Western Asset

First Quarter 2022

GLOBAL OUTLOOK

Executive Summary

- In the US, the recovery from the shut-down-induced recession/repression is largely complete. Growth will be mostly trend-like, 1.5%-2.5%, with some potential for above-trend growth in leisure-oriented sectors.
- We maintain the view that global inflation will return toward pre-COVID-19 rates sometime soon, as pipeline pressures begin to ease.
- After a very strong rebound in 2021 returning GDP to its pre-crisis level, we expect economic growth in Europe to moderate gradually over the course of 2022.
- We expect China growth for 2022 will come in between 4.5% and 5.5%, with policymakers focused on high-quality growth and assuming no reversal in China's intended policy messaging on housing, education and internet sectors.

Western Asset expects global growth to decelerate from the robust 2021 levels as we move into 2022. Contributing factors include a sharp pullback in global fiscal stimulus, a reduction in monetary accommodation by key central banks such as the Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE), and the persistence of secular-related headwinds that include rising global debt burdens, aging demographics and technology displacement. Inflation overshoots have proven more persistent than anticipated, and remain challenging for policymakers globally. However, we expect that the impact of leading inflationary components will ease meaningfully through the course of 2022. The COVID-19 pandemic continues to bedevil global populations, but we remain optimistic that the worst is behind us as vaccination rates improve around the world. While the new omicron variant risks delaying the reopening of global economies, we do not believe it will derail it and therefore remain optimistic about spread-product performance going forward. Here, we provide a summary of the key drivers behind our global outlook and describe where we see value across global fixed-income markets.

GLOBALOUTLOOK

Key Drivers

US: Growth Moderating as Expected

The US economy has evolved in recent months, and is essentially in line with our outlook for economic growth. Price increases have been sharper than we expected, but we still anticipate these will moderate substantially in the months to come. Consumer spending has been shifting in recent months from goods back to services, after the reverse switch in late-2020 and early-2021. Thus, consumer spending on goods has been essentially flat since March 2021. At the same time, consumer spending on services has grown steadily if unspectacularly. Services spending has actually slowed a bit in recent months, as the recovery in restaurants came to completion and as lingering COVID-19 concerns limited growth in other hard-hit sectors such as recreation, lodging and travel. Meanwhile, homebuilding has largely continued a gradual slide that has been in place since late-2020, as rates of homebuilding continue to pull back to levels more consistent with the pace of new-home sales.

In most of the economy, the recovery from the shutdown-induced recession/repression is largely complete. The sectors where there is room for further recovery are precisely those where COVID-19 restrictions still bite: the leisure-oriented sectors referenced earlier. Non-residential construction also remains depressed, but post-COVID-19 realities suggest this sector will likely see little recovery in the next few years. In sum, our best guess is that US growth will be mostly trend-like, 1.5%-2.5%, with some potential for above-trend growth in leisure-oriented sectors, if government policies allow.

> *In most of the economy, the recovery from the shutdown-induced recession/repression is largely complete.*

We still fail to see any credible sign that Fed policy has stimulated the economy, in which case we believe the inflation increase seen to date reflects pipeline pressures as well as a retracement of shutdown declines by some commodities and services. Hence, we expect inflation to return toward pre-COVID-19 rates sometime soon, as pipeline pressures begin to ease.

Europe: Growth Moderating Slowly, Inflation More Quickly

After a very strong rebound in 2021 returning GDP to its pre-crisis level, we expect economic growth in Europe to moderate gradually over the course of 2022. Omicron-related restrictions should be temporary, and high-frequency data indicate that the economic impact of these restrictions is less pronounced than in previous waves, including because booster vaccination drives are making rapid progress across the continent. Employment continues to rebound but remains below pre-pandemic levels as some workers on furlough schemes are gradually rejoining the labor market. Higher-frequency, forward-looking activity indicators have receded from recent peaks as supply bottlenecks are still significant. The main risk to our outlook on the supply side is that disruptions could continue for longer than initially expected, and on the demand side that disposable income and therefore consumption is significantly curtailed by sustained high inflation notwithstanding the significant household savings accumulated during the pandemic. We are less concerned about a "fiscal cliff" risk in Europe compared to elsewhere, and we don't expect the forthcoming revision of the European fiscal rules to become a tightly binding constraint on most governments. Disbursements from the Next Generation EU (NGEU) recovery fund to most countries have been sizeable already, pre-financing a large number of projects across the continent.

We expect inflation in the eurozone to have peaked in 4Q21 and the forthcoming deceleration to be gradual at first, picking up speed in 2H22. Continued supply disruptions and energy price volatility can still influence this profile somewhat, but the downforce exerted by base effects is significant, especially later in the year. Underlying inflation (excluding food and energy) in the eurozone has risen somewhat but is likely to drop back

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Key Drivers

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to, and then below, the inflation target as soon as there are still no indications of wage inflation picking up. Unsurprisingly, inflation expectations at all time horizons have been drifting back up toward the target. In its December meeting, the ECB provided clear long-range guidance on its asset purchase plans, confirming the end of the PEPP for March but indicating a temporary increase in the APP over the summer quarters, resulting on aggregate in a smooth and gradual reduction of monetary accommodation throughout the year. That said, the ECB also revised up its inflation forecast for headline and core to about 1.8% in 2023 and 2024. While there are no interest rate hikes until 2023 in our base case, it is worth noting that just a small further upward revision is enough to fulfill the ECB's forward guidance criteria and maneuver the central bank into rate hiking territory.

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Post-pandemic normalization in the UK is more advanced compared to that of the continent, both in terms of policies and key data points. Notwithstanding most fiscal support measures having been phased out, the labor market continues to be tight, displaying a record number of open positions. Moreover, inflationary pressures are significant and are likely to peak only in the second quarter of 2022. Households' disposable income is also affected by a planned increase of contributions to national insurance, leading to questions about the strength of real aggregate demand. Meanwhile, disagreements with the EU around the implications of the Northern Ireland protocol in the context of the UK's Withdrawal Agreement with the EU will continue to create an uncertain backdrop for investments, and trade flows have been severely damaged even though the effective control of goods imports into the UK has only started this year. The BoE's asset purchase program has come to an end in December and the Bank has also moved to hike the bank rate from its record low. Given the still somewhat uncertain inflation outlook and the strong labor market, we expect the BoE to continue a gradual but shallow rate hiking cycle throughout this year.

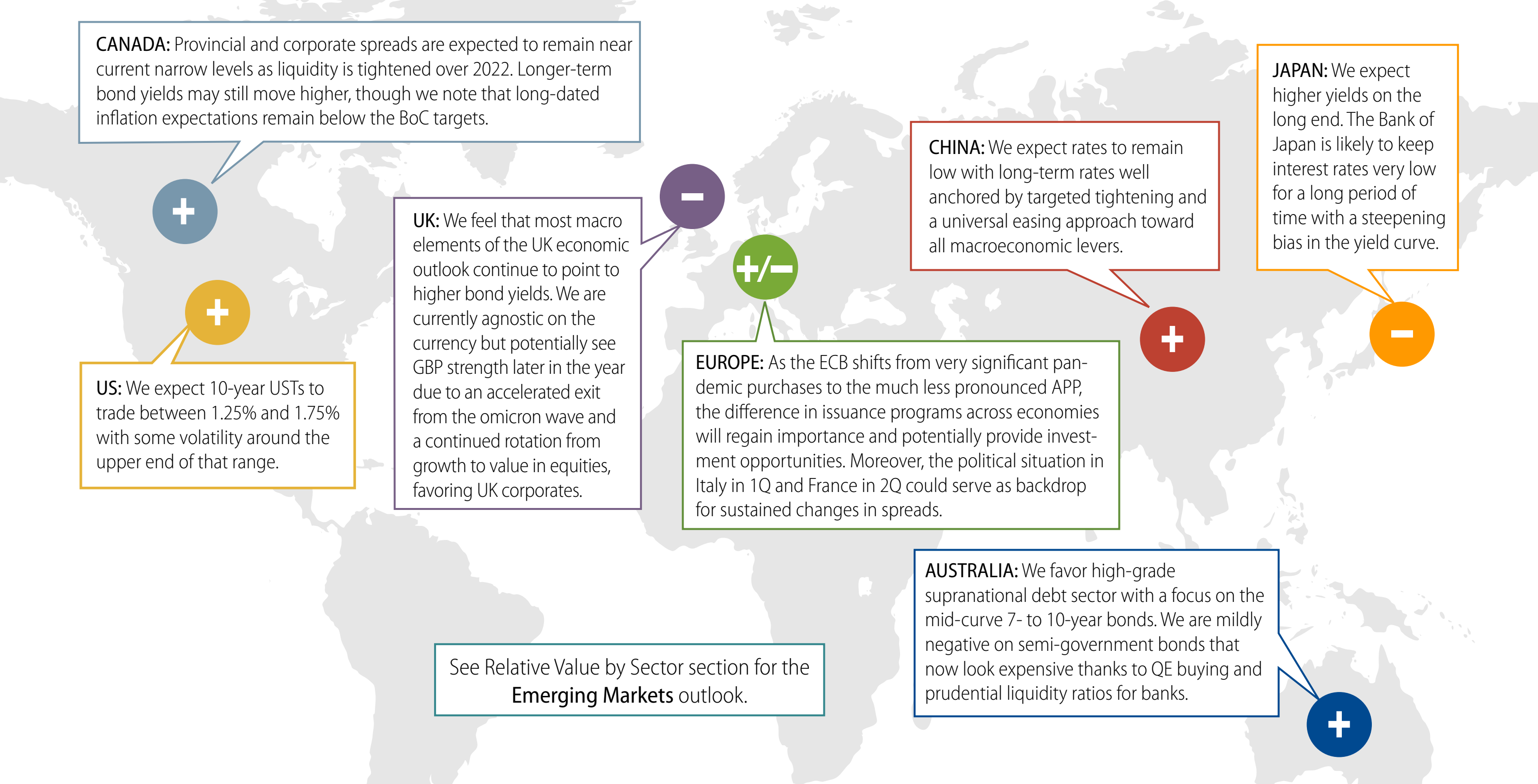
China: Addressing Growth Headwinds in a Piecemeal Fashion

Growth in China for 2022 should come in between 4.5% and 5.5%, with policymakers focused on high-quality growth and assuming no reversal in China's intended policy messaging on housing, education and internet sectors. Consumer confidence remains soft with the specter of COVID-19-related flareups lingering as well as a broadly negative wealth sentiment given a poor outlook for property prices. On December 15, the People's Bank of China (PBoC) implemented a cut in the reserve requirement ratio (RRR), the second RRR cut for the cycle (the first occurred in July 2021). This is on the back of a Politburo work meeting that emphasized stability as a policy objective in 2022, including stability in employment, financial, trade, foreign direct investment (FDI), investment and expectations. Emphasis on "stability" is usually an indirect way of recognizing near-term downward pressure. Several recent statements from Premier Li Keqiang express concern about "new downward pressure" on economic growth. However, it is unlikely that there is going to be a sharp policy turn on its intent to curb property market excesses as well as other measures taken in other sectors such as technology and tuition. The broad thrust continues to be micro-tightening while keeping macro policy stable and supportive.

China's emphasis on "stability" may be an indirect way of recognizing near-term downward pressure on its growth outlook.

The Big Picture

Global Market Rates: Relative Value by Region



US	US growth should be mostly trend-like, 1.5%-2.5% for 2022, with some potential for above-trend growth in leisure-oriented sectors, if government policies allow.
Canada	With the labor market fully recovered, rate hikes by the Bank of Canada (BoC) are expected in the upcoming months. However, with wage growth still moderate and inflation just above the top of the target range, we still expect a relatively cautious rate hike cycle as the BoC has to slowly deflate the too-hot housing market.
Europe	The continued healing of the labor market, combined with only a moderate reduction in fiscal and monetary support, should support the economic recovery for most of this year. Net issuance (after redemptions and ECB purchases) likely will increase in 2022 compared to the pandemic years 2020 and 2021, and EU-level borrowing should continue to expand the pool of supranational safe-haven assets. The ECB has confirmed the very gradual removal of monetary accommodation as long as inflation is receding as projected in 2022.
UK	The UK has experienced a significant economic bounce but the narrative for 2022 is more complex as an earlier hiking cycle (compared to that of the continent) and a higher inflation trajectory cloud the outlook. The UK's relationship with continental Europe is bound to evolve and further trade altercations cannot be ruled out. Uncertainty could weigh on investment decisions, especially in the tradable sector.
China	We expect growth to come in between 4.5% and 5.5% in 2022, with policymakers focused on high-quality growth and assuming no reversal in China's intended policy messaging on housing, education and internet sectors.
Japan	We expect that the Japanese economy will grow 3.5% in 2022 and 1.5% in 2023, slightly higher than consensus forecasts. The growth will be driven by business investments and exports as well as private consumptions as the supply-chain disruptions in Japan would improve faster than expected. In addition, the Japanese government decided on a huge additional economic package which would be worth about JPY78.9 trillion (18% of nominal GDP) with JPY55.7 trillion of fiscal spending.
Australia	The Reserve Bank of Australia (RBA) is likely to drop its QE program in 1Q22, but still remains very dovish on the outlook for the policy rate, 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 remain cautiously optimistic about corporate fundamentals near-term as overall economic growth in 2022 should still be supportive. We remain vigilant of potential shareholder-friendly activity (e.g., share buy-backs, M&A, etc.) but outside of a few examples of bondholder-unfriendly behavior, we have generally witnessed conservative balance sheet management in 2021 with deleveraging occurring both passively (through earnings growth) and actively (via debt tenders).	+/–	Valuations have largely recovered to pre-COVID-19 levels for most sectors while pockets of opportunity remain. We favor banking, select reopening industries and rising-star candidates where allowed.
Europe	Corporate fundamentals are solid but we don't expect meaningful improvement from here. Sector and security selection are important with M&A activity (e.g., in telecommunications and retail). Bank balance sheets remain in strong shape with higher rates supportive of profitability.	+	Low government bond yields and ongoing ECB corporate purchases support relatively tight investment-grade (IG) credit spreads. We find most value in subordinated financials and real estate investment trusts (REITs).
Australia	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 over the coming year at least (previously until 2024).	+	We favor the IG sector. REITs and infrastructure sectors still remain relatively more attractive than financials.
High-Yield (HY) Corporate Credit			
US	High yield (HY) spreads remain relatively attractive given a supportive nominal economic growth and low default outlook. Credit quality continues to improve with much of the index rated BB and with declining CCC exposure compared to several years ago. Technicals remain supportive as demand for relatively high income-producing securities compares to moderate net supply.	+	We continue to position for a "reopening trade" and rising stars. We remain positive on certain cyclical sectors including airlines, cruise lines and select lodging credits, complemented by a higher quality bias in less cyclical subsectors.
Europe	Fundamentals are much improved as default rates have dropped to around 1%. Earnings should benefit from reduced supply-chain issues. Higher input prices are anticipated to subside, although near-term COVID-19-related headwinds will be in focus.	+	Valuations are attractive in the context of lower-yielding European asset classes. We expect spreads to be range-bound in early 2022. We favour European cable/telecom companies and consumer-related issues.
Bank Loans			
US	Fundamentals remain healthy and minimal defaults are expected given the strong economic outlook. Issuance has been very robust, driven by leveraged buyout (LBO)/M&A activity. That said, demand for higher-yielding floating-rate securities from retail, institutional clients and CLOs is expected to be supportive for spreads.	+	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	Returns to CLO equity should be supportive given the relatively low cost of financing and elevated investment spreads. 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 AAA CLO debt will continue to perform well in either bullish or bearish bank loan spread environments given strong technicals. Heavy supply will lead to opportunities to add lower-rated CLO debt.
Structured Credit			
Agency 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 exposure in production coupons relative to benchmarks, while favoring coupon and collateral selection.
Non-Agency Residential MBS (NARMBS)	Housing has performed strongly over the past year with national home prices increasing 19.1% YoY. 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 enterprise (GSE) credit risk transfers as well as legacy non-agency and new-issue loan deals.
Non-Agency Commercial MBS (CMBS)	Fundamentals continue to improve but the pace of recovery is uneven across property types. Valuations are fair but a wide dispersion exists between the "haves" and "have-nots." Heavy new-issue supply challenges technicals.	+/–	We are neutral up the capital stack and positive on select mezzanine and below-IG 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 ABS classes from higher quality sectors.

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Relative Value by Sector

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Inflation-Linked	Outlook		Relative Value
US	Inflation will peak over the next few months and we expect inflation declines could be sharp as the economy slows relative to 2021. Higher housing inflation this year will be offset by the decline in goods prices as shortages wane.	–	Our expectation is that short- and medium-maturity TIPS will underperform comparable nominal USTs in 1Q22 after outperforming as markets extrapolated recent high monthly CPI prints.
Europe	Inflation has peaked in the eurozone but is expected to fall back only gradually at first. Volatility in natural gas prices remains high and could keep inflation elevated this quarter.	–	We have a modest unfavorable view toward eurozone index-linked bonds, whilst remaining negative on nominals bunds as the ECB responds to higher inflation via scaling back asset purchases.
Japan	We believe that inflation-linked JGBs remain undervalued as about 0.5% of 10-year BEI is way below 2% of the BoJ's inflation target as well as 1% of our core CPI forecast this year. The balance between issuances and buybacks continues to be supportive. Inflation-linked JGBs total JPY200 billion, while buybacks total JPY240 billion on a quarterly basis.	+	We maintain a favorable view towards Japanese real yields against nominal yields.
Municipals			
US	Municipal credit will continue to be supported by favorable fundamentals following strong revenue collections and robust direct federal aid measures that will continue to be distributed in 2022. However, we believe incremental caution is warranted at current spread levels, which have retraced pre-pandemic levels to near-record tights.	+/–	We maintain a favorable view towards key higher-beta revenue sectors that would continue to benefit from an ongoing economic recovery.
Emerging Market (EM) Debt			
EM Sovereigns (USD)	The unevenness of the post-pandemic recovery across regions and countries has led to a greater emphasis on idiosyncratic risks. The need to differentiate long-term credit themes across countries is of paramount importance. This contrasts with a uniformly dominant theme in favor of high-grade spread duration last year, reflecting synchronized economic contractions in 2020.	+/–	We continue to believe IG- and crossover-rated EM sovereigns are attractive from a carry standpoint, while vigilance is warranted on lower-rated countries given the pandemic's impact on sovereign credit quality.
EM Local Currency	The global growth recovery provides a supportive cyclical backdrop for EM countries going into 2022, balanced with risks from global central bank tightening. Inflation concerns continue to be a dominant theme for central banks, while government plans for post-pandemic fiscal consolidation will be under scrutiny.	+/–	We continue to maintain an opportunistic and differentiated approach to EM currencies amid US Fed taper concerns. By region, Asia stands to benefit given a resumption of global trade, while the currencies of weaker countries could be vulnerable to market swings.
EM Corporates	EM corporates continue to maintain discipline with lower leverage and conservative financial policies despite loosening DM credit standards. We believe that near-term risks to EM corporates will generally emanate from sovereign dynamics rather than traditional balance sheet considerations.	+	We believe EM primary issuance priced at a concession to secondary and DM levels offers attractive relative value, while we continue to watch for more dislocated pockets of value in HY-rated corporate issuers.

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."

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.

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

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

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

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.

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.

The ECB's **Asset Purchase Programme (APP)** is part of a package of non-standard monetary policy measures that also includes targeted longer-term refinancing operations, to support the monetary policy transmission mechanism and provide the amount of policy accommodation needed to ensure price stability.

Pandemic emergency purchase programme (PEPP) is a non-standard monetary policy measure initiated in March 2020 by the European Central Bank to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by the COVID-19 outbreak.

In July 2020, the European Council agreed to a massive recovery fund of 750 billion € branded **Next Generation EU (NGEU)** in order to support member states hit by the COVID-19 pandemic.

Safe havens are sought by investors to limit their exposure to losses in the event of market downturns.

Supranational refers to debt of international organizations or unions such as the World Bank, the International Monetary Fund, Eurozone, regional multilateral development banks, etc. European Stability Mechanism.

Semi-government bonds are bonds issued by the various state and territory governments.

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

A **fiscal cliff** is a situation in which sudden changes in government spending and tax have a big and sudden effect on a country's economy.

A **share buyback** is a decision by a company to buy back its own shares from the marketplace.

A **debt tender** offer is when a company retires all or a portion of its outstanding bonds or other debt securities.

Mezzanine financing is a capital resource that sits between (less risky) senior debt and (higher risk) equity that has both debt and equity features.

The **reserve ratio** is the portion of reservable liabilities that commercial banks must hold onto, rather than lend out or invest.

WHAT ARE THE RISKS?

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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