

Third Quarter Macro Insights

By Rick Harrell, VP, Senior Sovereign Analyst

The global economy is in the midst of a major rebalancing, and many [themes we have tracked](#) since the start of the year intensified during the third quarter.

Our primary theme—that the current state of the global credit cycle favors developed market consumers—remains intact. But markets have focused their attention on the counterpart of that theme: many emerging markets (EMs), including China, are entering the downturn phase of the credit cycle, and the availability of foreign capital to emerging markets is becoming scarce. Investors have drawn little comfort from China’s fiscal and monetary stimulus efforts to date.

Though advanced economies are currently in a favorable part of the credit cycle, many wonder whether the developed and emerging markets are destined to recouple, and if so, in which direction. In the US, the tension between positive domestic fundamentals and concerns about the global economic outlook culminated with the Federal Reserve’s (the Fed’s) decision to leave rates unchanged at its September meeting, citing risks from abroad.

THIRD QUARTER
MACRO INSIGHTS

- 1 **Crunch Time:**
The Credit Cycle in China & EM
- 2 **The Fed Bows to International Risks;**
Will the US Consumer Become a Growth Engine?
- 3 **Global Growth: DM vs. EM**
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Temporary Weakness or More to Come?
- 5 **Rates Can Stay Low;**
Can Risk Appetite Stay High?

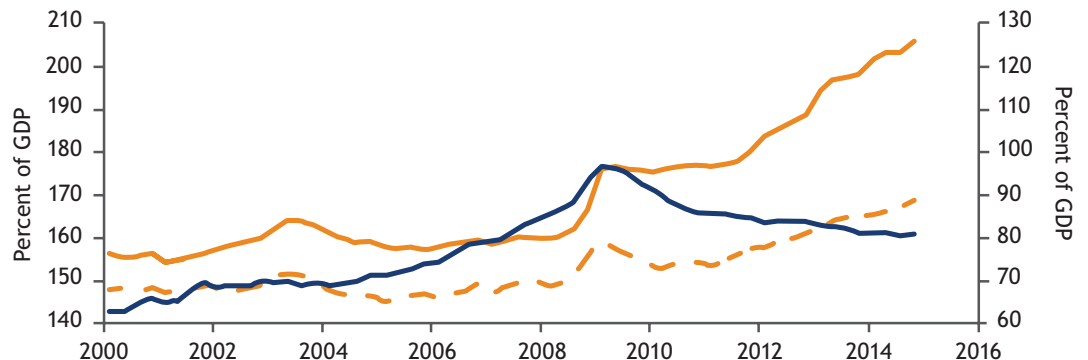
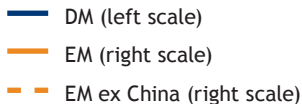


1. Crunch Time: The Credit Cycle in China & EM

EM POISED TO PASS BORROWING & SPENDING BATON TO DM

Private Credit, Broad Definition

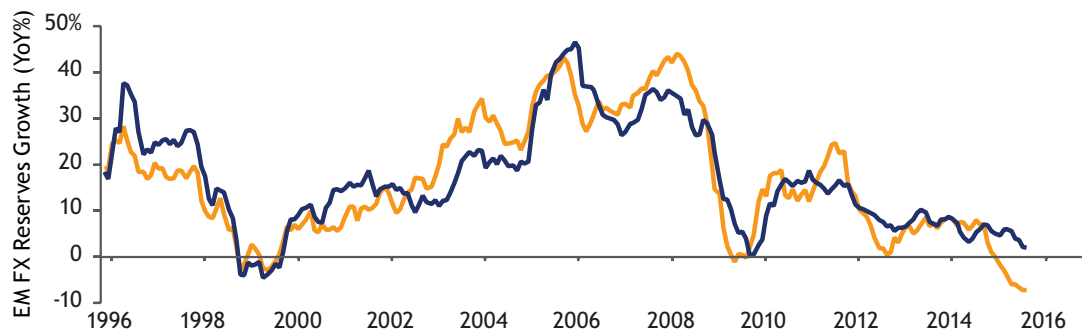
Source: JPMorgan, BIS, IMF, data as of September 2, 2015.



LIQUIDITY BOOM IN EM IS FADING

EM FX Reserves Growth (YoY%)

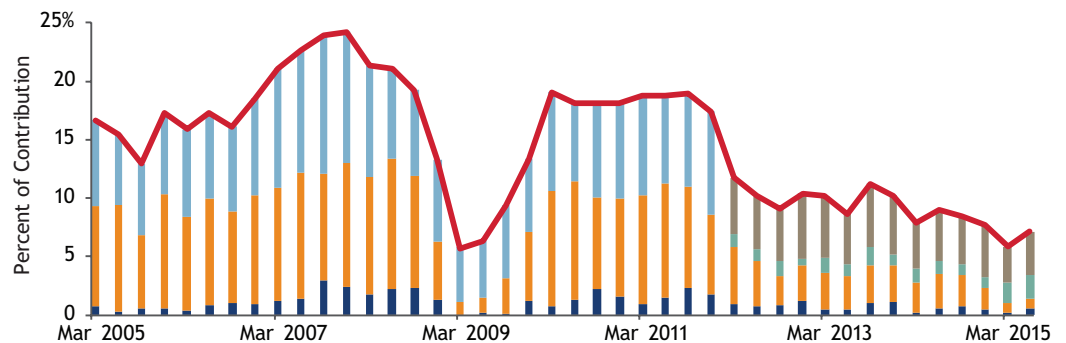
Source: Thomson Reuters Datastream, data as of July 31, 2015.



CHINA'S SOLID SERVICES SECTOR MASKS INDUSTRIAL WEAKNESS

China GDP Growth

Source: CEIC, Haver, data as of June 30, 2015.



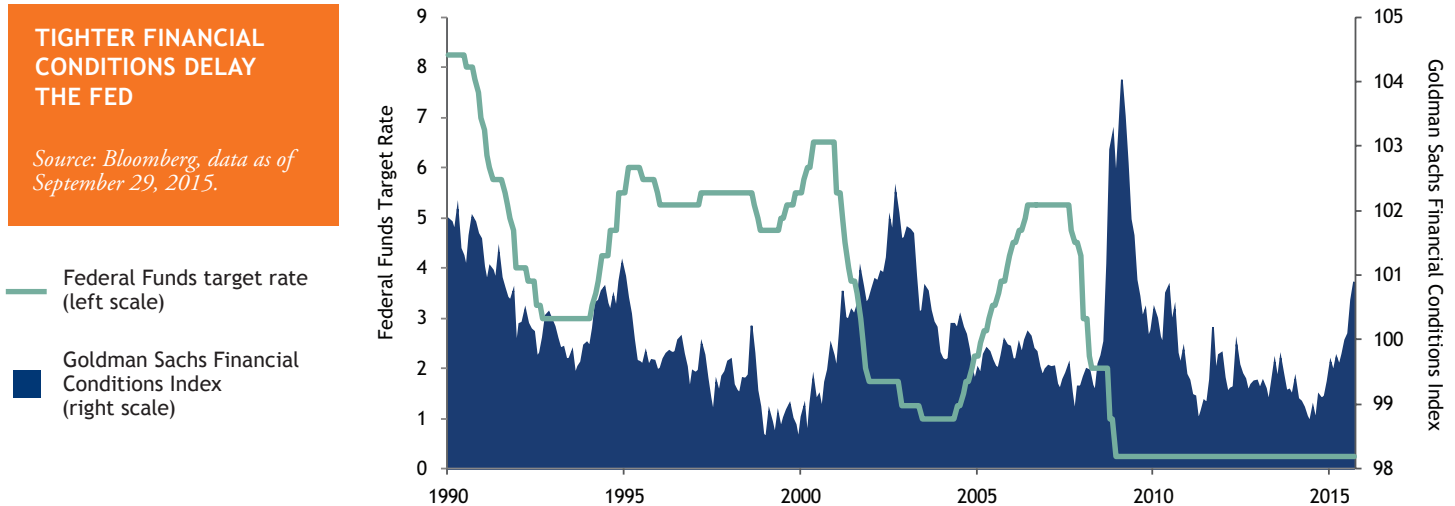
- During the past five years, EMs have been on a credit binge, propelling global growth. Meanwhile, the private sector in developed markets saved and delevered. Looking ahead, EM may now be entering a period of deleveraging and slower growth.
- China's economic malaise lies at the heart of the EM downturn. And while the country's growth trajectory is decidedly lower, what is perhaps more significant is the composition of that growth. Consumption and services sector activity are now the key engines of growth, whereas fixed investment and industrial activity now contribute very little.
- As China pivots from its investment-led growth model and demand growth for raw materials slows, commodity prices have cratered, global trade has stagnated and EM foreign exchange reserves are now falling. EM reserves grew spectacularly in the early 2000s when booming global trade sent a torrent of capital to emerging economies. Reserves increased more than tenfold from 2007 to 2014, peaking at \$8 trillion in 2014.¹ With reserves now in decline, EM central bank balance sheets will need to adjust, which could lead to tighter financial conditions.



2. The Fed Bows to International Risks; Will the US Consumer Become a Growth Engine?

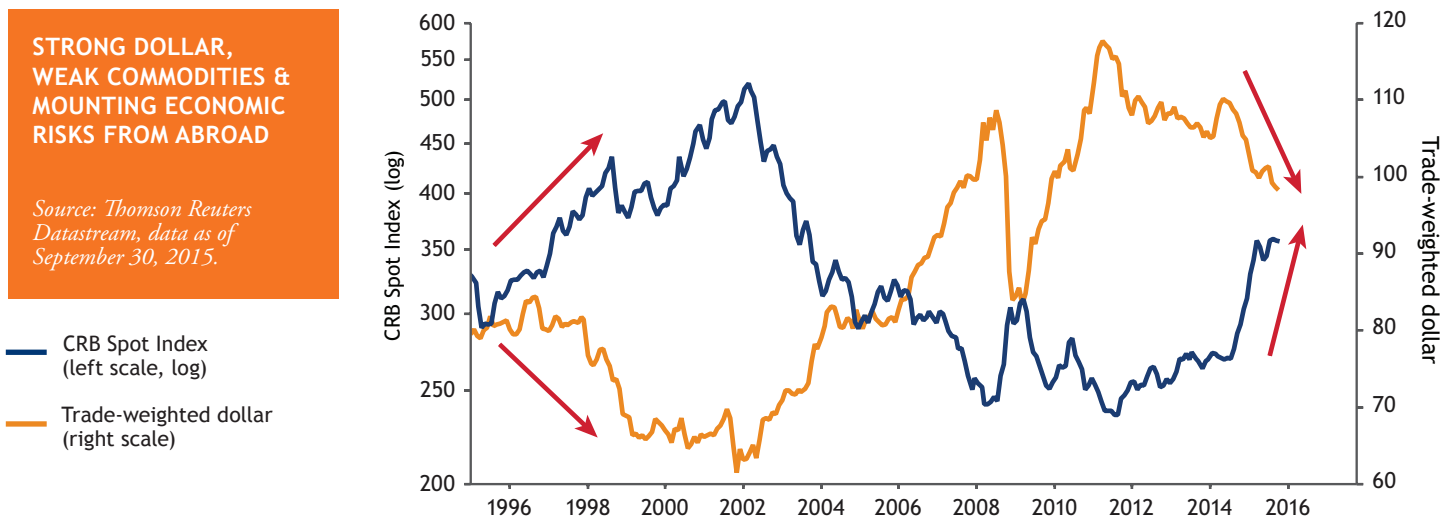
TIGHTER FINANCIAL CONDITIONS DELAY THE FED

Source: Bloomberg, data as of September 29, 2015.



STRONG DOLLAR, WEAK COMMODITIES & MOUNTING ECONOMIC RISKS FROM ABROAD

Source: Thomson Reuters Datastream, data as of September 30, 2015.



- In August, Fed officials talked tough in the face of pronounced market volatility, insisting that a September rate hike was still a possibility. Yet when the Fed ultimately left interest rates unchanged at its September meeting, Chair Yellen cited tighter financial conditions, including the stock market adjustment, stronger dollar and higher risk spreads, and their connection to the uncertain global economic outlook. The Fed's decision to hold steady fits a long-standing pattern of accommodation in the face of tighter financial conditions.
- There is a vicious cycle whipsawing markets: weak commodities darken prospects for EMs, which in turn stokes global growth fears. The strong US dollar is a key variable here. A strong dollar typically pressures commodity prices, and previous dollar bull cycles have persisted for several years. We do not expect the dollar to sustain such a blistering ascent, but it can stay strong for many years.



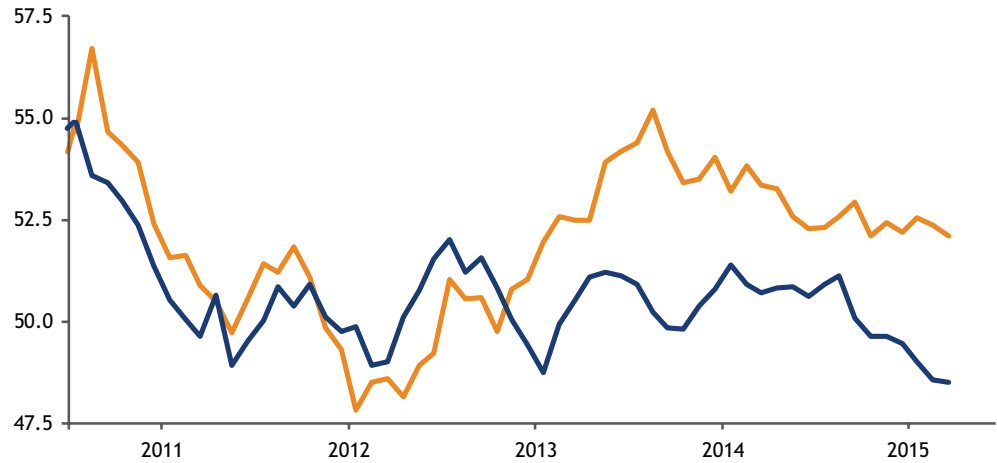
3. Global Growth: DM vs. EM

EM & DM GROWTH IS DIVERGING; WILL IT RECOUPLE?

Source: Markit/Haver Analytics, data as of September 22, 2015.

Emerging Markets PMI: Manufacturing Seasonally adjusted, 50+=expansion

Developed Markets PMI: Manufacturing Seasonally adjusted, 50+=expansion



G4 LABOR MARKETS ARE IMPROVING DESPITE BELOW-TREND GROWTH

Unemployment Rate (%)

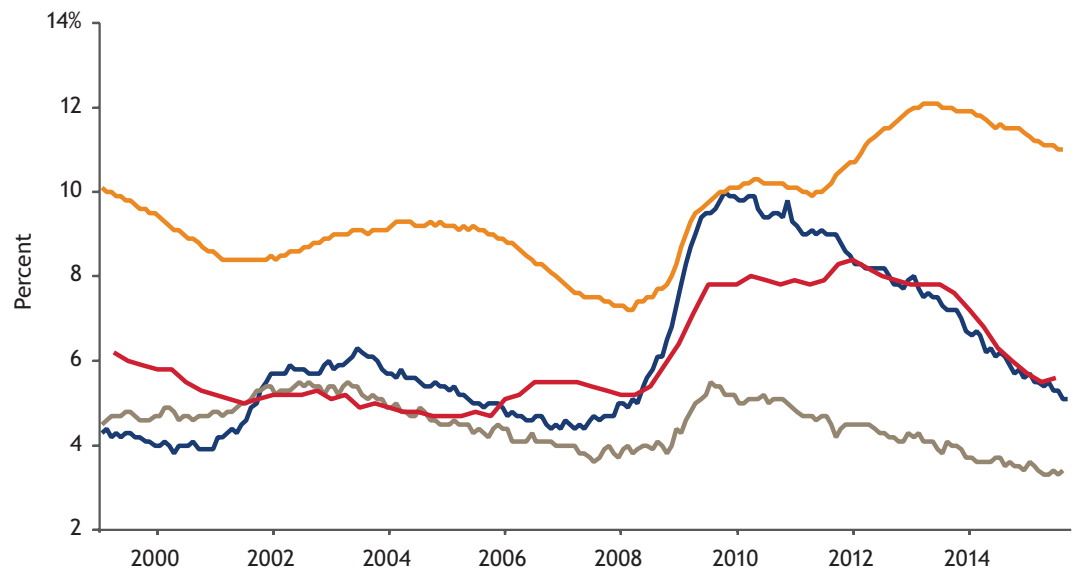
Source: Thomson Reuters Datastream, data as of September 24, 2015.

US (5.1)

Japan (3.3)

Euro Area (10.9)

UK (5.6)



- Developed economies, led by the US, continue to diverge from the emerging world on a number of fronts, including manufacturing. Developed and emerging market PMIs have shadowed each other fairly closely in recent years, leaving many to wonder whether they will recouple. And if so, in which direction?
- Labor market conditions across developed markets suggest the developed world will hold its spot in the favorable part of the credit cycle. Unemployment rates are falling rapidly across the US, Japan, euro zone and UK as the economies continue to heal. In the US, the consumer and household sectors are on sure footing: mortgage delinquencies are near record lows, and real consumer spending and consumer sentiment appear to be holding in well. In Europe, despite complex challenges, improved consumption helped drive solid growth this year. While there are downside risks, the European Central Bank's quantitative easing program remains a critical tailwind.



4. US Profits: Temporary Weakness or More to Come?

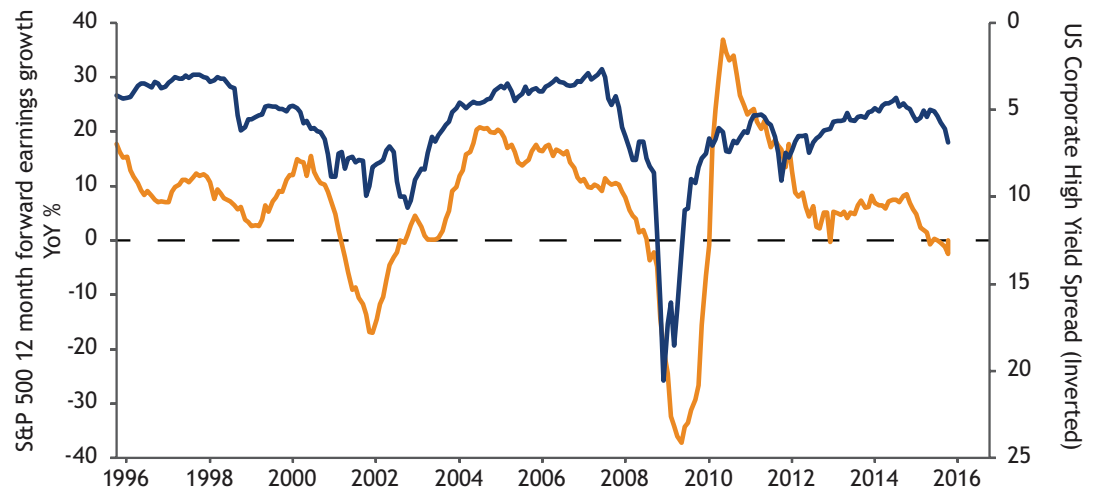
WEAK EARNINGS BELIEF ECONOMIC STRENGTH

S&P Forward Earnings
Growth vs. HY Spread (YoY%)

Source: Thomson Reuters
Datastream, I/B/E/S, Bloomberg,
data as of September 22, 2015.

— US corporate high yield
spread
(right scale, inverted)

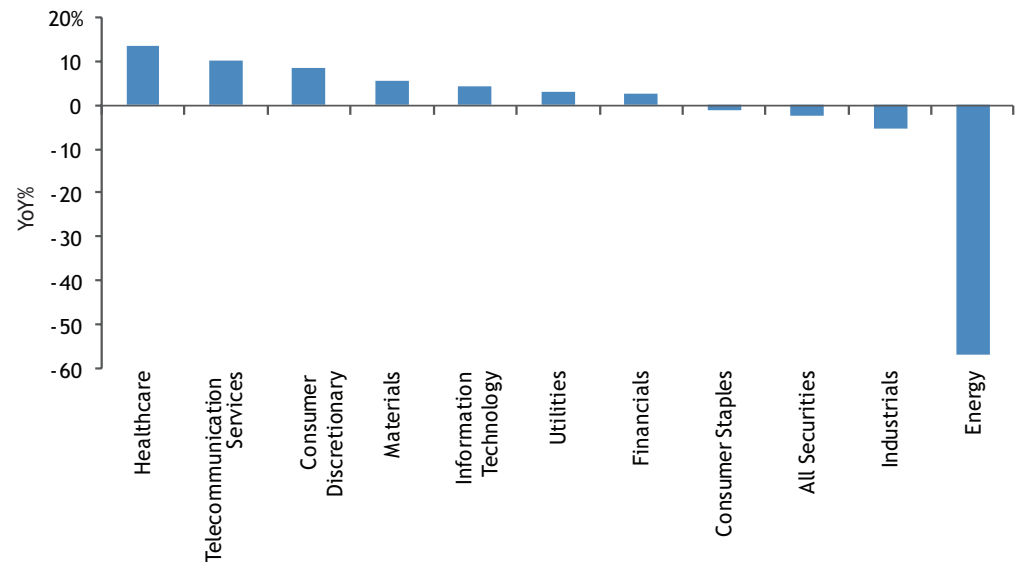
— S&P 500 12-month forward
earnings growth, YoY%



ENERGY & INDUSTRIALS TO BLAME

S&P Earnings Growth by
Sector (YoY%)

Source: Bloomberg, data as of
September 25, 2015.



- Low energy prices have plagued the energy sector since the fourth quarter of 2014, and energy sector earnings growth has turned spectacularly negative. Despite decent earnings growth in other sectors of the economy, the earnings picture next year will likely depend heavily on energy. Forward earnings growth expectations for the S&P 500® Index have dipped into negative territory.
- Fundamentals in the broader corporate sector appear to be peaking. Profit margins are at record highs but the prospect of rising wages could squeeze margins. Moreover, profit growth needs to accelerate in order to outpace the growth of debt, otherwise leverage will rise and corporate health will deteriorate.

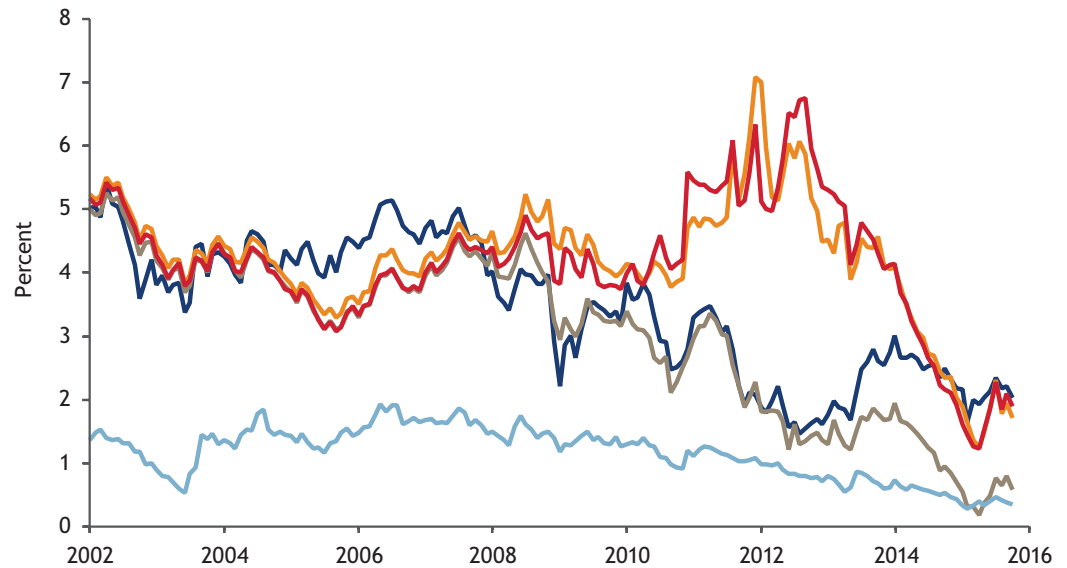


5. Rates Can Stay Low; Can Risk Appetite Stay High?

TEN-YEAR GOVERNMENT BOND YIELDS

Source: Thomson Reuters Datastream, data as of September 23, 2015.

— US
— Spain
— Italy
— Germany
— Japan

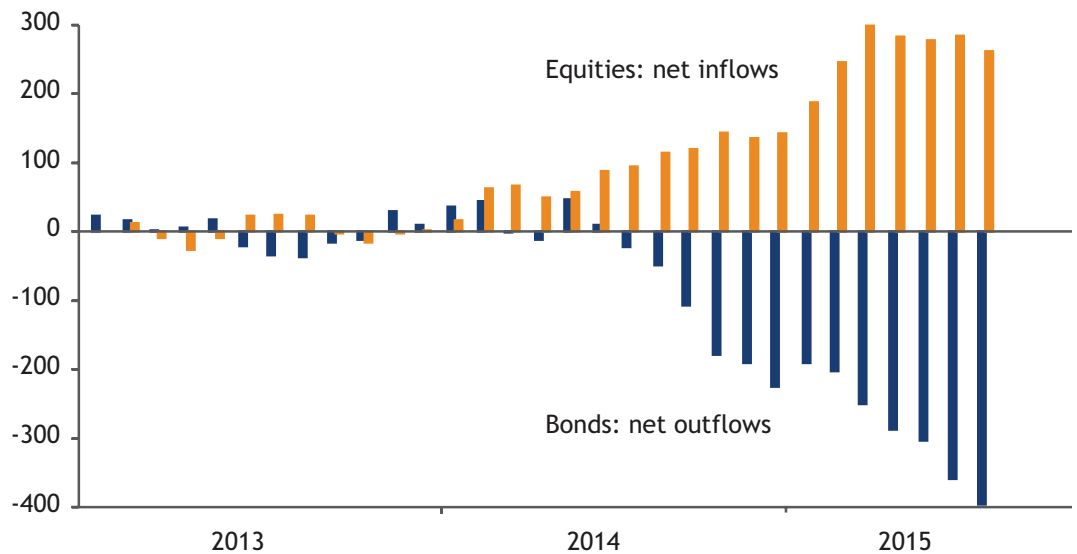


EUROPEAN INVESTORS ARE MOVING INTO RISKIER ASSETS

Euro zone Net Portfolio Flows (billions of euros, cumulative since 2013)

Source: Thomson Reuters Datastream, ECB, data as of July 15, 2015.

■ Equities: net inflows
■ Bonds: net outflows



- Interest rates are still extremely low globally, a theoretical boon for risk assets. Investors have poured flows into equities, eager to capture their high yield relative to interest rates and an attractive equity risk premium. But in a highly uncertain environment prone to bouts of volatility, are low rates enough to sustain risk appetite?

AUTHOR

Disclosure

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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