Webcast Q&A

LEGG MASON WESTERN ASSET GLOBAL MULTI STRATEGY FUND

Ian Edmonds believes Europe is the main area of weakness within the global economy. This Q&A is based on a webcast that took place on 8 October 2014, in which Ian considered the outlook for global bonds and discussed the key themes underpinning the fund's positioning.

KEY POINTS

- **The outlook for the global economy is benign.**
- **There is a possibility that the ECB will announce outright QE in the first half of 2015.**
- **Overall exposure to emerging market bonds has been reduced.**
- **The manager has been tactically adding duration as a hedge against some of the credit positions in the fund.**

Q: Can you elaborate on the fund´s recent performance?

IE: It has been a positive year for most fixed income asset classes and for the fund. This was despite a correction in September, when we saw slightly higher US Treasury yields as well as emerging markets coming under some pressure due to the strengthening US dollar. High yield bonds also suffered some technical outflows at this time. As a result, our performance over the third quarter was slightly negative. Nevertheless, year-to-date returns have been positive, as has our performance in the first few days of October.

Q: Could you talk us through the recent market environment?

IE: Following last year's increase in US Treasury yields due to the announcement that the Fed was going to start its tapering programme, we have actually seen a dramatic decline in US Treasury yields. 10-year US Treasury yields have dropped by around 65 basis points since the start of the year to around 2.35% today. This has led to a return of just under 6% from US government bonds year-to-date.

With the European Central Bank (ECB) continuing with its rate cutting stance and providing more monetary accommodation, we have seen German government bonds return 10%. Peripheral sovereign markets, meanwhile, have been the star performer, with Italy returning 15%, an area where we have some exposure. In combination with this, we have also seen broad-based, positive returns across all non-government sectors.

Turning to local currency emerging market bonds, we have seen positive returns from Brazil and also Poland, which again feature in the fund. Poland, for instance, has been cutting interest rates.

This is very different to what happened last year when emerging market debt was one of the asset classes that really struggled. This year, it has actually been one of the better performing asset classes, and has even beaten high yield.

Q: What have been the main themes in currency markets?

IE: On the currency front, I would say the strong US dollar has been the main theme so far in 2014. Certainly, the Japanese yen and the euro, along with the Polish zloty, which is very much aligned to the euro, have been weak compared to the US dollar. As concerns about disinflation have emerged, we have seen the ECB become increasingly accommodative.

On the flipside, some emerging market currencies that really underperformed last year, such as the Indian rupee and the Brazilian real, have actually had positive returns so far this year against the US dollar. We have actually been increasing exposure to these currencies.

Q: How is the portfolio currently positioned?

IE: We have got about 9% of the fund allocated to government bonds, which is predominantly a combination of US Treasuries and Italian government bonds. Taking into account the recent slowdown in the global growth outlook, we have been tactically adding duration in the fund, mainly as a hedge against some of the credit positions within the portfolio.

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Within the fund's investment grade exposure, we hold some asset-backed securities, as well as corporate bonds denominated in the euro, British pound and US dollar. These corporate bond holdings are concentrated in financials issuers, including US banks, UK banks and insurance companies.

In addition, we think the correction we have seen in high yield is starting to provide some more opportunities. Therefore, we have started to look at some of the new high yield issues in the US and Europe with a view to take advantage of this set back and increasing our exposure to high yield bonds.

In terms of emerging markets, we have actually reduced the fund's exposure recently, especially in Mexico, Poland and South Africa. However, this was mainly a case of taking profits following strong performance. The fund retains a diversified local emerging market exposure, with holdings in Brazil, Mexico, South Africa and Poland: in fact, we have actually increased our exposure to Brazil.

On the currency front, we have got a large exposure to the US dollar. It is a US dollar-based fund, so we don't have too much in the way of non-dollar currency risk. Where we do have non-dollar currency exposure, it is in some of the currencies that we think are the most undervalued but also offer the best risk-adjusted returns going forward. A lot of these are Asian currencies or Latin American currencies. More recently we have cut our short position in the euro via options, and also reinstated our short Australian dollar position.

Q: Has your approach to duration become more tactical than usual?

EI: Not more than usual. We did trim duration earlier on in the year when yields came down. As they have moved back up again, we have just tactically added to it: we felt that the market was fully pricing in any potential interest rate movements by the Federal Reserve (Fed), but we were also looking at Europe and certain other parts of the world and not seeing really strong growth. Adding to duration was, therefore, an obvious hedge against a slowdown. Likewise, if US Treasury yields decline much further from here, while emerging market sectors do really well, then we would look to tactically reduce duration.

Q: What are the key characteristics of the portfolio?

EI: At the end of the month, the portfolio was yielding 5.1%: to put that in context, this is in line with US BB high yield index. While duration was 5.9 years, this is not pure interest rate sensitivity. There is a lot of diversification, both in terms of asset classes and geographical exposure. In terms of the high yield segment, which is just pure credit, this gives us about 1.2 years of duration. Emerging markets, meanwhile, contribute about 0.7 years' duration. That means the duration contribution is diversified within the fund.

Q: What is your outlook for the months ahead?

EI: We have a fairly benign outlook for the global economy. Growth is positive on a global basis, but the recovery continues to be fairly slow. While the US economy has picked up recently, with growth there in the 3% range, we expect Chinese growth to be around the 7% mark. The main weak spot at the moment is Europe.

In terms of interest rate expectations, we agree that the Fed is likely to raise rates next year – probably sometime in the spring to early summer. However, that is priced in, and our belief is that, as long as inflation remains under control, any rate increases are likely to be gradual.

We are therefore happy to own US Treasuries within the portfolio as ballast against our credit positions. We feel comfortable adding to US Treasury holdings on weakness, as we have done more recently. But if we see US Treasury yields fall much further and high yield spreads stabilise, then we would be happy to take some of the interest rate risk out of the portfolio.

In terms of global monetary policy, we would expect more accommodation from the ECB, but this is dependent on inflation expectations and growth, and how much euro-zone exports benefit from a weaker currency. If we do get outright quantitative easing from the ECB, it is likely to come at some point in early to mid-2015.

On the emerging markets front, we still have round two of the Brazilian elections on the horizon. The Brazilian real came under a lot of pressure during September and yields backed up as the market was concerned that the incumbent would stay in place. However, rival presidential candidate Neves did a lot better than expected in round one of the elections, and he generally has a pro-business stance. Whatever the outcome, the next round of televised debates will focus on the economy and we expect that positive reforms will come out of this. That could help bring down inflation and improve confidence.

Q: How does the recent increase in geopolitical concerns impact the fund?

EI: Some of our investments could be directly impacted by rising geopolitical concerns, in particular the exposure to US dollar-denominated Russian government bonds and some Russian corporates. These bonds are pricing in a lot of bad news surrounding the negative implications of sanctions. Meanwhile, the corporate bonds are at cheap valuations compared to similarly rated companies in the same type of industry. Where necessary, we think that the Russian government will help these companies in terms of access to capital if they need it. A lot of them get a lot of their revenues from day-to-day business activities anyway.

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We have cut back our Polish zloty exposure because we felt that Poland is caught between a slowdown in Europe and the crisis in Ukraine. This reinforces our approach of considering each individual event around the world, seeing where you are positioned, and making adjustments when the need arises.

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