



Central Bank Dovishness and Good Fundamentals Create Opportunity in Spread Sectors in 2020

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by Kenneth Leech
of Western Asset Management

This time last year, the general market consensus called for multiple rate hikes and a continuation of monetary policy tightening. But at Western Asset, we weren't so sure of that in light of our view that both growth and inflation would remain moderate. Then, in July, the Federal Reserve (Fed) surprised markets with a significant pivot when it announced what would be the first of three consecutive rate cuts. This helped to propel the bull market that is still charging ahead today.

The Fed's overt focus on inflation outcomes suggests rates will remain "low for long." Given this backdrop and the continued easing by global central banks, we think global growth should improve, spread products should outperform government bonds and, although volatile, emerging markets (EM) should also outperform.

The Fed has moved to directly target inflation, and Fed Chair Jerome Powell has stated that he will stay the course with easy policy until he sees "sustained inflation" above the Fed's 2% target. Central banks around the world also returned to rate cutting in 2019. The European Central Bank (ECB) made a new commitment to lifting inflation and simultaneously downgraded its inflation outlook as ECB President Mario Draghi stepped down.

Global growth slowed in 2019 as trade levels declined along with manufacturing activity; US-China trade tensions were a big part of the problem. US inflation has remained low, even as unemployment has continued to improve to record levels.

Our outlook for the US economy is constructive. The US economy remains solid; this year we expect 2% growth, but inflation will remain tame. We believe that we are in a low-inflation environment, which is likely to persist and implies a low probability of rate hikes this year.

Globally, growth should rise, albeit from a low base, as the downside risks to global growth have receded. Debt loads and challenged demographics in economies around the world continue to be headwinds to global growth.

In Europe, the trajectory of growth appears to be improving; we believe the worst is over. The outcome for Brexit looks to be very positive given the pro-business UK government. In Japan, we think the Bank of Japan is likely to remain accommodative unless inflation were to rise above target for a prolonged period. Finally, the completion of the US-China "phase one" trade deal appears very encouraging. We view it as essentially a truce that has come to fruition and think the resulting reduction in uncertainty should be very positive moving forward.

As we look ahead, central bank policy wins the battles, but the wars are won by the fundamentals, which are the growth and inflation outlook over long periods of time. Our view of investment opportunities by sector include:

- **US credit markets:** offer both attractive yield and size relative to other mature markets and continue to be very attractive to the global investor in search of "safe" yield. Year-to-date, spread sectors have recovered from last year's dramatic selloff.
- **Investment-grade:** Sector and security selection are key at tighter valuations in 2020; we continue to focus on industries that are deleveraging. BBBs were the place to be in 2019 despite downgrade fears; management teams of the largest issuers in 2020 continue to focus on lowering or at least maintaining their leverage levels.
- **High-yield:** Bank loans lagged the broader high-yield rally for most of 2019 leaving upside opportunity and attractive yields for 2020. With a stable fundamental backdrop, we expect default rates to remain benign in high-yield and bank loans this year.
- **Mortgage-Backed Securities (MBS):** Although agency mortgage spreads were pressured by both prepayments and higher volatility, they remain attractive.
- **China:** Healthy domestic demand and robust stimulus is supportive of growth. We expect stimulus measures to remain in place until signs of economic stabilization appear. Policy actions are likely to be enough to mitigate cyclical slowing.
- **Japan:** We expect the economy to grow around 0.5% in 2020 with continuing robust domestic demand and

moderately improving external demand.

- **EM:** Higher yields combined with weak currency presents an attractive buying opportunity.

Geopolitical risk is always present, and we are always cognizant of it. But we choose to look at it with a long-term perspective, weighing the likelihood of whether or not the news of the day could potentially change the fundamental direction of global growth and global inflation. Global demographics are a headwind to growth and a factor that will serve to keep interest rates persistently low.

S. Kenneth Leech is the Chief Investment Officer at Western Asset Management, a subsidiary of Legg Mason. His opinions are not meant to be viewed as investment advice or a solicitation for investment.

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