1Q 2022

Investment Highlights

Oregon Local Government Intermediate Fund

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	Portfolio	Index**
1Q22 Performance*	-3.47%	-3.45%

As of 31 Mar 22.
**Performance is gross of fees*
*** Bloomberg 1-5 Year US Government/Credit Bond Index*
Attribution is calculated using prices sourced from independent pricing vendors or brokers in accordance with Western Asset's approved pricing hierarchy. Therefore, performance presented here may differ from performance calculated by official sources for benchmarks and for funds that use a third party administrator.

Performance Review

During the first quarter of 2022 the portfolio underperformed its benchmark, the Bloomberg 1-5 Year US Government/Credit Bond Index, by 3 basis points (bps) on a gross basis.

During the first quarter of 2022, bonds sold off and risk assets weakened as the Federal Reserve (Fed) hiked the fed funds rate (FFR) for the first time since 2018 amid a string of upside inflation surprises and strong employment data. Subsequent hawkish rhetoric from Fed speakers reinforced investor expectations for an accelerated pace of monetary tightening. US Treasury (UST) yields surged during the quarter, led by the front end, which resulted in a much flatter yield curve, with the 2s/10s spread ending the quarter at zero bps, as well as yield-curve inversion in certain segments, including 5s/30s. Geopolitical risks came to the forefront with Russia's invasion of Ukraine on February 24. The imposition of financial and economic sanctions on Moscow pushed oil prices past $100/barrel and renewed concerns over global growth as much of the world was still recovering from economic disruptions brought on by recent COVID-19 variants late last year. Credit spreads widened and the S&P 500 saw its first quarterly loss since the start of the pandemic. Rates positioning, including both duration and yield-curve positioning, was the main contributor to performance as the portfolio's neutral-to-slightly short duration and underweight at the front-end (2-year KRD) benefitted as yields significantly rose over quarter with front-end yields rising more than intermediate yields. Investment-grade corporate exposure had a negative impact on performance as spreads widened over 1Q22.

Investment Outlook

Economic growth has largely dovetailed with our outlook. Consumer spending growth has been only moderate, with a shift in spending from goods to services, leaving goods demand flat for the last 11 months. Flat goods demand opposite gradually rising domestic production and a sharp increase in goods imports has led to an extremely strong increase in US inventories. This served to overstate 4Q21 GDP growth, but it is also serving to moderate price pressures in goods markets.

The two problems are that first, the Fed has come under increasing pressure from financial markets to actively subdue inflation, and, second, the crisis in Ukraine has intensified pressures on headline inflation measures. The Fed's shift to a more aggressive tightening stance has been met by sharp increases in US yields across the board, but especially at short maturities, so that the yield curve is vastly flatter and higher than was the case just three months ago.

We have been skeptical that Fed policy has been effective in stimulating either the economy or inflation, and our take has been that price pressures mostly reflect imbalances in the economy in view of ongoing Covid restrictions in some sectors, only recently removed disincentives to work and supply pipeline disruptions. None of these are disturbances that call for a monetary response. But with impatient investors both domestically and globally, Fed action is likely necessary anyway, and with the further distortions/disruptions from the war in Ukraine muddying the inflation waters, the risk is that the Fed—or the markets—will overdo the increases in yields, slowing the US and global economies more than would otherwise occur.

The upside outlook is that growth is more widely perceived to be modest and that the markets see through headline inflation measures—held up by Ukraine issues—and recognize that core inflation measures should be coming down with the assuagement of supply problems in goods sectors (and reopening/de-restricting of service sectors given declining Covid risks). Under these developments, we are likely at or already above a peak in term-maturity yields, and Fed hiking efforts likely will not have to be as extensive as presently expected.

A downside outlook is that war-induced increases in energy prices feed through to core inflation measures, terminating the apparent moderation of the last two months and thereby intensifying pressures on the Fed to follow through with or even intensify its hiking regimen. Such developments would clearly be negative for economic growth, but any downward effects of that on yields would be postponed until markets are assured that inflationary risks are being effectively dealt with.

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