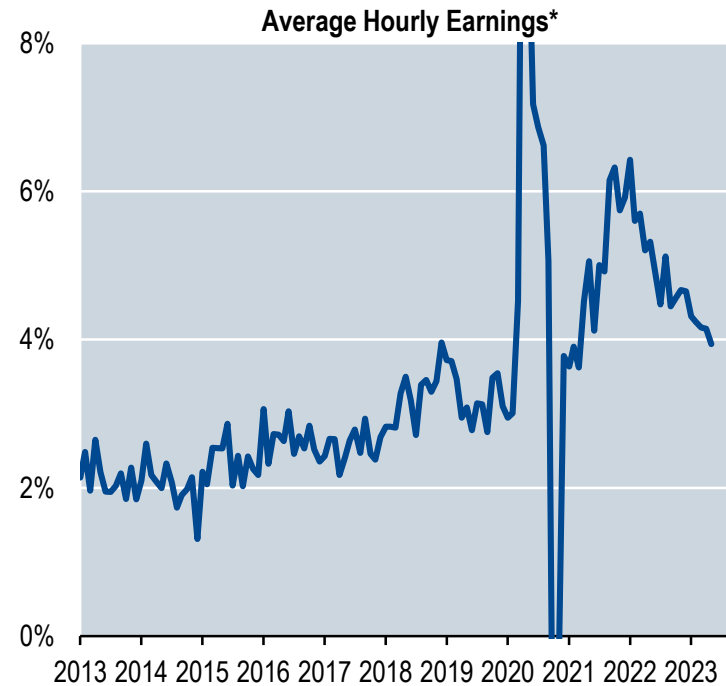
Source: U.S. Treasury, S&P Global Market Intelligence, Haver Analytics. As of 31 Jul 23

Labor Market Loosening and Wage Growth Moderating

Quits rate close to pre-Covid level. Job openings declining.



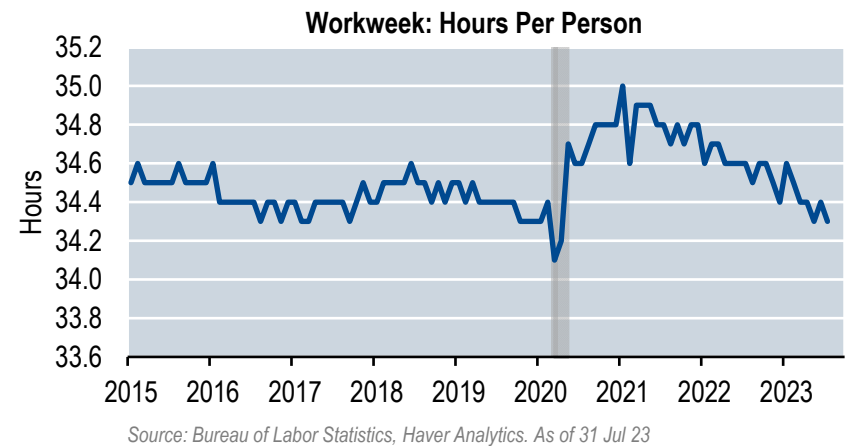
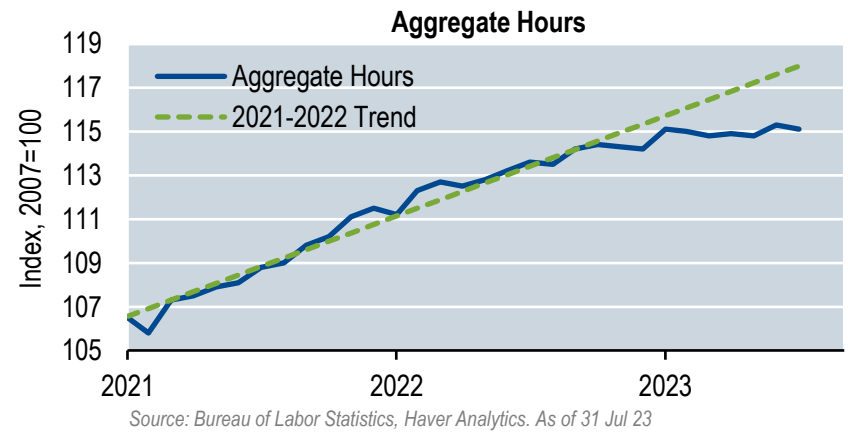
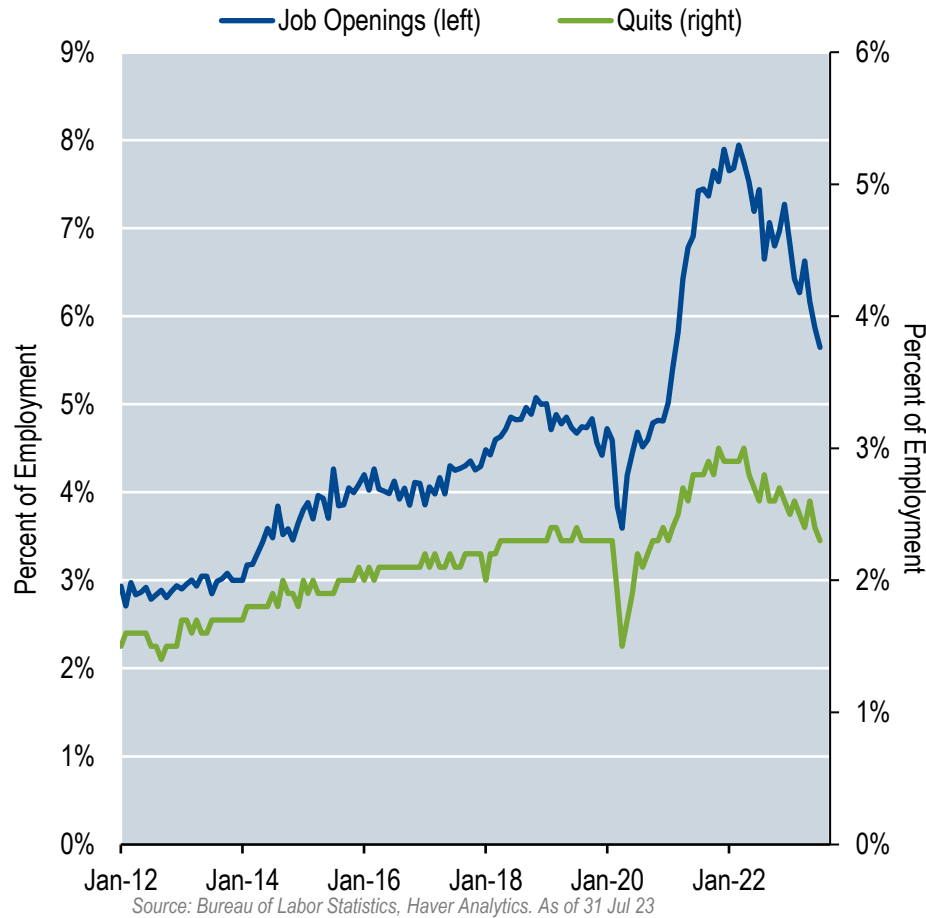
Source: Hiring Lab. As of 31 Jul 23



Source: Bureau of Labor Statistics. As of 31 May 23
*6-Month percent change, annual rate

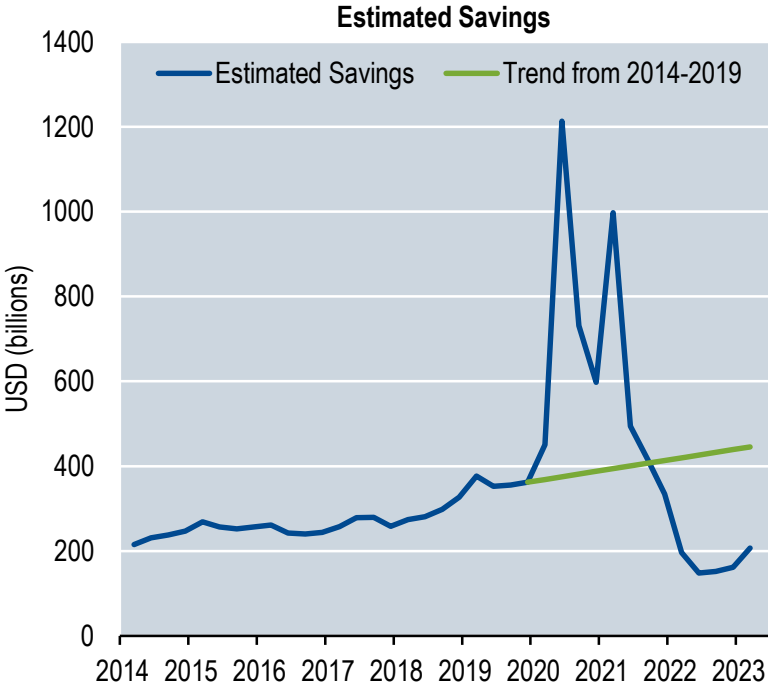
Labor Demand Moderating

Job openings declining. Aggregate hours work normalizing.

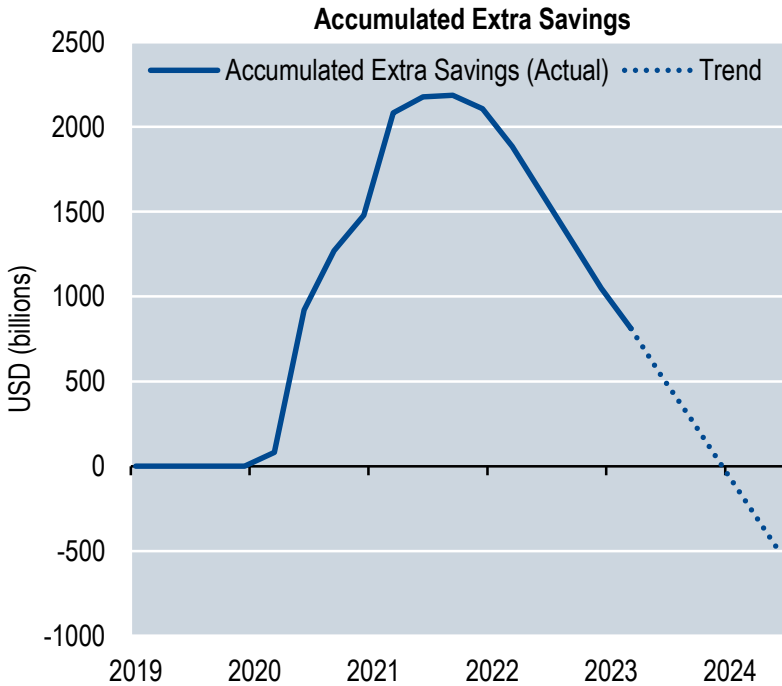


Consumers Under Pressure

Extra savings accumulated due to Covid policies are being depleted



Source: Bloomberg, Western Asset. As of 20 Mar 23



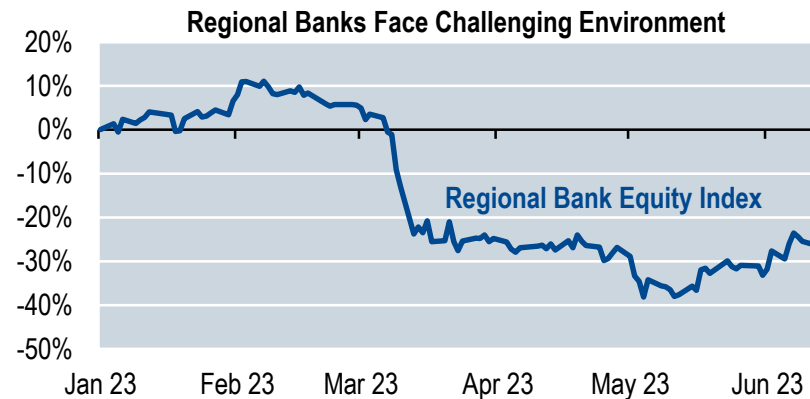
Source: Bloomberg, Western Asset. As of 20 Mar 23

Financial Stability and Credit Conditions

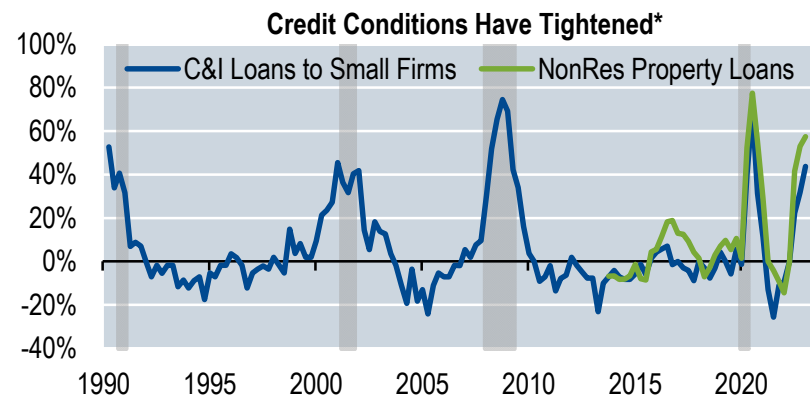
“Developments in the financial sector are contributing to tighter credit conditions and are likely to weigh on economic growth, hiring and inflation. So as a result, our policy rate may not need to rise as much as it otherwise would have to achieve our goals.”

“Our tools can have separate objectives, but their effects are often not entirely independent ... Financial stability affects macroeconomic stability and vice versa.”

– Chair Powell, May 19, 2023



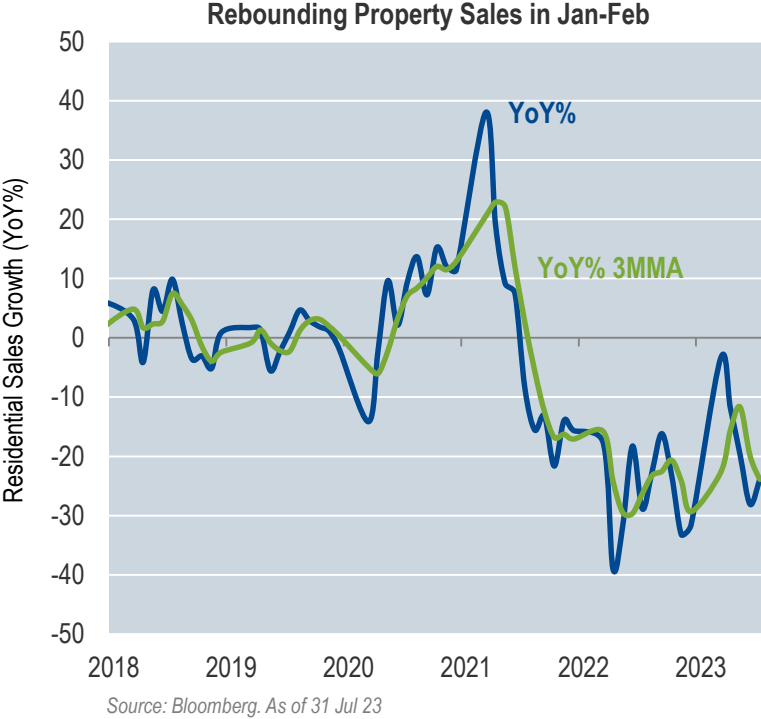
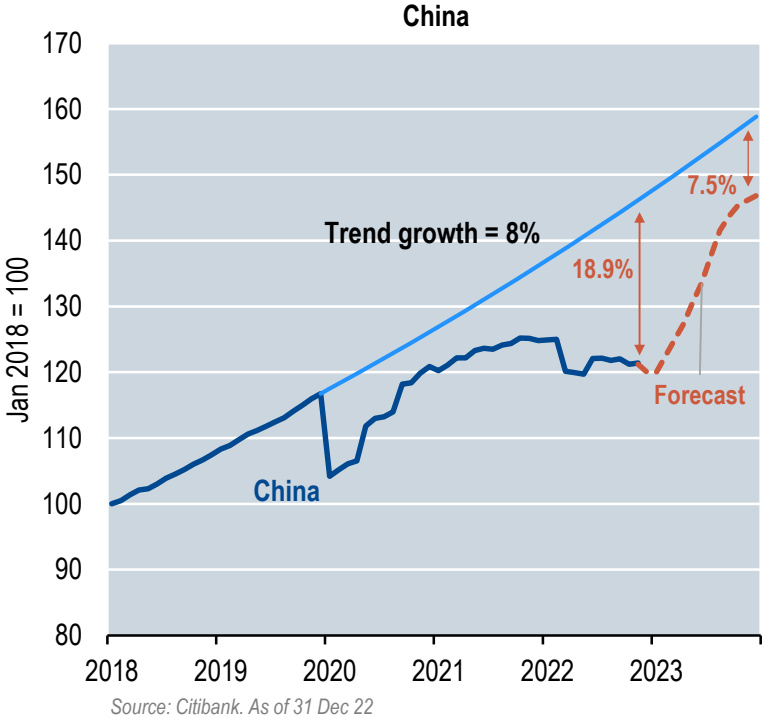
Source: Bloomberg. As of 12 Jun 23



Source: Federal Reserve. As of 31 Mar 23
*Percent of Banks Tightening Standards

China Outlook: Cyclical Rebound, Secular Concerns

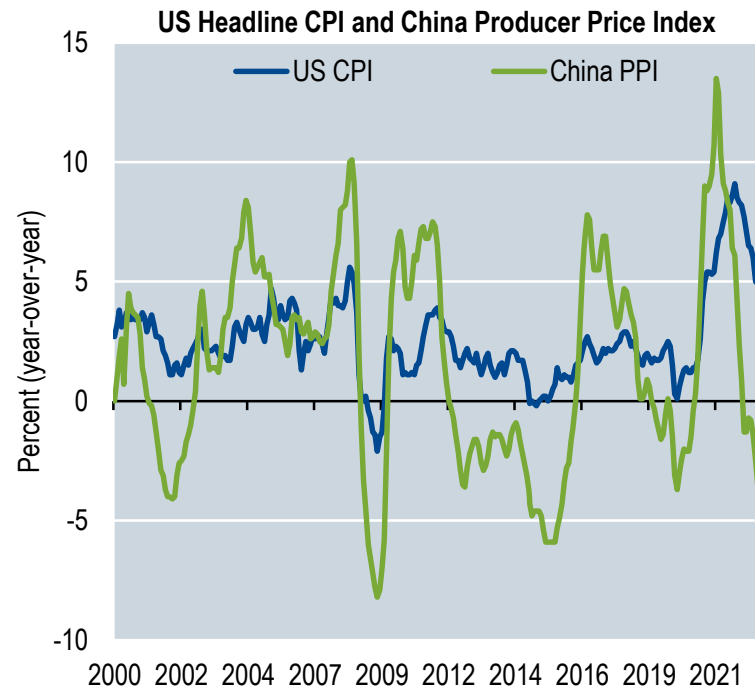
- Consumption will be a key growth driver, although the trend in China remains unimpressive
- Broad policy accommodation should nonetheless remain intact until the economy is on strong footing
- Support for property market should help contain further fallout from current market doldrums



China Becoming a Source of Global Deflation



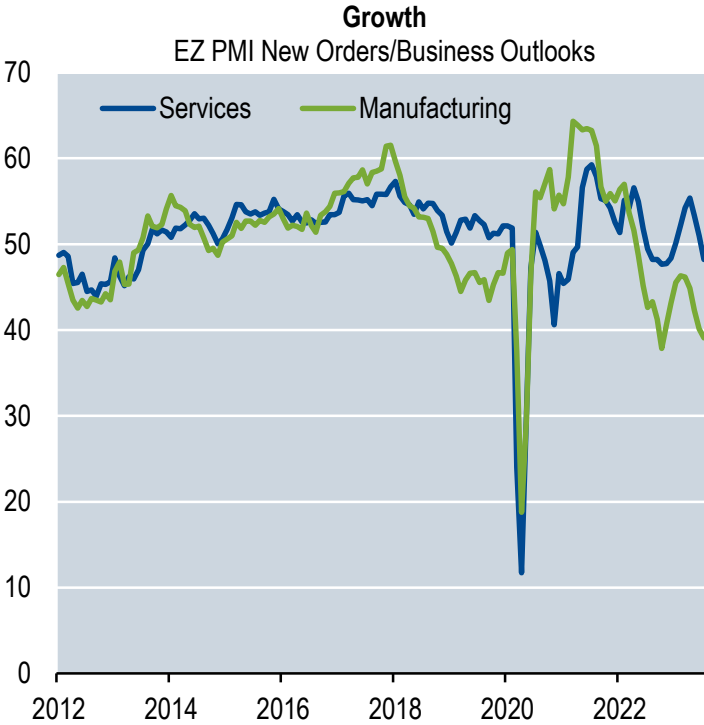
Source: Bloomberg. As of 30 Jun 23



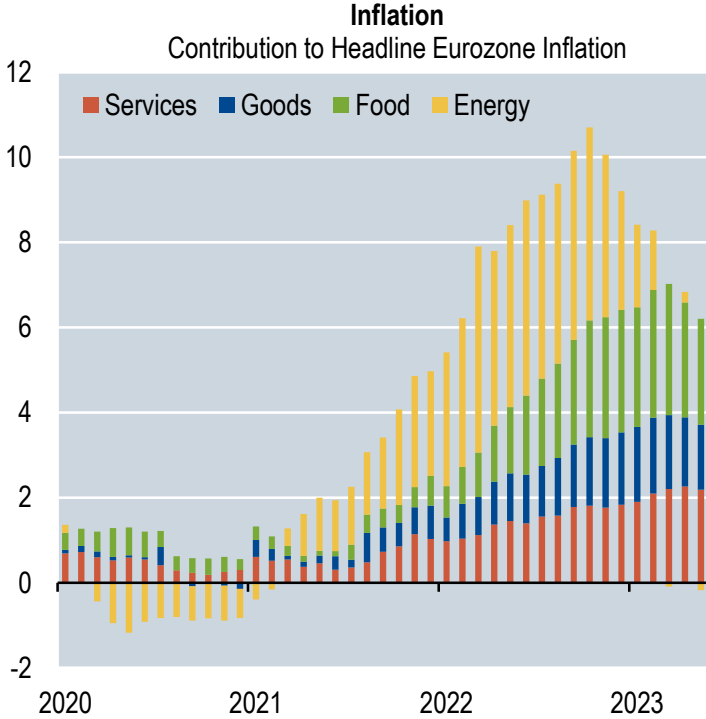
Source: Bloomberg. As of 31 Jul 23

Europe's Growth Slowing and ECB Tightening Gaining Traction

- Manufacturing demand soft, services demand turning lower
- Inflation peaked in October 2022, core beginning to turn lower, inflation expectations moderate
- Need for further rate increase questionable

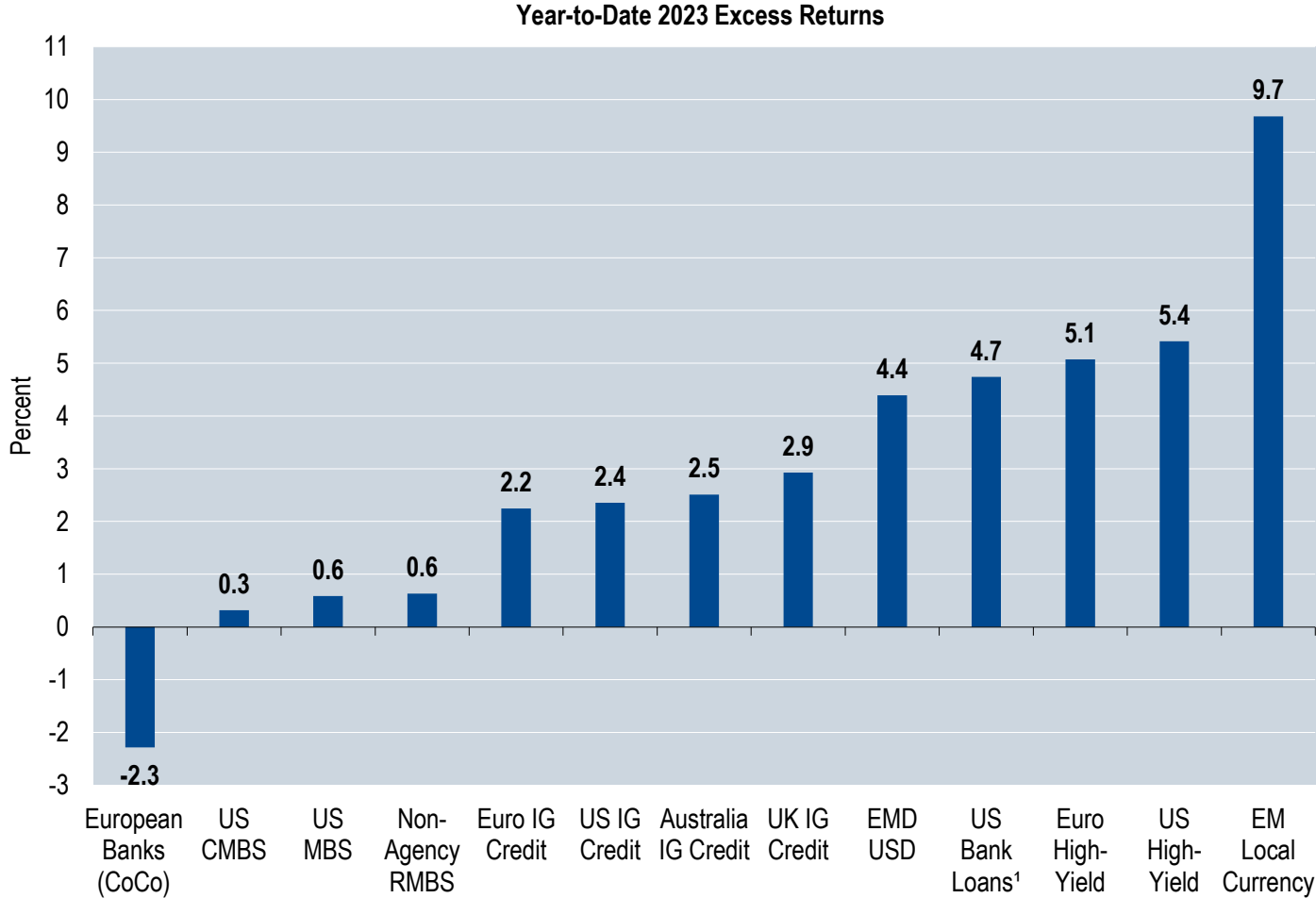


Source: S&P Global, Hamburg Commercial Bank, Haver Analytics. As of 31 Jul 23



Source: Eurostat, Haver Analytics. As of 31 May 23

Spread Sector Excess Returns

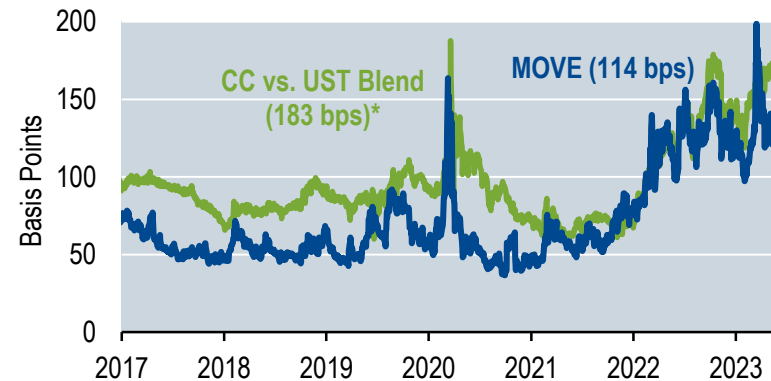
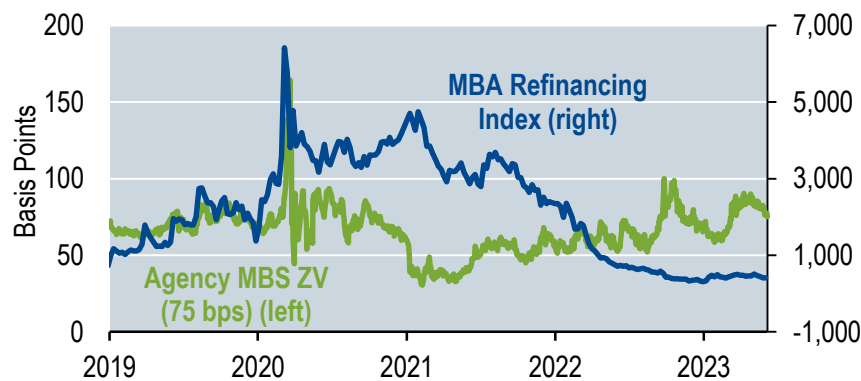
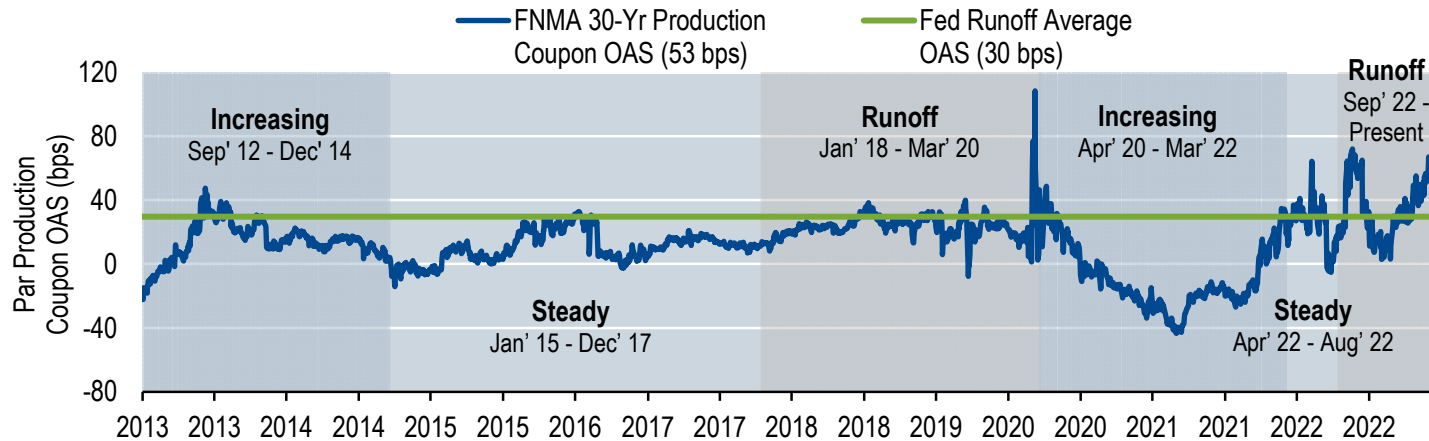


Source: Bloomberg, Citi, J.P. Morgan, S&P Global Market Intelligence, a division of S&P Global Inc, Western Asset. ¹S&P/LSTA Leveraged Loan Total Return Index excess return vs. 3-Month LIBOR. As of 31 Jul 23
 Past performance is not a reliable indicator of future results.



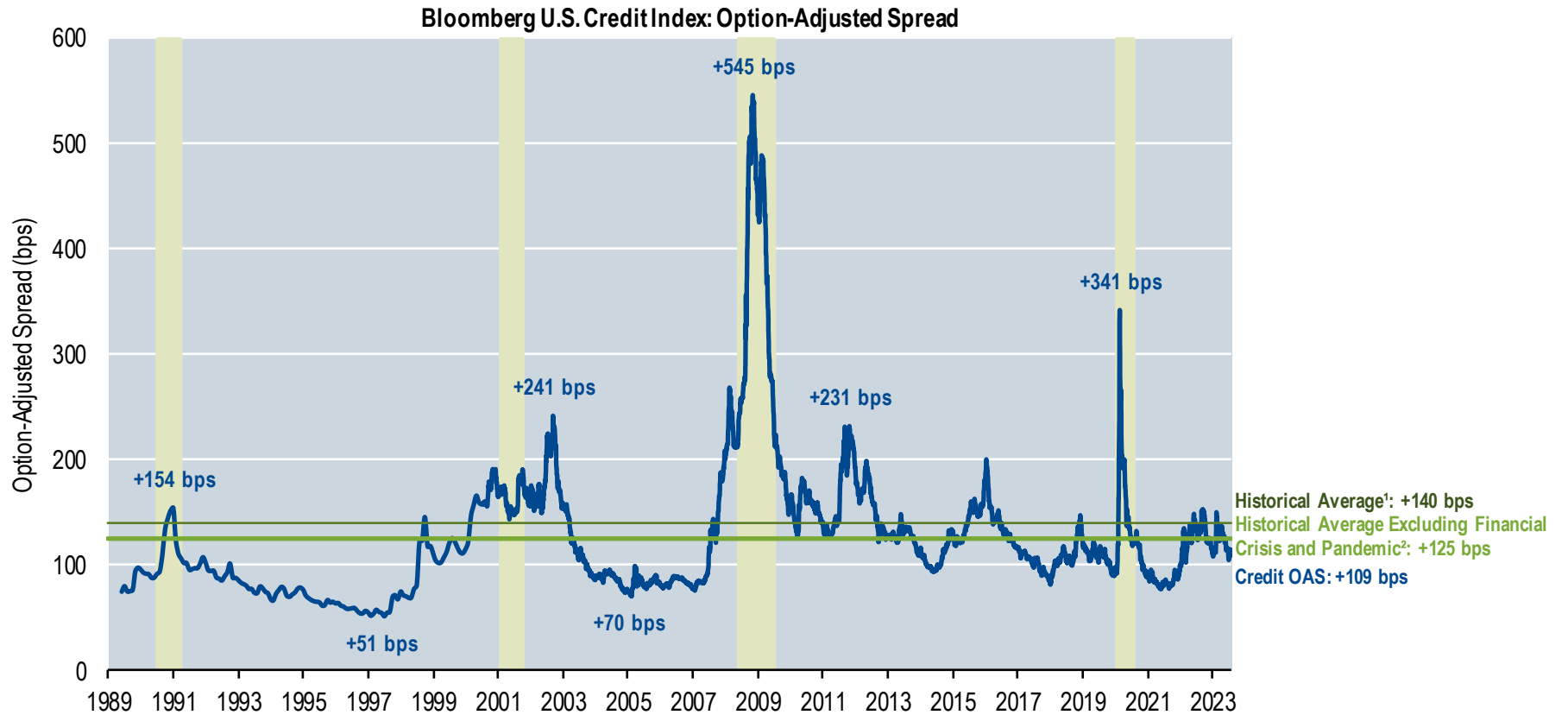
Agency Mortgage-Backed Securities: Fundamentals and Valuations Have Improved

- Agency MBS spreads tied to volatility but cheap historically
- Currently above average levels when Fed balance sheet is in runoff
- Prepayment risk remains muted as mortgage borrowers have little refinancing incentive



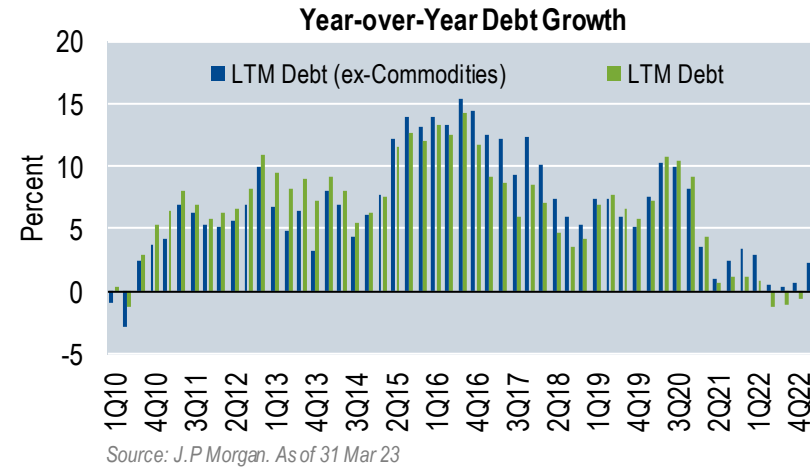
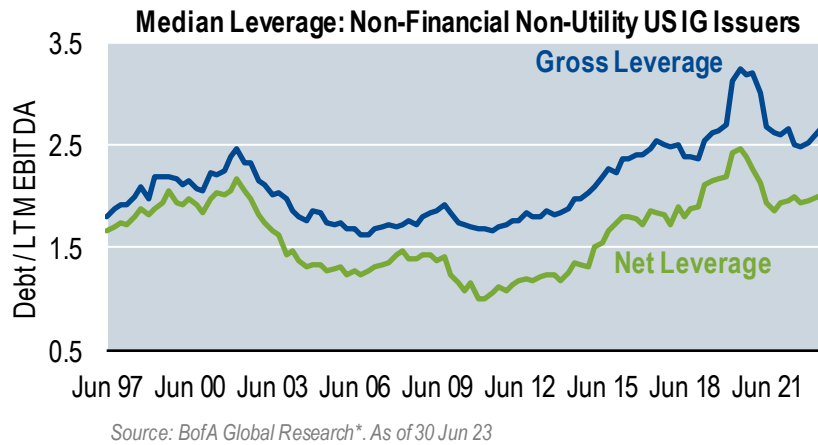
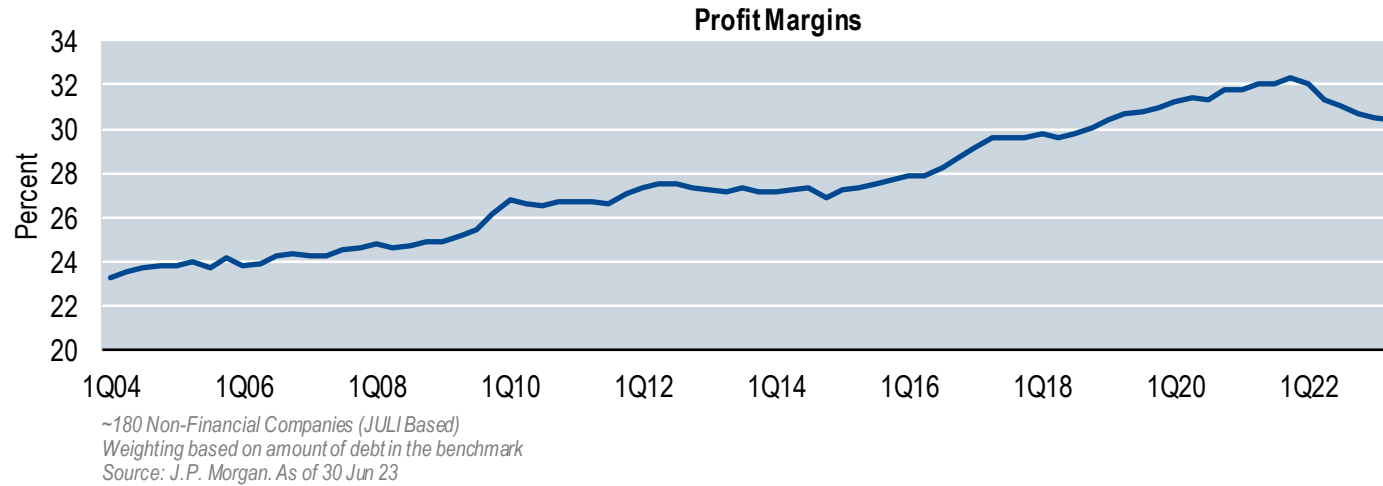
Source: Bloomberg, MS Research, Western Asset. As of 06 Jun 23
 *As of 30 May 23

Valuation: US Credit “Fair” at +109 OAS



Source: Bloomberg. As of 31 Aug 23
Periods of recession highlighted in yellow

Cash Flow and Debt Metrics Support Investment-Grade Credit



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Investment-Grade Energy – Strong Relative Performance in 2022

Since 2016, IG managements have

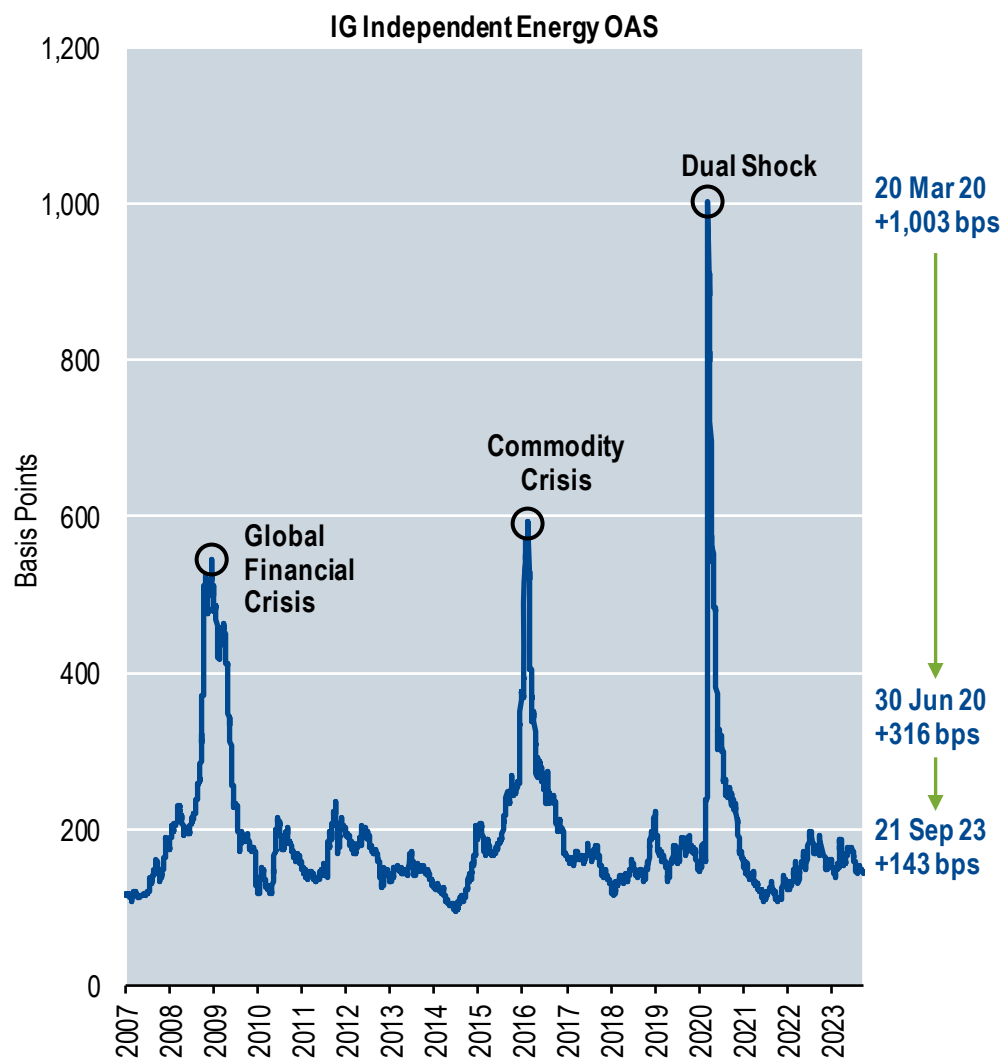
- Acted conservatively
- Lowered cost structures
- Improved cash flow
- De-levered balance sheets
- Extended maturity runways
- Improved liquidity

Conservatism Prevails

- Capital budgets remain conservative
- Shareholder returns from excess free cash flow

Conclusion

- Focus continues to be on cost reduction and greater capital discipline even in the face of higher commodity prices
- Seeing bottlenecks in the energy space also
- Under-owned sector
- Continue to hold our overweight



Source: Bloomberg. As of 21 Sep 23

Energy Companies: 2022 About Deleveraging, 2023 About Upgrades and Mergers

Issuer	2022 Debt (\$mm)	2022 Change in Index Debt (\$mm)	Upgraded in 2023/ Positive Outlook
IG Energy Index Change in Debt Outstanding 2022		-42,408	
BP PLC	25,539	-5,000	Positive Outlook
Chevron Corp	14,687	-4,700	
Exxon Mobil Corp	29,500	-4,000	
Energy Transfer Partners LP	32,611	-2,643	Positive Outlook
Valero Energy Corp	7,598	-2,602	
TotalEnergies SE	11,850	-2,000	
Conoco Inc	12,860	-1,768	
Sabine Pass Liquefaction LLC	10,350	-1,468	Upgraded
Enterprise Products Operating LLC	25,975	-1,250	Upgraded
Halliburton Company	7,600	-1,200	
Plains All American Pipeline LP	7,033	-1,100	Positive Outlook
Phillips 66	11,741	-1,032	
Canadian Natural Resources	7,250	-1,000	
Shell PLC	30,750	-1,000	
ONEOK Inc	11,885	-925	Upgraded
Kinder Morgan Inc	24,168	-725	
TC Energy Corp	14,625	-625	
Williams Cos Inc	21,058	900	
Enbridge Inc	15,150	900	
MPLX LP	19,057	1,011	
IG Bond Index Change in Debt Outstanding 2022		321,300	

Source: J.P. Morgan, Bloomberg Finance L.P. As of 07 Oct 22

BB Energy Issuers and Change in Index Debt Outstanding 2022

Issuer	2022 Debt (\$mm)	2022 Change in Index Debt (\$mm)	Upgraded in 2023/ Positive Outlook
Occidental Petroleum	19,937	-8126	Upgraded
Apache	5,037	-1310	Upgraded
Petrofac Ltd	600	-600	Positive Outlook
Antero Resources	1,120	-979	Positive Outlook
Southwestern Energy	4,161	-573	Positive Outlook
Western Midstream Operating	6,256	-502	Upgraded
TechnipFMC plc	203	-430	
MEG Energy Corp.	1,971	-225	Upgraded
DCP Midstream Operating	4,275	-350	Upgraded
Murphy Oil Corp	2,044	-442	Upgraded

Source: J.P. Morgan. As of 11 Oct 22

Mergers in 2023

Acquiring Company	Target	Size (\$bn)	Date Announced
Phillips 66	DCP	3.8	Jan 2023
Targa Resources	Grand Prix	1.1	Jan 2023
Energy Transfer	Lotus Midstream	1.5	Mar 2023
Ovintiv	Multiple Targets	4.3	Apr 2023
Chevron	PDC Energy	7.9	May 2023
Conoco	Total-Surmont	3.0	May 2023
OneOK	Magellan	18.9	May 2023
Patterson-UTI	NexTier	2.1	Jun 2023

Source: Bloomberg. As of 15 Jun 23

The information provided is not a recommendation to purchase, sell, or hold any particular security and should not be construed as an endorsement of or affiliation with Franklin Templeton or Western Asset.

The Two Tiers of the US Banking System

We prefer large US banks over regionals

	Regulatory Scrutiny	Balance Sheet Strength	Deposit Mix	Interest Rate Risk	Current Market Confidence
Large US Banks	High	Very High	Diversified, Low Risk	Low	High
Regional US Banks	Moderate	Moderate	Narrow, Medium Risk	Medium	Low

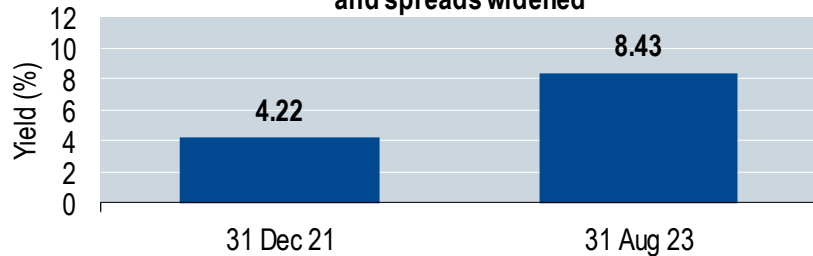
Expectations:

- Large banks will get stronger while weaker regionals will consolidate
- Regulation (and issuance) will increase for regional banks
- Regional bank ratings will come under pressure

Source: Western Asset. As of 31 May 23

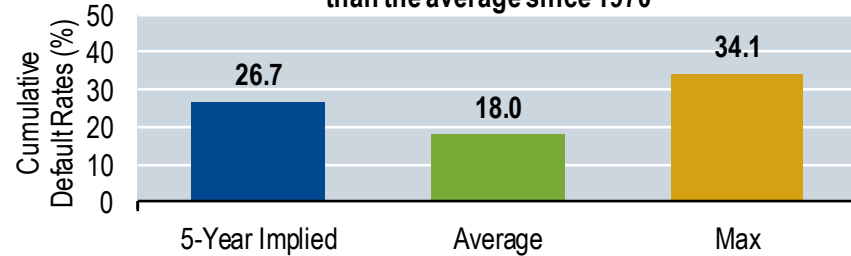
High-Yield Credit: Valuations Are Compelling

Yields rose by more than 4% since 2021 as rates rose and spreads widened



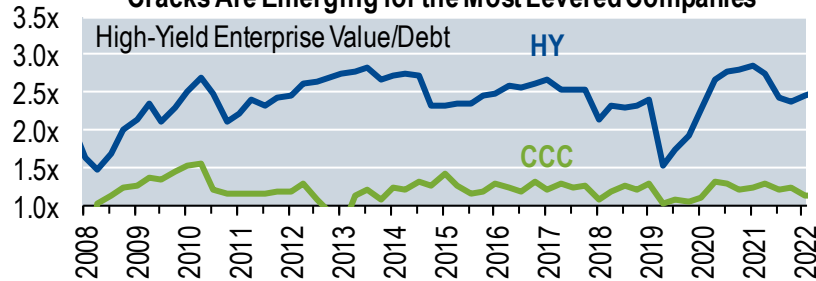
Bloomberg US High-Yield 2% Issuer Cap Index
Source: Bloomberg. As of 31 Aug 23

Spreads now imply much higher defaults than the average since 1970



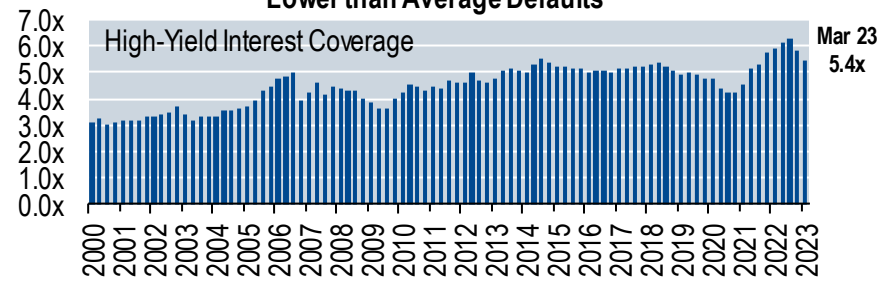
Source: Bloomberg, Moody's, Western Asset. As of 31 Aug 23
40% recovery assumption was used and spread used to imply cumulative defaults over 5 years.
Worst cumulative 5-year default period since 1970 was 1992

Cracks Are Emerging for the Most Levered Companies



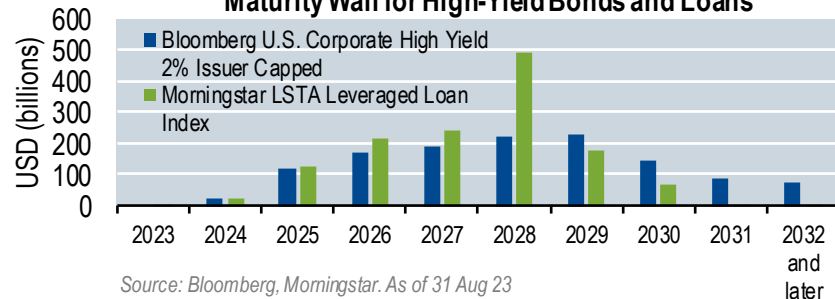
The sample is confined to public reporters for which we are able to retrieve four consecutive quarters of data from Bloomberg or S&P Capital IQ. New constituents are integrated quarterly based on additions to the Bloomberg US Corporate HY Bond Index).
Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Mar 23

Ability to Service Debt Also Supportive of Lower than Average Defaults



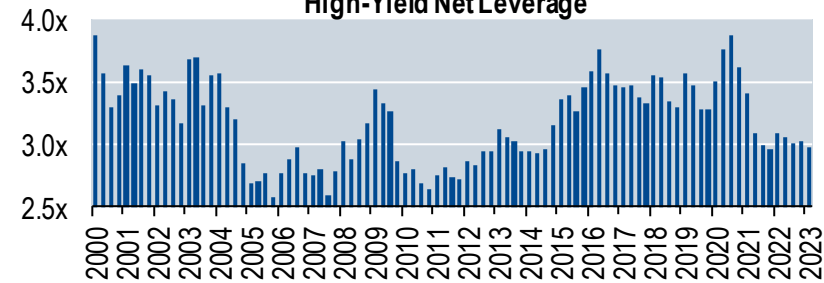
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Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Mar 23

Maturity Wall for High-Yield Bonds and Loans



Source: Bloomberg, Morningstar. As of 31 Aug 23

High-Yield Net Leverage



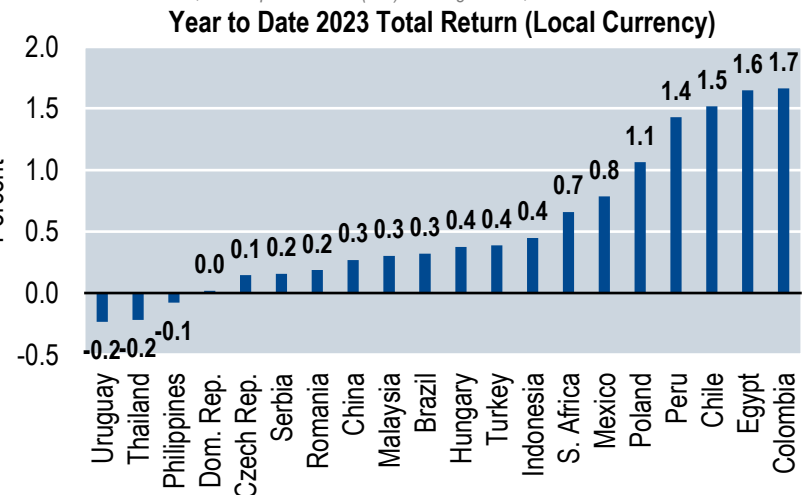
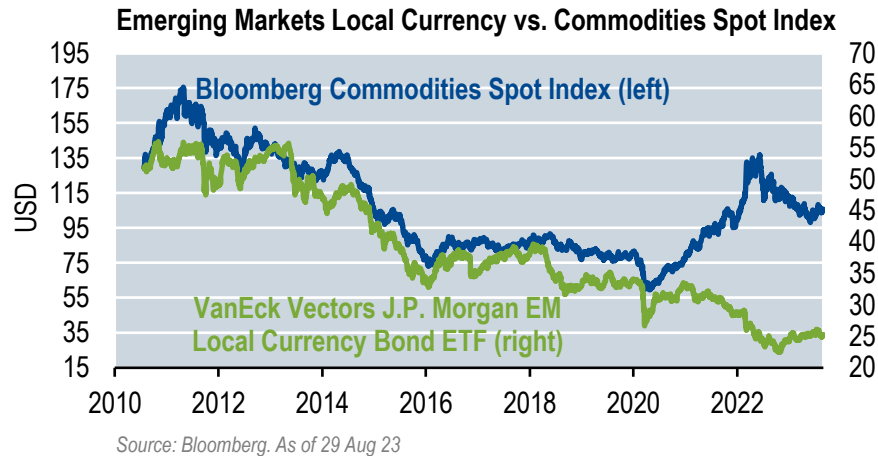
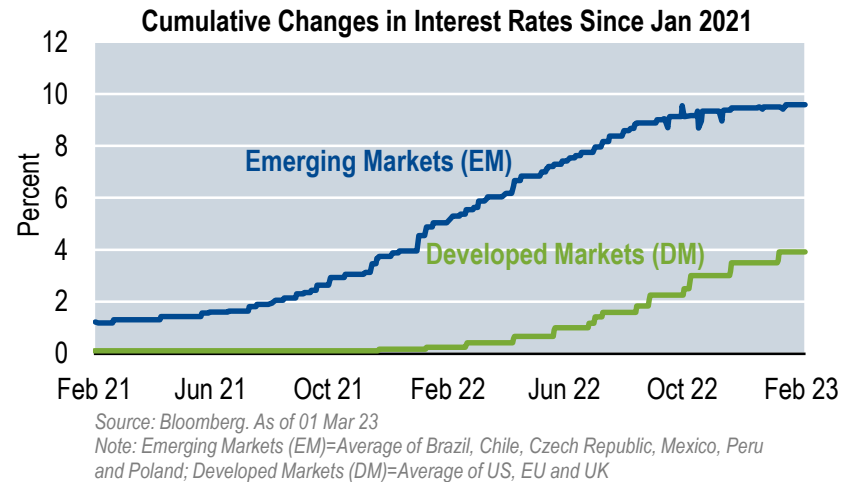
Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ. As of 31 Mar 23

The USD and Commodities: Key Emerging Market Drivers

EM central banks are closer to the end of the tightening cycle relative to the developed world

USD relative strength and commodity prices are both inputs into EM economic conditions and returns.

A Fed pause combined with China reopening bodes well for EM



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