Webcast Q&A

LEGG MASON WESTERN ASSET MACRO OPPORTUNITIES BOND FUND

Joe Filicetti believes global pressures are dampening the outlook for inflation. This Q&A is based on a webcast that took place on 18 February 2015, in which Joe considered the implications for Fed policy and highlighted recent changes to the portfolio.

KEY POINTS

- **Falling oil prices, US dollar appreciation, additional central bank easing and lower global inflation are likely to keep US inflation levels low**
- **This is likely to mean the Fed remains cautious on raising interest rates**
- **The manager has taken the portfolio's duration to its lowest possible level**
- **The exposure to high yield debt has been increased to take advantage of last year's sell-off**

Q: What have been the major economic developments since your last update a couple of months ago?

JF: A lot has happened for financial markets to digest in the last two months. The Federal Open Market Committee (FOMC) meeting in late December was extremely important in terms of providing visibility on when the US Federal Reserve (Fed) may raise rates. In addition, oil prices have seen a tremendous decline, the pace and volatility of which we did not anticipate. Furthermore, the European Central Bank has made a historic move to effect a formal quantitative easing and, of course, Greece has a new Prime Minister and a new deadline with its creditors. No wonder fixed income markets have been volatile.

Q: With US growth picking up, do you feel that the Fed is moving closer to raising interest rates?

JF: No we don't. After the FOMC meeting in mid-December, Janet Yellen was repeatedly asked about what would make the Fed raise rates. Her response was that participants would need to be "reasonably confident in their expectation that inflation will trend back towards a 2% target" in order to raise rates. So, to answer your question, we need to focus on the outlook for inflation.

Our view is that there are material risks to the inflation outlook, that those risks are global and to the downside. Falling oil prices, US dollar appreciation, additional central bank easing and lower global inflation are going to delay the normalisation process and will mean that the Fed will need to be very cautious when raising rates in 2015.

Q: What have been the implications for portfolio positioning?

JF: What has changed most in the portfolio over the past two months is really our curve position.

Considering all that we have just said about the challenges to the Fed raising rates, it seems as though the long end and short end of the US yield curve are telling us different things – and they both can't be right. 30-year US Treasury bonds seem very expensive given our expectation of 2.5% plus growth in 2015, as well as 1.4% inflation. At yields of 2.7%, they appear to be pricing in more global deflation and no growth, rather than recovery. In contrast, at the front end of the curve, the market has priced in about six rate hikes at 25 basis points apiece by December 2016.

As a result, we have taken the opportunity to move some of our duration from the back end of the curve, where we think valuations are expensive, into the front end, which has priced in significant rate rises. We ended January with an overall duration of about -5 years, which is the lowest duration exposure we can hold in the fund. During February, this has been profitable as US Treasuries have backed up quite a bit so far this month.

Additionally, we are taking more spread duration risk and less interest rate duration risk. This reflects our view that extraordinary monetary policy that we are living through will eventually take hold, be it ever so slowly, and that global growth, which is currently far slower by historical standards, will over time inch its way towards health.

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Q: Can you elaborate on your emerging market exposure?

JF: At the end of January, we had about 25% in emerging market bonds, with the bulk being local currency debt, representing 17% of the portfolio.

That exposure is country specific. For example, our position in Mexican debt reflects the country's structural reforms and its proximity to the United States. Meanwhile, Brazil is more of an opportunistic position. Three-year notes are trading on yields of over 12%, so the carry and roll-down can be very advantageous. Also, this is not a position that we need to hedge, since the real is trading on a lower level than it was in 2008 when Brazil's exports were curtailed by the global financial crisis. Today, you have almost the opposite situation and, we believe, Brazil is well positioned to benefit from a pick-up in global growth.

Q: Have you been able to take advantage of the sell-off in high yield at the end of 2014?

JF: Yes, while our position in investment-grade debt remains significant, at about a third of the overall portfolio, during December, we added to our high-yield exposure which now stands at around 20%.

Our high yield exposure is concentrated in financials and three select energy names. The energy names were added in late December, after the big sell-off, and are companies that, we believe, have strong balance sheets and a good ability to pay down debt.

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UK/Scandinavia: +44 (0) 20 7070 7444

France/Benelux: +33 15805 3347

Germany/Austria: +49 69 719143720

Italy: +39 020068 1590

Switzerland: +41 22 747 7567

Spain: +34 91702 6745