Global Opportunistic Fixed Income

Quarterly Commentary

REGIME SHIFTS

History will be the judge, but in our opinion, the third quarter of 2016 has a very good chance of being the secular low for developed-country sovereign bond yields. Our position throughout the year was that most sovereign bond markets in developed countries offered no value—and in some instances were extremely overvalued. Yet until the fourth quarter, the trend-setting U.S. long-term Treasury bond yield continued to slide, the curve flattened, the Federal Reserve (Fed) balked at raising rates, and trillions of dollars of global debt traded with a yield of zero or less. The rallying cry for the bond bulls has been "secular stagnation," the theory of a world short on spending and long on savings, proposed by Larry Summers of Harvard. According to this theory, underwhelming productivity and dwindling labor force growth condemned the world economy to perpetual low nominal gross domestic product (GDP) growth and yields below 1% for over 70% of the constituents of the most popular global bond benchmarks.

In the fourth quarter a major sell-off in the global fixed-income markets finally unfolded. Much of what has been written about this bear phase has been tied to the pro-growth economic agenda expected of the newly elected Trump administration. While certainly a factor, the change in U.S. leadership is only one of several regime shifts taking place—all of which may be connected.

The world economy also turned out to be a lot stronger than the expectation that was embedded in bond prices for most of the year. We made the case for a better cyclical outlook early in the first quarter of 2016. Chinese policymakers flipped the switch on fiscal spending to end their downturn, the Fed bought into secular stagnation and balked at increasing rates, and the dollar stabilized early in the year. Correspondingly, global growth ended the year on a strong note with the bulk of the marginal improvement coming from the developing world—especially China—which is what we had been looking for. Near the end of the year, growth in the developed countries also picked up, possibly a delayed reaction following the shock of the "Brexit" vote and uncertainty ahead of the American elections.

But our call for a better outlook for the world economy also hinged upon tentative signs of another regime shift, which we described last quarter as the "Stirrings of an End to Financial Repression." We believe there is increasing evidence that the main propellants behind feeble post-2008 growth continue to lose momentum:

- Household deleveraging in the U.S. stopped in 2016. Coincidentally, the growth of Chinese nominal GDP bottomed out as well. The synchronicity of credit-financed American consumption and Chinese production defined the pre-2008 world economy. As a result, the beginning of China's growth deceleration coincided with the U.S. housing bust and the subsequent hole in household credit growth and spending. The collapse in U.S. household borrowing and corresponding downturn in Chinese economic growth have been the cornerstones of the post-global financial crisis (GFC) slow-growth environment. China boosted domestic credit growth in 2009 in order to contain the decline, but ultimately reversed course. This year's realignment of U.S. household spending is more in line with domestic incomes and the bottoming out in China's economic growth would remove a big source of the post-2008 subnormal "new normal," if it can be sustained.
- A shift in economic policy is also taking place. Central banks in developed countries have exhausted all means to reinvigorate growth. The baton is passing to fiscal policy, with the Chinese the first to lead the way. China's credit impulse in the first quarter of 2016 was the biggest since 2009. In the United States, the agenda of the incoming Trump administration can be thought of in a narrow way of shifting the burden of growth from the shoulders of the Fed to fiscal stimulus. These are dramatic changes from what has dominated most of the last eight years.
- Lastly, productivity is probably not as weak as suggested by the secular stagnationists. Statisticians measure output growth per capita. This measure will obviously be slow if deleveraging and fiscal austerity have depressed economic growth. Correspondingly, this measure will rise once these factors lift. A more

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believable guesstimate of labor's marginal factor productivity could be what businesses are willing to pay labor when the economy is at full employment, a status many observers believe the U.S. has achieved. Real wage growth is running somewhere between 1.5 and 2%, depending on what index you use. The implication would be nominal GDP growth ahead of closer to 4.5-5% in comparison to the 3-3.5% of the past several years.

Populism—another regime shift—reared its head in 2016 partly in reaction to the years of post-2008 economic gloom. Voters laid the blame at the feet of the elites and their policies for the failure of family incomes to rise and for the growing income divide. The market failed completely to anticipate the Brexit vote, while most observers did not think Donald Trump would win the U.S. election. Contrary to the anxiety expressed ahead of these political developments, the British economy is stronger than many would have anticipated. In the U.S., capital markets are pricing in an economic boom. Stock prices and bond yields have been going higher since November 8. Similarly, commodity prices have been stronger despite a strong dollar, a combination only seen during periods of strong global growth. Dollar strength in 2014 and 2015 was more a sign of weakness in the rest of the world and led to a volatile U.S. equity market and a flattening yield curve. But since November, the market has behaved as if the Trump administration is going to light a fire under the economy, just as cyclical and secular factors also make the turn.

President-elect Trump has given every sign that he intends to reset American domestic and foreign policy through the lens of what he believes is in the nation's commercial self-interest; tax cuts/reform and deregulation are priorities. "Globalism" is out. Bilateral treaties focusing on trade balance and fairness could usurp multilateral free trade. Cross-border tax reform proposals and a potential import tax have emerged as part of a possible mélange of carrots and sticks aimed at discouraging multinationals from outsourcing production for repatriation back to the U.S in an effort to help revive domestic manufacturing and jobs. But these plans also carry the strong whiff of protectionism.

The details of Trump's policy agenda will be important, especially for China. The world's second largest economy is dead center in the cross-hairs of the administration and has been flatly accused of gaming the world trading system and cheating America. The relationship between these two economic super-powers has defined the global economy for the last 25 years; how this relationship evolves will have enormous ramifications for the world economy and investors. As in all outcomes, there are positive and negative tail risks. The negative is that China retaliates with tariffs and import taxes of its own to counter any reactionary U.S. trade decisions. The positive would be if China slashes domestic taxes and tries to boost domestic growth.

If geopolitical uncertainty was not already high enough, the president-elect also intends to reset America's position/role in the world order. Trump believes that many of the institutional structures, alliances, and global rules of the road that have been created and enforced by the U.S. over past decades in its role as the world's benevolent hegemon, no longer make sense. It was inevitable that the global order would change over time as the rest of the world grew in significance relative to the U.S. There is historical precedent for structural breaks in the global economic and political order that follow financial crises, which the GFC would certainly qualify as. History is unambiguous in its observation that the world is less stable without strong hegemonic leadership. What remains to be seen is whether U.S. leadership reframes and modernizes its relationships for a changing world in a way that is constructive for everyone or creates a power vacuum through a drift towards isolationism.

PERFORMANCE

The Global Opportunistic Fixed Income strategy composite returned -6.06% gross of fees (-6.17% net), outperforming the Citigroup World Government Bond Index for the fourth quarter, which dropped 8.53% during the same period as bond yields rose. The strategy was not exposed to the riskiest segments of developed-market global bonds. While the strategy was down for the quarter, its 2.5% relative outperformance was attributed to what we did not own. A lack of exposure to the Japanese yen, the euro, and generally avoiding core-eurozone sovereign debt and minimal exposure to peripheral countries were the greatest contributors to relative performance. Higher-quality European sovereign yields rose higher on burgeoning regional reflation. It was this backup in developed-market yields that hit global bond benchmarks hard in the fourth quarter. The sharp contrast between the Fed's path to interest-rate renormalization and continued easing from the Bank of Japan and the European Central Bank (ECB) caused the yen and euro to decline against a surging U.S. dollar during the quarter.

Dollar strength was indiscriminant this quarter, appreciating against most developed- and emerging-market currencies—and only accelerated after the U.S. election. Therefore, currency exposure was also a leading detractor to absolute performance for the quarter. Although positions held in Mexican Bonos explain 36% of the absolute decline in the strategy—of that drop, 70% was attributed to unhedged exposure to the peso. Despite a variety of positive factors—attractive real yields, a low unemployment rate, strong retail sales, credible central bank—Mexican assets have been at the mercy of the speculation regarding its trade relationship with the U.S. Local-currency Indonesian government bonds were also at the mercy of investment bankers' apprehension over emerging market liquidity; rising yields detracted from performance. The possibility of developed markets repatriating manufacturing jobs and a shift toward protectionism—a movement that may be led by the U.S.—also weighed on the Malaysian ringgit and Indonesian rupiah; stabilizing crude prices helped slow down their depreciation. The Brazilian real managed to retrace its losses immediately following the U.S. election and ended flat for the quarter—unhedged exposure contributed modestly to relative performance.

Emerging market currencies were not necessarily the hardest hit by events emanating from the U.S. Exposure to a basket of European currencies detracted from performance, including the British pound sterling, Swedish krona, Norwegian krone, Polish zloty, and Hungarian forint. We believe the respective economies of these currencies have exhibited relative strength, and their cheapened currencies should help improve their terms of trade so long as global growth and commodity prices hold up. We also believe the Australian economy should benefit from this environment; however the outlook for Australian economic growth remained fragile during the quarter, which only compounded the currency's decline against the dollar. Positions in Australian and New Zealand government bonds also detracted from performance given the back up in developed-market yields.

Late in 2015, we anticipated and made a strategic bet that the dollar would stabilize. In fact, we thought that the dollar needed to stabilize in order to support world growth. Stabilization came during the first half of last year and emerging market currencies outperformed—which was a major plus for the strategy because of overweight positions in several unhedged emerging-market sovereign bonds. In the second half of the year, the dollar began to rally again, strongly accelerating after the elections. The anticipation of a strong pro-growth agenda on the part of the incoming U.S. administration has catapulted the dollar higher against almost every currency in the world, and is probably the key risk factor affecting performance looking into 2017.

PROSPECTS

In general terms, the global cyclical outlook—signs of an end to financial repression and the ascendance of the Trump administration—are all duration bearish. Similarly, the thrust of these factors is broadly positive for the U.S. dollar. In response, markets have made significant price adjustments.

The real issue is how much has already been priced in and where are the price anomalies? What is the outlook for global growth relative to the view embedded in prices at the moment? Where is the information risk? What is the growth outlook for other major parts of the global economy relative to the U.S.? How quickly will Trump's pro-growth agenda take hold in the American economy and how stimulative will it be? How reactionary is U.S. trade policy going to be? Will there be a border tax? How big? How will China and other economies react to any reactionary U.S. trade legislation?

We think markets have priced in/discounted a business-friendly agenda but may underestimate the friction to hammering out legislation. Headline risk and volatility surrounding the execution of the Trump agenda could create market anxiety. The global bond market has already anticipated a substantial pick up in the world economy and may have reached the "show me the money" phase. China is always a lynchpin to global growth and the country's playbook for 2017 has us concerned. China's credit impulse is already in retreat, narrow money growth has rolled over and the central bank has been intervening to stabilize the currency—all a form of policy tightening. This suggests that by the second part of this year the momentum of Chinese expansion will taper off somewhat, leaving open the question of how the authorities might respond. In the United States, rising mortgage yields could foster some softening in housing demand. The growth rate in car registrations is already negative and net exports won't be helped by the most recent move in the dollar. Similarly, early leading indicators on Europe imply that the momentum of the recent pick-up in growth is close to a peak. On balance, the global economy continues to move ahead but absent the kind of acceleration which could lift bond yields materially higher.

The risk in this scenario is that the "animal spirits" of optimism create a positive feedback loop. For the past eight years, investors and Main Street have generally been worried about the economic outlook amid perpetual concerns about another financial crisis. Money multipliers in the banking sector and the velocity of money have been shrinking as the demand for money soared. If the incoming U.S. administration provokes a turnaround in sentiment, then the economic upside could be quite startling. There are trillions of excess cash reserves sitting idle on the balance sheets of U.S. commercial banks. If households and businesses start to borrow and spend again, the multiplier effects would be sizeable.

There is near universal positive sentiment on the U.S. dollar with the JPMorgan trade-weighted dollar index up 10% since July 2016, up 27% since 2014, and nearly 40% since its low in 2011. This is quite a headwind. From an historic perspective, the dollar has tended to move in 7-year cycles, with the last year being the mania or overshoot phase. Will 2017 be that blow-off year? The big risk for us is that currencies can run in one direction for a long time.

Nonetheless, the dollar is getting expensive relative to both the euro and the yen. In Europe, economic growth has picked up, its trade balance with the world is large at 3.3% of GDP, banking stresses are slowly resolving, and the central bank is likely to start tapering sometime in late 2017—all positives for the euro. The biggest risks for the currency are political and relate to the elections taking place this year that could result in isolationists taking power. Clearly a Le Pen victory in France would shock the world. In spite of these pressures, survey evidence continues to show uniform support for the euro across the European population. In Japan's case, it would not be farfetched to argue that Prime Minister Abe has been mildly successful. The surging trade balance reveals the effect of the large depreciation of the currency. This easy money policy has spilled over into a multi-quarter move higher in retail sales, industrial production, and indices like the Purchasing Managers Index. We are not there yet, but the yen is starting to look more attractive as well.

In addition, the prospect of a dollar surge on the back of tighter monetary policy and lower U.S. taxes puts monetary policy in conflict with the wishes of the president-elect to revitalize U.S. manufacturing. The U.S. needs a **weaker** currency if it wants to boost manufacturing. The president-elect has already shown a hands-on penchant for industrial policy, using social media to threaten individual companies with punitive taxes if they export production. It seems inevitable that at some point the new administration may address dollar strength in a similar direct way and/or challenge the Fed on policy.

Many emerging market currencies are trading at deep discounts relative to our measures of intrinsic value, at a time when underlying balance of payment conditions are improving—in some cases quickly. Global growth has boosted commodity prices. In our estimation the extent of the ensuing current account improvements in the emerging world will be a big story for 2017 and a big reason to stay long the currencies.

The risk is punitive taxation of imported goods by the new U.S. administration, a development which would clearly be a blow to emerging markets and their foreign exchange rates. At the moment, it is difficult to handicap the potential for such a development owing to the posturing of the incoming administration. The positive information risk is that the new U.S. administration does not want to provoke a change in global trade conditions so deleterious that it fosters widespread retaliation and/or widespread economic weakness. In addition, other countries could counter U.S. tax reform by cutting their own domestic taxes, thereby contributing to a win-win for world growth.

POSITIONING

The macro environment is always in motion. The process of evaluating macroeconomic conditions constantly misprices risk. The biggest pricing anomaly last year was the spread widening of corporate bonds in the oil sector. The spreads on some investment grade bonds were as wide as 900 basis points (bps). With oil deflation behind us and financial repression abating, these bonds have narrowed into the 250 bps zone. We believe the selloff in the U.S. Treasury market moved too far, too fast relative to the underlying changes likely to be forthcoming in the U.S. economy. We continue to believe that core bond yields in developed countries are headed higher over the long term. However, the combination of a stronger dollar and the 100bp back up in yields represents an optimistic outlook that could be checked by weak exports and a slight down drift to housing.

On the dollar, the strategy remains underweight yen and euro which has helped as these two large index weightings have depreciated significantly on the back of the U.S. election. Our strategy has been to focus on Scandinavia, Eastern Europe, and the U.K., where growth prospects and fiscal constraints are less onerous. In our view, the local bond markets in Europe are just not attractive.

The strategy remains overweight a range of emerging market currencies, including the Mexican peso. The peso currently offers one of the biggest discounts in price relative to almost every measure of intrinsic value in history. The last time the peso was this weak was during the Tequila crisis in 1994. However, the structure of Mexico's economy is much better than 23 years ago. Inflation is rising but low at 3% currently, and is due entirely to the decline in the currency. The shock this time, of course, is the Trump administration's promise to review the North American Free Trade Agreement (NAFTA) and its open antagonism about companies outsourcing production. The prospect of dwindling foreign direct investment (FDI) into Mexico has undermined the currency.

In many ways the situation in Mexico reminds us of the European sovereign debt crisis. The market failed to appreciate the political willingness to keep the monetary union together, and ultimately the euro rallied and bond yields fell on the back of ECB President Draghi's credibility. Similarly, the market may be underestimating the political willingness of the Trump administration to make sure that in the pursuit of fairer bilateral trade, the Mexican economy does not weaken so much that populist forces take over and create a hotspot of political instability on America's southern flank. What's needed to resolve the current period is clarity on public policy, the size and breadth of any import tax, and the nature of any changes to NAFTA. We are not sure when all that will happen but it should bring stability to the peso when it does.

The balance of our emerging market exposure is in Indonesia, South Africa and Brazil. The story line is that better global growth and higher commodity prices should narrow the risk premium embedded in the yield curve and provide a better setting for strong FDI flows—which we believe will push bond yields lower and firm up the currency markets in 2017.

Supplemental Information to the attached Global Opportunistic Fixed Income GIPS compliant composite.

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ANNUALIZED RETURNS (%) (Results shown in USD)

	Gross	Net	CWGBI	BLBCW
QTD	- 6.06	- 6.17	- 8.53	- 7.87
YTD	5.73	5.26	1.60	2.76
1 Year	5.73	5.26	1.60	2.76
3 Year	1.27	0.82	- 0.84	- 0.23
5 Year	2.82	2.36	- 0.99	- 0.28
7 Year	5.14	4.67	0.89	1.53
10 Year	5.73	5.26	2.99	3.42
Since Inception	7.62	7.09	4.31	4.70

Inception Date: 1/1/1998

GIPS INFORMATION (%, Unless Otherwise Noted) (Results shown in USD)

	Gross	Net	CWGBI	BLBCW	# of Accounts	Market Value (M)	Total Firm Assets (M)	Composite Dispersion	Composite Rolling 3Y SD	CWGBI Rolling 3Y SD	BLBCW Rolling 3Y SD
2016	5.73	5.26	1.60	2.76	27	10,337	65,498	0.27	7.53	5.89	5.64
2015	- 8.04	- 8.46	- 3.57	- 3.35	28	11,427	68,819	0.18	6.19	4.39	4.28
2014	6.84	6.36	- 0.48	0.00	25	11,888	63,375	0.26	6.66	4.28	4.26
2013	- 3.23	- 3.67	- 4.00	- 3.67	27	10,079	50,050	0.18	6.83	4.60	4.53
2012	14.34	13.83	1.65	3.09	30	9,333	42,894	0.49	6.50	5.52	5.31
2011	8.64	8.15	6.35	6.42	35	6,993	33,122	0.45	8.33	7.57	7.19
2010	13.77	13.27	5.17	6.00	32	5,542	31,996	0.66	11.26	9.26	8.90
2009	21.10	20.57	2.55	5.97	33	5,532	29,199	1.16	10.95	8.83	8.44
2008	- 8.30	- 8.71	10.89	7.73	36	5,120	32,755	1.25	9.17	7.39	7.12
2007	10.71	10.19	10.95	10.29	35	6,394	49,208	0.24	5.16	5.48	5.01
2006	8.59	8.00	6.12	6.62	31	4,390	39,241	0.49	5.08	5.86	5.50

CWGBI = Citigroup World Government Bond Index (Unhedged) BLBCW = 90% CWGBI / 5% ML High Yield Index / 5% JPM Emrg Markets Index

Organization: Brandywine Global Investment Management, LLC (the "Firm") is a wholly owned, independently operated, subsidiary of Legg Mason, Inc. The Firm has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS). For the periods July 1, 2000 through June 30, 2015, the Firm has been verified by Kreischer Miller. A verification includes assessing whether the Firm (1) complied with the composite construction requirements of the GIPS standards on a firm-wide basis, and (2) designed its processes and procedures to calculate and present performance results in compliance with the GIPS standards. A copy of the verification report is available upon request. Disclosed total firm assets represent the total market value of all discretionary and nondiscretionary, fee-paying and non-fee-paying assets under the Firm's management. Composite Description: The Global Opportunistic Fixed Income Composite (the "Composite") Inception date: January 1, 1998. Creation date: January 15, 2002. The Composite includes all fully discretionary, fee-paying, actively managed Global Fixed Income accounts with no minimum market value and flexible country, yield and/or credit quality mandates. Approximately 90% of the holdings consist of debts of governments or related agencies of developed countries with the remaining 10% in debts of governments of emerging countries and corporate high yield opportunities in developed countries that Brandywine believes are going to substantially increase in value due to improving fundamental factors that affect their valuation. The portfolios are typically invested in securities from 8 - 16 different countries. Effective Oct 1, 2008, The Composite was amended and a number of client-restrictive accounts were removed. This restructuring accounted for a significant portion of the Composite's market value decrease. The Composite utilizes over-the-counter forward exchange rate contracts to manage its currency exposure. These contracts are valued daily using closing forward exchange rates. Brandywine uses WM/Reuters daily FX rates taken at 4 p.m. London time. Benchmark indices' exchange rates may vary from Brandywine's exchange rates periodically. Benchmark: The CWGBI measures the performance of developed countries' global fixed income markets invested in debt issues of U.S. and non-U.S. governmental entities.The blended index is constructed of monthly rebalanced returns of the Citigroup World Government Bond Index (CWGBI), which measures the performance of developed countries' global fixed income markets invested in debt issues of U.S. and non-U.S. governmental entities. ML HY Master II measures performance of U.S. domestic market debt instruments with a rating lower than BBB-. JPM EMBI+ tracks total returns of USD currency-denominated emerging market debt instruments such as Brady bonds, loans, and Eurobonds. JPM GBI measures the performance of developed countries' global fixed income markets invested in debt issues of U.S. and non-U.S. Performance Calculation: Preliminary data, if so noted, reflects unreconciled data for the most recent reporting period. Portfolios are valued daily on a trade date basis and include dividends and interest as well as all realized and unrealized capital gains and losses. Return calculations at the portfolio level are time-weighted to account for periodic contributions and withdrawals. Performance results are calculated on a before tax, total return basis. Prior to July 1, 2007, portfolios were included in the Composite beginning with the first full quarter of performance through the last full quarter of performance. After July 1, 2007, portfolios are included in the Composite beginning with the first full month of performance through the last full month of performance. Composite returns are reported on quarterly basis. The Composite returns consist of size-weighted portfolio returns using beginning of period values to weight the portfolio returns. Monthly linking of interim performance results is used to calculate quarterly and annual returns. Composite's valuations and returns are computed in U.S. Dollars ("USD"). The results are presented in USD or in other currencies (to accommodate overseas investors), the latter by converting monthly USD returns into other currency returns using the appropriate currency exchange rate returns. Gross returns reflect the deduction of trading expenses. Net of fee returns reflect the deduction of trading expenses and the highest investment management fees charged within the composite membership as stated in the fee schedule below. Composite dispersion is calculated using the asset-weighted standard deviation method for all portfolios that were in the Composite for the entire year. Composite dispersion is not presented for periods with five or fewer portfolios. The number of accounts and market values are as of the end of the period. The three-year annualized standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period. Past performance is no guarantee of future results. A complete list describing the Firm's composites as well as any additional information regarding the Firm's policies for calculating and reporting performance results is available upon request. Fee Schedule: Institutional Client Separate Account Management Fee Schedule (minimum initial investment: $50 million): 0.450% on the first $50 million; 0.400% on the next $50 million, and 0.350% on any portion of assets in excess of $100 million. Institutional Client Commingled Account Management Investment Trust Fee Schedule (minimum initial investment: $5 million): 0.450% on the first $50 million; 0.400% on the next $50 million, and 0.350% on any portion of the assets in excess of $100 million. Institutional Client Commingled Account Management Global Investment Trust Fee Schedule (minimum initial investment: $5 million): 0.450% on the first $50 million; 0.400% on the next $50 million, and 0.350% on any portion of assets in excess of $100 million. Additional information on the Firm's fee schedule can be found in Form ADV Part 2A which is available upon request.

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