LEGG MASON
GLOBAL ASSET MANAGEMENT

2019 GLOBAL OUTLOOK December 2018

LEGG MASON WESTERN ASSET 2019 GLOBAL OUTLOOK

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Executive Summary

- We expect global growth to remain positive in 2019, as US growth moderates slightly and Europe and EM economies, buoyed by China and the Asia-Pacific complex, regain their footing.
- In the US, we expect slower growth in 2019 as some of the fortuitous factors recently boosting growth begin to fade.
- The Fed' s renewed focus on contained inflation, risk management and a lack of certainty about equilibrium or neutral rates suggests a more dovish direction moving forward.
- We continue to believe that EM fundamentals remain resilient despite current headwinds. Compared with DMs, the cyclical growth recovery remains intact after challenging years marked by the taper tantrum, collapsing commodity prices and political scandals.
- We believe EM is the most undervalued asset class and would be the biggest beneficiary of any attenuation of global risks.

As 2018 draws to a close, we wanted to offer this high-level summary of our views for the year ahead. This is of course a snapshot of this moment in time wherein we describe some of the most significant matters of interest for fixed-income investors. The "Big Picture" table that begins on page 4 provides an at-a-glance compilation of our current views for major sectors, including a simple dashboard of our sentiment for each sector distilled down to either positive (+) negative (–) or mixed (+/–) along with brief commentary.

In 2019, we expect global growth to remain positive, as US growth moderates slightly and Europe and emerging markets (EM) economies, buoyed by China and the Asia-Pacific complex, regain their footing. We acknowledge that there are risks that may challenge this view, such as a collapse in US-China relations, unexpected Federal Reserve (Fed) rhetoric or policy decisions, an escalation in tensions between Italy and the EU as well as the UK separating from the EU via a "hard Brexit." The market, however, is pricing each of these scenarios for extremely negative outcomes. Below, we provide a summary of the key drivers behind our global outlook, how we are positioned in broad market portfolios and a more detailed description about where we see glimmers of light amidst all of the doom and gloom.

US-China Trade Developments Still in Flux

The US-China trade front has introduced tremendous uncertainty in the global economy. Risk premia have risen substantially, particularly in EM countries. While there is always hope that some definitive resolution in trade can be reached between the two countries, the more salient point now is the reversal of Chinese economic policy that the dispute has engendered. For instance, gone is China's deleveraging campaign from earlier in 2018. Interest-rate cuts, reserve requirement reductions, targeted fiscal spending increases, individual tax-rate cuts and a renewed emphasis on providing credit to the private sector all suggest that slowing Chinese economic growth will reverse over the course of the next several quarters.

That stated, there are wide-ranging views among market participants as to what constitutes a reasonable pace of growth. We would not be surprised if China's GDP growth trajectory moderates to 6.2% and 6.0% in 2019 and 2020, respectively. However, we do not view this as apocalyptic: a 6% expansion today has far greater impact on global GDP than 10% did in the early 2000s. More importantly, our view is that a measured pace of growth with domestic consumption, improvements in information technology and high-end manufacturing is in China's long-term interest. While this is not a bullish scenario, our expectation is that at a minimum it reduces the tail-risk of an extreme China meltdown.

The challenge is to distinguish cyclical factors from secular ones. Within a normal course of a cycle, the pace of economic activity in China will respond to evolving developments, such as capital flight worries and (presently) heightened trade tensions with the US. The question is whether policymakers have sufficient ammunition in their policy toolkit to navigate near-term turbulence. In the context of a command-style economy with capital controls, they have sufficient tools to deploy, as amply depicted by recent efforts in fiscal pump-priming and cuts in reserve requirements.

In the US, we expect slower growth in 2019 as some of the fortuitous factors recently boosting growth begin to fade. While 3%-4% growth (annualized) in some recent quarters has garnered headlines, average growth for all of 2017-2018 was a more modest 2.8%. Given the 2017 tax bill's incentives, one would think capital spending would continue to hum, but recent capital goods data has been spotty. Meanwhile, homebuilding looks to have embarked on a downtrend. If foreign trade and inventories do indeed revert to 2015-2016 trends and either equipment investment or housing sputters, economic growth could drop to the 2.0%-2.25% range. We think the claims of runaway growth are exaggerated and that we will likely see more modest performance in 2019, along with continued low inflation.

The Fed's renewed focus on contained inflation, risk management and a lack of certainty about equilibrium or neutral rates suggests a more dovish direction moving forward. What's more, Fed Chair Jerome Powell just declared in late 2018 that the Fed is very near the neutral range (thought to be a fed funds rate of 2.5%-3.5%). We are optimistic that the new tone will prove helpful, but it is too soon to tell. More importantly, monetary policy has been tightening for two years and fiscal stimulus is waning. We think as the Fed comes to face more seriously a moderating growth and inflation outlook, a pause will be both signalled and warranted.

Bounce-Back in European Growth?

A key driver for our global outlook is our view on European growth prospects. In hindsight, it was the very strong performance of the eurozone economy from mid-2016 to early-2018 that sowed the seeds for the disappointing outcome in 2018. The bar for the eurozone was raised and expectations grew that the strong performance would continue. We would argue that the bulk of this deterioration stems from uncertainty over global trade and by contraction of the German economy in 3Q18, mainly stemming from a large fall in auto production due to new tighter emission tests.

For 2019, we believe eurozone growth will come in around 1.8% (above the trend of 1.25%) and that this will foster further falls in unemployment and a gradual rise in wages and core inflation, allowing the European Central Bank (ECB) to continue down its path toward policy normalization. Recent data shows that eurozone unemployment has breached the level of non-accelerating rate of inflation (NAIRU). Although the level of NAIRU is subjective, anecdotes such as supply backlogs and area-wide labor shortages strongly indicate that the eurozone is facing capacity constraints. This is filtering into wage negotiations, which tend to lead core inflation (especially so when supply constraints are present). Thus, we expect growth to stabilize above trend and core inflation rates to move toward the ECB's target of 1.60% in 2019.

Key risks to our European view are developments happening in Italy and the UK. In Italy, political risks, a weaker growth outlook and medium-term fiscal concerns warrant some flight-to-quality bund premium, but at this juncture we do not think that this has the potential to derail our eurozone growth and inflation outlook. Likewise, ongoing volatility and uncertainty surrounding Brexit negotiations between the UK and the EU represent a substantive risk should "no deal" be forthcoming, but this is not our base case. The low points in the annual range of bund yields in 2016 were related to the initial Brexit vote whereas the low points in 2017 and 2018 were both related to stress in the Italian sovereign; hence these two risks are still key in 2019.

Japan and Australia Moving Sideways

Japan's economy posted a -1.2% GDP contraction in 3Q18, but we believe that this should be transitory as the contraction was likely due to a series of natural disasters, including the severe floods in the western part of Japan and the earthquake in Hokkaido. We believe the economy will continue to grow above potential until 4Q19 when the consumption tax is set to increase from 8% to 10%. Robust capital expenditures and continuing positive investment sentiment and steady growth in exports will also likely drive the economy forward in the coming quarters. Moreover, the administration of Prime Minister Shinzo Abe has started to address demographic challenges with the reform of labor markets including foreign workers in Japan, which should be positive over the longer term.

The greatest downside risk to Japan's economy would be an acceleration in weakening external demand due to increasing trade tension between the US and China. That stated, we believe the Bank of Japan (BoJ) is committed to supporting domestic economic activity via its current monetary policy approach. At this moment, we do not see anything that would push the Japanese economy into a recession.

In Australia, GDP growth was strong through 1H18 and included a stronger contribution from the consumer than many had expected. The domestic residential property sector continues to cool slowly, with the major banks tightening lending standards in response to criticism from the banking royal commission and pressure from financial market regulators. We are very mindful of the contributors and drivers in this market and we think there is a little more softening to come, but we consider expectations for a more significant weakening to be overblown. We expect GDP to moderate a little from the 1H18 level but to remain close to the trend of around 3% for all of 2018, aided by increased government spending on infrastructure projects, solid exports and a slightly weaker Australian dollar. Given the downtrend in unemployment and low wage inflation, we expect the Reserve Bank of Australia (RBA) to remain patient with any future adjustment to the cash rate. Our base case remains for the RBA to keep rates on hold at 1.5% until at least 4Q19.

Emerging Markets Remain a Key Linchpin

Rounding out our global outlook is our assessment of EM. In our view, China is not the single dominant factor driving EM asset prices as of late. Idiosyncratic considerations and other exogenous forces (notably US Treasury yields and geopolitics) have asserted substantial pressure on EM asset prices. Indeed, extreme market pessimism pulled the entire asset class downward in 2018 despite important positives in the sector, such as remarkably subdued inflation and resilient sovereign and corporate balance sheets.

We continue to believe that EM fundamentals remain resilient despite current headwinds. Compared with developed markets (DMs), the cyclical growth recovery remains intact after challenging years marked by the taper tantrum, collapsing commodity prices and political scandals. In aggregate, external debt as a percentage of GDP for EM countries continues to be in relatively better shape than it is for DM countries, which reaffirms our view that most EM economies are now better positioned to absorb exogenous shocks than at any time over the past few years.

Admittedly, recent volatility stemming from a tougher than expected macroeconomic environment year to date (YTD) should not be overlooked. Higher US interest rates, US dollar strength, a perceived growth gap between the US and the rest of the world, and fears of an impending trade war have collided so far this year to provide a challenging backdrop. However, valuations and technicals are likely to be supportive of the asset class over the medium-term. Consider the following statistics: index yield spreads between EM debt and DM debt are near 2008 and 2016 wides; currency levels are 35% lower than just five years ago, and the real yield of EM debt is at a 15-year wide versus the real yield of DM debt. While the path to improving risk sentiment may well still be volatile, we believe EM is the most undervalued asset class and would be the biggest beneficiary of any attenuation of the global risks.

The Big Picture—2019 Outlook

Region/Sector	Outlook

Developed Market Rates	
US	We expect growth in the 2.0%-2.25% range in 2019. We see little evidence that recent tax changes and government spending will materially improve the longer term trajectory for the US economy.
Europe	We view the recent growth weakness as transitory; we expect growth of around 1.8% for 2019. Core eurozone inflation is expected to move higher by the end of 2019 as spare capacity diminishes.
UK	The UK's domestic political situation is muddling its near-term economic outlook. Our best guess on Brexit is that some version of a deal with the EU is still more likely than the alternative outcomes of a "hard Brexit," snap general election with a Labour Party victory or a second referendum.
Japan	We expect the BoJ to maintain its accommodative monetary policy for some time to meet its 2% inflation goal, which is in line with recent forward guidance.
Australia	Our growth expectations remain at 3.0%-3.25%, and our base case is for the RBA to remain on hold until 3Q19 as we expect wage inflation to remain low.
Investment-Grade Corporate Credit	
US	Corporate fundamentals continue to be strong across the majority of sectors and earnings are supportive of credit investing. However, spreads have widened in 2018 on valuation concerns and heightened idiosyncratic risk; further volatility in 2019 cannot be ruled out. Technical drivers such as high primary issuance, mutual fund outflows, waning Asian demand and tighter financial conditions are weighing on sentiment.
Non-US	The technical tailwind is diminishing as the ECB ends its asset purchase program; Italian political risk and Brexit will weigh on investor sentiment.
High-Yield Corporate Credit	
US	Risk premia in high-yield corporate bonds and bank loans continue to widen. While fundamentals remain strong with default rates trending lower, valuations remain, at best, at fair value.
Non-US	Fundamentals remain firm, but we are keeping an eye on rising debt issue leverage and weakening covenant protection; increased earnings dispersion is currently confined to certain sectors.
Bank Loans	
US	LIBOR continues to trend higher; however, the primary market concern in this space is weak lending standards. That stated, demand remains firm from retail investors and CLOs.
Structured Credit	
Agency MBS	Agency mortgages have underperformed US Treasuries YTD; option-adjusted spreads have moved close to the three-year high; the Fed taper and increased volatility are risks to the market, but the prepay environment is benign and spreads are attractive.
Non-Agency Residential MBS (RMBS)	We are constructive on housing fundamentals and expect modest home price growth over the coming years, with limited downside risks as housing appears reasonably valued and supported. Credit underwriting standards are historically high, making the quality of new loan production strong.
Non-agency Commercial MBS (CMBS)	We remain constructive on the CMBS market, due to broadly positive commercial real estate fundamentals and a favorable economic outlook; we expect the fundamental outlook to be uneven across property types and markets.
Asset-Backed Securities (ABS)	We are generally positive on consumer fundamentals as the opportunity set exists in well-protected, off-the-run sectors, which offer attractive risk/return; although spreads have tightened, we think high-quality ABS remains attractive and well-bid.

Inflation-Linked	

US/Europe	The level of breakeven inflation spreads has moved closer to fair value versus actual inflation. Overall, medium-term inflation expectations should remain muted relative to historical levels. Any additional upside would likely require higher core inflation data in the US and the eurozone.
Municipals	
US	We continue to see improving fundamentals in the overall municipal market due to a number of factors, including low unemployment, steady tax revenues and modest budgetary spending proposals; adjusted for ratings, municipal bonds are attractive versus their taxable counterparts for maturities 10 years and greater.
EM Debt	
Emerging Markets	EM fundamentals remain resilient despite recent headwinds: higher US interest rates, US dollar strength and fears of an impending trade war. Additionally, idiosyncratic factors such as access to external funding and monetary policy independence drove performance in Argentina and Turkey, resulting in significant devaluations. From a technical standpoint, emerging markets debt remains underrepresented in global indices despite the rising gravitational force of EM economies. In this regard, the progressive inclusion of sizable markets, notably China and Gulf Cooperation Council countries, will have a salutary effect on investor appetite.

Important Information:
Source: Legg Mason, 8 January 2019. Data as of 31 December 2018, USD.

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