2Q 2021

Investment Highlights

Western Asset Structured Opportunities Sector

WESTERN ASSET

Key Takeaways

- *The COVID-19 pandemic fears have turned into reopening optimism. However, structured credit spreads remain at wider levels relative to pre-Covid, in spite of strong consumer and US housing fundamentals.*
- *While the commercial sector remains further behind in terms of recovery for certain property types hit hardest by the pandemic such as hotels and retail, the reopening of economies—supported by the release of multiple effective Covid vaccines—should be a positive catalyst for commercial non-agency mortgage spreads to continue recovering.*
- *The combination of improving fundamentals with depressed valuations suggests significant potential for the asset class to generate strong performance.*

Market Review

The US economic data surprised in both directions over the quarter with the employment data coming in surprisingly weak. Only 266,000 jobs were added in April compared to expectations of approximately 1,000,000. This was followed by a slightly better but still disappointing 550,000 jobs added in May.

The inflation data, on the other hand, has been surprisingly strong. Two successive months of above-consensus prints have taken core Consumer Price Index (CPI) inflation to 3.8% year-over-year (YoY), its highest level in nearly 30 years. However, the vast majority of recent monthly gains have come from reopening activity, specifically hotel and airfare prices, as well as surging used car prices. In addition to monthly price gains from reopening activity, one of the main reasons for the large YoY increases in inflation readings has been due to base effects as the 12-month growth rates key off severely depressed year-ago levels.

The June Federal Open Market Committee (FOMC) forecast for core Personal Consumption Expenditures (PCE) inflation in 2021 increased to 3.0% (up from 2.2% in March). The median FOMC member also pulled forward their forecast for the first rate hike, so that now the median participant expects two hikes in 2023 (in March the median FOMC member forecast that the first rate hike wouldn't come until 2024). While forecasted rate hikes were pulled forward the taper timeline was not moved up. Instead, Federal Reserve (Fed) Chair Jerome Powell cautioned that any decision on the balance sheet was "still a ways off."

Spreads for corporate credit and structured products over the quarter generally tightened. The S&P 500 rose 8.2% and the 10-year US Treasury yield ended at 1.45% (from 1.74% in March). WTI oil rose $14/barrel (+24%) to $73.47 and the US dollar was mixed but generally weakened versus most developed market (DM) and emerging market (EM) currencies.

Outlook

The COVID-19 pandemic fears have turned into reopening optimism. However, credit spreads remain at wider levels relative to pre-Covid, in spite of strong consumer and US housing fundamentals. Fueling the housing boom of the post-Covid world are historically low mortgage rates, a dismal lack of supply on the market, marginally easing lending conditions, and a rebirth of household formations. Consumer fundamentals have improved post-Covid with increased savings rates, revolving consumer credit outstanding YoY and lower interest rates have decreased debt burden levels to the lowest in 20 years. While the commercial sector remains further behind in terms of recovery for certain property types hit hardest by the pandemic such as hotels and retail, the reopening of economies supported by the release of multiple effective Covid vaccines should be a positive catalyst for commercial non-agency mortgage spreads to continue recovering. We believe single-asset, single-borrow (SASB) non-agency mortgages secured by high quality commercial properties with strong equity sponsors will benefit as Covid restrictions begin to lift and the economy moves toward a full reopening offering. The combination of improving fundamentals with depressed valuations suggests potential for the asset class to generate strong performance. We believe the largest dislocated opportunities are in residential and commercial mortgage credit, which are sectors that have not received the benefit of a Fed backstop and have lagged other credit sectors in the rebound since March. In corporate credit, the Fed's purchase programs included significant support for investment-grade-rated securities (down to BBB rated securities) and even fallen angel credits in the high-yield segment. Within mortgage and consumer credit markets, only AAA rated conduit CMBS and new-issue AAA rated ABS have been supported by the Fed, which has resulted in full recovery of spread widening in these subsectors. The team believes mortgage credit offers value backed by real assets that benefit from a rising inflation environment and can generate attractive risk-adjusted returns.

Risk Disclosures

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.

High-yield bonds possess greater price volatility, illiquidity and possibility of default.

Investment-grade bonds are generally rated BBB and above.

Spread refers to the difference between Treasury securities and non-Treasury securities of similar maturity but different credit quality.

Credit quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. The credit ratings discussed are based on a security's rating as provided by Standard and Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd., and they typically range from AAA (highest) to D (lowest), or an equivalent and/or similar rating. These ratings are updated monthly and may change over time. Investment-grade bonds are bonds that are rated Aaa, Aa, A and Baa by Moody's Investors Service and AAA, AA, A and BBB by Standard & Poor's Ratings Service, or that have an equivalent rating by a nationally recognized statistical rating organization or are determined by the manager to be of equivalent quality. A below-investment-grade bond or high-yield security has a rating of BB or lower; it pays a higher yield to compensate for its greater risk.

Gross domestic product (GDP) is an economic statistic that measures the market value of all final goods and services produced within a country in a given period of time.

U.S. Treasuries are direct debt obligations issued by the U.S. government and backed by its "full faith and credit." The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity.

The Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Bond Index is a component of the U.S. Corporate High-Yield Bond Index, which covers the universe of fixed-rate, non-investment-grade corporate debt of issuers in non-emerging market countries. It is not market capitalization-weighted; each issuer is capped at 2% of the index.

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