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Q4 Round Up: US Election Implications, Resilient US Economy and Potential for Unstable Inflation

Markets Take Direction from Decisive US Election Result

Fourth quarter market sentiment was largely driven by the much-anticipated US election, during which Donald Trump was elected as the 47th president. Republicans took majority control of the Senate and maintained the House of Representatives for a clean sweep. The initial reaction in risk assets was positive, likely driven by many investors being underweight risk coming into the election given the uncertain outcome, in our view. The decisive outcome of the election supported market sentiment due to the potential for pro-growth policies, such as tax cuts and deregulation. Post-election, the Federal Reserve (Fed) continued on its easing path with 25 basis points (bps) in interest rate cuts during November and December of last year, however, the market re-priced expectations for fewer rate cuts in 2025 and beyond. The Treasury curve shifted higher during the quarter, with the 10-year US Treasury increasing from 3.78% to 4.57%. Investment grade and high yield spreads tightened, supported by higher expectations for a soft landing and strong investor demand for yield.

Resilient US Economy, Potential for Unstable Inflation

Our base case continues to call for trend/above trend US economic growth and we do not anticipate a recession at this time. Low unemployment and healthy financial markets (i.e., strong equity performance and real estate appreciation through COVID) are supporting the mid-to-upper tier consumer, who drive much of the US economy. In addition, corporate fundamentals have remained stable, and earnings growth is robust, which are also supportive of economic activity. These factors are helping to provide a floor to economic activity, and we expect growth consistent with a "soft landing" in the coming quarters. On a global basis, European growth is gradually improving but momentum has slowed, and we see inflationary risks persisting. We expect European Central Bank (ECB) rate cuts to be more gradual than market expectations as a result. We also anticipate a rise in government borrowing, as we believe an investment-oriented set of fiscal measures is required to boost growth. In Japan, we expect increased tolerance for higher yields by the Bank of Japan (BOJ) if the bank's confidence grows regarding the achievement and sustainability of 2% inflation. Lastly, the People's Bank of China (PBOC) has stepped up stimulus efforts to address economic challenges, ensuring necessary fiscal spending

	BASE CASE
CREDIT CYCLE	Late Cycle
MACRO	Resilient US Economy
INFLATION	Unstable
POLICY RATES	Shallow & Prolonged Rate Cutting Cycle
US RATES	Neutral
CORPORATE FUNDAMENTALS	Stable
FX	Range Bound
KEY RISKS	Trump Policies at the Forefront

to bolster growth; however, we believe uncertainty remains regarding the scale and effectiveness of such measures.

Cyclically, we are anticipating US inflation to decline in the coming months before leveling out somewhere just above the Fed's 2% target. In the short-term, we believe there is a potential upside risk to inflation as a result of Trump policies, specifically tariffs, and that inflationary pressures could begin to build with a lag now that the Fed has embarked on a rate-cutting cycle and the economy potentially builds momentum. On a long-term basis, we have been suggesting that inflation may remain unstable and potentially experience higher lows in future cycles due to structural factors, such as the fiscal deficit, trade protectionism, deglobalization, decarbonization and aging demographics.

Interest Rate Uncertainty

Combining our cyclical and structural views suggests the level of interest rates and the shape of the yield curve could take a number of different paths. On the front end of the curve, we recognize the risk that the Fed could be compelled to hold rates or to lean against stimulating fiscal spending and inflationary tariff hikes. It is possible we could see an initial short-term boost in growth and inflation from government policies, which could potentially put the Fed on hold in the second half of 2025, in our view. The dual mandate of the Fed is back in focus, so a measured response is likely, and we have moderated our view of future Fed cuts for a shallower cycle with a trough rate expectation of 3.75-4.25%, likely reached in 2026. We see little scope for the 10-year and longer maturities to rally as we believe the US deficit is structural in nature and do not expect a hawkish stance on fiscal responsibility under the new administration. We believe Treasury supply will continue to be a topic of heavy discussion, which could increase interest rate volatility and put a floor under long-term Treasury yields or potentially push them higher. We believe long-term fair value for the 10-year US Treasury is approximately 4.50%, based on a 1.50-2.00% real rate and 2.25-2.50% breakeven rate; however, Trump's policies could push the fair value target slightly higher.

Stable Corporate Fundamentals and a Benign Loss Environment

In our view, the credit cycle is firmly in the late cycle stage. Corporate fundamentals appear stable, technicals have remained supportive and earnings growth is robust, which should fuel investor appetite in 2025. In our opinion, corporate balance sheets have remained healthy and can weather potential volatility in the macroeconomic backdrop. Our Credit Health Index (CHIN)* and risk premium framework within investment grade and high yield suggest defaults/losses will be below historical averages for this part of the cycle. Even though credit spreads appear optically on the richer side, it is difficult to see any real signs of credit deterioration. Credit risk premiums may not be cheap, but we do view them as being adequate given a benign loss backdrop. Technicals have remained supportive as investment grade issuance has surprised to the upside but has been met with strong investor demand, and we continue to see this trend going forward where demand outpaces supply. In addition, specific to the high yield market, defaults may have already peaked for this cycle and most signs of distress seem idiosyncratic, in our view. The high yield maturity wall also seems manageable through 2026, not posing a major threat after a wave of refinancing in 2024. Lastly, we are encouraged by corporate profitability and believe that earnings growth will be more inclusive across sectors in 2025.

**The Credit Health Index (CHIN) is a macro tool created by Loomis Sayles. The CHIN is currently managed by the Loomis Sayles Applied IQ team. It is a proprietary framework that utilizes a combination of macro, financial market and policy variables to project US corporate health.*

Carry May Drive Fixed Income Returns

We believe that long-term value has returned to fixed income markets with a combination of discount-to-par (positive convexity) and favorable yields. As investors sit on record levels of cash, we expect strong demand will likely support bond markets. We believe spreads have moved to the tightest levels of this cycle. Our view is that investors can feel comfortable going for the extra spread pick-up available in the credit markets. Spreads will likely live in a range that is typical of a non-stressed market, which for high yield corporates tends to be in the +275 to +425bps range. We are mindful of the risks going forward, such as a growing US deficit, trade protectionism (tariffs) and geopolitical risk.

Please see Important Disclosure on following page, an integral part of this document.

Meet the Team

Matt Eagan, CFA
Head of Full Discretion, Portfolio Manager

Brian Kennedy
Portfolio Manager

Todd Vandam, CFA
Portfolio Manager

David Zielinski, CFA
Investment Director

Cheryl Stober
Investment Director

Kristen Doyle
Associate Investment Director

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