

Flip-flopping Federal Reserve (Fed) policy defined the third quarter. Last quarter, the Fed threw the markets a curve ball by announcing possible tapering of its large-scale asset purchases beginning this year. That “taper talk” set off a mini-riot in global bond markets. Many emerging market (EM) countries, like Brazil, India, Indonesia and South Africa, were the biggest victims, as their bond yields rose and their currencies crashed.

A THIRD MANDATE?

The Fed’s mandate is twofold—to provide maximum sustainable employment subject to price stability. Currently, it is failing to meet both targets because measured inflation is almost a full 1% below its 2% target, and the 7.3% unemployment rate is well above its 6.5% easy-money threshold. If the Fed had its eyes on a third goal, moderating excessive risk-taking, and wanted to shake up investor’s complacency, it succeeded.

We may be critical of the Fed’s communication efforts and the unexpected goal of reducing excessive risk-taking when the economy is failing to meet the central bank’s targets, but in the end, the Fed took prudent action and delayed tapering its asset purchases until sometime in the future. It was prudent because inflation is low and nominal US GDP growth is only 3.1%. The Fed was also cognizant of the impending debt ceiling debate and the potential negative impact on confidence that might occur if it was dragged out as painfully as in 2011. The market’s response to taper talk added economic headwinds: mortgage rates shot up by over 1%, oil spiked on geopolitical concerns and the US dollar rallied against a large number of emerging market currencies. These factors combined to tighten monetary conditions, so the Fed elected to assess the overall impact on the economy before tapering.

Fed rhetoric caused several recent trends to reverse. For example, emerging markets posted some of the worst performance in the second quarter mostly due to the Fed, which is not unusual since several EM crises have been precipitated by tighter Fed policy. During the third quarter, many EM bond, currency and equity markets were the best-performing assets. Another unusual phenomenon from the second quarter was rising Treasury yields with widening credit spreads, which caused investment grade credit and high yield bonds to underperform our expectations but led to more attractive valuations. During the third quarter, spreads tightened resulting in solid excess returns for these sectors.

PLANNING FOR A QE EXIT

Rising Treasury yields with widening spreads in the second quarter and the turmoil in emerging markets indicate that exiting from quantitative easing (QE) could be challenging for many asset classes. As we have written many times previously, QE works through portfolio rebalancing and has the effect of pushing investors out the risk spectrum. Investors may move into higher-risk asset classes, where they may be uncomfortable with the additional risk, simply because they are searching for yield. As QE reverses, it is expected that some of those yield-seeking capital flows also reverse. In such an environment, investors need to sharpen their pencils and do their fundamental valuation work. Investors need a good valuation cushion to help deal with the potential volatility accompanying the ending of QE.

We still believe many credit spread sectors can offer value *relative* to Treasuries. The absolute returns for fixed income in the months ahead should be low, as we expect a gradual rise in yields. However, areas of fixed income that could provide positive absolute returns in a rising rate environment include bank loans, convertible bonds and residential mortgage-backed securities (RMBS). We also believe emerging markets offer better value at a time when we do not believe this is anywhere near a crisis environment that has hit EM in the past, such as the Asian crisis of 1997-1998 or the less developed country (LDC) crisis of the 1980s.



THIRD QUARTER REVIEW

RETURNS BY SECTOR¹ as of September 30, 2013

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US Broad Market				
Aggregate	0.95	0.57	(1.77)	(1.68)
Government/Credit	0.75	0.36	(2.16)	(1.96)
S&P 500®	3.14	5.24	8.31	19.34

After a difficult second quarter, several fixed income indices rallied back to post positive returns for the third quarter. "Taper talk" continued, but the Fed grew increasingly dovish, and by September, the Federal Open Market Committee (FOMC) opted to delay tapering asset purchases. The more accommodative language and policy stance boosted risk appetite and sent investors back into higher-yielding assets. While the market understands that liquidity will be incrementally withdrawn, Fed accommodation will likely continue for the time being.

US Governments				
US Treasurys	0.70	0.10	(1.83)	(2.09)
3-month T-bills	0.01	0.02	0.05	0.11
2-year Treasury	0.17	0.22	0.13	0.28
5-year Treasury	1.26	0.69	(1.76)	(1.59)
10-year Treasury	1.39	(0.66)	(5.20)	(5.71)
30-year Treasury	0.11	(3.16)	(9.10)	(13.01)
US TIPS	1.45	0.70	(6.40)	(6.10)
US Agency	0.72	0.28	(1.27)	(1.09)

Economic data, including low core inflation, below trend growth, a fundamentally weak labor market and tighter financial conditions, proved inconsistent with Fed expectations and prevented a taper in September. Shifting Fed rhetoric was a source of volatility in the Treasury market, but the moves were marginal relative to last quarter. At their latest meeting, the Fed decided not to adjust purchases until economic data offers evidence of a more sustained recovery. The short end of the yield curve remained anchored, but longer maturities posted losses due to increased uncertainty about the Fed's role in the Treasury market.

US Municipals	2.15	(0.19)	(3.15)	(2.21)
The small loss municipals suffered can be attributed to the Index's strong correlation with US Treasurys, high duration at 8.31 years and steady outflows from municipal mutual funds. Top-performing states included Montana, Connecticut and Iowa; the laggards were Illinois, South Dakota and Maine.				
US Securitized				
MBS: Mortgage-Backed	1.41	1.03	(0.96)	(1.20)
ABS: Asset-Backed	0.56	0.16	(0.64)	(0.38)
CMBS: Commercial Mortgages	0.92	1.02	(0.43)	0.91

MBS outperformed similar-duration Treasurys and rallied after the Fed announced it would hold MBS purchases steady at \$40 billion per month. The average option-adjusted spread of the CMBS and ABS indices peaked in July and then drifted lower during the quarter. CMBS returns outpaced similar-duration Treasurys, while ABS returns did not.

¹All returns sourced from Barclays Indices except: currency returns (Bloomberg), World Government Bond (Citigroup), Emerging Market Bond (JPMorganChase), and S&P500 (FactSet and Ned Davis Research).



RETURNS BY SECTOR¹ as of September 30, 2013

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Corporates				
US Investment Grade	0.69	0.82	(2.51)	(1.58)
AAA	0.31	(0.11)	(3.93)	(5.33)
AA	0.69	0.48	(2.48)	(2.52)
A	0.73	0.89	(2.36)	(1.98)
BBB	0.66	0.83	(2.67)	(0.86)
European Investment Grade (local currency returns)				
	0.67	1.31	0.84	4.46
AAA	0.38	0.19	(2.28)	0.65
AA	0.58	0.76	(0.15)	1.88
A	0.60	1.12	0.36	3.29
BBB	0.77	1.69	1.72	6.70
Sterling Investment Grade				
	0.95	2.63	(0.35)	3.96
AAA	1.25	2.03	(1.73)	(1.30)
AA	0.99	1.85	(1.34)	0.95
A	0.85	2.58	(0.78)	2.36
BBB	1.03	2.85	0.42	6.95

Several speeches by regional Fed presidents in July indicated that the Fed was not as confident in a September taper as the market first thought. As a result, US corporates rallied through July and corrected much of the spread widening sparked by the taper talk in May. For the remainder of the quarter, corporate indices traded in a range while investors awaited the next FOMC statement. Investment grade corporates in Europe and the UK behaved similar to US corporates and registered positive quarterly returns, with financials leading the charge in all regions. Sterling investment grade was the top performer, followed by Europe and the US, respectively. Lower quality investment grade corporates posted the highest returns in all three markets.

Corporates				
US High Yield	0.99	2.28	0.81	7.14
BB	1.00	1.77	(0.13)	4.69
B	0.99	2.33	0.80	7.28
CCC	1.25	3.67	3.18	12.77
Pan-Euro High Yield (local currency returns)				
	1.48	4.02	4.39	12.29
BB	1.25	3.49	3.72	11.12
B	1.87	4.81	4.93	13.74
CCC	2.08	5.47	7.63	17.26

High yield corporates behaved much like investment grade corporates but with less sensitivity to rising rates and a higher spread to Treasuries. By late July, three-quarters of the spike in US high yield spreads, spurred by taper talk, had reversed. Triple-C rated high yield corporates led the group in both Europe and the US, but all rating qualities provided significant excess return over Treasuries.

Bank Loans				
US High Yield	0.23	1.17	1.35	5.07
BB	0.07	1.01	0.93	3.57
B	0.10	1.24	1.19	4.36
CCC	0.06	(1.83)	(1.91)	3.22

The floating rate nature of the bank loan asset class is proving beneficial this year as investors prepare for higher interest rates. Bank loans provided excess return over Treasuries again this quarter on the back of consistent flows and solid market technicals. Loan supply remained slightly less than demand, which also drove positive performance.



RETURNS BY SECTOR¹ as of September 30, 2013

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Developed Countries				
World Government Bond Index (WGBI) <i>(local currency returns)</i>	0.70	0.73	(0.79)	0.88
Non-USD WGBI	0.71	1.00	(0.37)	2.09
United States	0.67	0.08	(1.77)	(2.01)
Canada	0.36	(0.12)	(2.30)	(2.09)
European GBI	0.77	0.94	0.68	4.10
France	0.92	0.51	(0.66)	1.20
Germany	0.73	(0.003)	(1.91)	(0.43)
Ireland	1.63	1.86	2.84	11.53
Italy	0.06	1.40	3.39	8.85
Spain	1.57	3.47	6.03	15.02
United Kingdom	0.79	0.48	(3.39)	(3.10)
Japan	0.58	1.36	(0.52)	1.90
Australia	0.55	0.66	0.56	(0.22)

Developed sovereigns produced positive returns, led by the selected countries in the European periphery and Japan. Traditional safe haven markets, like US Treasuries, German bunds and Canadian government bonds, underperformed the broader WGBI index as investors waded into higher-yielding sovereigns. Risk-taking was supported by easy central bank policies, the global manufacturing recovery and higher 2014 growth projections. Additionally, the US dollar, as measured by the US Dollar index (DXY), declined 3.5% as the Fed backed away from taper talk and eventually announced it would maintain its current pace of asset purchases. Several developed market currencies appreciated versus the US dollar, which supported local currency bond returns.

Emerging Market Bonds				
Emerging Market Government (EMBIG) <i>(Sovereign/Quasi-Sovereign, USD)</i>	2.67	0.87	(5.25)	(4.34)
Corporate Emerging Market Bond (CEMBI) <i>(Corporates, USD)</i>	1.48	1.04	(3.40)	0.26
Emerging Market Government (GBI-EM) <i>(Governments, local currency)</i>	2.13	0.70	(1.92)	3.00

After suffering from a relentless taper-talk-inspired selloff in the later half of the second quarter, emerging markets zigzagged through most of the third quarter. Unlike corporate bonds, emerging market bond indices did not recover the majority of those second-quarter losses as Fed speak grew more dovish. Since the Fed announcement to hold asset purchases steady, EM bond indices have still shown flat-to-slightly-negative performance. Despite the sideways trade, returns in emerging markets were still positive for the third quarter, helped by stronger data out of China and a brighter outlook for 2014 global growth.



RETURNS BY SECTOR¹ as of September 30, 2013

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Currency Markets²				
Dollar Bloc				
Canadian Dollar	2.21	2.04	(1.31)	(4.58)
Australian Dollar	4.67	1.96	(10.58)	(10.22)
New Zealand Dollar	7.42	7.26	(0.85)	(0.01)
Western Europe				
Euro	2.31	3.97	5.52	5.19
Norwegian Krone	1.69	0.93	(2.77)	(4.80)
Swedish Krona	2.94	4.21	1.53	2.11
Swiss Franc	2.75	4.43	4.90	3.86
British Pound	4.40	6.40	6.50	0.12
Emerging Europe & Africa				
Czech Koruna	2.55	5.29	5.73	2.94
Hungarian Forint	3.50	3.16	7.91	0.90
Polish Zloty	3.48	6.52	4.44	2.56
Russian Ruble	2.78	1.39	(4.12)	(3.74)
South African Rand	2.51	(1.47)	(7.89)	(17.08)
Turkish New Lira	0.97	(4.48)	(10.31)	(10.97)
Asia				
Japanese Yen	(0.10)	0.89	(4.12)	(20.67)
Chinese Renminbi	(0.01)	0.27	1.46	2.68
Indonesian Rupiah	(1.95)	(12.29)	(14.65)	(15.91)
Malaysian Ringgit	0.77	(3.04)	(5.08)	(6.15)
Philippine Peso	2.54	(0.78)	(6.13)	(3.99)
Singapore Dollar	1.52	0.96	(1.23)	(2.26)
South Korean Won	3.29	6.27	3.42	3.42
Latin America				
Argentine Peso	(2.07)	(6.99)	(11.57)	(18.91)
Brazilian Real	7.60	0.66	(8.81)	(8.60)
Chilean Peso	1.10	0.74	(6.44)	(5.94)
Colombian Peso	1.41	0.88	(4.25)	(5.53)
Mexican Peso	2.20	(1.23)	(5.81)	(1.78)
Peruvian New Sol	0.86	(0.09)	(7.00)	(6.73)

The US dollar rallied into July on stronger growth prospects for the US economy but fell against most currencies during the rest of the third quarter as the Fed grew increasingly dovish. As a result, all major currencies appreciated versus the US dollar, but gains in emerging market currencies were less broad as investors became more selective. Improving global growth and renewed stimulus out of China increased demand for commodity currencies, which prompted the Canadian, Australian and New Zealand dollar to bounce, especially in September.

¹All returns sourced from Barclays Indices except: currency returns (Bloomberg), World Government Bond (Citigroup), Emerging Market Bond (JPMorganChase), and S&P 500 (FactSet and Ned Davis Research).

²Currency returns are relative to the US dollar.

Past performance is no guarantee of future results.

Indexes are unmanaged and do not incur fees. It is not possible to invest directly in an index.

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INDEX DEFINITIONS

Barclays US Aggregate Bond Index is a broad-based benchmark that measures the investment grade, US-dollar-denominated, fixed-rate taxable bond market including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS.

Barclays US Government/Credit Index includes Treasuries (i.e., public obligations of the US Treasury that have remaining maturities of more than one year), government-related issues (i.e., agency, sovereign, supranational, and local authority debt), and corporates.

Barclays US Treasury Index includes public obligations of the US Treasury with at least one year until final maturity, excluding certain special issues such as state and local government series bonds (SLGs), US Treasury TIPS and STRIPS.

Barclays US Treasury Inflation Protected Securities Index is an unmanaged index that tracks inflation-protected securities issued by the US Treasury.

Barclays US Agency Index includes agency securities that are publicly issued by US government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the US government (such as US AID securities).

Barclays US Municipal Index covers the US-dollar-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and preredefined bonds.

Barclays US Securitized Index consists of the US MBS Index, the Erisa-eligible CMBS Index, and the fixed-rate ABS Index. The US Mortgage-Backed Securities (MBS) Index covers agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The US CMBS Investment Grade Index measures the market of conduit and fusion CMBS deals with a minimum current deal size of \$300mn. The fixed-rate ABS Index includes securities backed by assets in three sectors: credit and charge card, auto and utility.

Barclays US Corporate Index is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market. It includes US-dollar-denominated securities publicly issued by US and non-US industrial, utility, and financial issuers that meet specified maturity, liquidity, and quality requirements.

Barclays Euro Corporate Index tracks the fixed-rate, investment-grade euro-denominated corporate bond market. Inclusion is based on the currency of the issue, not the domicile of the issuer. The index includes publicly issued securities from industrial, utility, and financial companies that meet specified maturity, liquidity and quality requirements.

Barclays Sterling Aggregate Corporate Index is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate sterling-denominated bond market. Inclusion is based on the currency of the issue, not the domicile of the issuer. The Index includes publicly issued securities from industrial, utility, and financial companies that meet specified maturity, liquidity and quality requirements.

Barclays US Corporate High-Yield Index measures the market of US-dollar-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.

Barclays Pan-European High-Yield Index covers the universe of fixed-rate, sub-investment grade debt denominated in euros or other European currencies (except Swiss francs). Must be rated high-yield (Ba1/BB+ or lower) by at least two of the following rating agencies: Moody's, S&P, Fitch. Excludes emerging markets.

Barclays US High Yield Loan Index covers syndicated term loans which are US-dollar denominated, with at least \$150 million funded loans, a minimum term of one year, and a minimum initial spread of LIBOR +125.

Standard & Poor's 500 (S&P 500®) Index is a market capitalization-weighted Index of 500 common stocks chosen for market size, liquidity, and industry group representation to measure broad US equity performance.

S&P 500® is a registered service mark of McGraw-Hill Companies, Inc.

Citigroup World Government Bond Index (WGBI) measures the market for the US and most developed nation government bond markets. Countries must have a minimum rating of A3/A- by both Moody's and S&P to enter the index and will be removed from the index if the ratings fall below Baa3/BBB-.

JPMorgan Emerging Markets Bond Index Global (EMBIG) measures the market for US-dollar-denominated Brady bonds, Eurobonds, and traded loans issued by sovereign and quasi-sovereign entities of qualifying emerging market countries.

JPMorgan Corporate Emerging Markets Bond Index (CEMBI) is a market capitalization weighted index consisting of US-dollar-denominated emerging market corporate bonds.

JPMorgan Government Bond Index-Emerging Markets (GBI-EM) tracks local currency bonds issued by emerging market governments.