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GLOBAL ASSET MANAGEMENT

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GLOBAL BOND REVIEW AND OUTLOOK

European bonds rise on QE expectations

- Global bond returns were mixed, with European bonds posting strong positive returns while U.S. bonds were negative
- High-yield corporate bonds underperformed. The U.S. dollar continued to strengthen
- Market volatility has declined from the peaks seen in August
- Western Asset believes the Fed will start the monetary policy normalization process in December

NOV 2015

MARKET
OUTLOOK

Western Asset's view remains that the global recovery — though fragile — will be ongoing.

Policy accommodation from central banks around the world will continue to underpin growth given global inflationary pressures that remain very subdued and show little sign of increasing. The decline in commodity prices should support global growth by increasing real consumer incomes and corporate earnings in the medium term.

In the U.S., our forecast remains for a 1.5% to 2.0% growth trend. U.S. labor market conditions have improved, and although current inflation remains low, both remain consistent with the Federal Reserve's (Fed's) dual mandate of full employment and price stability. Western Asset believes the Fed will start the monetary policy normalization process in December, but that it does not want to upset the recovery or the markets. As such, Western Asset expects the pace of rate increases to be very slow and gradual and that a sustained rise in long-term U.S. bond yields is unlikely while inflation remains subdued. Western Asset expects global bond yields to remain in relatively tight ranges over the next year

Europe

In Europe, the European Central Bank (ECB) is targeting an aggressive expansion of its balance sheet via negative deposit rates, targeted lending operations and sovereign debt purchases. Western Asset does not favour the euro, but has a positive view of Italian government bonds. Western Asset continues to believe structural reforms are required to raise the Eurozone's potential growth rate. However, growth should continue to improve modestly into 2016 helped by the weaker euro, lower energy costs, higher real incomes, and the availability of cheaper financing.

Despite massive monetary stimulus by the Bank of Japan (BoJ), growth has been disappointing. Long-term market inflation expectations remain depressed and Western Asset expects further stimulus by the BoJ. The divergence of policy between the BoJ and the Fed should place further downward pressure on the Japanese yen.

China

Western Asset feels the recent slowdown in China is a necessary consequence of the ongoing shift from an investment- and export-led growth model to a more sustainable consumption- and service-based economy. The authorities have again demonstrated their willingness to ease policy to support growth as well as to liberalize financial markets. With the recent commodity price declines, many Emerging Market (EM) countries face a more challenging environment. In Western Asset's opinion, current valuations reflect many of these problems and present an opportunity to add value in select countries, such as Mexico and India. Longer term, Western Asset believes EM countries will benefit from the recovery in global growth.

Western Asset favors global corporate bonds where the fundamental outlook and management of companies remain positive, particularly in the financial sector where the complementary processes of deleveraging, capital rebuilding and regulatory constraint remain credit positive. Western Asset sees select opportunities in the higher-yielding corporate bond and bank loans sectors, which traditionally do well in an improving growth environment.

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>
> Western Asset

MARKET **REVIEW**

Volatility in global bond markets continued in November. U.S. yields rose and the yield curve flattened as market expectations of a December fed funds rate hike increased.

Despite modestly stronger Eurozone economic data, European yields fell and peripheral markets outperformed as expectations increased that the ECB would announce a further reduction in the deposit rate as well as an expansion of its asset purchase program in December. In Japan, Consumer Price Index inflation remained negative and consumer spending surprised significantly to the downside, but on a positive note unemployment declined to a 20-year low.

Diverging rate expectations between the U.S. and other developed markets pushed the U.S. dollar higher versus the euro and the Japanese yen. The International Monetary Fund agreed to include the Chinese yuan in its currency reserve Special Drawing Rights basket from October 2016 alongside the U.S. dollar, euro, British pound and Japanese yen.

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Figure 1: Bond sector total returns[1]

	1 Month	12 Months
Barclays European Treasury Index	0.4	3.8
Barclays European Corporate Index	0.7	0.8
Barclays Pan-European High Yield (Euro) Index	0.6	2.8
Barclays Sterling Gilts Index	1.0	3.5
Barclays Sterling Corporate Index	1.8	3.1
Barclays Pan-European High Yield (Sterling) Index	0.8	5.6
Barclays U.S. Treasury Index	-0.4	1.2
Barclays U.S. Agency Mortgage Backed Securities (MBS) Index	-0.1	1.7
Barclays U.S. Corporate Index	-0.2	0.2
Barclays U.S. High Yield Index	-2.2	-3.4
JPMorgan Emerging Markets Bond Index Plus (EMBI+)	-0.4	0.6
JPMorgan Corporate Emerging Market Bond Index (CEMBI) Broad Composite	-0.6	0.0
JPMorgan Government Bond Index — Emerging Market (GBI-EM) Global Diversified Composite	-2.2	-18.1

Source: Bloomberg, as of November 30, 2015. Past performance is no guarantee of future results. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment. Indexes are unmanaged, and not available for direct investment. Index returns do not include fees or sales charges.

[1] The **Barclays European Treasury Index** is the Treasury component of the Euro Government index, which is part of the Barclays Euro-Aggregate Index. The Barclays Euro-Aggregate Index consists of bonds issued in the euro or the legacy currencies of the 16 sovereign countries participating in the European Monetary Union (EMU). All issues must be investment grade rated, fixed-rate securities with at least one year remaining to maturity. The Euro-Aggregate Index excludes convertible securities, floating rate notes, perpetual notes, warrants, linked bonds, and structured products. German Schuldscheine (quasi-loan securities) are also excluded because of their trading restrictions and unlisted status, which results in illiquidity. The country of issue is not an index criterion, and securities of issuers from outside the Eurozone are included if they meet the index criteria.

The **Barclays European Corporate Index** is the Corporates component of the Euro-Aggregate Credit index, which is part of the Barclays Euro-Aggregate Index.

The **Barclays Pan-European High Yield (Euro) Index** covers the universe of fixed-rate, sub-investment-grade debt denominated in euros or other European currencies (except Swiss francs). This index includes only euro-and sterling-denominated bonds, because no issues in the other European currencies now meet all the index requirements. To be included, the bonds must be rated high-yield (Ba1/BB+ or lower) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be high-yield. Bonds must have at least one year to maturity and an outstanding par value of at least EUR50 million. The index does not include non-rated bonds, and it excludes debt from entities in countries that are designated as emerging markets.

The **Barclays Sterling Gilts Index** is the Gilts component of the Barclays Sterling Aggregate Bond Index. The Sterling Aggregate Index contains fixed-rate, investment-grade Sterling-denominated securities. Inclusion is based on the currency of the issue, and not the domicile of the issuer. The principal asset classes in the index are Treasuries (Gilts), Corporates, Government Related and Securitized. Securities in the index are all eligible for the Pan- European Aggregate and Global Aggregate indices.

The **Barclays Sterling Corporate Index** is the Corporates component of the Barclays Sterling Aggregate Bond Index.

The **Barclays Pan-European High Yield (Sterling) Index** is the sterling component of the Pan-European High Yield Index.

The **Barclays U.S. Treasury Index** is the U.S. Treasury component of the U.S. Government index, which is part of the Barclays U.S. Aggregate Bond Index. The Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

The **Barclays U.S. Agency Mortgage Backed Securities (MBS) Index** is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The **Barclays U.S. Corporate Index** is the corporate component of the U.S. Credit index, which is part of the Barclays U.S. Aggregate Bond Index.

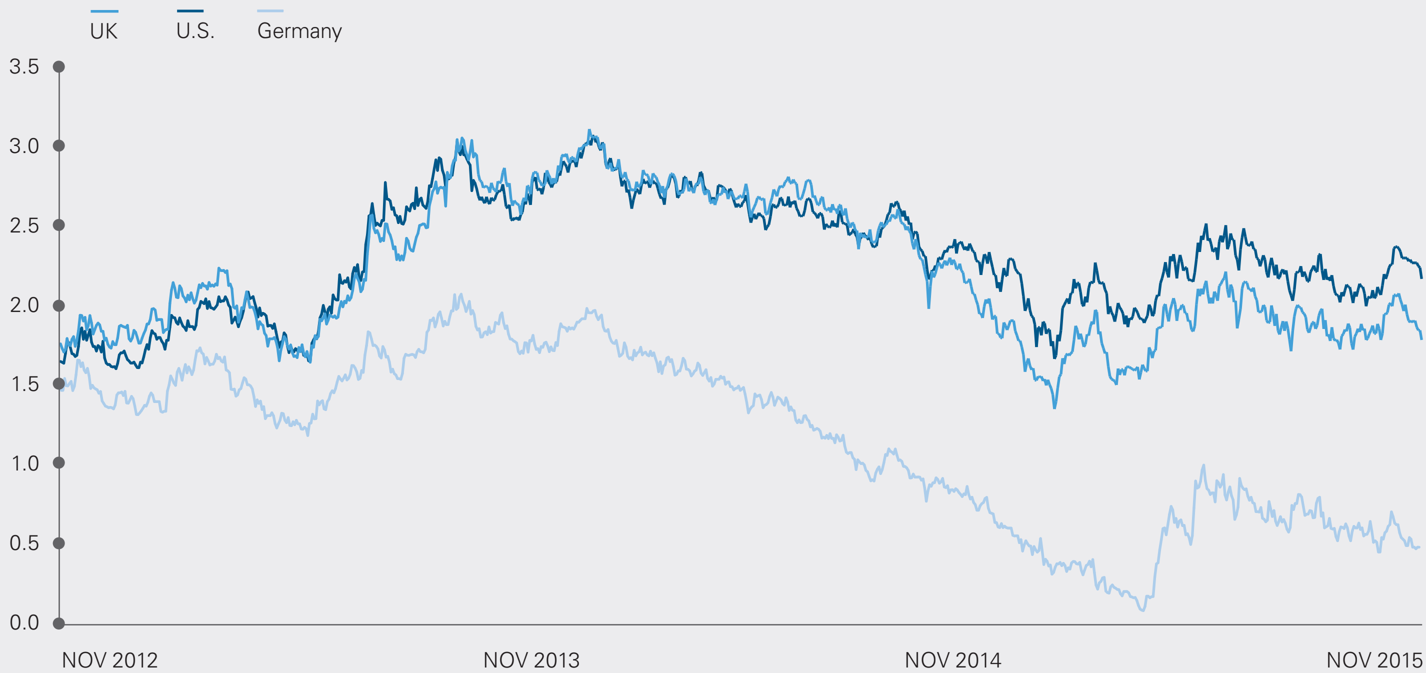
The **Barclays U.S. High Yield Index** covers the universe of fixed rate, non-investment grade debt, including corporate and non-corporate sectors. Pay-in-kind (PIK) bonds, Eurobonds, and debt issues from countries designated as emerging markets are excluded, but Canadian and global bonds (SEC registered) of issuers in non-emerging market countries are included. Original issue zero coupon bonds, step-up coupon structures, and 144-As are also included.

The **JPMorgan Emerging Markets Bond Index Plus (EMBI+)** is a total return index that tracks the traded market for U.S. dollar-denominated Brady and other similar sovereign restructured bonds traded in the emerging markets. Please note an investor cannot invest directly in an index.

The **JPMorgan Corporate Emerging Market Bond Index (CEMBI) Broad Composite** tracks USD denominated debt issued by emerging market corporations.

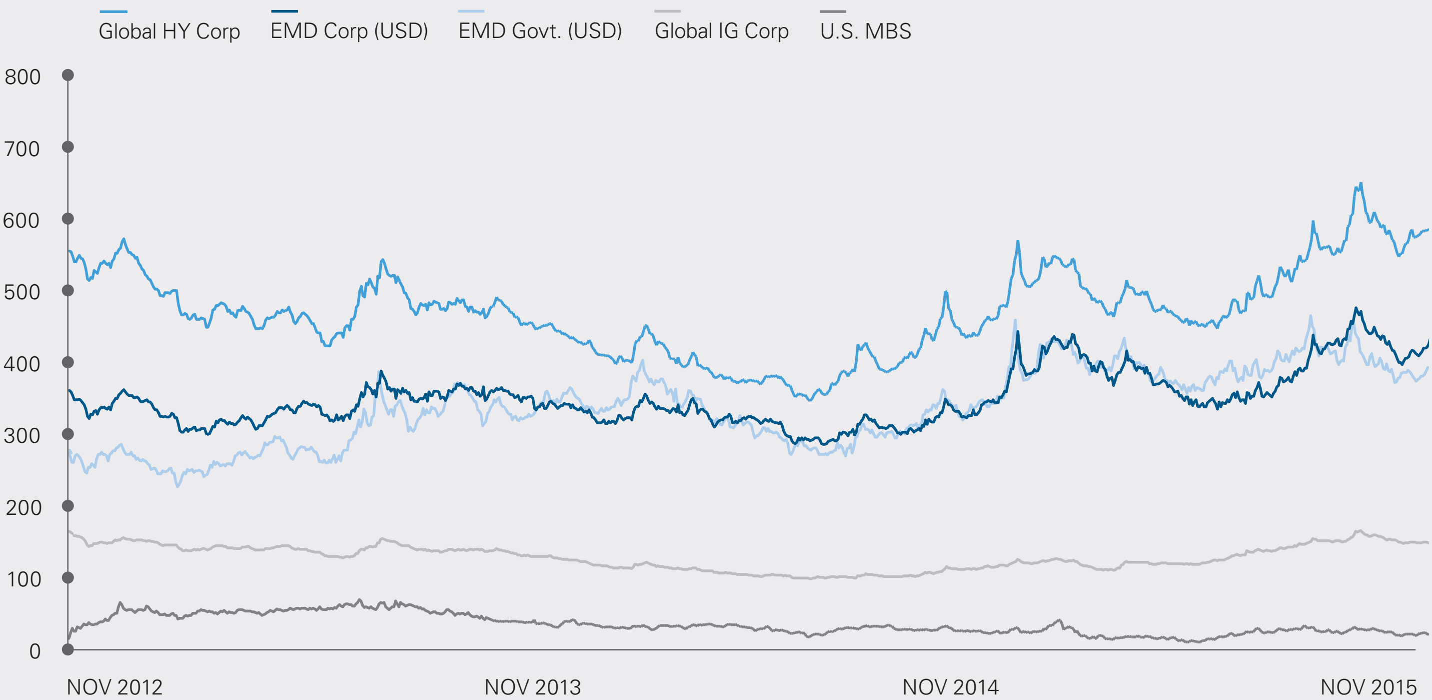
The **JPMorgan Government Bond Index — Emerging Market (GBI-EM) Global Diversified Composite** tracks local currency bonds issued by Emerging Market governments.

Figure 2: Government bond yields (%) 10-year



Source: Bloomberg, as of November 30, 2015. Past performance is no guarantee of future results. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Figure 3: Sector spreads over U.S. Treasuries[2] (bps)[3]



Source: Bloomberg, as of November 30, 2015. Past performance is no guarantee of future results. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

[2] A **spread** is the difference in yield between two different types of fixed income securities with similar maturities.

[3] A **basis point (bps)** is one one-hundredth of one percent (1/100% or 0.01%).

Investment risks

The opinions and views expressed herein are subject to change and are not intended to be relied upon as a prediction or forecast of actual future events or performance, or a guarantee of future results, or investment advice.

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Fixed income securities are subject to interest rate and credit risk, which is a possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. As interest rates rise, the price of fixed income securities falls.

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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. Treasury securities, 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.

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

High yield bonds are subject to increased risk of default and greater volatility due to the lower credit quality of the issues.

Outperformance does not imply positive results.

Diversification does not guarantee a profit or protect against a loss.

Definitions

The **Federal Reserve Board ("Fed")** is responsible for the formulation of U.S. policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

Gross Domestic Product ("GDP") is an economic statistic which measures the market value of all final goods and services produced within a country in a given period of time.

Emerging markets 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.

The **European Central Bank (ECB)** is responsible for the monetary system of the European Union (EU) and the euro currency.

Deleveraging refers to decreasing financial leverage; most often via paying off existing debt.

The **federal funds rate** is the interest rate that banks with excess reserves at a U.S. Federal Reserve district bank charge other banks that need overnight loans.

A **yield curve** shows the relationship between yields and maturity dates for a similar class of bonds.

The **yield to worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

A **spread** is the difference in yield between two different types of fixed income securities.

Quantitative easing (QE) refers to a monetary policy implemented by a central bank in which it increases the excess reserves of the banking system through the direct purchase of debt securities.

The **Consumer Price Index (CPI)** measures the average change in U.S. consumer prices over time in a fixed market basket of goods and services determined by the U.S. Bureau of Labor Statistics.

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* As of September 30, 2015.