

2Q
2018

Investment Report

Oregon Local Government Intermediate Fund



Performance Review

For the second quarter of 2018, the portfolio outperformed the Bloomberg Barclays US Government/Credit Bond Index (1-5 Year) by 5 basis points (bps) gross.

The portfolio's duration positioning during the quarter was a slight detractor from performance as interest rates rose; the 10-year US Treasury (UST) yield increased from 2.74% to 2.85%. However, this was more than offset by a positive contribution from the portfolio's yield curve flattening positioning as 2s to 10s flattened from 47 bps to 33 bps.

The portfolio's overweight position to USD-denominated emerging market (EM) corporate bonds was the primary negative detractor from performance as spreads widened, generating negative excess returns.

We continue to believe that opportunities exist for high-quality carry in investment-grade corporate bonds and we added approximately 4.5% in select financial and industrial names to the portfolio.

Investment Outlook

The optimism for a global synchronized recovery at the beginning of the year has given way to anxiety over potential EM and European crises. The divergence in performance between the US bond market and markets in the rest of the developed world has been breathtaking. The driver of this divergence is the expectation that US growth will pick up sharply in the second half of 2018, while growth expectations for Europe, China and EM have all been lowered.

Our investment thesis has been that as global growth improves, even with a two-steps-forward/one-step-back pattern, spread products would continue to outperform USTs and sovereign bonds. This thesis also relies on the premise that developed market (DM) central banks will be cautious in outlining and proceeding on their respective paths to

normalization. It has been almost a full 10 years since the global financial crisis. After flirting with deflation in 2016 on the back of global recession fears, with oil prices plunging to \$25 a barrel, then dealing with Brexit, global DM inflation has bounced and the fears of global deflation are receding into the rearview mirror. But the global inflation lift-off is still in its early days, and improving from very low levels. Indeed, as growth expectations for much of the world outside the US have been scaled back, the DM central bank focus on underpinning growth remains the key priority, rather than dampening remote inflation fears.

We are steadfast believers that the low-inflation world we inhabit is not going to change quickly. Portfolios need buffers against adverse events, and Treasury securities remain the best diversifying hedge. During the long recovery since 2009, there have been several periods of market optimism that the economy had accelerated sufficiently (escape velocity) to bring about a surge in inflation. There have been other periods when market pessimism has led to concerns over portfolios with insufficient holdings in sovereign and Treasury debt, as well as strategies offering downside protection. We believe the global economies are mending, and that central bankers should finally but gradually be able to withdraw stimulus. It is not a sure thing by any stretch. If this outlook proves broadly correct, spread sectors should do well. If there are any meaningful wobbles, Treasury bond gains should help provide a cushion.

For more information on Western Asset visit www.westernasset.com.

Exhibit 1 Oregon Local Government Intermediate Fund

	Portfolio	Index**
2Q18 Performance*	0.23%	0.17%

*As of 30 Jun 18. *Performance is gross of fees. **Bloomberg Barclays U.S. Government/Credit Bond Index (1-5 year).*

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