

Global Fixed Income Investment-Grade

Quarterly Commentary

DO WHAT IT TAKES

The second quarter of the year delivered three punches to the global economic and investment outlook: the unravelling of China's equity mania, the status of Greece's participation in the European Monetary Union and the potential restructuring of Puerto Rico's municipal debt. Though significant in their own right, the three hits come at a particularly important point in the global cycle. World economic growth had been struggling throughout most of 2014. As the new year drew closer, we expected last year's market stabilizers (lower oil prices and bond yields), along with the redistributive benefits of a strong dollar, to provide a foundation for global stabilization. The insurance package to terminate the downward trajectory in global growth was the European Central Bank's (ECB's) asset purchases followed by China's abrupt change in economic policy in early and late March, respectively. The rebound in oil prices during the first half of the year, along with the across-the-board rise in global bond yields, were classic reactions to the reflationary effectiveness of these initiatives. However, the more recent slide in commodity prices, retreat in global bond yields, and weakness in emerging market equities begs the question of whether this year's sequence of political and financial disturbances could at least temporarily disrupt any potential growth revival.

That these developments might disrupt the global growth trajectory is a remarkable statement on the state of the global economy after six years of expansion. It is a reminder that the dominant structural feature of the global economy continues to be a glut of savings and a dearth of demand. The world is full of productive capacity, much of which has been kept alive by the lowest borrowing costs in history. This persistent overcapacity and excess of savings act as a constant weight on the structure of yields in high-quality global bond markets.

The big change since 2008 is global demand. The collapse of the U.S. private sector debt super-cycle torpedoed the world's marginal spender of last resort. No one country or region has really picked up the slack, although there have been periodic cyclical counter-trends. Instead, Europe has gone through an austerity binge which only made the global dearth of spending worse. Together the U.S. and European spending cutbacks knocked out the part of China's economic boom powered by its mercantilist export machine. That setback reinforced dwindling returns on its domestic investment spending boom, which conspired to deliver the slowest Chinese economic growth in 30 years. Chinese gross domestic product (GDP) got a temporary fillip from the massive post-crash stimulus measures adopted in 2009. But the slump in its export markets, the buildup of debt, and the obvious areas of capital misallocation have encouraged the new administration to pursue a new growth model. So far, they have not found one and lately have been plugging holes in the GDP-dike with short-term measures.

OVERCOMING THE FORCES OF DEFLATION

We wrote at length in our last report about the battle between the structural forces of deflation and reflationary forces provided by the market and policymakers. We expressed optimism that the forces of reflation would get ahead of deflation over the period ahead but also concluded that the process was going to be very slow. The trajectory of global yields would change if reflationary measures were successful, which could happen as early as this year or as late as mid-2016. This development continues to be the most important macro factor in terms of setting appropriate levels of duration, country, and currency exposure.

Updating our views, we still think that last year's falling global economic growth has been checked, notwithstanding the latest salvo of negative news. The normal lag between a change in oil prices and world activity implies that the next 12 months should see the maximum pass-through effect into spending from the plunge in energy prices. However, sparse evidence of a global upturn exists. Instead, world growth seems flat, leading economic indicators are rolling over, and deflationary pressures persist.

As these new deflationary developments unfold, it is important to keep in mind that global economic policy has shifted to the position of "do what it takes." That approach started with former U.S. Federal Reserve (Fed) chairman Ben Bernanke vowing to avoid the mistakes of the 1930s. It continued with ECB President Mario

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Draghi's determination to keep the European Monetary Union together. Japanese Prime Minister Shinzo Abe followed suit by spearheading a regime change at the Bank of Japan that launched the most aggressive monetary stimulus since the 1920s. For the most part, investors have underestimated the resolve of authorities or their creativity in coming up with ways to avert deflation. Even when major policy moves are announced, investors have largely been skeptical or worried about the outcome of their efforts. In the meantime, central banks have purchased all types of financial assets in the past few years ranging from sovereign bonds, corporate and mortgage credit, commercial bank debt, exchange-traded funds, and equities. In our view, we think reflationary policy measures could get bigger and brasher still.

The biggest trouble spot for global growth is the developing world, especially China. This group of economies represents almost 58% of global GDP and growth there has converged closer to the rate of U.S. growth than at any time since the late 1990s. The combined economic output of the BRICs—Brazil, Russia, India, and China—represent about 50% of this region and matched U.S. GDP last year. In 2007, the U.S. economy was twice as big as these four countries! The collective trend in these countries is important. Monetary growth, defined as M2, when adjusted for inflation, is as low as it was in the late 1990s around the time of the emerging market crisis, and their Purchasing Manager Indices point to recession. The BRICs are a part of the world in need of a lot of reflation.

China is the biggest BRIC country and the most important in terms of regional activity. Its monetary conditions index warns that monetary policy is dramatically behind the reflationary curve in spite of recent rate and reserve requirement cuts. The components of this index include real interest rates, the currency value and lending levels—all of which get to the heart of the issue. Real interest rates remain elevated because inflation is falling faster than Chinese policymakers are cutting nominal rates. Producers are liquidating inventories while deregulation has left corporate lending rates too high. The average bank lending rate is still over 7%, which when compared to the negative producer price inflation rate implies punitive corporate borrowing costs. Similarly, our research shows that the Chinese yuan is overvalued, yet the authorities' determination to liberalize and be part of the International Monetary Fund's (IMF's) basket of Special Drawing Rights encourage them to sustain the currency at an overvalued level. Correspondingly, loan growth remains subdued and the trade sector keeps spewing out deflation. Contracting foreign exchange reserves in an inherently pegged monetary system is a de facto tightening.

In our view, Chinese authorities are moving toward the "do what it takes" brigade. They are still behind the curve but getting to a more appropriate support level. The government encouraged the boom in the equity market earlier this year as another way of funneling household savings into the corporate sector. It was only when the bull market turned into a casino that it neutralized the speculation with higher margin requirements. The bust is so troubling in terms of potentially undermining consumption growth, however, that the People's Bank of China is now participating in market stabilization indirectly through the China Security Commission. What's clear from all this volatile market movement is that the authorities are not yet ahead of domestic deflationary impulses but much more stimulus is coming. The only issue now is what form that stimulus will take.

In other emerging market countries, economic policy is hung up over inflation-pass-through anxiety tied to falling currencies. The decline in many of these currencies has matched the fall in their respective terms of trade. The latter, in turn, are linked to falling commodity prices. Tightening to prop up currencies weakened by a negative terms of trade shock is stagflationary. This stagflation is especially pronounced in Brazil where money growth is close to zero, and the economy is in recession but inflation remains sticky. The authorities are waiting for inflation to break before moving to stimulate. Clearly a period of stability in emerging market currencies would help a lot.

Part of the pressure on emerging market currencies stems from generalized dollar strength along with expectations that the Fed will raise rates this year. But Fed policy is data dependent and dollar strength has hurt the economy. In a world of low nominal income growth, last year's surge in the dollar represents an endogenous tightening visible so far in reduced profit growth and lower corporate margins. Broad-market revenue growth correlates closely with export growth, which is weak. Similarly, business sales growth correlates closely with producer price inflation which has been weighed down by global deflationary trends. The Fed wants to end zero interest rate policy but market-based inflation measures have flattened out since April, which suggests the central bank will react later and more slowly. The market has already priced in a low probability for the Fed to raise rates in September. We agree.

Europe's economic fortunes seemed to be on the rise this year. Money growth has been a consistent and reliable indicator of future European growth and has been bolstered by a weaker euro, the end of austerity measures, and ECB large-scale asset purchases. Early signs are visible that European credit growth has started to turn as well.

Nonetheless, it would be a mistake to call this a robust recovery or that deflation risks have passed. Market-based measures of inflation expectations have been fairly flat since April, part of which could be linked to problematic negotiations with Greece. At the time of writing this letter, Greece voted "No" in its austerity referendum, and the E.U. gave Greece additional time to implement reform that would be rewarded with a new, nearly €86 billion, three-year bailout package. The impact effect of a potential "Grexit" is hard to assess. The direct effect on the European Monetary Union seems small under most conventional guesses of how much it contracts because it is only 2% of euro-zone GDP. A reasonable chance exists, however, that the Greek economy could literally implode, which would carry with it more serious repercussions for the European economy as a whole. Greece will still incur considerable economic pain even if there is an agreement and a new aid package. Either way, what is clear is that the ECB is likely to double down its efforts to maintain stability and reflationary momentum. It could increase the scale of asset purchases, widen the range of securities eligible for purchase, as well as extend the purchase program beyond the period when the current round is scheduled to end in mid- to late-2016.

STRATEGY PERFORMANCE AND POSITIONING

The second quarter of 2015 was challenging for performance. The Global Fixed Income Investment-Grade strategy underperformed its Citigroup World Government Bond Index benchmark on both a gross- and net-of-fees basis. Duration was close to benchmark levels and yield curve effects broadly produced a modest benefit

to relative performance. Currencies detracted from a contribution and attribution perspective, mainly because the second-quarter rebound in the euro and British pound produced a positive contribution from the benchmark. During the quarter we swapped out positions in the British pound ahead of the election into Norwegian krone and Swedish krona, both of which we considered would be likely beneficiaries of a rebound in oil and world growth. This positioning hurt performance on net when global growth worries reappeared.

Looking ahead for the balance of the year and beyond, we expect to maintain duration at or near the benchmark's levels. As indicated earlier, we are optimistic on the reflation process but believe it will be very slow to overcome the structural forces of deflation.

Consequently, the sharp sell-off in U.S. government bonds during the early part of the quarter prompted us to add about a year's worth of duration back to the strategy through long-term U.S. Treasuries. Currently, yields seem reasonable relative to the global backdrop. We would be inclined to cut U.S. duration on rallies, assuming our view of the macro outlook does not change much. Another significant part of our strategies' duration positioning is in Mexican Mbonos. Mbono yields traditionally have a high correlation to U.S. government bond yields. Mexican inflation is the lowest in decades, providing solid valuation for the local bonds. The big plus for the Mexican bond position, however, is the currency's valuation, which has fallen to a level that strikes us as highly anomalous. Unlike other emerging countries during the past few years, the Mexican central bank has been easing into the commodity bust which has helped its economy without compromising inflation.

In addition to Mexico, long duration assets are held in Brazil and South Africa. Although not all less-developed countries are alike, deflationary pressures are global and attempts to avoid pass-through from weak currencies into domestic inflation, such as in Brazil, only invite bigger overshoots in currencies and higher domestic interest rates. This story is precisely what we believe is playing out in these two countries. South African bonds have been in a trading range of roughly 9% to about 7% for the last 10 years and are currently in the upper half of that range.

The dollar is now one of the more expensive currencies in the world and anytime you have this much momentum, the tendency is to go with the flow—higher valuations for longer. Dollar strength is affecting behavior, however, and more importantly, affecting corporate profitability. The price action moved us in the opposite direction. Over the past five months, we reduced our dollar weighting. Nonetheless, we continue to underweight the yen and euro although this relates more to their local bond markets than the currencies per se, which are beginning to look cheap based on our internal research. This year's reflationary push took some of the fear premium out of Bunds, which resulted in a significant sell off. The uncertainty fostered by Greek bailout negotiations has pulled yields a little lower again on German 10-year Bunds but prices continue to trade at a level we consider overly expensive. Similarly in Japan, Japanese Government Bonds have followed the ebb and flow of the global reflation story yet remain fundamentally low relative to our measures of fair intrinsic value.

The reduction in our dollar overweight has been in favor of several less-developed countries that remain caught up in the vicious cycle of rate hikes to fight the inflation pass-through from lower currencies, which only weakens the currency more. Ultimately, once inflation falls, we expect this vicious cycle to end and be replaced by a virtuous cycle of rate cuts and currency stability/strength.

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ANNUALIZED RETURNS (%) (Results shown in USD)

	Gross	Net	CWGBI	BGA
QTD	- 2.91	- 3.02	- 1.55	- 1.18
YTD	- 3.21	- 3.42	- 4.02	- 3.07
1 Year	- 4.87	- 5.35	- 9.02	- 7.09
3 Year	1.95	1.41	- 2.45	- 0.81
5 Year	5.46	4.89	1.05	2.07
7 Year	6.05	5.48	1.75	2.58
10 Year	6.03	5.46	3.07	3.54
Since Inception	8.96	8.37	5.19	5.35

Inception Date: 7/1/1992

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

	Gross	Net	CWGBI	BGA	# of Accounts	Market Value (M)	Total Firm Assets (M)	Composite Dispersion	Composite Rolling 3Y SD	CWGBI Rolling 3Y SD	BGA Rolling 3Y SD
2015	- 3.21	- 3.42	- 4.02	- 3.07	15	2,053	67,284	0.14	5.35	4.33	3.94
2014	5.58	5.00	- 0.48	0.58	15	2,046	63,375	0.42	5.77	4.28	3.93
2013	- 3.43	- 3.96	- 4.00	- 2.60	16	1,871	50,050	0.26	6.08	4.60	4.36
2012	12.98	12.37	1.65	4.32	18	2,195	42,894	0.50	5.84	5.52	4.90
2011	7.61	7.02	6.35	5.64	16	1,783	33,122	0.29	7.88	7.57	6.53
2010	12.90	12.29	5.17	5.55	17	1,588	31,996	0.78	10.08	9.26	7.96
2009	17.85	17.22	2.55	6.94	19	1,925	29,199	1.59	9.78	8.83	7.53
2008	- 2.60	- 3.13	10.89	4.79	28	3,484	32,755	1.56	7.86	7.39	6.38
2007	10.32	9.73	10.95	9.48	37	8,869	49,208	0.62	4.57	5.48	4.40
2006	5.55	4.97	6.12	6.64	40	7,347	39,241	0.67	4.67	5.86	4.78
2005	- 2.83	- 3.36	- 6.87	- 4.48	36	4,876	26,332	0.14	6.24	7.24	5.99

CWGBI = Citigroup World Government Bond Index (Unhedged) BGA = Barclays Global Aggregate Bond 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, 2014, the Firm has been verified by Kreisler 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 Fixed Income Investment Grade Composite (the "Composite") Inception date: July 1, 1992. Creation date: July 1, 1992. The Composite includes all fully discretionary, fee-paying portfolios managed in the Global Fixed Income Investment Grade Strategy. The strategy invests only in U.S. and foreign investment grade fixed income securities with portfolios typically invested in securities from 8 to 12 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 Composite returns are benchmarked to the Citigroup World Government Bond Index (CWGBI) and Barclays Capital Global Aggregate Index (BC Global Agg). 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 BC Global Agg provides a broad-based measure of the global investment-grade fixed income markets by including agencies, corporates and asset backed issues. 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. 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. As a result of our internal review process during the quarter ended September 30, 2007, the performance results shown reflect certain immaterial revisions to performance information previously reported by the Firm for periods through June 30, 2007. The three-year annualized standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period. 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 Group Trust Fee Schedule (minimum initial investment: \$1 million): 0.550% flat fee on all assets. Institutional Client Commingled Account Management Global Investment Trust Fee Schedule (minimum initial investment: \$1 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. Additional information on the Firm's fee schedule can be found in Form ADV Part 2A which is available upon request.

Past performance is no guarantee of future results.

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