

Second Quarter Macro Insights

By Rick Harrell, VP, Senior Sovereign Analyst

The [major macroeconomic storylines](#) we have been tracking since the start of the year continued to play out during the second quarter.

The growth impulse we were expecting from developed market (DM) consumers has only recently started to kick in. Still, the US, Europe and Japan ended the first six months of the year in a favorable part of the credit cycle, helped by easy monetary policy, low energy prices and stronger credit growth. In the US, labor market conditions are tightening while measures of corporate health are signaling a cycle that is entering late stages. Assuming global markets avoid a major shock from the euro zone or emerging world, we believe a 2015 Federal Reserve (Fed) rate hike looks inevitable. The Fed is doing its best to reassure markets that its accommodative stance will remain in place even after the first interest rate increase.

At the same time, China's economic metamorphosis continues to reshape global trade and growth prospects for many emerging market (EM) countries. Economic stimulus by the Chinese is becoming more aggressive in an effort to stabilize growth. But the country's structural move away from an investment-led growth model is an unwelcome change for EM economies tethered to commodities. Risks to much of the EM asset class remain high.

SECOND QUARTER
MACRO INSIGHTS

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1. Rotation of Global Credit Cycle Favors DM over EM

M2 GROWTH SHOWS LIQUIDITY BOOM IN EM IS FADING

Source: National Sources; includes Brazil, Chile, China, Colombia, Czech Republic, Hungary, India, Indonesia, South Korea, Malaysia, Mexico, Philippines, Poland, Russia, South Africa, Thailand, Turkey, US, UK, Euro Area, Japan, data as of April 30, 2014.

— EM (left scale)
— DM (right scale)



- As the global credit cycle rotates, developed economies remain better positioned than their EM counterparts.
- Though some indicators suggest the US is plodding toward late cycle, Europe and Japan continue to enjoy the tailwinds from exceptionally easy monetary policy, significantly weaker exchange rates (boosting export growth), and cheaper energy prices. Meanwhile, most emerging market (EM) economies are in a challenging part of the credit cycle, led by China and weak commodity prices.
- Liquidity in EM is drying up, and this creates a difficult growth environment. M2, a measure of the money supply that generally moves coincident with economic activity, is one way to observe this effect. In the past six months, M2 growth in EM fell to its lowest level since 2001 while developed market M2 continued to climb. Lower liquidity in China is the primary culprit for the downturn, but the trend is playing out in Brazil and other commodity-producing countries.



2. Fed Rate Hike: Is it Time?

US: WHAT SLOWDOWN?

Final Sales to Domestic Purchasers



Source: Datastream, data as of February 13, 2015.

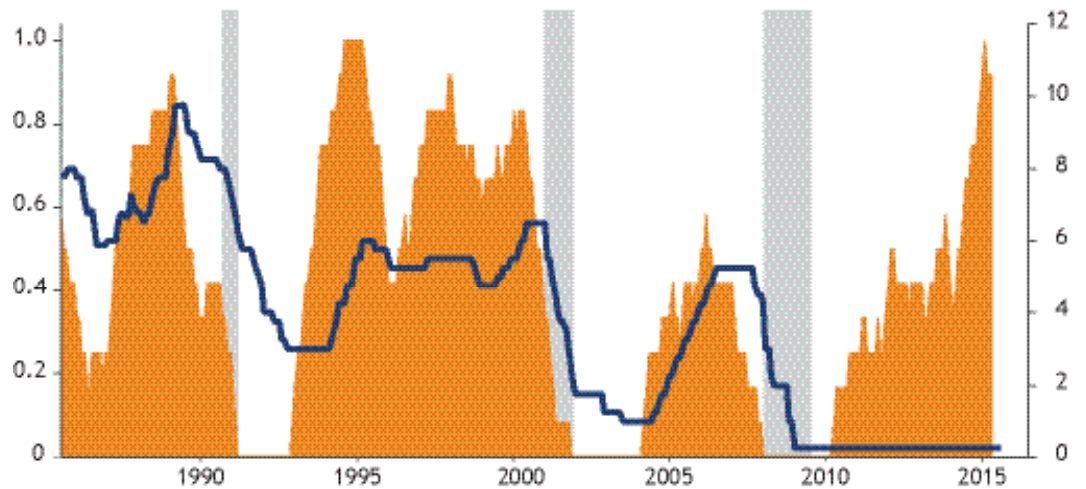


ECONOMY READY FOR FED TO HIKE

Nonfarm Payroll vs. Fed Funds Target Rate

Source: Datastream, data as of May 29, 2015. Shaded areas represent US recessions.

 % of nonfarm payrolls >200K in rolling 12M (left scale)
 Federal funds target rate (right scale)



- Observers buzzed about a massive slowdown in first-quarter US economic activity, but the panic was misplaced. Blame for the dip rests squarely on a weak export sector, which suffered a temporary hit from the strong US dollar. US domestic demand remains robust.
- Labor market indicators give us reason to believe the economy is ready for a rate hike. We see a pattern of strong, sustained job growth; unemployment has held steady below 6% for some time, and the pace of job creation is at its highest level in nearly 20 years.
- The labor market is beginning to tighten, and wage inflation (as measured by the employment cost index) has started to materialize. Barring a shock to global markets from Greek contagion or EM stress, the Fed appears on course to hike interest rates in the coming months.



3. The Disjointed Credit Cycle: Corporate Fundamentals Leaning Late, but the Fed Still Easy

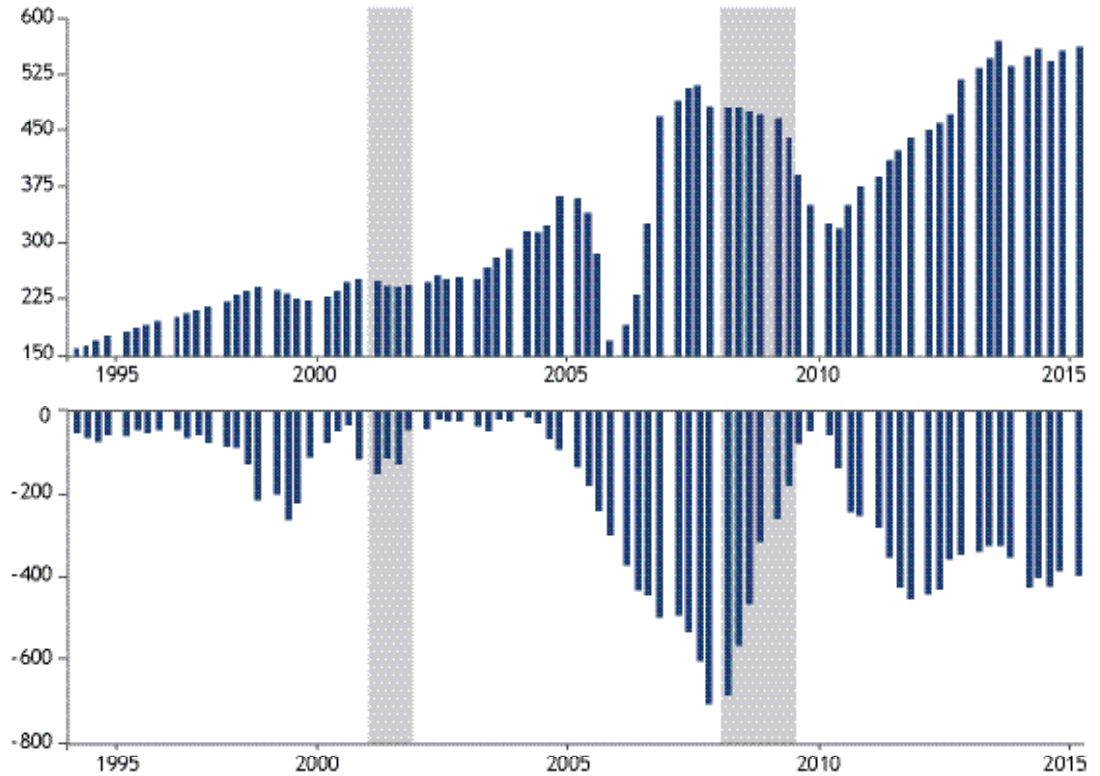
SHAREHOLDER-FRIENDLY ACTIVITY HINTS AT LATE STAGE OF CREDIT CYCLE

TOP
Dividends

BOTTOM
Net Equity Issuance

Source: Federal Reserve Board, Haver Analytics, data as of March 29, 2015. Shaded areas represent US recessions.

■ Four-quarter moving average, seasonally adjusted annual rate, US billions, US non-financial corporate

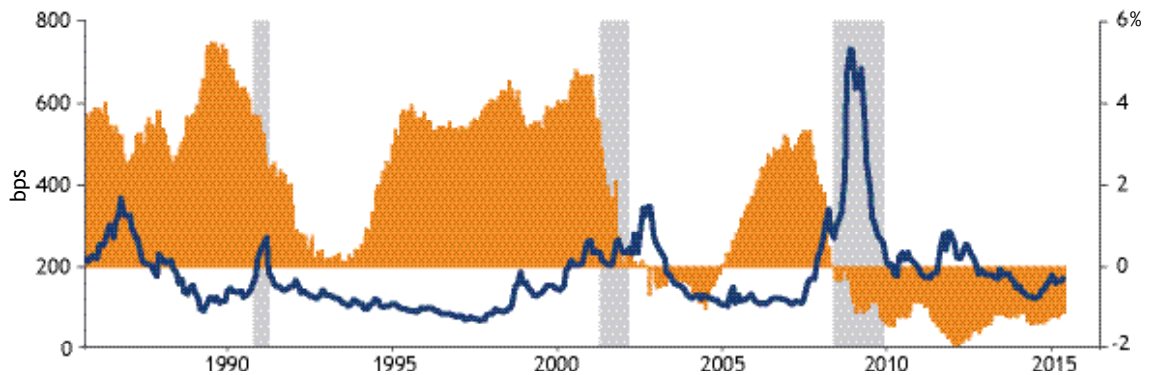


REAL FED FUNDS RATE NEGATIVE INTO 2017

Source: Haver Analytics, data as of May 29, 2015. Shaded areas represent US recessions.

— BBB spread splice of Moodys, Barclays, Barclays OAS (left scale)

■ Real federal funds rate (US federal funds rate less core PCE inflation) (right scale)



- Investors hoping to presage a turn in the US credit cycle are fielding mixed signals from US corporate health and monetary policy indicators. US corporate health may be tiptoeing toward a peak. Corporate debt levels are now growing in near lockstep with profits. Profit margins, which are near record highs, could come under pressure as wage inflation builds. The trend in shareholder-friendly activities, including high dividend payouts and share repurchases, is another sign of late-cycle behavior. Sustained profit growth will be critical to keep investment grade credit spreads from widening.
- The Fed, on the other hand, remains easy. Though a rate hike looks imminent, the real fed funds rate is still highly accommodative. Chair Yellen has urged markets not to agonize over the date of the first rate hike, stressing the Fed's commitment to accommodative policy in the near term. It will likely be a long time until we see tight policy, and this may keep the US credit cycle "earlier" than corporate fundamentals suggest.

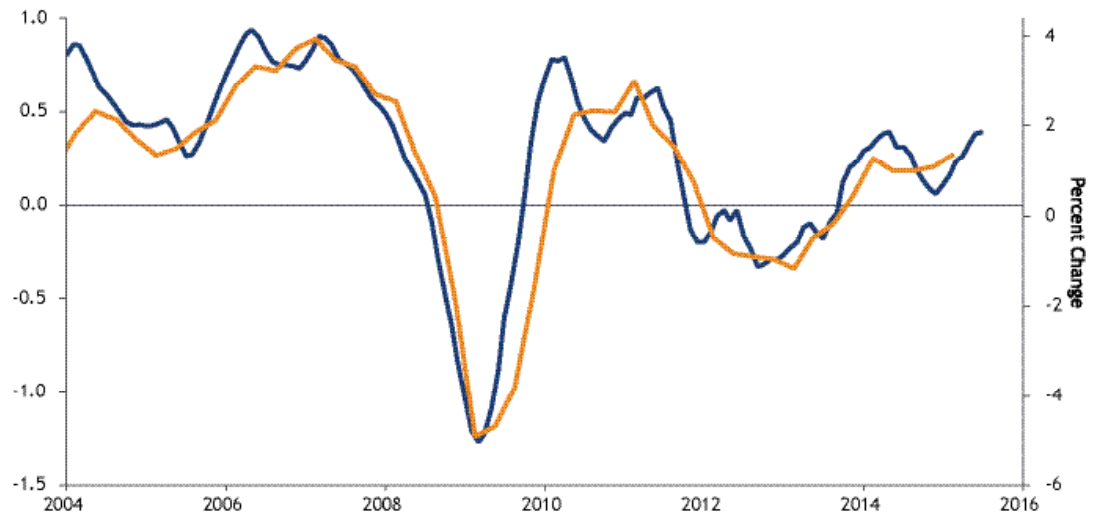


4. Europe: Will a Greek Tragedy Sidetrack the Region's Growth?

EURO ZONE GROWTH LOOKING BETTER

Source: Datastream, data as of
May 29, 2015.

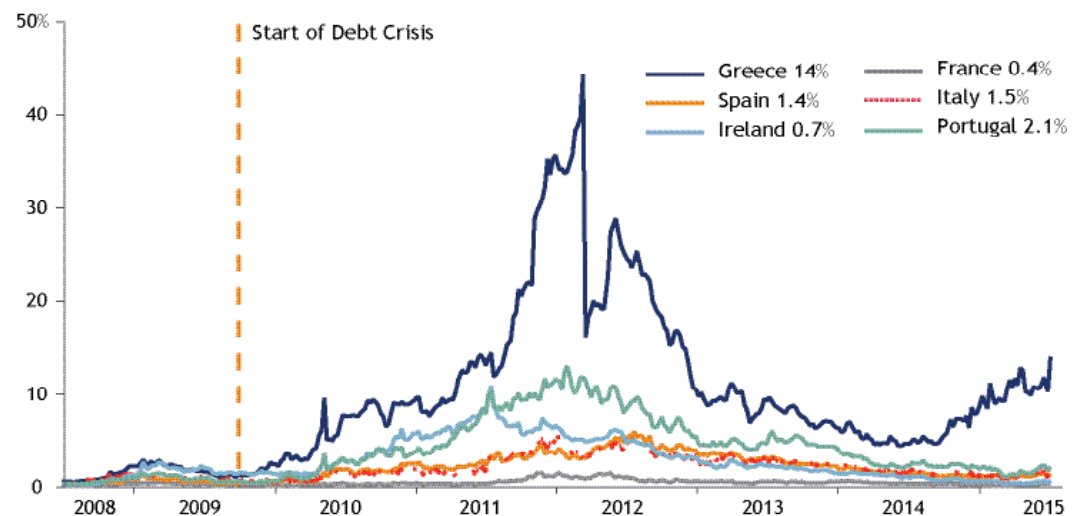
- Euro-coin monthly GDP indicator (left scale)
- Euroland GDP annual % change (right scale)



DÉJÀ VU: DEAL OR NO DEAL?

Euro Area 10-Year Bond
Spreads

Source: Datastream, data as of
July 3, 2015.



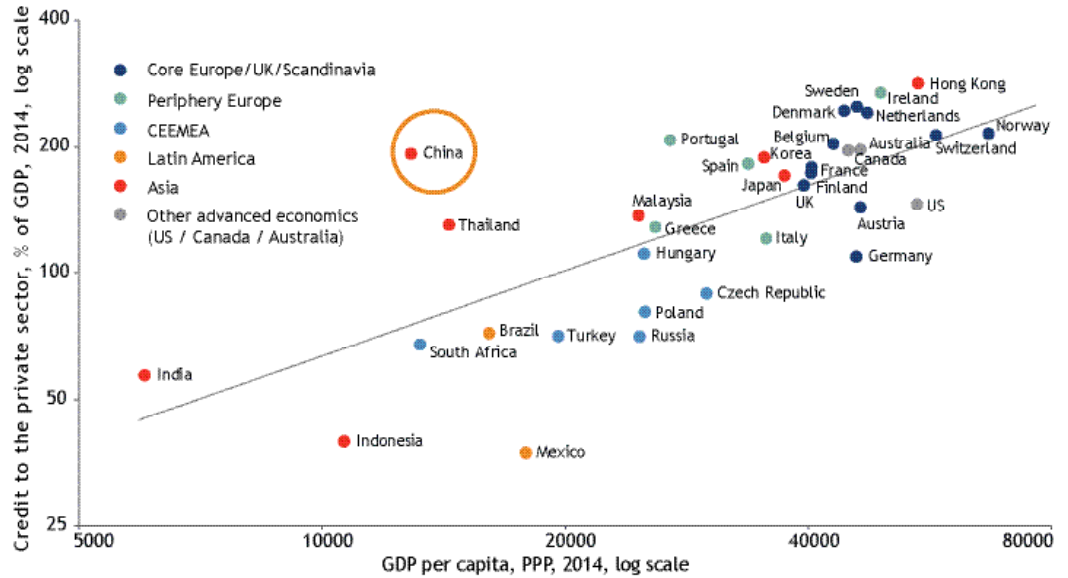
- Europe seems to be pulling itself out of disinflationary quicksand, and certain leading indicators are consistent with better growth outcomes. The European Central Bank's (ECB's) commitment to quantitative easing, a significantly weaker euro, lower energy costs and positive credit growth have helped lift the region's growth outlook.
- In a rerun of years past, disquiet in Greece is again threatening the euro zone's recovery. Spreads on Greek sovereign debt have marched higher, and we expect a highly uncertain environment in European markets could prevail for many months ahead.
- Despite growing tail risks of "Grexit" and the attendant fallout to the rest of the monetary union, investors appear assured that the ECB will use "all the instruments available within its mandate" to stem any contagion. This should help contain market swings as the saga plays out, but we caution that the ECB's power is constrained by its rules, jurisdiction and European Union political will.



5. Difficult Outlook for EM: China Deleveraging & Weak Global Trade

CHINA'S DELEVERAGING HAS A LONG WAY TO GO

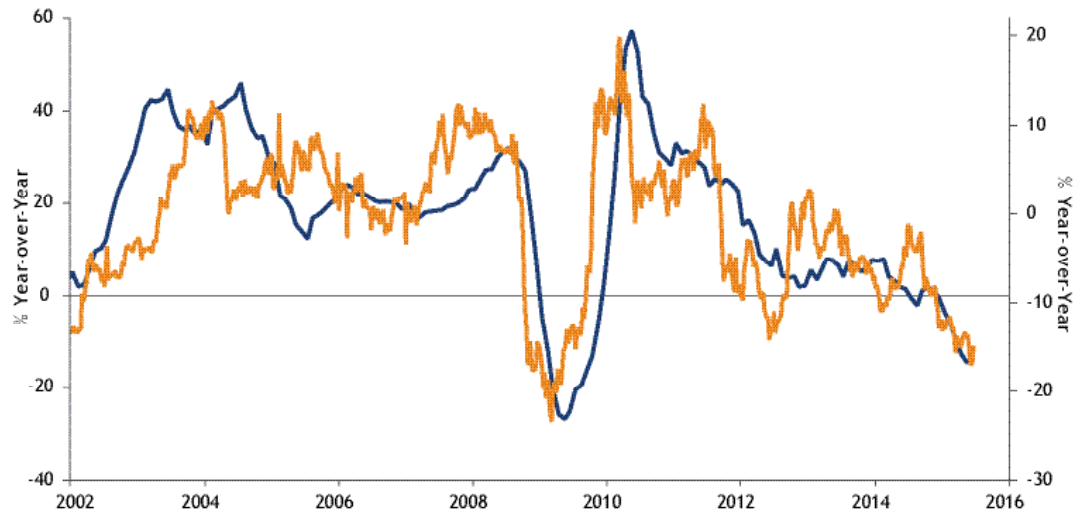
Source: Haver Analytics, BIS, IMF, data as of December 31, 2014.



SLOWER CHINESE IMPORTS HAVING RIPPLE EFFECTS ACROSS THE GLOBE

Source: Datastream, data as of June 22, 2015.

- China's total import growth (6M moving average) (left scale)
- EM FX (right scale)



- China's protracted credit binge has left the country with a mountain of debt relative to its wealth. To restore economic balance, China will need either drastic deleveraging or resurgent growth.
- Recent stimulus measures have not spurred growth, and Chinese policymakers continue to search for that elusive upturn. We do not expect the search to be fruitful, and the government's latest machinations to prop up wobbles in the soaring stock market smack of desperation.
- Chinese imports have recently turned negative, an unwelcome development for emerging economies that rode the coattails of China's once insatiable demand for commodities. We think these recent trends confirm that the boom in global trade and commodities is over.



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Disclosure

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