

# 2017 SECTOR TEAMS' OUTLOOK



THINK BROADLY. ACT DECISIVELY.



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

Composed of **TRADERS, ANALYSTS, STRATEGISTS, 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 12/31/2016; 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



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 estimated returns and relative value ideas.

### THE GLOBAL ASSET ALLOCATION PROCESS





## We're Modestly Optimistic About 2017, but There Are a Host of Unknowns

The world economy now looks to be on sounder footing, with economic data surprising to the upside, developed and emerging market economic momentum improving, global manufacturing recovering and the US profits recession seemingly ended.

**THE GLOBAL ECONOMY IS  
LESS LIKELY TO STUMBLE**

We expect global growth potentially ticking up to around 3.25% in 2017.

For much of 2016, we were focused on a world lacking in demand and the attendant problems. We were waiting to see who might step up to borrow and spend to spur growth. After a recession scare early in the year, markets rallied, as the Federal Reserve (Fed) went dovish in February and global bond yields declined substantially. Subsequently, markets seemed exuberant as we remained in a profits recession for most of the year. Economic execution and a profits rebound were needed to justify market levels. They are now showing up.

We're modestly optimistic about 2017, but there are a host of unknowns as we become acquainted with our new President Trump, what policies he may pursue, and how they will impact the world body politic.

### The Global Macro Picture Has Brightened

The global economy is less likely to stumble as signaled by the rising global Purchasing Managers Indices (PMIs). In Europe, there have been a lot of worries about politics, including the Brexit overhang in the UK which will likely dent growth in 2017. However, euro-area growth trends look good, with real GDP expected to be near 1.2-1.4% in 2017. China performed better than we expected in 2016, though we remain concerned that markets are too complacent regarding capital flight, the devaluation of the renminbi and financial stability risks.

A year ago, a lot of economists were lowering their growth estimates across many countries. Now, we see more stable trends (fewer cuts) which makes us think 2016 may be the trough for global GDP growth. We expect global growth in the 3% range in 2016, potentially ticking up to around 3.25% in 2017.

In the US, the profits recession appears to be over, and the possibility of an economic recession is off the table at least for 2017. For the first time in years, the Fed raised its key interest rate forecast in its so-called dot plot chart. The US government may be the one to step up and borrow and spend, which is good for global demand but likely won't hit until 2018. We expect US real GDP growth of approximately 1.5% in 2016, potentially improving to around 2.1% in 2017.

We think economic growth will be strong enough for S&P 500® Index earnings growth of around 7% in 2017 and possibly up to approximately 15% in 2018 if corporate taxes are cut to 20% from 35% today, as suggested in Trump's policy statements. Growth could be substantially better in 2018 depending on fiscal policy. For now, we think fiscal policies could add 0.25%-0.50% to our growth forecasts going forward, but significant hurdles lie ahead. The Republican Congress will likely pursue tax reform and infrastructure spending programs, but deficit hawks may restrain what they're able to push through.



## Global Political Volatility Should Persist

President Trump is an unknown quantity, having never held public office before. As he fills in his cabinet, we're starting to get a sense of his priorities, but he seems to enjoy being unpredictable (a debate tactic designed to keep your opponent off guard). This type of unpredictability can increase market volatility, but so far, equity volatility has been remarkably absent.

### UNPREDICTABILITY CAN INCREASE MARKET VOLATILITY

Will Trump attempt to implement some of his more controversial proposals from the campaign?

Will Trump attempt to implement some of his more controversial proposals from the campaign? Or will the realities of governing cause him to tone down his actions? We're assuming the latter for now but remain watchful of the former. For example, Trump has indicated he is no fan of free trade, and he has broad authority to act, but we think other policy makers may prevail. Sparking a global trade war is in no one's best interest, so we assign it a low probability. We are closely monitoring proposals relating to border adjustment.

We can't forget that after the vote for Brexit and the election of Trump, markets are likely to be keenly sensitive to political risks around the Dutch, French, and German elections in 2017. Geopolitical tensions with Turkey that renew refugee flows could doom Chancellor Merkel in Germany. China has their twice-a-decade Party Congress with their own leadership changes this fall.

## Bigger Booms and Busts Likely Ahead

The US remains in the late stage of the credit cycle, and we expect 2017 to be a fairly benign year. But 2018 could see fiscal stimulus and monetary tightening, which could increase recession risks later on. President Trump is likely to be bolder than President Obama and that can increase the cyclical amplitude of this cycle—a bigger boom and then a bigger bust. Higher fiscal spending will likely extend the credit cycle, but with that we could see greater corporate leverage. We believe this is a significant change from the more benign low growth, low inflation, easy Fed policy that we have experienced since the financial crisis in 2008. After Trump got elected, we saw the Fed's dot plot interest rate forecast increase for the first time which could be a warning that markets may be complacent about tightening monetary policy.

Inflation risks have been rising in developed markets. In the US, Trump will be unleashing fiscal stimulus at a time when the unemployment rate is below 5%, putting upward pressure on inflation. Across developed markets in general, inflation is rising and curves are steepening. We also see Chinese producer price inflation rising for the first time since 2013, and that could spill over to global goods price inflation.

Fixed income assets have been supported by a search for yield, but as rates rise and prices fall, it could spark a rotation into equities.



## Financial Conditions Have Been Tightening, Raising the Risk of a Policy Mistake

Yields have risen, the dollar has been strengthening and oil prices are up. It seems that with every turn of the calendar since 2008, we have had a first half swoon in growth. Barring that potential shock, both growth and inflation trends are expected to rise but remain fairly benign in 2017. However, both could rise more substantially in 2018, leading to a more hawkish Fed. The market is not priced for that. We think the Fed will hike interest rates two times in 2017 and four times in 2018, but risks seem tilted for more hikes which would be a major shift, compared to years of revising interest rate expectations lower.

### WHAT THE FED MAY DO

We think the Fed will hike interest rates two times in 2017 and four times in 2018, but risks seem tilted for more hikes which would be a major shift.

## Markets Are Still Ahead of Fundamentals, but the Gap Is Shrinking

Equity price-earnings (P/E) ratios are currently high, but earnings are poised to accelerate. We have a positive view on dividend growth for 2017 based on higher earnings and repatriation of capital from overseas. We worry that markets have discounted a lot of good news about corporate tax reform and could be disappointed—more by the timing than the actual delivery. It could take longer to get tax changes through Congress than investors anticipate.

In credit markets, the turn in commodities is positive. We believe the peak in defaults is behind us, now that energy and metals and mining companies have moved into credit repair. However, like the equity markets, credit investors may have overdone the reflation excitement.

Generally speaking, we have a positive macro view for 2017 and then expect greater amplitude of the cycle as we move into 2018. We think by then, the rubber will hit the road. Trump's policies, in whatever form they take, will start impacting growth, inflation, earnings, and leverage. The Fed will take notice and likely ramp up efforts to manage the inflationary effects, and we will have a "normal" cyclical recovery on our hands. As we move through 2018, the risk of a policy error will rise; historically, we've seen that expansions don't die of old age but are often killed in Washington.



## SECTOR VIEWS

### Governments & Currencies

Global purchasing managers' indices (PMIs) are rebounding. We are getting the economic execution many of us had wished for, along with a rebound in profits. But uncertainty reigns with a new administration and unclear policy direction. We believe a fiscal stimulus package could boost GDP growth and inflation, but not until 2018. We anticipate two rate hikes from the Federal Reserve (Fed) in 2017. We think this will only put marginal pressure on yields as the move is largely anticipated by the markets. However, we think the Fed may be more hawkish in 2018, because of higher inflation, than investors may anticipate. The US dollar could strengthen with fiscal stimulus and a more hawkish Fed, though we don't expect a substantial move higher. Some countries, such as Brazil, may cut interest rates by several percentage points.

### Securitized

President Trump's election injected greater uncertainty around the Fed's continued reinvestment in mortgage-backed securities (MBS) causing MBS option-adjusted spread (OAS) to widen. MBS performance could be further strained by changes in the Federal Reserve Board, particularly with Chairwoman Janet Yellen's term set to expire in 2018, and any resulting shifts in their investment policy of the MBS portfolio and/or any continued speculation of a Republican driven government-sponsored enterprise (GSE) reform agenda calling for an unwind of Fannie and Freddie. While in our base case we do not expect significant spread widening akin to what we saw during the 2013 'Taper Tantrum' event, it is hard for us to be constructive on MBS versus duration matched treasuries given the looming risks. Comparatively, we believe agency MBS spreads are still expensive and that more attractive opportunities can be found in the non-agency space where credit fundamentals remain strong. US house prices rose 6% in 2016, and continue to be supported by household formation, median income growth, and limited construction. However, higher rates and uncertainty in housing policy create a broader range of potential outcomes to our house price forecast, especially for 2018 and beyond. Our residential mortgaged-backed securities (RMBS) outlook for 2017 is largely positive, as pre-crisis loans are curing and new mortgages have been exhibiting low delinquencies. However, pockets of uncertainty will keep us focused on shorter maturities. Most asset-backed securities (ABS) sectors continue to offer modest yield advantages to corporates with similar ratings. Consumer ABS fundamentals remain positive where commercial ABS fundamentals are mixed with risks to the downside related to global trade. We think this could create attractive investment opportunities in 2017. Commercial Real Estate (CRE) fundamentals continue to be strong, but the CRE cycle is maturing. Commercial mortgage-backed securities (CMBS) spreads tend to follow corporate bond spreads with a lag, but technical support from light dealer inventory and negative net issuance could lead to modest outperformance in 2017, particularly in a stable spread environment.

#### ASSET-BACKED SECURITIES

Most asset-backed securities (ABS) sectors continue to offer modest yield advantages to corporates with similar ratings.





## Equities

We are positive on global equities for 2017, favoring the US over most other regions. The S&P 500 appears to be resuming positive year-over-year earnings growth after showing little growth during the past two years. Energy sector earnings have been improving worldwide from very low levels. Financial sector earnings have also been picking up, particularly in the US as interest rates have moved a bit higher, providing a small boost to net interest margins. Expectations for a modest cyclical pick-up and corporate tax cuts underpin recent US small-cap stock outperformance relative to large-cap. Value-oriented sector outperformance over growth sectors has been a global theme in recent months and is likely to continue. To get more bullish on the rest of the world, we really need to see profits rebound. Profits in the US have been weak until recently, but around the world they have been horrendous.

## Investment Grade Corporate Bonds

Driven by a recovery in commodity sectors and continued strong demand from both domestic and foreign investors, investment-grade (IG) corporate bonds posted healthy returns in 2016. Looking into 2017, we expect spreads to trend sideways but are encouraged by recent signs of better US economic growth and the potential for additional fiscal support from the new administration. However, the timing and potential impact of policy changes is highly uncertain and could lead to periods of spread volatility. IG credit remains in late expansion with the main focus among US companies continuing to be the return of cash to shareholders. Commodity exposed sectors (energy and basic materials) look attractive, as their earnings power continues to recover and management focuses on their balance sheets. Areas of concern are primarily consumer focused, including retail, autos and healthcare, due to uncertainty over the potential Affordable Care Act (ACA) repeal. A main worry is that credit metrics have peaked, with leverage at a 10-year high and margin growth stalling. However, free cash flow (FCF) generation among IG companies remains strong, and rising interest rates should slow the pace of debt-financed share repurchase agreements (repos). We expect positive technicals to be a driving factor in 2017, with continued strong demand from foreign investors given that nominal yields for US credit remain more attractive. New issue supply is expected to be down approximately 11% in 2017, which should provide a positive technical for this asset class.

### A CORPORATE ABOUT-FACE

Commodity exposed sectors (energy and basic materials) look attractive, as their earnings power continues to recover and management focuses on their balance sheets.

## Taxable Municipals

Taxable municipals are a defensive sector that historically performs well during times of market volatility and can be a good diversifier versus IG corporates. Looking ahead, we are likely to see modest spread tightening and returns this year as rising rates will support demand for long-duration bonds. Fundamentals look stable, with state and local government credit quality continuing to improve, although the pace has been slowing and the extent of the recovery varies from state to state. State revenue growth is expected to increase modestly in 2017 as local governments continue to see increasing property tax collections, which are a main revenue source for many. However, increasing pension and retiree healthcare costs could put stress on some state's finances, particularly those with large unfunded liabilities. President Trump's policies could affect the municipal market in a variety of ways, with conflicting statements about his policy goals introducing a significant dose of market uncertainty. At this time, it appears the healthcare sector will be the most adversely affected due to his stated goal of repealing and replacing the Affordable Care Act.



## European Investment Grade Credit



European credit fundamentals remain solid and notably better than in the US with balance sheet stability and prudent outlooks the focus, though concerns of potential releveraging are rising and could gain steam if the economic outlook improves. The European Central Bank (ECB) buying was a key driver of spreads and sentiment in 2016, and while we expect that to remain the case for most of 2017 as well, concerns about ECB tapering and political risk events are of increasing concern. Our base case is that corporate tapering is unlikely to start in any magnitude during 2017, but this is highly dependent on the ECB's inflation forecasts and their reading of the "success" of the program. Even hints of tapering could have a material impact without actual tapering being initiated. We continue to favor the US IG market over the European given higher all-in yields but have seen more pockets of value in the European market on the back of the recent pull back. Going into 2017, we are concerned about political risk events and spreading populism (the Dutch, French and German elections, Brexit and the US post inauguration). We also worry about fund flows as demand for corporates could diminish as sovereign yields look increasingly attractive.

## High Yield

High yield had a strong year in 2016 largely due to elevated spreads at the beginning of the year, the rebound in commodity prices and a more dovish central bank tilt. Now, in 2017, we find ourselves in the late expansion phase of the credit cycle with corporate leverage high. However, interest coverage remains strong given low absolute rates (which we don't think will move significantly higher near term). Most importantly, corporate profits appear to be trending higher. With spreads significantly tighter than a year ago, we do not expect a repeat performance but do believe investors are being compensated for a lower expected default rate and a stronger US economy in 2017. Fundamentally, the majority of industries in high yield remain in the late phase of the credit cycle which prevents us from becoming overly optimistic at current spread levels.

## EM Credit (Hard Currency and Corporate)

This past year was a strong one for Emerging Market Credit, and for 2017, we look for a continuation of this positive trend, albeit with more modest return potential. In the year ahead, we see stable commodity prices, broad base improvement in corporate fundamentals and supportive market technicals as positive dynamics for EM credit. The trajectory of US rates has been a source of apprehension for investors. However, while the pullback in the fourth quarter led to considerable re-pricing of US rates, EM credit markets absorbed the move and demonstrated significant resilience in the face of developed market challenges. Protectionist trade policy under Trump may test EM in 2017, but we believe policy will pose largely idiosyncratic risks for specific countries and companies and that these risks can be mitigated through careful sector and security selection. Overall, we view EM US dollar credit as well positioned to overcome potential headwinds under Trump. We also see EM as a net beneficiary of large US fiscal expansion, as it will bolster EM growth levels. EM credit continues to offer favorable yields.



## Bank Loans

For the bank loan market, 2016 was a strong year. We expect returns to be “yieldish” in 2017 as there is limited return potential from price appreciation after 2016’s price recovery, and repricing pressure may lower average coupon somewhat before rising rates push up overall yield. Some analysts believe it is possible that regulators will be a bit more forgiving under the Trump administration than they have been in the last couple of years, which could increase supply and help keep default rates low. We believe technical conditions will likely be favorable for the bank loan market through a combination of robust collateralized-loan obligation (CLO) issuance, retail inflows and strong demand from domestic and foreign separate account mandates.

### POSITIVE ON CONVERTIBLE BONDS

We believe improved earnings and changes in tax policy (a potential tax cut and a cash repatriation holiday) will have an outsized benefit for healthcare, industrial and consumer convertibles.

## Convertible Bonds

We are incrementally more positive on convertible bonds going into 2017 and believe convert returns can slightly outperform high yield. At present, we believe improved earnings and changes in tax policy (a potential tax cut and a cash repatriation holiday) will have an outsized benefit for healthcare, industrial and consumer convertibles. Structurally, we believe balanced converts present the best risk-adjusted return, but also believe credit-sensitive converts offer attractive return profiles, too. Given the potentially interesting equity landscape, we believe increased selective beta exposure is warranted to favored industries but are remaining disciplined in case the markets become more volatile and range-bound.

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## Disclosure

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

***Past performance is no guarantee of future results.***

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***All information provided as of December 31, 2016, unless otherwise noted, and is subject to change at any time without notice.***

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