

# Western Asset Structured Opportunities Sector

## Key Takeaways

- *UST bond yields rose over the quarter as global central banks, including the Fed, emphasized that rate cuts were conditional on greater confidence that inflation was approaching target.*
- *Consumer fundamentals remain strong and stress has been manageable, but we are still watchful of credit deterioration and lean toward higher quality consumer sectors, established sponsors and sectors with positive tailwinds.*
- *The largest dislocated opportunities we see are in residential and commercial mortgage credit where spreads are implying a significant deterioration in collateral performance that we believe is overly pessimistic.*

## Market Review

During the first quarter of 2024, US Treasury (UST) bond yields rose as global central banks, including the Federal Reserve (Fed), emphasized that rate cuts were conditional on greater confidence that inflation was approaching target. Broad signs of economic resilience supported risk assets with credit spreads tightening and the S&P 500 notching fresh record highs as the quarter progressed.

In the US, inflation data generally exceeded expectations, while jobs data showed tentative signs of moderation. The latest monthly nonfarm payrolls added 275,000 jobs, above consensus expectations, but downside revisions to the prior two months removed a combined 167,000 jobs and the unemployment rate ticked higher from 3.7% to 3.9%. Inflation data appeared to show that the pace of disinflation has slowed even as the year-over-year (YoY) inflation rate continues to improve compared to prior quarters. Headline and core Consumer Price Index (CPI) increased the most in months, mainly due to higher core service prices. Core CPI rose above consensus expectations for two consecutive months, bringing the YoY rate to 3.8%, slightly lower than 3.9% at the end of the fourth quarter. The Fed's preferred measure of inflation, the core Personal Consumption Expenditures (PCE) price index, ended the quarter rising 2.8% YoY, lower than 2.9% at the end of last year and the slowest annual rate since March 2021.

As expected, the Federal Open Market Committee (FOMC) kept the fed funds target rate range at 5.25% to 5.50% in the January and March meetings. The March FOMC post-meeting statement reinforced a message communicated in January that the committee doesn't expect to cut rates "until it has gained greater confidence that inflation is moving sustainably toward 2%." The updated Summary of Economic Projections showed that the median FOMC member still expects to reduce the fed funds rate by 75 basis points (bps) in 2024; however, the median year-end fed funds rate forecast for 2025 was raised to 3.9% from 3.6%. The median forecast for

the long-term fed funds rate was raised to 2.6% from 2.5%. Other 2024 economic projections also showed upward revisions with projections for core PCE and real GDP growth rising from 2.4% to 2.6% and from 1.4% to 2.1%, respectively. By the end of the quarter, fed fund futures contracts were pricing in two to three 25-bp rate cuts during 2024, with the first coming in July.

Outside of the US, the European Central Bank (ECB) maintained the deposit rate at 4.00%, but in the March meeting, ECB President Christine Lagarde mentioned that a June cut could be possible. The Bank of England (BoE) kept the Bank Rate at 5.25%, but indicated that "monetary policy could remain restrictive even if Bank Rate were to be reduced," suggesting that it is no longer opposed to rate cuts. The Swiss National Bank (SNB) surprised markets in March by becoming the first developed market (DM) central bank to cut interest rates, taking its monetary policy rate from 2.00% to 1.75%, citing prices had stabilized. Finally, in a long-awaited move, the Bank of Japan (BoJ) ended its unconventional interest rate policy by removing its yield curve control target and lifting the overnight policy rate to 0.0%-0.10%. The BoJ also ended its commitment to expanding quantitative easing.

During the quarter, corporate credit and structured product spreads generally tightened. Emerging market (EM) local yields in aggregate rose and hard currency EM bond spreads tightened. The S&P 500 Index rose 10.2% while WTI oil rose approximately 16% to around \$83/barrel. The US dollar appreciated versus most DM currencies but was mixed versus EM currencies. Over the month, UST yields rose; the 2s-10s portion of the yield curve bear-flattened from -35 bps to -39 bps, while the 5s-30s segment bear-flattened from +19 bps to +13 bps. Two-year UST yields rose from 4.23% to 4.59%, 5-year yields rose from 3.84% to 4.21%, 10-year yields rose from 3.88% to 4.20% and 30-year yields rose from 4.03% to 4.34%.

### Investment Outlook

Global growth has downshifted and inflation rates worldwide are generally receding. Deflationary pressures in China, tightening financial conditions in the US and Europe, and subdued demand for manufacturing and services across a number of countries are easing price pressures globally. These trends, coupled with the major central banks promoting a measured and gradual approach to easing monetary policy, are expected to further dampen economic growth and inflation, which, in turn, should lead to lower DM government bond yields and a modestly weaker US dollar. That stated, concerns over monetary policy missteps, inflation rates stabilizing above central banks targets, stronger-than-expected growth in the US and increased UST supply to cover a growing fiscal deficit are all phenomena that may lead to periods of heightened market volatility. Spread sectors such as EM, high-yield, bank loans and select areas of the MBS space offer attractive yield, but we acknowledge their vulnerability to unanticipated shifts in macro-related sentiment, geopolitical developments and the ongoing uncertainty over monetary policy rate trajectories.

The aftershocks of the Covid experience have been uneven across parts of the economy, geographically, across demographics, and among different asset classes with certain segments of the economy operating well above and others well below the pre-Covid economy. Additionally, geopolitical risks have arisen, broad-based inflationary pressures have persisted, and the Fed's policy accommodation has been actively reduced, significantly tightening financial conditions. Caught in the crosshairs of this uncertain backdrop, the mortgage and consumer credit spreads and yields have repriced significantly and are well wide of the levels we saw pre-Covid and in December 2018, the last time the Fed hiked the US economy into an economic slowdown.

The recent back-up in mortgage rates in conjunction with sticky inflation has kept pressure on housing affordability in the US. In the near-term, home prices on a national level are expected to remain constrained as they move toward long-run average increases of 3%-5% yearly. Regionally, however, increasing variations in home price performance as well as inventory levels are likely to persist. While real estate is presented with various challenges due to broad economic uncertainty, we do not see a significant risk of defaults in the broad residential market. Credit standards have remained high during this cycle and we do not see the risk of higher rates hitting borrowers who already locked in ultra-low mortgage rates.

The commercial mortgage market has also been particularly volatile during the Covid cycle with previously stable properties like such as offices undergoing significant downward pressure, while multifamily housing, industrial, hospitality and retail sectors have all recovered to and, in many cases, outperformed their pre-Covid revenues and in large part rents have been able to keep up with higher rates and inflation. The office market faces a highly uncertain future with significant questions about the long-term viability of lower quality properties. The ferocious recent catch-up rally across the capital structure leaves AAA bonds fairly priced and no longer cheap to credit sector relative comparables. However, spreads remain wide across mezzanine and subordinate bonds. CMBS is one of the few active CRE financing markets and capital is being deployed to take advantage of the cyclical opportunity. Low leverage exposures on high-quality real estate with meaningful borrower equity present compelling opportunities to lend in both the conduit and single-asset/single-borrower (SASB) market, but prudent credit selection is warranted. New origination screens particularly attractive on a yield versus credit risk basis; however, some high-quality seasoned credits may offer outsized total return opportunities.

Consumer fundamentals remain strong, and stress has been manageable. We are still watchful of credit deterioration and lean toward higher quality consumer sectors, established sponsors and sectors with positive tailwinds. Strong investor demand has led to tighter spreads and a flatter credit and term curve across benchmark sectors and issuers. Off-the-run sectors and issuers across higher credit quality consumer and commercial ABS sectors can provide attractive risk/reward relative to investment-grade corporates. Bank selling may result in opportunities in the form of risk transfer or outright portfolio sales in the auto sector.

In several parts of the mortgage and consumer credit market, we see a combination of strong fundamentals with attractive income and valuations, which suggests significant potential for the asset class to generate strong performance over the long-term. The largest dislocated opportunities are in residential and commercial mortgage credit where spreads are implying a significant deterioration in collateral performance that we believe is overly pessimistic. The team believes attractive valuations in mortgage credit offers value and the sector can generate attractive risk-adjusted returns, and that the strong total return potential and diversification benefits will provide value to investors.

## Risk Disclosures

All investments involve risks, including 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 and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. Asset-backed, mortgage-backed or mortgage-related securities are subject to prepayment and extension risks. High yield bonds are subject to greater price volatility, liquidity, and possibility of default.

The **Bloomberg U.S. Mortgage-Backed Securities (MBS) Index** tracks the performance of fixed-rate agency mortgage-backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC).

**Core Personal Consumption Expenditures (PCE)** refers to the PCE Price Index excluding food and energy. The core PCE price index is closely watched by the Federal Reserve as it conducts monetary policy.

**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.

**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.

**Summary of Economic Projections (SEP)** is released by the Federal Reserve four times a year. SEP features the Federal Open Market Committee (FOMC) participants' projections for GDP growth, the unemployment rate, inflation and the appropriate policy interest rate.

**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.

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