2Q 2021

Investment Highlights

Oregon Local Government Intermediate Fund

WESTERN ASSET

Oregon Local Government Intermediate Fund

	Portfolio	Index**
2Q21 Performance*	0.43%	0.27%

As of 30 Jun 21.
**Performance is gross of fees*
*** Bloomberg Barclays 1-5 Year US Government/Credit Bond Index*

Performance Review

During the second quarter of 2021 the portfolio outperformed its benchmark, the Bloomberg Barclays 1-5 Year US Government/Credit Bond Index, by 16 basis points (bps) on a gross basis.

US economic data surprised in both directions over the quarter with the employment data coming in surprisingly weak. Only 266,000 jobs were added in April compared to expectations of approximately 1,000,000. This was followed by a slightly better but still disappointing 550,000 jobs added in May. There were a number of reasons put forth to explain the disappointing jobs reports due to labor supply shortages. However, it could also be the case that matching one million plus workers with employers is quite difficult, especially if workers are changing industries or relocating. Restarting an economy takes time. The greatest contributor to performance during the quarter was duration positioning, contributing 8 bps as yields fell. Agency mortgage-backed securities (MBS) exposure detracted over the quarter.

Investment Outlook

The US economy in recent months has performed in line with our expectations as set out a few months ago. Growth has moderated in the manufacturing and construction sectors now that these have achieved essentially complete recovery from the Covid-induced shutdown recession of 1Q20. Meanwhile, growth in the service sectors has been decent, but not spectacular and not suggestive of a quick return to pre-Covid norms. Much of this relatively sluggish rebound in services reflects the fact that a general reopening of the service sectors has been occurring only in the last few weeks. Still, growth has moderated in the restaurant and medical care sectors—the reopening occurring in various states in late-June and after are not quite "full" reopening, and residual fears of Covid among some cohorts will likely be an ongoing restraining factor as well.

As a result of these factors, we would expect growth in the service sectors to continue to disappoint relative to consensus expectations and that growth in manufacturing and construction sectors will be muted as the recovery there is already complete. There is enough slack remaining in service sectors to single-handedly drive US GDP growth of 7% or so for a number of quarters yet. Instead, however, we would expect growth in a 2% to 5% range—not bad, but, again, lower than what seems to be already baked into consensus accounts.

While market and media rhetoric are still trumpeting an inflation flare-up, we see most of the run-up in reported inflation in recent months reflecting adverse comparisons to especially low Consumer Price Index (CPI) prints in April and May 2020, and rebounds in prices of a number of services where reopening is occurring to some extent (and where prices are still well below pre-Covid levels even with the recent run-up).

Treasury markets have already reacted to these developments, pulling the 10-year yield down from a high of 1.74% in April to the low 1.40s range recently. We don't expect further significant declines in term yields, but we would expect yields to remain in the trading range of the last three months, with a lot of time spent toward the lower end of that range.

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