Investment Highlights

Western Asset Structured Opportunities Sector

This is a marketing communication.

Key Takeaways

- *During the first quarter, UST bond yields fell, the yield curve bull-steepened and structured product spreads widened.*
- *Proposed tariffs and other policy changes from the new US administration have created uncertainty and volatility in financial markets.*
- *Mortgage and consumer credit market spreads are elevated from pre-pandemic levels with increased risk premiums.*
- *US growth is likely downshifting, but we see a combination of strong fundamentals with attractive income and valuations coming into this downturn, which suggests a positive outlook for the asset class to generate strong performance over the long-term.*

Market Review

During the first quarter, US Treasury (UST) yields fell and the yield curve bull-steepened during a risk-off period. The S&P 500 Index declined and credit spreads widened. The S&P 500 posted its worst quarterly performance since 2022, and the significant market decline was largely attributed to escalating trade tensions and economic uncertainties.

Diverging signals in the market between "hard data"—quantifiable metrics—and "soft data," which includes surveys and sentiments, persisted throughout the quarter. Hard data (retail sales, durable goods orders and the unemployment rate) suggests that the economy remained resilient. However, several surveys indicated that policy uncertainty was weighing heavily upon consumer and business sentiment, which could lead to slower activity in the coming months. Policy uncertainty remained elevated as the US announced that 25% tariffs on imports from Mexico and Canada (though a one-month reprieve for most goods was announced soon thereafter), an additional 10% tariff on Chinese imports, a 25% tariff on steel and aluminum imports and a 25% tariff on auto imports, would become effective in early April, when reciprocal tariffs were also scheduled to be announced.

In the US, job growth showed an upward trend, with nonfarm payrolls increasing by 151,000 jobs in February, up from a downwardly revised 125,000 jobs in January. The three-month payroll average of 200,000 jobs was above the fourth-quarter average of 182,000 jobs, which included weak numbers in October due to a severe storm and a labor strike. The unemployment rate remained steady at 4.1%. Inflation data was mixed; over the last three months, core Consumer Price Index (CPI) data year-over-year (YoY) declined from 3.30% to 3.10%, while the Core Personal Consumption Expenditures (PCE) Price Index targeted by the Federal Reserve (Fed) remained steady at 2.80%, indicating persistent inflationary pressures.

The Federal Open Market Committee (FOMC) maintained the target range for the fed funds rate at 4.25% to 4.50% at both its January and March meetings. The post-meeting statement in March announced that the monthly pace of UST balance sheet reduction would decrease from $25 billion to $5 billion beginning in April, while the cap on agency debt and agency mortgage-backed securities (MBS) would remain unchanged at $35 billion. During the press conference, Fed Chair Jerome Powell described the economy as "strong overall," but noted that recent policy changes in trade, immigration, fiscal policy and regulatory policy complicate the reliability of near-term forecasts.

In the UK, the Bank of England cut the Bank Rate by 25 basis points (bps) in February to 4.50%. The voting pattern was dovish, with two dissenters voting for a more aggressive cut. Meanwhile, the Bank of Japan hiked policy rates by 25 bps to 0.50% in January, the highest level since 2008. Japanese government bond yields rose during the quarter due to strong growth and inflationary pressures, supported by higher wage growth and a structurally tight labor market, leading the market to anticipate further rate hikes over the coming year. In Germany, following February's election, incoming Chancellor Friedrich Merz announced a significant fiscal plan, including a special €500 billion off-budget infrastructure fund to be spent over 12 years, exempting defense spending above 1% of GDP from the constitutional debt limit, and allowing states to borrow up to 0.35% of GDP. Throughout the quarter, credit spreads widened and emerging market (EM) local yields largely rose. The S&P 500 Index returned -4.59%, and the US dollar weakened versus most EM and developed market (DM) currencies. As noted earlier, UST yields declined, leading to a bull-steepening of the curve. Specifically, 2-year UST yields fell from 4.25% to 3.89%, 5-year yields fell from 4.38% to 3.96%, 10-year yields fell from 4.58% to 4.23% and 30-year yields fell from 4.78% to 4.59%.

Investment Outlook

Proposed tariffs and other policy changes from the new US administration have created uncertainty and volatility in financial markets. Global growth is expected to slow given the heightened uncertainty but should remain solidly in positive territory. US growth is downshifting due to a myriad of factors: uncertainty over tariffs, waning benefits from immigration and reduced government spending, among others. A significant fiscal boost from European defense and Germany infrastructure spending should support eurozone confidence and growth, providing some relief from tariff-related uncertainty. In China, deflationary pressures remain and confidence is weak amid property market concerns, but sentiment is improving with fiscal stimulus and policy easing.

The disinflationary trend may be interrupted as tariffs and retaliatory actions are implemented, but we expect inflation to move lower again over the longer term. Monetary policy remains restrictive. We expect central banks will continue to cut rates further in 2025. The Fed remains well positioned to provide support if the US economy falters. Public debt levels continue to rise and yield curves may steepen given concerns over fiscal policies globally. We see pockets of opportunity in DM rates in Europe, the UK and Australia. While the overall uncertainty in the market environment necessitates caution, we do see some longer-term value opportunities in EM local currency debt. Spread sector fundamentals remain supportive, but valuations reflect those fundamentals and credit spreads persist at below historical averages. We continue to find opportunities within spread sectors and related securities while remaining tactical. DM duration provides useful diversification.

The Fed successfully engineered a soft landing with declining inflation as we entered 2025, and the process of unwinding tightness began through rate cuts and slower quantitative tightening. This process has eased pressure on interest-rate sensitive sectors of the economy like housing and real estate, and the recovery has been underway. From here US growth is likely downshifting, but coming into this downturn, we see a combination of strong fundamentals with attractive income and valuations, which suggest a positive outlook for the asset class to generate strong performance over the long-term. Mortgage and consumer credit market spreads are elevated from pre-pandemic levels with an increased risk of premiums.

Elevated mortgage rates continue to apply pressure on buyer demand while housing inventory continues to grow. Collateral performance measures remain positive which continue to provide strong fundamentals to residential securitized credit. National home price appreciation is expected to remain subdued with low single digits values for the foreseeable future. Tariffs may actually risk home price increases to the upside given higher input costs and less supply of new construction. Given this backdrop, we do not see a significant risk of defaults in the broad residential market. We favor credit risk transfer as well as non-QM deals that present strong borrower profiles and higher credit qualities.

Commercial real estate prices have likely bottomed out, and an increase in capital is being deployed to take advantage of the reset valuations in both debt and equity markets. While the office sector remains challenged, property sectors such as hotels, industrial distribution centers and retailers have benefited from continued economic tailwinds. Tariffs will likely impact the retail and hotel sectors. The multifamily and industrial sectors should be impacted to a lesser degree. New-issue underwriting offers the best quality in over a decade, with low-leverage, in-place cash flow and lender-friendly structures as well as low exposure to non-trophy office properties. Commercial MBS market spreads, which are particularly down in credit, continue to price wide and offer substantial yield pickup to corporate credit.

While consumer fundamentals are expected to deteriorate in the new tariff regime, the higher-quality consumer is well prepared to weather the storm. The end of the Saving on a Valuable Education (SAVE) plan moratorium is expected to continue putting pressure on consumer credit scores, but lenders have had ample time to prepare. Given this backdrop, we expect moderate weakness for the lower-credit consumer. As a result, we have a strong preference for higher-quality consumer credit; we are staying farther up the capital structure and are diversifying across consumer and senior tranches of esoteric sectors. Consumer deal structures appear to remain robust with deleveraging features.

The team believes attractive valuations in mortgage credit offer value, the sector can generate attractive risk-adjusted returns, and that the strong total return potential and diversification benefits will provide value to investors.

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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.

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