

# The Big Picture

Western Asset's latest insights on economic drivers and credit markets for fixed-income investors

## 4Q24 HIGHLIGHTS

- In the US, the economy should continue to expand near trend well into 2025 as housing and consumer demand will be modestly helped by the recent decline in borrowing costs. We believe US bond yields remain high relative to pre-pandemic growth and inflation rates.
- In Europe, we see fiscal retrenchment next year as a further headwind to growth; we maintain our overweight duration via both nominal and real yields.
- In the UK, we think that the market's terminal Bank Rate expectation still stands too high; we expect UK gilts to provide positive returns.
- In China, recent stimulus measures will help to temper cyclical headwinds, but structural balances will persist without deeper reforms.

## OVERVIEW

Our base case calls for further weakening of global growth and further declines in inflation with a greater emphasis on services disinflation. Goods price inflation is running modestly below pre-pandemic levels, but with ongoing deflationary pressures from Asia, it's hard to see a meaningful persistent uptick going forward. Services inflation remains elevated, but wage pressures are abating as job markets soften and service sector demand is slowing. Headline inflation is close to target in most advanced economies, which has allowed central banks to reduce policy rates as their inflation concerns lessen while growth concerns rise. Growth is slowing in the US and remains moribund in the rest of the world. At the same time lower policy rates and the recent Chinese stimulus package should lessen recessionary fears. We remain overweight to interest-rate duration, but less so as rates have fallen, and markets have moved closer to our base case. Spread sectors have performed well and we expect this to continue if the downward growth trajectory remains gentle and services disinflation continues. However, valuations have less yield advantage now to offset potential macro and political risks going forward. Emerging market (EM) debt appears to remain attractive fundamentally, but both internal and external political risks have hampered performance in some countries.



**Michael Buchanan**

Chief Investment Officer

**“Our base case is materializing as we see global growth moderating and inflation declining further, particularly in services. Central banks are reducing policy rates as inflation worries diminish and growth concerns rise. While the US economy remains resilient, we anticipate a gentle downward growth trajectory. This environment supports our overweight to interest-rate duration and positive outlook on spread sectors, though we remain vigilant of potential macro and political risks.”**





## Gordon S. Brown

Head of Global Portfolios

**“Divergent global economic conditions are evolving across regions through 2025. The US expects continued expansion, Europe faces headwinds and UK growth remains subdued. Asia sees Japan’s further policy tightening and China’s stimulus, while EM presents selective opportunities. This diverse picture necessitates a nuanced, region-specific approach to fixed-income investing.”**

### KEY DRIVERS AND RELATIVE VALUE BY REGION

#### US: Soft Landing on Track

**+** Despite a decline in job growth and income gains, the US economy should continue to expand near trend well into 2025 buoyed by housing and consumer demand. Monthly core inflation should run near Federal Reserve (Fed) target levels, helped by modest goods deflation and declining shelter and services inflation. US bond yields remain high relative to pre-pandemic growth and inflation.



#### EUROPE: Lacklustre Growth with Inflation at Target

**+** We expect the European Central Bank (ECB) to deliver two more cuts this year. Headline inflation fell back to target, but services remain elevated. We expect services inflation to soften more meaningfully in 1H25. Growth remains lacklustre with recent pickup in sentiment now waning. Fiscal retrenchment next year is a headwind. We maintain our overweight duration via both nominal and real yields.



#### UK: Rate Further Removing of Policy Restraint Remains Appropriate

**+** The UK growth outlook remains subdued while inflation returned to the 2% target earlier this year and the Bank of England delivered its first policy rate cut. Further cuts are anticipated as concerns over wage growth and price pressures ease further. However, we think that the market’s terminal Bank Rate expectation still stands too high. We expect UK gilts to provide positive returns.



#### CANADA: Data Tug of War Continues

**+** With inflation near target, the Bank of Canada can increase the 25 bp rate cut pace they’ve maintained since June. Slack in the economy appears substantial, though the decline in mortgage rates may drive already expensive residential real estate costs higher. Remaining concerns over housing and wage gains might hinder even more policy accommodation.



#### AUSTRALIA: Higher for a Little Longer

**+** Progress on inflation remains slow, but there are signs of progress with the labour market loosening and wages growth rolling over. The RBA remains hawkish to encourage restraint, but we expect the conditions to allow them to start a shallow easing cycle in early 2025. Growth is slow, but tax cuts from mid-year will help to rebuild buffers.



#### JAPAN: Higher Rates Ahead

**+/-** We expect Japan’s economy to grow at an annualized rate of 1.5% to 2.0% in 2H24, and that inflation will remain above 2%. As such, we expect the Bank of Japan to raise policy rates at a cautious pace while reducing government bond purchases. This should result in higher Japanese government bond yields and curve flattening.



#### CHINA: Cyclical Shift, Structural Challenges Persist

**+/-** Recent measures by the Chinese government signal an attempt to revive investor sentiment and consumer confidence. There is, however, no shift from the structural goals of deleveraging local governments and de-risking the property sector. Deflationary pressures persist and confidence is weak, but for now it does appear that cyclical headwinds have abated.



#### MEXICO: Key Milestones on the Horizon

**+** Claudia Sheinbaum assumes office after her presidential victory in the wake of higher budget deficits and controversial judiciary reforms enacted by AMLO. With the US election and Mexico’s budget data forthcoming, we are biased toward local rates versus foreign exchange (FX) as Banxico will likely accelerate the rate-cutting cycle in the context of an easing Fed and disinflationary trends.



#### INDIA: Full Steam Ahead

**+** A strong economic story supported by robust foreign direct investment flows (on increasing friendshoring benefits) and significant FX reserves in the top five globally. Local bonds are expected to outperform given attractive carry relative to peers and strong technical tailwinds associated with EM bond index inclusion.



#### BRAZIL: Climbing the Ladder

**+** Moody’s recently upgraded Brazil’s sovereign debt rating to Ba1 with a positive outlook. Meanwhile, the central bank bucked broader trends and raised benchmark interest rates to quash rising inflation expectations and concerns over Brazilian fiscal dynamics. This should keep the Brazilian real anchored and encourage carry trades.





## Greg E. Handler

Head of Mortgage and  
Consumer Credit

**“Agency MBS offers attractive spread valuations with low pre-payment risk. In non-agency markets, easing mortgage rates are alleviating housing affordability pressures. We see opportunities in high-quality CMBS with robust structural protections, while remaining vigilant toward consumer credit in select ABS sectors.”**

### SECTOR THEMES

#### Investment-Grade (IG) Corporate Credit

In the US, IG credit valuations may appear stretched from a historical perspective, but they are pricing in a soft landing and reflect resilient underlying fundamentals along with confidence in management teams that are by and large exercising balance sheet discipline and defensive behavior. Meanwhile, the technical backdrop remains supportive as demand remains robust from yield-based buyers even as supply has surprised to the upside.

+/-

In Europe, IG fundamentals are more challenged in some sectors, such as the automobile sector, but bank balance sheets remain strong. Inflows also remain strong and have been met with high levels of issuance. Spreads continue to look relatively tight, but we see value in European banks and real estate issuers.

+/-

In Australia, fundamentals remain sound despite the economy slowing due to defensive positioning. We maintain an overweight in credit, particularly within short-dated holdings, with a preference for select REITs and utility/infrastructure assets that have regulated resets. We also favor senior unsecured major bank and foreign national champion bank issuance.

+

#### High-Yield (HY) Corporate Credit

In the US, HY credit spreads reflect balance sheet strength, the prudent behavior of management teams and supportive demand for higher-yielding securities relative to supply. We continue to see some opportunities in service-related sectors that are still recovering from pandemic-era recession (i.e., reopening trades, including cruise lines and lodging), energy (E&P), and potential rising stars. We are more cautious on consumer products, retailers and home construction.

+

In Europe, credit fundamentals remain resilient. Issuers have continued to focus on terming out debt maturities, so net supply remains muted. Spreads are close to their tight for the year; as a result, the near-term return potential is more income-focused. We remain selective with a BB/B rating bias, favoring telecom/cable, consumer and transportation issuers.

+

#### Bank Loans

Bank loan spreads appear relatively attractive. We continue to expect a stable carry profile for BB loans with strong underlying credit quality and remain selective in single B loans for total return potential, as lower interest rates may have a more impactful reduction on their interest expense burden. We remain cautious on certain industries such as chemicals and communications, and we are finding higher-quality CLO tranche investments to be attractive.

+

#### Collateralized Loan Obligations (CLOs)

We see more opportunity in AAA, BBB and select BB rated CLO debt tranches invested in broadly syndicated bank loans (BSLs). We believe that AAAs and BBBs should continue to perform well in either bullish or bearish bank-loan-spread environments, given strong structural protections.

+

#### Mortgage and Consumer Credit

Agency mortgage-backed securities (MBS) offer attractive spread valuations with low prepayment risk. We favor 30- and 20-year over 15-year MBS, higher coupons and non-benchmark sectors, focusing on security selection to enhance yield and convexity profiles.

+

In non-agency residential MBS (NARMBS), the continued relief in mortgage rates in conjunction with easing inflation is expected to alleviate pressure on US housing affordability. Home prices on a national level are expected to remain constrained as they move toward long-run average annual increases of 3%-5%. We are opportunistic on credit risk transfer (CRT) securities as well as non-qualified-mortgage deals.

+

In non-agency commercial MBS (CMBS), the market has reopened with tight underwriting and year-to-date issuance volume on pace with the 2013-2020 average. Valuations have bottomed out and capital is being deployed to take advantage of the reset basis in both debt and equity markets. High-quality underwriting with low leverage, strong cash flow and robust structural protections are prevalent across the new-issue market, thereby providing support for new origination credit risk with high current yields while discount priced seasoned bonds offer intriguing total return opportunities.

+

While consumer fundamentals are generally strong, we are vigilant toward further credit deterioration. We tend to be opportunistic on higher credit quality consumer sectors and select esoteric asset-backed securities (ABS) sectors, with a preference for sectors that benefit from positive tailwinds and deals with robust structural features.

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**SECTOR THEMES** *continued*

**Inflation-Linked**

US Treasury inflation-protected securities (TIPS) real yields remain attractive at near-two-decade highs, and breakeven inflation (BEI) levels are near Fed targets throughout the yield curve. TIPS should outperform cash on a total return basis but may struggle to find support versus nominals as inflation continues to trend down. BEIs have ticked up recently but are still close to fair value versus nominal US Treasuries (USTs) and could be attractive as a diversifier within US bond portfolios.	+
European inflation expectations (via 5-year swaps) have averaged around 2.05% so far in 2024, which is consistent with the ECB achieving its inflation mandate. Inflation expectations fell quite sharply in 3Q24 with falling energy prices. We preferred adding US exposure, which exhibits great energy sensitivity.	+
In Japan, the consumer price index (CPI) remains above 2% and wage growth is gaining momentum. We maintain an overweight to Japanese real yields versus nominal yields as the current BEI rate is still below 2%.	+

**Municipals**

Fundamentals are likely to remain resilient due to strong labor conditions that support tax collections and elevated cash balances. We anticipate that supply and demand technicals will also be supportive, considering the potential for supply to decline into the election cycle, and potentially increasing demand due to attractive relative valuations and declining cash yields on continued Fed easing.	+
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**Emerging Market (EM) Debt**

We believe that frontier market sovereigns continue to represent a compelling carry and total return opportunity, given still-wide valuations and key idiosyncratic credit stories. IG-rated EM sovereigns remain tight and can be considered a source of cash for trades with better relative value across EM and other sectors.	+
Ongoing disinflation and the start to the Fed cutting cycle have allowed for a weaker US dollar environment that has benefited EM FX. Given high real yields, we currently favor Latin American local rates, while Asian local currency bonds appear unattractive given historically low yields relative to USTs. We are monitoring US growth exceptionalism and the post-election trade friction as risks to EM FX going forward.	+/-
EM corporates continue to maintain strong balance sheets, especially compared to their developed market (DM) peers. But with sector spreads at historically tight levels, we are seeking value in the primary market and in shorter-dated HY corporates.	+/-

**Michael T. Borowski**

Head of US Corporate  
Credit Research



**“Our research indicates selective opportunities in top-quality global banks, energy companies with strong balance sheets and the gaming sector, particularly in Asia. We continue to find metals & mining attractive, maintaining an overweight position with a preference for copper producers. However, we exercise caution with food & beverage and retail sectors due to margin pressures and declining consumer spending.”**

**INDUSTRY THEMES**

Industry	Key Observations
Auto & Related	We favor a neutral sector positioning with a bias toward US auto manufacturers. The US automakers are stronger and more pragmatic about EV market prospects and profitability. In Europe, several legacy OEMs and Tier 1 suppliers have highlighted fundamental challenges that we believe will take time to play out.
Banks	We are maintaining a large overweight to top-quality global banks due to their history of resilient performance. These banks have lower risk profiles due to stringent regulations, heightened oversight and improved risk management following the global financial crisis.
Energy	We remain constructive yet selective on this sector given balance sheet strength and strong liquidity. Demand remains resilient, and the oil market is increasingly supply-driven. The industry continues to embrace M&A activity in a conservative manner while remaining restrained on organic capital investment.
Food & Beverage	We remain underweight due to rich valuations given modest sales growth and limited pricing power. Additionally, food & beverage companies are facing rising labor and input costs that are pressuring margins and free cash flow.

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**INDUSTRY THEMES** *continued*

Gaming	The US gaming sector's fundamentals remain intact, and we expect flat to modest growth trends to persist throughout the balance of this year and throughout FYE 2025. Outside the US, we continue to believe in the long-term growth story in Singapore and Macau with a preference for the latter.
Health Care	We are bearish on IG health care due to the cyclical and secular decline in credit quality, rich valuations and negative event risks.
Metals & Mining	We continue to favor the sector with a bias toward copper producers. All eyes remain on China with particular focus on its economic policy, reform agendas and subsequent execution, given its stance as the largest consumer of commodities.
Pharmaceuticals	We are bearish on IG pharmaceuticals on continued sector headwinds. Lower-rated specialty pharmaceuticals are expected to pursue aggressive liability management this year.
Retailing	We are bearish as discretionary spending continues to wane driven by budget constrained consumers. Elevated inflation has also diminished the purchasing power of certain segments of the population, although lower interest rates should be a tailwind for consumer spending.
Telecommunications & Media	Our view remains fundamentally constructive, despite the maturing market and increased competitive intensity, as the leading operators continue to grow free cash flow and remain focused on the balance sheet. We remain selective within media given the secular shift from linear TV to streaming.
Transportation	We continue to favor a focus on airlines as they reap continued benefits from consumers prioritizing experiences over items. Volatile fuel prices have been a headwind, but the large legacy airlines have decent pricing power and the ability to pass along higher fuel prices with a minimal amount of lag time.
Utilities	We remain focused on first mortgage bonds and transmission & distribution assets. The industry continues to generate material negative free cash flow with large and growing capital budgets. The regulatory environment and ability to recover costs remains key to company assessments.

**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.”

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.

**Break-even inflation** is the difference between the nominal yield on a fixed-rate investment and the real yield (fixed spread) on an inflation-linked investment of similar maturity and credit quality. If inflation averages more than the break-even, the inflation-linked investment will outperform the fixed-rate. Conversely, if inflation averages below the break-even, the fixed-rate will outperform the inflation-linked.

**Broadly syndicated loans** are also known as leveraged loans.

**Carry** refers to a differential in interest rates across sectors, such that tactical profits could be generated by trading between them.

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

Pioneered by Freddie Mac in 2013, **credit risk transfer (CRT)** programs structure mortgage credit risk into securities and (re)insurance offerings, transferring credit risk exposure from US taxpayers to private capital.

**Developed markets (DM)** refers to countries that have sound, well-established economies and are therefore thought to offer safer, more stable investment opportunities than developing markets.

**Emerging markets (EM)** are nations with social or business activity in the process of rapid growth and industrialization. These nations are sometimes also referred to as developing or less developed countries.

A **foreign exchange (FX)** derivative refers to a financial instrument that locks in a future foreign exchange rate.

**Frontier nations** are countries with investable stock markets that are less established than those in the emerging markets.

**High yield**, or below-investment grade bonds are those with a credit quality rating of BB or below.

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

**Agency mortgage-backed securities (MBS)** are asset-backed securities secured by a mortgage or collection of mortgages issued by federal agencies like Fannie Mae, Freddie Mac and Ginnie Mae.

The **Organization of the Petroleum Exporting Countries (OPEC)** is a permanent intergovernmental organization of 13 oil-exporting developing nations that coordinates and unifies the petroleum policies of its member countries.

**Residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS)** are forms of asset-backed securities, holding pools of residential or commercial mortgages (respectively) used as collateral for the securities.

**Single-Asset, Single-Borrower (SASB) CMBS** refers to a type of commercial mortgage-backed security that is collateralized by a single commercial property loan.

A **spread** is the difference in yield between two different types of fixed income securities with similar maturities; usually between a Treasury or sovereign security and a non-Treasury or non-sovereign security.

**US Treasury inflation protected securities (TIPS)** are a special type of Treasury note or bond that offers protection from inflation. Like other Treasuries, an inflation-indexed security pays interest six months and pays the principal when the security matures. The difference is that the coupon payments **yield curve** shows the relationship between yields and maturity dates for a similar class of bonds.

## WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Please note that an investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges. Past performance is no guarantee of future results.

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.

Derivative instruments can be illiquid, may disproportionately increase losses, and have a potentially large impact on performance. Liquidity risk exists when securities or other investments become more difficult to sell, or are unable to be sold, at the price at which they have been valued.

Low-rated, high-yield bonds are subject to greater price volatility, illiquidity and possibility of default.

Commodities and currencies contain heightened risk that include market, political, regulatory, and natural conditions and may not be suitable for all investors.

U.S. Treasuries are direct debt obligations issued and backed by the "full faith and credit" of the U.S. government. The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity. Unlike U.S. Treasuries, debt securities issued by the federal agencies and instrumentalities and related investments may or may not be backed by the full faith and credit of the U.S. government. Even when the U.S. government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.

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