



# Western Asset Diversified Income Fund (WDI)

Q&A Update – June 30, 2023

**Last year was a turbulent one for fixed income. The first half of this year has also been a rollercoaster ride with regional bank and debt ceiling headlines dusting up more market volatility. Has this changed your view on the US economic outlook and Fed policy?**

No. We maintain the view that US growth is decelerating, but that a recession is avoidable. Disinflation in the US is also underway, although we expect this process to be uneven. The decline in shelter inflation is set to continue, while the recent rise in goods inflation is likely to reverse, leaving core inflation broadly lower on net. The last few months of slowing labor demand is also likely to continue, as indicated by the forward-looking business surveys. Looking abroad, lessening bottleneck pressures, financial stability concerns contributing to tighter credit conditions in Europe and softer manufacturing and services demand worldwide are helping to alleviate price pressures globally.

Digging deeper into Fed policy, there are three things to keep in mind. First, any future rate rises are likely to be small relative to the rate hikes already done. Second, the full impact of the rate rises has yet to be felt, as it will likely increase over coming quarters when real interest rates increase further. Finally, the stress caused by elevated funding costs is significant and likely to continue. None of these considerations will change much, if at all, should rates end up closer to 5.5% instead of at their current level.

The bottom line is this: with the Fed and other major central banks nearing the end of their respective hiking cycles and looking to maintain restrictive monetary policy for an extended period, we think growth and inflation will moderate further which bodes well for risk assets.

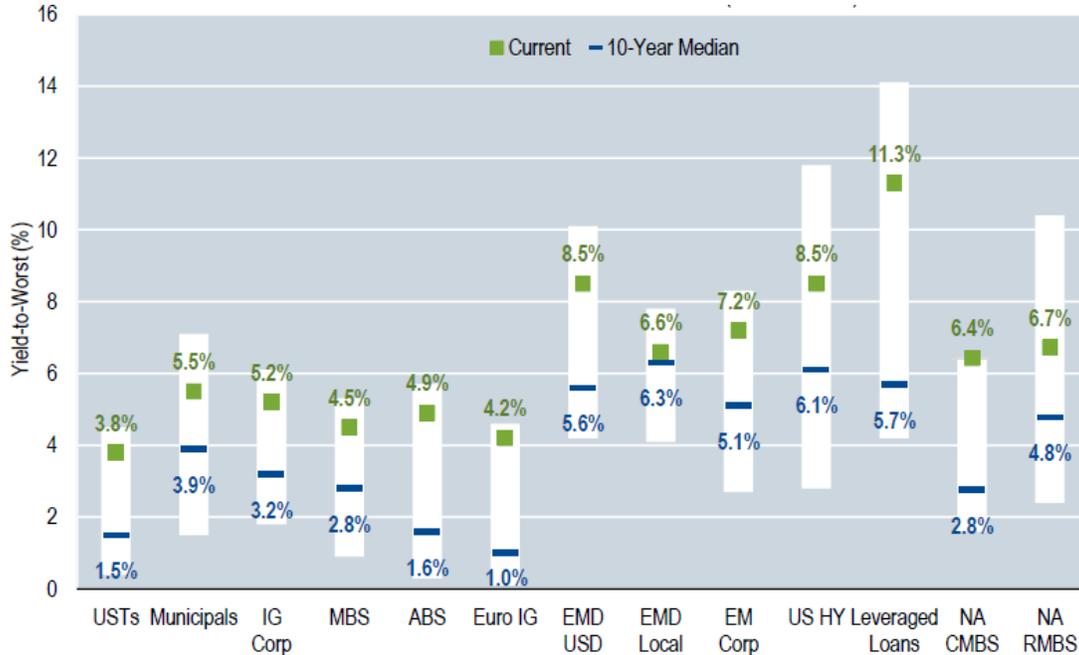
**Despite the pick-up in US rates volatility, credit markets have exhibited surprising resilience. What explains this dynamic?**

The one word to keep in mind: yield. Bear markets in fixed income are challenging, but on the flip side they restore valuations which is what 2022 delivered, albeit in a very painful way. At present, all-in yields across fixed income sectors are near their 10-year highs; if you remove the 2008 crisis from the data series, yields are near their 20-year highs.<sup>1</sup> Investors remain nervous about wading back into the waters of the credit market given uncertainties around Fed policy and a possible recession; these concerns are valid, but the breadth of yield opportunities out there have fired up investor demand for credit as evidenced by positive year-to-date performance across various segments of the credit market. The increasing yield environment has enabled WDI to increase its monthly distribution to shareholders five times since inception.

1. Source: As of March 31, 2023, most recent data available. Bloomberg, FactSet.

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### Yield-to-Worst Across Fixed-Income Sectors (Past 10 Years ended March 31, 2023)<sup>2</sup>



2. Source: As of March 31, 2023, most recent data available. Bloomberg, FactSet, J.P. Morgan Credit Research, J.P. Morgan Asset Management. Indices used are Bloomberg except for emerging market debt and leveraged loans: EMD (USD): J.P. Morgan EMIGLOBAL Diversified Index; EMD (LCL): J.P. Morgan GBI-EM Global Diversified Index; EM Corp.: J.P. Morgan CEMBI Broad Diversified; Leveraged loans: JPM Leveraged Loan Index; Euro IG: Bloomberg Euro Aggregate Corporate Index; Euro HY: Bloomberg Pan-European High Yield Index. Yield-to-worst is the lowest possible yield that can be received on a bond apart from the company defaulting. All sectors shown are yield-to-worst except for Municipals, which is based on the tax-equivalent yield-to-worst assuming a top-income tax bracket rate of 37% plus a Medicare tax rate of 3.8%. Guide to the Markets.

### How do you see a recession this year impacting credit spreads and default risk?

It's important to note that most of the challenges associated with credit in recessionary periods may not come to fruition this time around. The recessions of the last 20 years were deflationary in nature; specifically, the years 2000 and 2008. The Savings and Loan crisis from 1986-1995 was the last inflationary recession and investment grade (IG) credit option-adjusted spreads (OAS) in that period topped-out at 150bps. Today, IG spreads are closer to 125bps, which is below the 25-year historical average of 140bps.<sup>1</sup> This suggests to us that inflationary recessions like the one we're dealing with today may not result in the higher credit spreads that many market pundits are looking for. We have to bear in mind that companies borrowed at low rates for years and are now in a much stronger position to weather any potential recession.

A similar argument can be made for the high yield market where a refinancing wave over the past years should keep defaults at bay. With over 50% of BB rated debt making up today's high yield market and just 11% rated CCC and below, we expect defaults to come in well below the highs observed in 2001 (the Telecoms crash), 2008-2009 (the global financial crisis) and 2020 (the COVID-19 pandemic). We think the current 2.5% default rate (implied by today's HY OAS of 420 bps) will likely migrate towards the historical average of 4.5% over the next 12-18 months.<sup>1</sup> But we would highlight that coercive debt exchanges and selective defaults will likely comprise a significant portion of that default estimate despite those issuers remaining current on their debt. In many instances, these liability management exercises are credit positives improving an issuer's financial flexibility and maturity profile.

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### **Given your economic outlook, what areas of the credit market offer the most compelling risk-reward trade-off over the next three to six months?**

We're constructive on high-yield corporate credit and continue to see opportunities in service-related sectors including airlines, cruise lines, gaming, and consumer services. We also see value in copper credits given projected tailwinds in commodities and in exploration and production issuers within the energy sector where management teams have had a relentless focus on paying down debt via free cash flow generation. We're also constructive on bank loans. Here, we favor defensive sectors such as health care, property & casualty brokerage and environmental waste management issuers that have strong competitive positions, less cyclical industry dynamics and decent asset coverage. Most of our focus in portfolios is on high single-B to BB credits where asset coverage is in the 1.5x to 2.5x context, respectively.<sup>3</sup> The high asset coverage and other fundamental attributes are what will likely minimize the default risk should growth slow more than our base case.

We also see a lot of value in AAA rated tranches of collateralized loan obligations (CLOs) in the 7% yield context that can provide high quality, attractive risk-adjusted return potential. With the structural protections of CLOs, an AAA security can absorb 60%-80% of the loan portfolio defaulting without taking a loss, which is well in excess of our expectations for default rate of 3.5%-4.0% over the next year. Further to that point, the various covenants of a CLO drive the portfolios to be weighted toward the higher quality segments of the loan market. As a result, the default rate within CLOs has historically been approximately half the default rate of the broader loan market (per the LSTA). Non-agency residential mortgage-backed securities is another area of the credit market that offers good carry and return potential. In the near-term, US home prices are expected to remain constrained and gradually move towards long-run averages of 3%-4% yearly. Regionally, however, increasing variations in home price performance as well as inventory persist. While US real estate faces various challenges due to higher mortgage rates and broad economic uncertainty, we don't see a significant risk of defaults in the broad residential market. Our focus remains on credit risk transfer securities as well as non-QM deals that present attractive borrower profiles and higher credit qualities.

The commercial real estate market (CRE) still faces headwinds due to negative sentiment around office space and concerns over regional bank CRE exposures. As such, spreads are wide in the context of a variety of historical scenarios as well as relative to other credit sectors. In our view, underlying fundamentals remain generally benign with limited distress outside of the office sector. Both new-issue conduit and secondary single-asset-single-borrower deals present compelling opportunities to lend on high-quality collateral with acquisition or cash-in financing. Subordinate credit screens particularly cheap, but we recognize that performance may be idiosyncratic and volatility remains high.

### **With all of the uncertainties in today's environment, how should investors position their portfolios?**

There's no question that markets are hostage to Fed policy and the overall economic outlook both in the US and abroad. While we're optimistic we can make it to the other side, we recognize the path will not be linear. At a minimum, this means investor portfolios need to have a high resiliency against further bouts of volatility. At Western Asset, we've long advocated a diversified-strategies approach to mitigate the risk of any one strategy dominating portfolio returns. Heavily bar-belled approaches in credit portfolios may seem intuitive (i.e., having an equally high concentration to low and high beta asset classes), but for portfolios with higher risk tolerances (i.e., high return objectives) they're vulnerable in scenarios where both spread sectors and government bonds sell off in tandem. We saw this on full display last year. Investing in only one or two areas of the market for an extended period of time can also be a losing proposition if those segments fall out of favor and there's no opportunity to pivot elsewhere in a timely way.

In our view, a diversified portfolio like the Western Asset Diversified Income Fund (WDI), that can take high conviction views and dynamically rotate across credit sectors to harvest various sources of income and return makes the most sense. Credit sectors don't necessarily move in tandem; they have different cycles and they do well in different markets. In an environment of prolonged uncertainty and expectations of continued volatility, embracing diversification and flexibility is going to be vital for long-term investment success.

3. Source: Western Asset Management

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### What are the Risks?

**All investments involve risks, including possible loss of principal. The fund is newly organized**, with a limited history of operations. **Fixed income securities** involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. **Low-rated, high-yield bonds** are subject to greater price volatility, illiquidity and possibility of default. **Asset-backed, mortgage-backed or mortgage-related securities** are subject to prepayment and extension risks. **International investments** are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in **emerging markets**. **Derivative instruments** can be illiquid, may disproportionately increase losses, and have a potentially large impact on performance. **Leverage** increases the volatility of investment returns and subjects investments to magnified losses and a decline in value. **Diversification** does not assure against market loss.

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