

2016 SECTOR TEAMS' OUTLOOK



OUR MISSION. YOUR SUCCESS.



SECTOR TEAMS are a critical part of the investment process at Loomis Sayles.

Composed of **TRADERS, ANALYSTS** and **PORTFOLIO MANAGERS**

who are experts within their specific financial **market sectors**, these teams are designed to

‘separate the wheat from the chaff.’ Each sector team provides **return scenarios**

and **relative value recommendations** to the firm.



- Teri Mason, CFA, VP, Director of Macro Strategies

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This outlook reflects the current opinions of the various sector teams as of 3/31/2016; views and opinions are subject to change at any time without notice.



SCOURING THE GLOBE FOR OPPORTUNITIES

We continuously scour global capital markets seeking attractive opportunities for our client portfolios. Each investment opportunity is examined from a top-down and bottom-up perspective in our quest to determine what should drive their return and what risks we might take along the way.

SECTOR TEAMS



The bottom-up work consumes us; it is the bulk of what our research analysts and traders focus on. However, the top-down work is just as critical, as it helps us identify important factors that may influence returns beyond a security's idiosyncratic features.

Our sector teams bring together experts from research, trading and portfolio management. Every day they're watching their markets, discussing trends and debating the investment opportunity du jour. Every quarter, our sector teams gather for our global asset allocation team (GAAT) process. Our GAAT process sets the stage for delivering our expected returns and relative value ideas.

This note summarizes the key takeaways from our most recent GAAT gathering.

THE GLOBAL ASSET ALLOCATION PROCESS



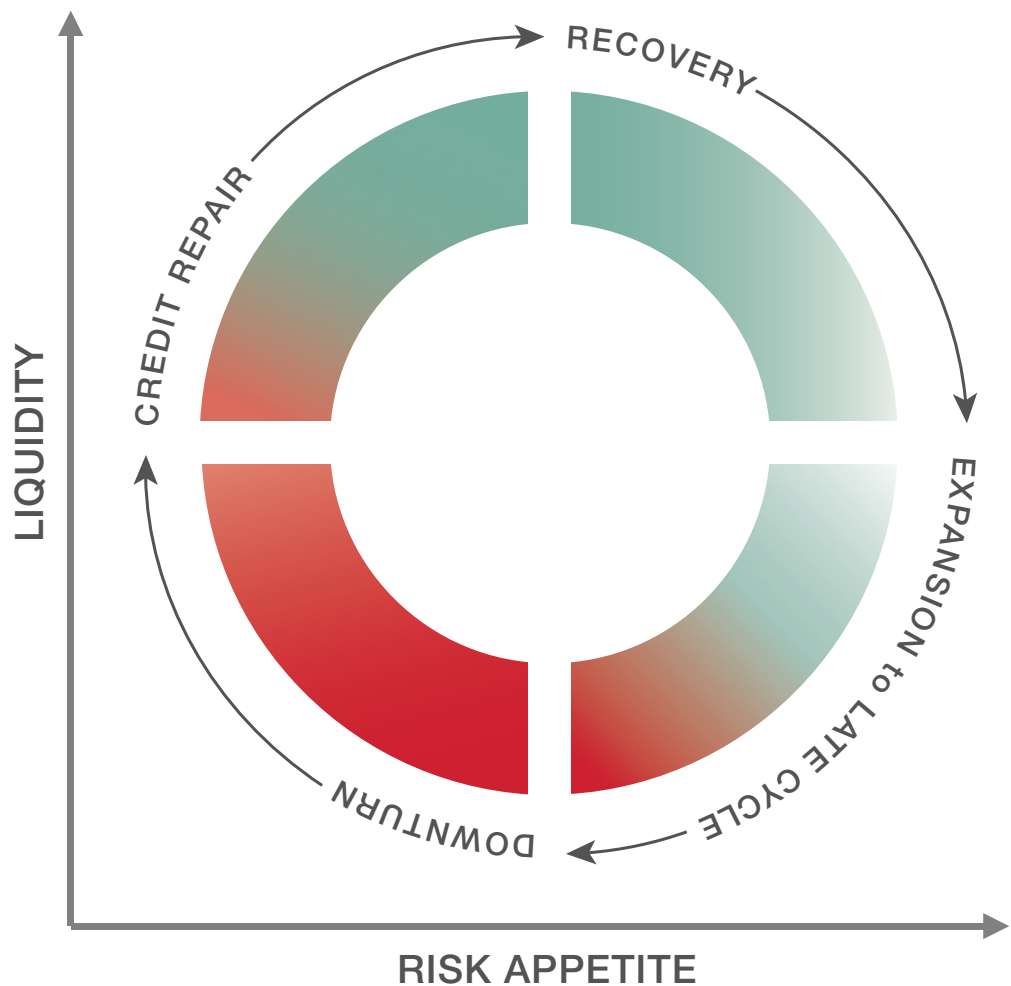


Our Framework: The Global Credit Cycle

The global credit cycle, which tracks changing credit conditions, risk appetite and liquidity, is part of our framework for analyzing the top down. Each stage of the cycle signals what we might expect in terms of relative market performance. We determine where key countries are in their credit cycle largely by looking at the borrowing and spending patterns of households, corporations, governments and banks.

The hard part is fitting it all together. Each country has its own cycle, but they don't exist in isolation, and we need to consider how those cycles mesh. What happens in one country impacts others. Remember the old cliché, when the US sneezes, the world catches a cold? It still holds true. Just think about what global impact a move by the Federal Reserve (the Fed) can have.

THE GLOBAL CREDIT CYCLE



Views as of 3/31/2016. This material is provided for informational purposes only and should not be construed as investment advice. Investment decisions should consider the individual circumstances of the particular investor. This reflects the current opinions of the authors and views are subject to change at any time without notice. Other industry analysts and investment personnel may have different views and opinions.

A World Too Fragile for Aggressive Fed Rate Hikes

Much ink has been spilled over when the Fed will hike rates next. If the Fed wore blinders and focused solely on its dual mandate of maximizing employment and stabilizing prices, then moving away from its accommodative stance would seem prudent. But given tightening financial conditions and the weak state of many developing economies, the world seems too fragile to accept the blow of higher interest rates in the near future.

If the Fed moves too far, too fast, it risks destabilizing the global economy, which would feed back to the US and could lead to recession. Throw in political risks such as the upcoming Brexit vote, which can introduce more volatility into vulnerable markets, and we see the Fed staying cautious. Our view is that Fed Chair Janet Yellen is sensitive to the pain a policy mistake can cause and will move cautiously, perhaps hiking in June and December this year, at most. While the Fed may hike, many other central banks are focused on easing rates to incent borrowing and spending and get growth moving.

Changing Global Growth Patterns: The Fed and China



How did we get here? We believe the Fed helped induce a borrowing and spending boom in emerging markets when, to combat the effects of 2008's global financial crisis, it adopted quantitative easing (QE). Debt ballooned, especially in Asia and Latin America, as investments poured into emerging markets (EM). At the same time, China levered up to support domestic growth, reviving a commodity and global trade boom that started in 2002.

Now, the world is adjusting to tighter monetary policy in the US and to a different China—one that is rebalancing its economy away from investment and toward consumption. Global trade has slumped, and as EM growth slows, we look for developed markets—consumers in particular—to pick up the slack.

A US Profits Recession and Low Global Inflation

Debt-to-profits is a critical metric when assessing a country's position in the credit cycle. Investors want to see profits growing faster than debt. Currently, low commodity prices and the strong dollar have conspired to eat into US profits.

And for the moment, the US is in a profits recession, largely in the energy, metals and mining sectors. But oil has moved off its lows, and a continuation of that rebound would bring relief to profits. We've seen this move before; profits dip into recession temporarily without the overall economy tipping into downturn.

However, the US is in the late cycle phase and a recession, while not imminent, is inevitable. This means investors may enjoy a well-earned reprieve this year if profits rebound as we believe they will, but eventually we believe that the cycle will turn and spreads will widen again.

Globally, inflation has moved lower, partly as a consequence of China's slower growth and downward pressure on commodity prices. Core inflation is just beginning to move up in the US as the labor market strengthens and wages improve. It's nudging higher in the UK as well, while decreasing in Japan and Europe.



What the Global Credit Cycle Is Telling Us

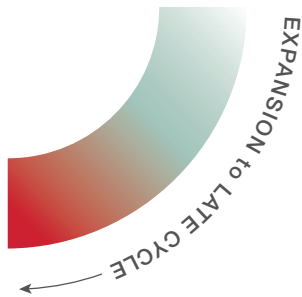
Summing it up, the global credit cycle tells us we are in a world where economic growth is generally modest, with past engines (China and EM) slowing while developed markets have yet to gather steam. Inflation is likely to remain low and monetary policy accommodative, but turning less accommodative in the US and UK.

Contrast that view with how the markets were behaving earlier this year. Equities plunged and spreads widened as investors seemed to fear that recession was almost imminent. Various quantitative measures suggested the markets were pricing in recession and/or a huge spike in defaults.

Our analysis indicated that a recession in the US in 2016 was a relatively low-probability event. Similarly, while we have long held a bearish view on China, our outlook remained measured; growth there would slow in fits and starts but not crash and burn. Latin America is in downturn, but we believe the US will escape that fate for now.

While the expansion in the US is long in the tooth, and risks have clearly risen, we see no immediate catalyst to plunge the US into the downturn phase of the cycle, outside of a policy mistake by the Fed. As more investors came around to those views, sparked by oil rebounding mid-first quarter, markets began to budge from their largely oversold levels earlier this year.

Looking ahead, several common investment themes came out of the most recent sector team discussions.



- Modest global growth and low inflation will keep a lid on rate pressures. The Fed is likely to take a cautious approach toward “normalizing” rates, seeking to avoid undue volatility in the markets.
- There were three primary drivers of wider spreads: recession fears, weak profits and liquidity concerns. Recession fears have waned, allowing spreads to tighten in most markets. However, liquidity remains challenged as dealers cautiously manage their inventories. Lower liquidity can exacerbate price moves and keep spreads from narrowing back to previous tights. We do expect the profits recession to end.
- This is a “risk on” environment with an expiration date looming. With the US in late cycle, a multi-year spread tightening phase is unlikely. For this year, we anticipate modest returns and prefer taking credit risk in portfolios over interest rate risk. We see negative returns for US Treasuries but positive returns elsewhere, on the order of 1-2% for investment grade sectors and 4% or higher for high yield sectors.
- As always, there are plenty of risks to keep us awake at night, but the ones that our sector teams worry most about right now are: the Fed moves too far, too fast, China missteps and slows dramatically, or commodity prices remain low for a prolonged period.



SECTOR VIEWS

Governments & Currencies

Given our expectation that the Fed could hike rates once or twice this year while many other central banks remain more accommodative, we continue to prefer global government bonds over US Treasuries. This includes selected offerings from both developed and emerging markets. If we are right that EM will soon pass the growth baton to developed markets, then we would favor taking duration in emerging markets over developed. Also, despite decent returns for local EM year-to-date, yields remain relatively attractive in selected markets. We see the US dollar as strong (though fading), limiting our enthusiasm for currency exposures. Within currencies, we see valuations in EM as getting cheaper, helped by the recent dovish tilt by the Fed, but there doesn't appear to be a major cyclical catalyst for a sustained rebound yet.

Securitized

We believe agency mortgage-backed securities (MBS) are still rich, though the sector will likely continue to benefit from strong Fed support through reinvestment of paydowns so it can earn a decent return in a range-bound rate environment. The securitized credit sector (asset-backed securities (ABS), commercial mortgage-backed securities (CMBS) and residential mortgage-backed securities (RMBS)) was stable relative to corporates throughout 2015, continuing the recent pattern of responding with a lag and less volatility to movements in investment grade (IG) corporate spreads. The sector widened abruptly in February, finally adjusting to the relative value differential from the bank and finance corporate sectors. Securitized credit, particularly consumer ABS, has now lagged the recent recovery in spreads witnessed in IG corporates leaving it relatively attractive. The overall securitized credit sectors remain supported by a strong consumer balance sheet, rising real estate prices and limited issuance which should dampen some of the volatility we may experience during the rest of the year.

Equities

We believe equities could offer returns in the mid- to high-single digits in 2016. For the third consecutive year, we expect operating earnings in the US to be flatish. The median S&P 500® company will likely see modest earnings-per-share growth. Currency translation from abroad should be less of a drag if the US dollar strength fades as we expect. However, broadly speaking, earnings revisions continue to be negative (holding back performance), and a recovery in energy earnings is still several quarters away. Given the low-growth environment, it is not surprising that our sector attribution analysis reflects a powerful interest in dividend yield and defensive industries.

SUPPORT AND STABILITY

The overall securitized credit sectors remain supported by a strong consumer balance sheet, rising real estate prices and limited issuance.

Investment Grade Corporate Bonds

Spreads widened in 2015, particularly industrials, but when spreads gapped out earlier this year, bank and finance led the way. The levels suggested the market's worst recession fears might become a reality and downgrades might unfold. Those fears eased quickly in mid-February when commodities rebounded and spreads tightened. Spreads can stabilize or even narrow further as fundamentals are broadly supportive (outside of energy, metals and mining). Leverage, however, is nudging higher, and many industries are in the late cycle phase of the credit cycle. Mergers-and-acquisitions (M&A) activity has picked up as companies try to offset stalling top-line growth and declining profitability. The focus is on appeasing shareholders, not bond holders, by prioritizing cash flow toward dividends and share repurchases. The M&A activity is adding to an already record level of new supply, but demand remains strong as both domestic and foreign buyers seek higher yields.

Taxable Municipals

Taxable municipals are a defensive sector that can be a good diversifier versus IG corporates, albeit one with a yield disadvantage. When IG spreads widened earlier this year, taxable municipals outperformed. When IG rallied, however, taxable municipals lagged behind. Looking ahead, we are likely to see modest spread tightening and returns this year. Fundamentals look stable, with state and local government credit quality continuing to improve in the majority of states (the oil producers being the notable exceptions). Healthcare, retiree pension and other post-employment benefit costs are a budget challenge for some. Pension obligations are likely to attract increasing attention as fiscal year 2015 audits are required to state pension liabilities on balance sheets.

European Investment Grade Credit

European credit is in a better part of the credit cycle than US credit, is less exposed to commodities and has a more dovish central bank, the European Central Bank (ECB), which recently grew even more supportive when it announced a plan to purchase corporate bonds. Interest coverage is strong and capital expenditure muted, with stable net leverage. Still, we generally prefer US IG credit over European because the all-in yields are higher. Another concern is that fund flows have been significantly negative, which could intensify on Brexit worries, though they have shown signs of turning up recently.

High Yield

Defaults rose in 2015, and we expect the default rate to move up again in 2016. However, judging by the spike in spreads earlier this year, the market feared something much worse as spreads are rarely that wide outside of recession. Like IG, spreads rebounded from the wides of mid-February, but only partially, so valuations remain interesting. We expect spreads can narrow further this year, enough to generate a return in the mid-single digits or perhaps better. The fundamental trends are the same as we've outlined above in IG—decent outside of the commodity sectors, though late in the cycle. Within high yield, a significant portion of the market is priced at distressed levels. While we are cautious, given where the US is in the credit cycle, we believe there are some good values in the lower-quality buckets for investors who can carefully sift through and do their homework.





EM Credit (Hard Currency and Corporate)

The EM universe is vast, with individual countries in different phases of the credit cycle. A country's status as a commodity producer or consumer is a key distinguisher. Beyond assessing the broad fundamentals, our analysts look at individual country dynamics that can overwhelm cycle positioning, like politics (Brazil being a recent example). Despite all the differentiation within EM, the sector can be buffeted by the same winds. When spreads widened earlier this year, the move was largely due to US Treasury yields falling, rather than EM yields rising. When oil rebounded in mid-February, supportive statements by the Fed and ECB helped EM as a class to rally. Still, EM yields look attractive, and with lower supply and the market holding light or short positions, the technicals are positive. Selected EM credits offer additional yield over their US counterparts for the same turn in leverage.

Bank Loans

We expect bank loans to generate mid-single-digit type returns on modest economic growth and low defaults. Like other sectors, the market selloff on default fears was exacerbated by poor dealer liquidity. While we believe the market went too far, and has since at least partially corrected, we note that a weaker economy may not necessarily be a disaster for bank loans. There are very few maturities coming due relative to the size of the universe, so we don't expect to see a lot of refinancing pressure that could create defaults. We see the balance of supply and demand as manageable for the market as well. Collateralized loan obligation (CLO) issuance is likely to be lower this year, reducing demand for loans, but demand outside of CLOs appears to have picked up. At the same time, supply remains light.

Convertible Bonds

Despite underperforming IG, high yield and equities year-to-date, we don't see a lot of convertibles with attractive reward-to-risk profiles. We tend to favor the higher-quality names. Like the broader high-yield market, the basket of bonds priced at distressed levels remains quite high (about 4% of the market today, up from 1% a year ago). Still, for the non-distressed portion of the market, we don't believe investors are paid a sufficient premium to swap from high yield to convertibles given the additional risks involved. Beyond that, it's an election year and key sectors of the convertible market, like healthcare, can face additional volatility as potential regulation is debated. Where there's pressure, there's often opportunity, though, and some of our current recommended names are in healthcare.

STILL LOW DEFAULTS

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Disclosure

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