SECTOR TEAMS' OUTLOOK

JANUARY 2019

SECTOR TEAMS ARE A CRITICAL PART OF THE INVESTMENT PROCESS AT LOOMIS SAYLES. THEY BRING TOGETHER TRADERS, ANALYSTS, STRATEGISTS AND PORTFOLIO MANAGERS, EACH WITH EXPERTISE IN SPECIFIC FINANCIAL MARKET SECTORS. THESE TEAMS ARE DESIGNED TO EFFICIENTLY DISSECT THE CONTINUAL ONSLAUGHT OF MARKET INFORMATION AND **"SEPARATE THE WHEAT FROM THE CHAFF."**

Every quarter, our sector teams engage in a global asset allocation team (GAAT) process. The ensuing conversations, interactions and analysis set the stage for delivering our estimated returns and relative value ideas. In this paper, each sector team shares its insights and outlook for 2019.

We See Modestly Higher US Government Bond Yields and Limited US Dollar Upside if Macro Risks Abate

- The Federal Reserve's (Fed) dovish pivot affirms a lasting patient stance, but a pick-up in the US economy and inflation later this year could lead to another rate hike. We believe the change in stance can be attributed to softer economic activity, tighter financial conditions, less robust corporate profitability and core inflation hovering at or below target levels.[1]

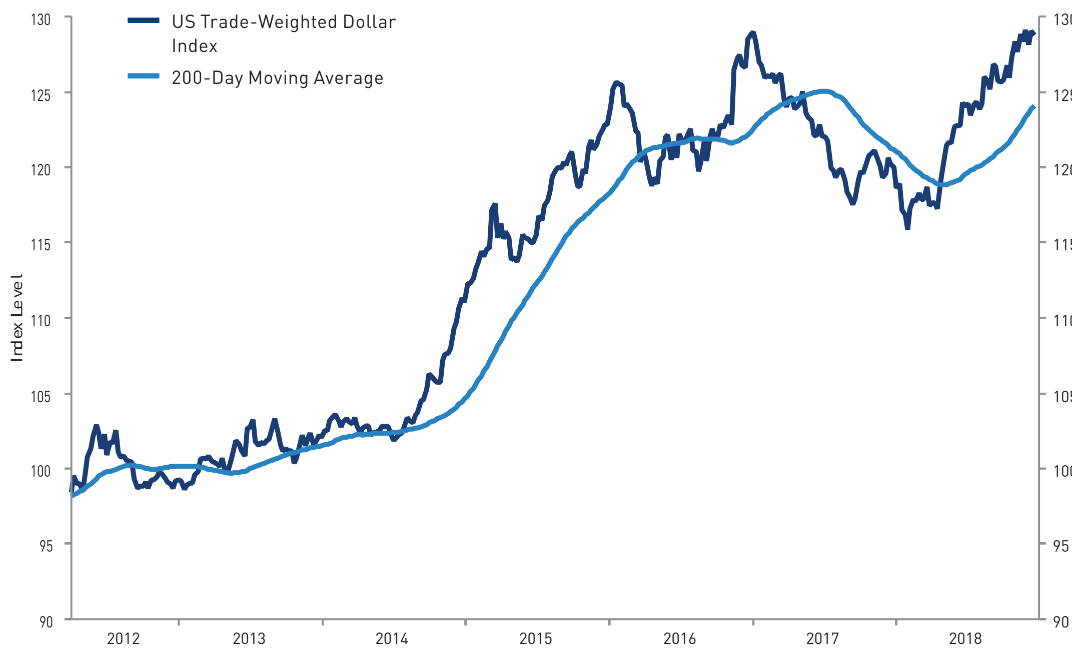
- Consensus expectations for global growth have been revised lower and fiscal stimulus in the US could fade in the coming quarters. However, we view this as a soft patch in a continued expansion that likely leads global economic growth back toward trend levels. In such a scenario, we envision government yields rising modestly while inflationary pressures remain subdued.

- During the course of 2018, the US dollar benefited from the level of US growth and interest rates relative to those of other countries. However, with the US economy also expected to slow this year, the dollar may establish a trading range rather than a meaningful break higher.

[1]*Revised view as of 2/6/2019.*

THE US DOLLAR HAS REACHED CRITICAL RESISTANCE; OTHER CURRENCIES LOOK INEXPENSIVE

US Broad Trade-Weighted Dollar Index



Source: Thompson Reuters Datastream, data as of 12/27/2018.

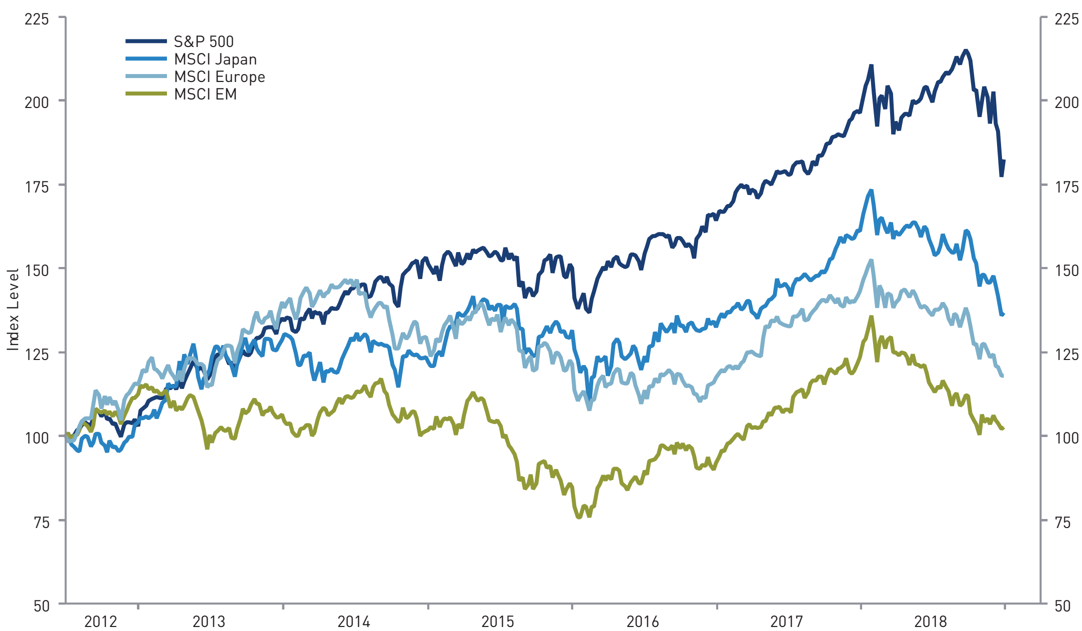
EQUITIES

While Equity Valuations Appear Compelling, the Technical Backdrop is Challenging and Late-Cycle Dynamics Could Keep Volatility Elevated

- Macro risks will likely dominate the equity landscape during the next few quarters despite decent earnings growth and valuations that have reached attractive levels not seen in several years.
- Tighter financial conditions and accelerating wage growth are late-cycle threats that may lead to increased volatility, particularly when compared with earlier periods of the expansion. Trade wars and global economic softness are additional key risks likely to remain in the near term.
- The severe challenges of 2018 left many equity sectors firmly in bear-market territory. Time and patience will be needed to repair the technical damage endured by even the most favored areas of the equity market.
- Equities appear to have meaningful upside if the macro backdrop becomes a bit more supportive. We believe US stocks will likely lead in an equity recovery but emerging markets could also present an attractive opportunity—especially if upward movement in the US dollar is limited.

THE GLOBAL EQUITY BULL MARKET BROKE DOWN IN JANUARY 2018; US EQUITIES HELD UP UNTIL THE FOURTH QUARTER

Global Equity Relative Performance



Source: Thompson Reuters Datastream, data as of 12/31/2018.
Past performance is no guarantee of future results.

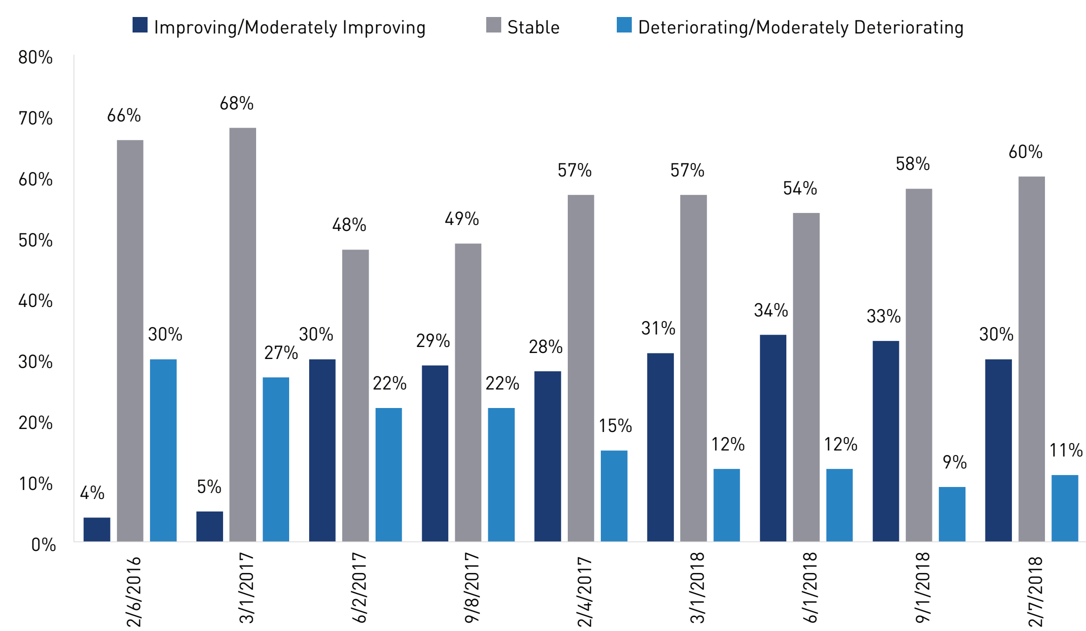
INVESTMENT GRADE CORPORATE BONDS

Recent Widening in IG Corporate Spreads Likely Overdone

- The IG Corporate spread ended the year 69 basis points (bps) wider than its narrowest point in 2018, with 48 bps of the widening occurring in the fourth quarter. We believe this move is overdone and forecast modestly tighter spreads in 2019.
- Much of the recent widening was due to macro concerns including the pace of Fed rate hikes, an inverted Treasury curve, US/China trade policy, slowing global growth, less supportive global monetary policy and Brexit.
- However, underlying fundamentals remain favorable and we forecast US corporate profits to be strong in 2019 with margins and free cash flow expected to be stable to improving in more than 80% of industries.
- Leverage of IG non-financial companies improved again in the third quarter of 2018, driven largely by earnings growth and decelerating debt growth. Our research group has stable to modestly improving outlooks on 90% of IG industries.
- Corporate spreads should benefit from lower-than-expected new issuance in 2019. Thus far, concerns about the growth of BBB debt appear overblown and we view downgrade risk to high yield as more idiosyncratic rather than systemic.
- Key risks include a significant pick up in leveraging M&As or LBOs, aggressive rate hikes by the Fed and a meaningful retreat of foreign demand.

90% OF IG INDUSTRIES RATED STABLE TO IMPROVING BY LOOMIS SAYLES RESEARCH ANALYSTS

Percent of US IG Industries by Market Value



Source: Loomis Sayles Data and Analysis, as of 12/7/2018.

EUROPEAN INVESTMENT GRADE CREDIT

With Volatility Persistent, Relatively Healthy Fundamentals Could Be Met by Weak Technicals

- We expect positive excess returns in 2019 given the relatively attractive valuations of the European investment grade bond sector after the weak 2018. At this point, we think key concerns—notably Brexit, Italy and the end of the European Central Bank's (ECB) corporate sector purchase program (CSPP)—are mostly priced in to the market. However, we do expect continued volatility throughout 2019 since fundamentals and technicals paint a mixed picture.

- While fundamentals should remain relatively healthy—our analysts estimate mostly stable-to-improving margins, free cash flow and leverage—softening economic data is a concern. We estimate that the European corporate market is solidly in late-cycle territory. Relative to historical levels for this point in the cycle, we believe valuations appear cheap, reflecting technical and macro pressures.

- The technical picture has weakened with outflows accelerating, decreased ECB buying, idiosyncratic and BBB concerns. While we do not foresee the withdrawal of ECB buying in December as materially impacting the market, it does remove the backstop buyer, which could be missed in weaker times.

VALUATIONS BY REGIME

1998 – 2018

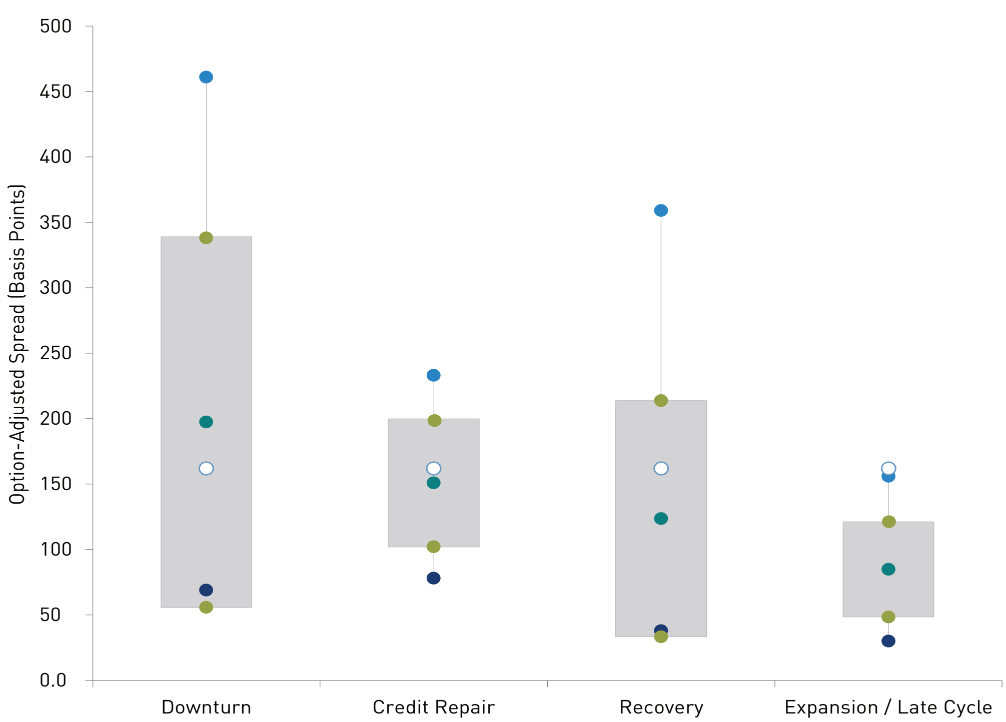
Regime Max

Regime Min

Regime Average

Current

+1/-1 Standard Deviation



Source: Loomis Sayles analysis, data from 11/31/1998 through 11/31/2018. Regime periods are determined by the investment team based on subjective and objective factors, including past economic and asset performance metrics. Views and opinions expressed reflect the current opinions of the investment team, and views are subject to change at any time without notice. Other industry analysts and investment personnel may have different views and opinions. See Disclosure for credit cycle dates during each period.

HIGH YIELD

The Health of the US Credit Cycle is Intact

- The Barclays High Yield Index ended 2018 yielding 7.95% after the market experienced dramatic fourth quarter volatility. This valuation can present an opportunity to increase exposure to an asset class whose income generation outpaces the majority of global alternatives. In addition, we believe the health of the US credit cycle is intact, which should support continued low default expectations.

- Investor concerns regarding the recent decline in oil prices contributed to the high yield (HY) market's volatility. However, our research shows the energy industry is in a better place compared to the 2015 energy cycle. Balance sheets boast stronger leverage metrics and operators appear to be far more disciplined after that experience.

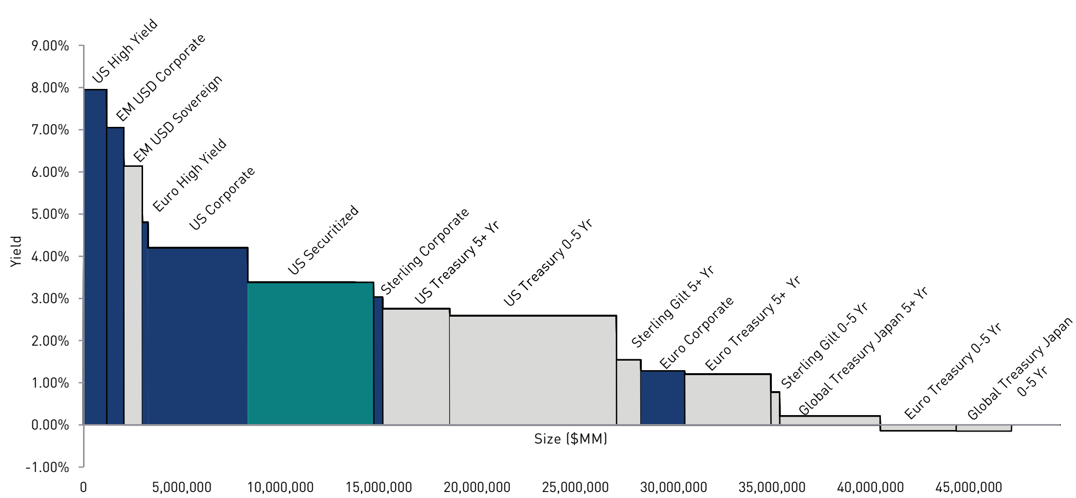
- More broadly, the credit trend is similar. Interest-coverage ratios are approaching all-time highs supported by growing earnings, while gross leverage appears stable. We believe the repricing of the US HY sector can be attributed to recent weakening of economic indicators, the increased fed funds rate and higher equity volatility.

- Four straight years of negative net issuance should support HY spreads, although the sector's negative outflows were challenging in 2018.

- Major risks to our thesis include the potential for aggressive Fed tightening, continued deceleration in global growth and oil prices resetting significantly lower.

HY INCOME POTENTIAL OUTPACES THAT OF GLOBAL ALTERNATIVES

Yield by fixed income asset class



Source: Bloomberg, Barclays, JP Morgan as of 12/31/2018.
Size represents market value of the index. Yield represents Yield to Worst.
All indices are unmanaged and do not incur fees. You cannot invest directly in an index.
Past performance is no guarantee of future results.

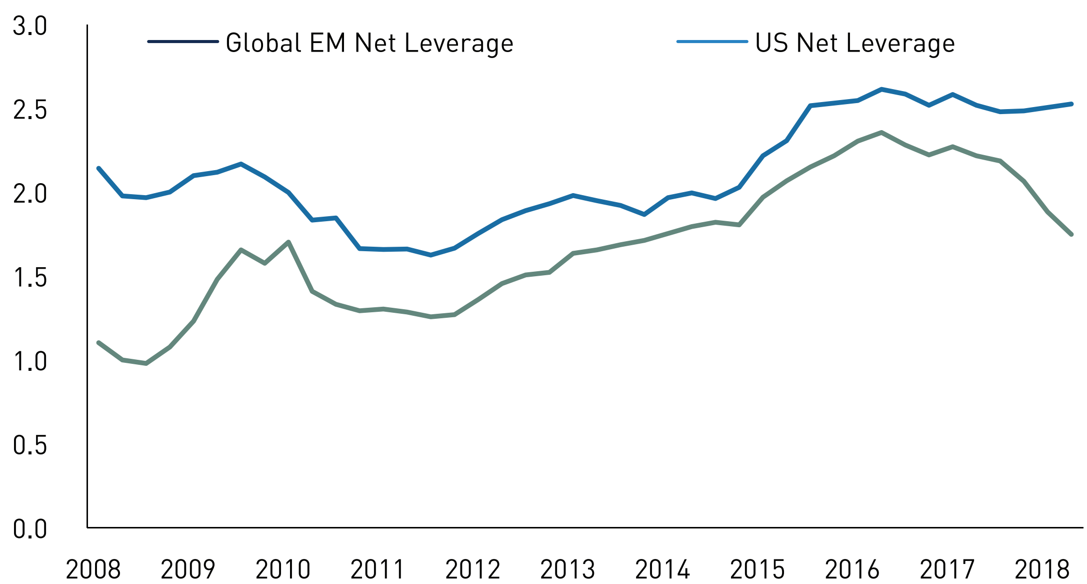
EMERGING MARKETS (EM) CREDIT, LOCAL DEBT AND CURRENCIES

Cautious Optimism About Investor Appetite for Risk Assets

- We remain cautiously optimistic on emerging markets in 2019 despite a challenging 2018.
- Tightening global liquidity is a risk for EM asset prices, but we expect Fed rate hikes to moderate in 2019 as US growth decelerates. This should benefit EM issuers and improve appetite for risk assets.
- EM currencies could find relief as a pause in the dollar and high real rates in EM may support inflows into local-currency assets.
- We agree with the consensus estimate of 3.6% global growth for 2019, and see healthy EM corporate balance sheets continuing. We prefer short-duration bonds and, in the near term, higher-quality credits with attractive yield potential.
- China is committed to long-term deleveraging efforts, but we anticipate short-term policy measures to help offset recent financial stress and the likely economic impact of rising protectionism.
- At the end of 2018, Latin America was showing signs of improved growth, with certain economies in the midst of credit repair and recovery. We are mindful of potential policy missteps from new administrations—Mexico and Brazil stand out.

NET LEVERAGE IN EM HAS FALLEN DRAMATICALLY

Net Leverage
2008 to 2018

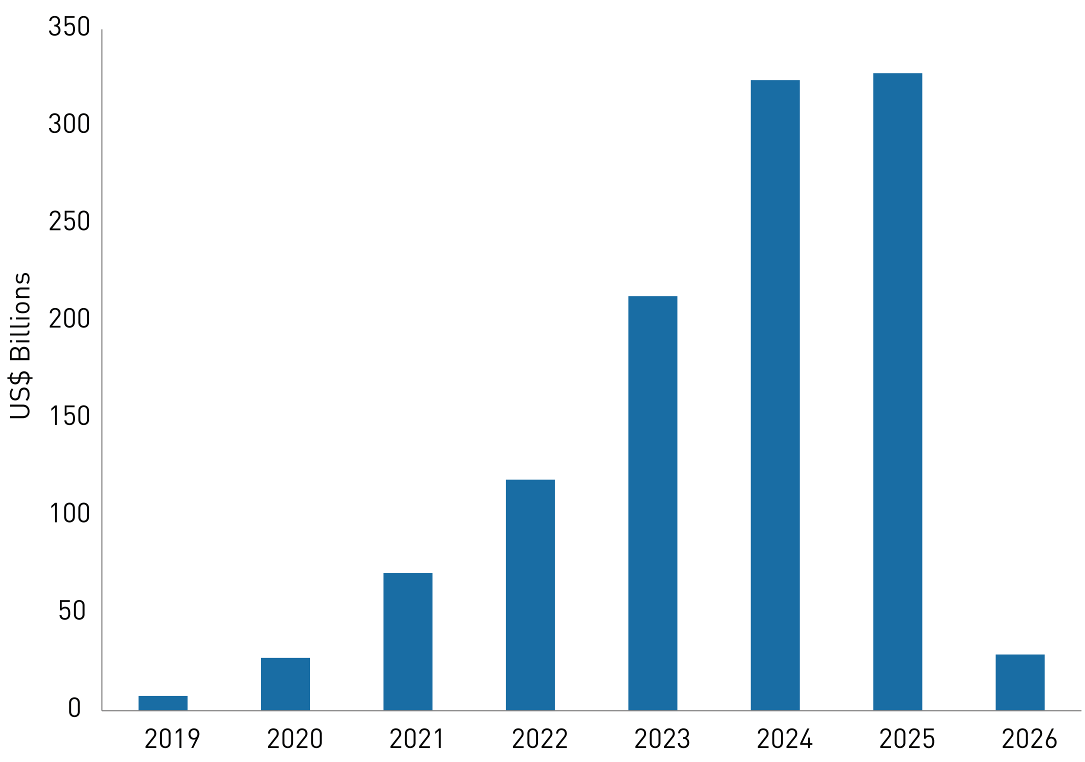


Source: Bank of America ML, data as of 6/30/2018.
Past performance is no guarantee of future results.

Default Rates Should Stay Below Historic Averages

- We expect the formation of collateralized loan obligations to remain a positive technical driver for loan demand through 2019.
- We believe that as the Fed raises rates, future loans will have higher coupons, which the market should anticipate.
- We have a positive outlook on corporate fundamentals. This, coupled with the low volume of loans maturing through 2020 and high rates of refinancing, should help keep default rates below historic averages.
- At the end of 2018, loans in our portfolios averaged historically robust interest coverage ratios.

ONLY $7.7 BILLION OF BANK LOAN MATURITIES IN 2019 (0.7% OF INDEX)



Source: S&P/LSTA Leveraged Loan Index. Data Source: S&P/LCD as of 11/2/2018.

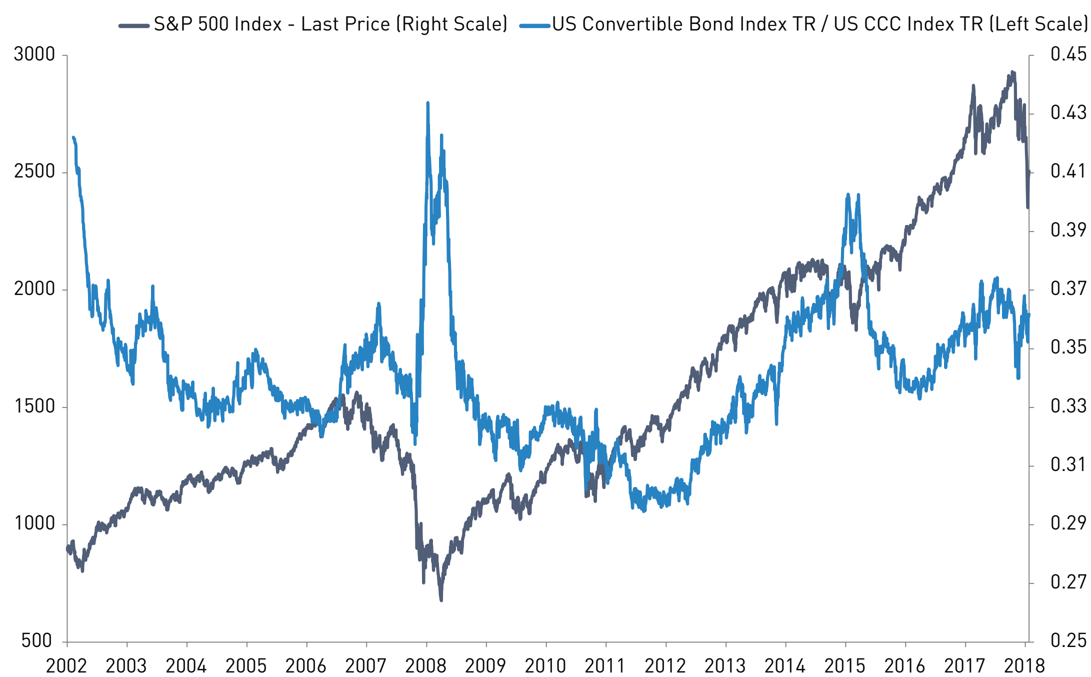
CONVERTIBLE BONDS

We Like Convertible Bonds in 2019 as Alternative to CCC-Rated HY

- Convertible bonds appear positioned to outperform the CCC tier of the HY market following the weakness of risk assets in late 2018.
- With regard to security selection, we prefer larger, higher-quality convertible bond issuers in the biotech, energy and industrial sectors. We believe converts with moderate equity sensitivity appear to provide the best combination of upside participation with downside protection.
- If the bear case plays out and the recent equity-market weakness is only in the early innings, history has shown convertible bonds can outperform CCC HY credits by not fully participating in selling pressures.
- The chart below shows Bloomberg Barclays US Convertible Bond Index total return relative to the Bloomberg Barclays US CCC Index total return (purple line). The blue line is the S&P 500® Index. In the past three market corrections (2007 to 2009, 2011 and 2015 to 2016), convertible bonds outperformed CCCs during the peak to trough S&P 500 correction in two of the three scenarios. The middle scenario (2011), converts were nearly flat with CCCs.
- We do note that following periods of convertibles' material outperformance relative to CCCs (e.g., 2007 to 2009 and 2015 to 2016 equity selloffs), it made sense to use that period to swap from converts into CCCs—as CCCs subsequently had strong periods of outperformance.

CONVERTIBLE BONDS CAN PROVIDE BALLAST IN RISK-OFF MARKETS

Convertible bond performance relative to CCC HY



Source: Bloomberg, as of 12/18/2018. Used with permission from Bloomberg Finance L.P.
Past performance is no guarantee of future results.

MORTGAGE AND STRUCTURED FINANCE

We Believe Consumer and Real Estate Fundamentals Should Support Attractive Risk-Adjusted Returns

- Domestic policy changes and global event risks will likely require a nimble approach to investing. However, 2019 is starting with higher incremental income and a flatter yield curve. We believe these factors increase the possibility of positive total returns and reduce the opportunity cost of taking a defensive stance.
- We believe the securitized sectors to continue to generate attractive risk-adjusted returns in 2019, supported by attractive consumer and real estate fundamentals, which can help mitigate late-cycle volatility.
- Our top pick is agency MBS, which can provide an important source of liquidity and intermediate duration in the event of a market dislocation. In securitized credit, we prefer ABS over CMBS and RMBS due to the sector's lower volatility.

Agency MBS

- We believe agency MBS spreads are near equilibrium levels, where the option-adjusted spread offers a strong income. We are constructive on the mortgage basis over a 6- to 12-month horizon. Fundamentally, we find the interest-rate sensitivity of the mortgage universe attractive and we do not believe that there are substantial contraction or extension risks (i.e., it is unlikely mortgage holders will be motivated to repay loans sooner than expected or take longer that expected to repay).
- The demand and supply picture has mortgages trading with increased spread volatility. With the Fed no longer reinvesting repayments into mortgages, uncertainties persist regarding demand. However, we do expect net supply to be lower than 2018 in the face of greater bank demand, which could provide an improved technical outlook compared to the second half of 2018.

Securitized Credit

- In consumer ABS, fundamentals remain positive as unemployment remains low and wages rise. The sector's short spread duration and lower volatility make it an attractive defensive play. We see opportunities in commercial ABS as well, though security selection will be important, with careful attention to assets and structure.
- We have a generally positive outlook for RMBS. Despite slowing home price appreciation, we believe strong demographic demand and lack of supply will continue to support prices. Quantitative tightening could present valuation risks to RMBS, so we prefer the shorter-duration and lower-beta segments of this market.
- We believe CMBS fundamentals are mid-to-late cycle. Valuations appear high and new construction is limited. However, continued job growth should support occupancy and rental gains and robust institutional demand for US properties should support modest price appreciation. Downside risks are on the rise, including the possibility of a corporate-led economic slowdown. We favor higher-quality and shorter-maturity CMBS with better liquidity profiles.

Disclosure

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All information provided as of December 31, 2018, unless otherwise noted, and is subject to change at any time without notice.

Credit Cycle dates:
Downturn periods include 9/29/2000 - 11/30/2001, 1/31/2008 - 6/30/2009.
Expansion periods include 11/30/1998 - 8/31/2000. 3/31/2006 - 12/31/2007, 1/31/2014 - 11/30/2018.
Recovery periods include 6/30/2003 - 2/28/2006, 6/30/2011 - 12/31/2013.
Credit repair periods include 12/31/2001 - 5/30/2003, 7/31/2009 - 5/31/2011

Investing involves risk including possible loss of principal.

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