LOOMIS | SAYLES

MACRO & MARKET COMMENTARY

First Quarter Macro Insights

By Rick Harrell, VP, Senior Sovereign Analyst

The major macroeconomic themes we identified at the start of the year continued to play out during the first quarter, and we offer our latest insights in this update.

We have seen further evidence that developed market (DM) consumers are becoming a global growth engine. The starkest example recently is the rebound in consumer confidence in Europe and upward revisions to economic growth there. Within the US, consumers are expected to lead the economy toward a 3% GDP growth rate this year.

With the US job market powering ahead, the Federal Reserve (the Fed) is still on track to hike rates later this year. While the pace of hikes may be slower than previously anticipated (thanks to a strong dollar weighing on the US export sector), the greenback is still favored among global currencies and is likely to continue its appreciating trend throughout the year.

Meanwhile industrial activity in China is still slowing, led by weakness in the property sector. This is adding to the price declines in many commodities.

The strong dollar, a slowing China and consequent decline in commodity prices are hitting many emerging market (EM) countries reliant on commodity exports. This problem is compounded by countries where excessive credit growth and US-dollar borrowing have built imbalances. Risks to much of the EM asset class remain high.

FIRST QUARTER MACRO INSIGHTS

1 Developed Market Consumers Drive Global Growth

2 The "Almighty" Dollar

3 Income Redistribution from the Commodity Collapse

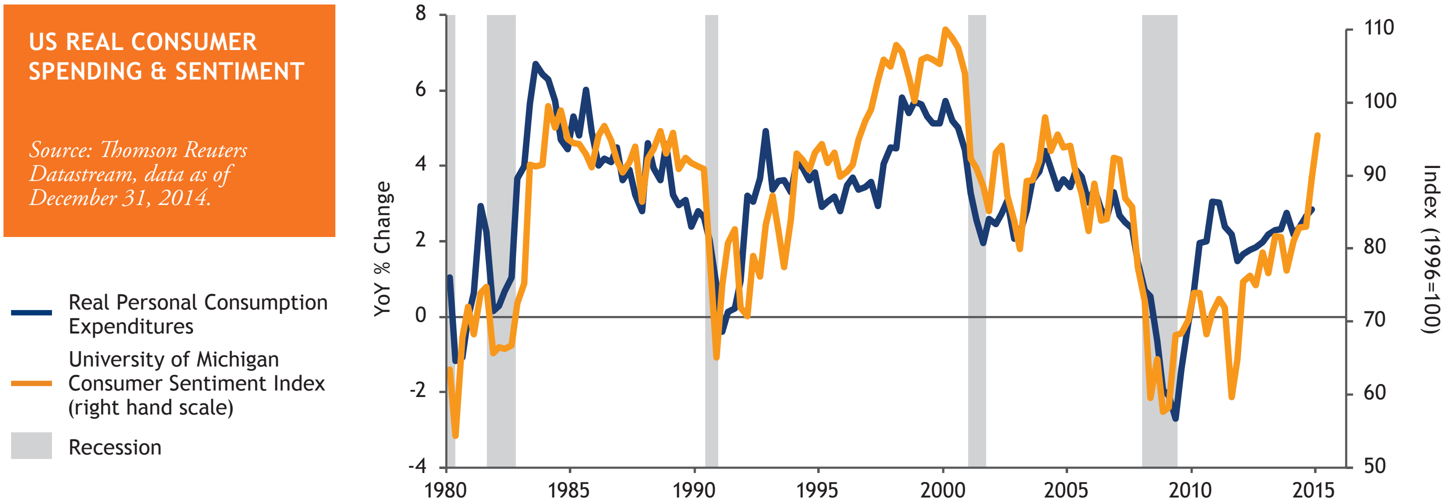
4 From Zero to Sub-Zero: Global Central Banks Stay Easy

5 Triple Threat for EM: China, Commodities & US Dollar Leverage

1. Global Credit Cycle Appears to Favor Developed Market Consumers

US REAL CONSUMER SPENDING & SENTIMENT

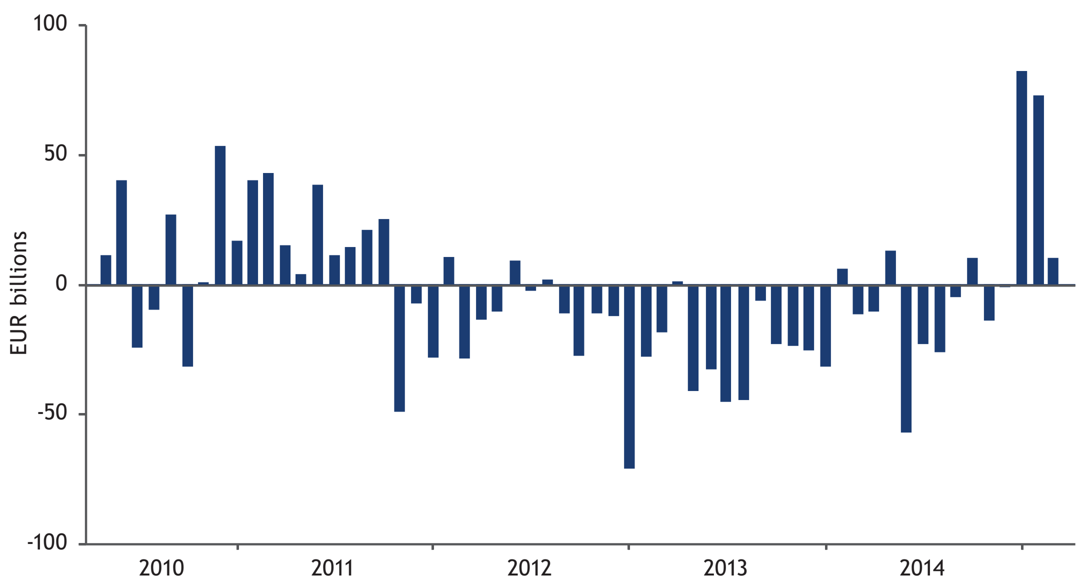
Source: Thomson Reuters Datastream, data as of December 31, 2014.



EURO AREA PRIVATE LOANS

1 month change

Source: Thomson Reuters Datastream, data as of February 27, 2015.

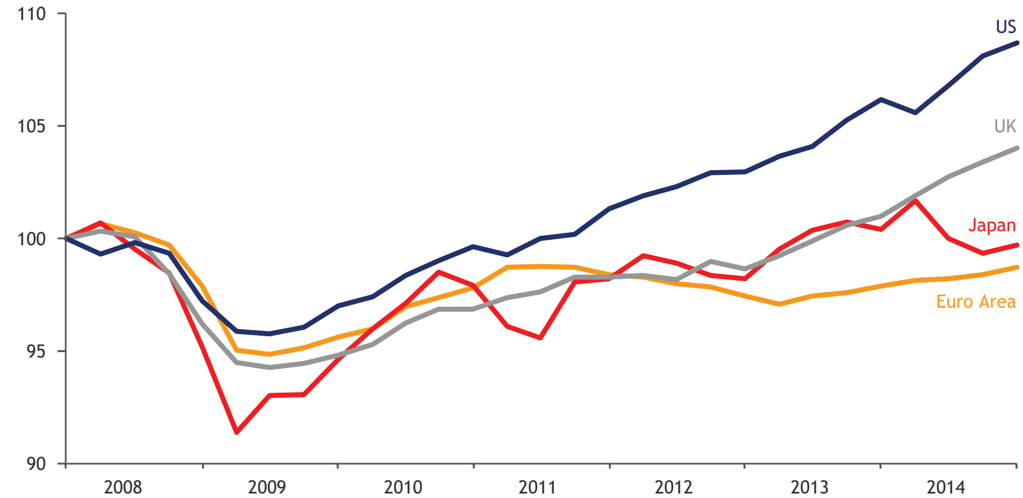


- Low energy prices and rock-bottom interest rates are setting up consumers in developed markets to become the global engine of growth in the coming quarters. In the US, improving labor market conditions have aided consumer sentiment and spending. Trend job growth is still strong despite recent data points on the weaker side, and there are early signs of upward wage pressure. Recent hourly pay increases by a string of major US employers seem to support our expectation that worker emolument is beginning an uptrend.
- There are signs of nascent recovery in the euro area, with "green shoots" of credit growth emerging after a long winter of deleveraging. Quantitative easing and targeted lending programs from the European Central Bank (ECB), along with stronger consumer and housing demand, have helped bank lending break out of its multi-year doldrums.

2. The "Almighty" Dollar

US STILL LEADING DM GROWTH: REAL GDP LEVELS
Rebased, 2008 = 100

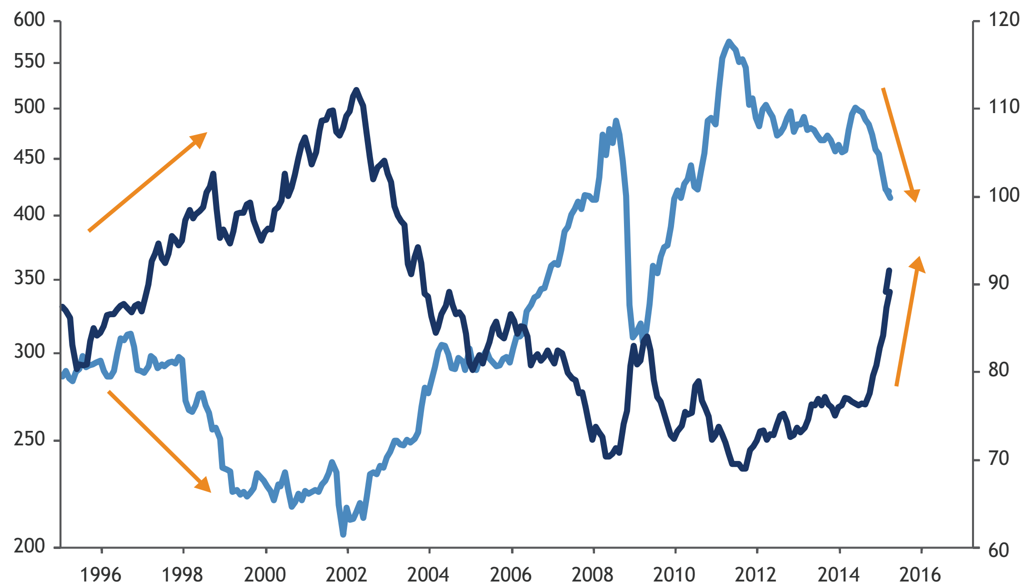
Source: Thomson Reuters Datastream, data as of November 14, 2014.



US
UK
Japan
Euro Area

STRONGER DOLLAR KEEPS DOWNWARD PRESSURE ON COMMODITIES

Source: Thomson Reuters Datastream, data as of March 13, 2015.



CRB Spot Index (left scale, log)
Trade-Weighted dollar (right scale)

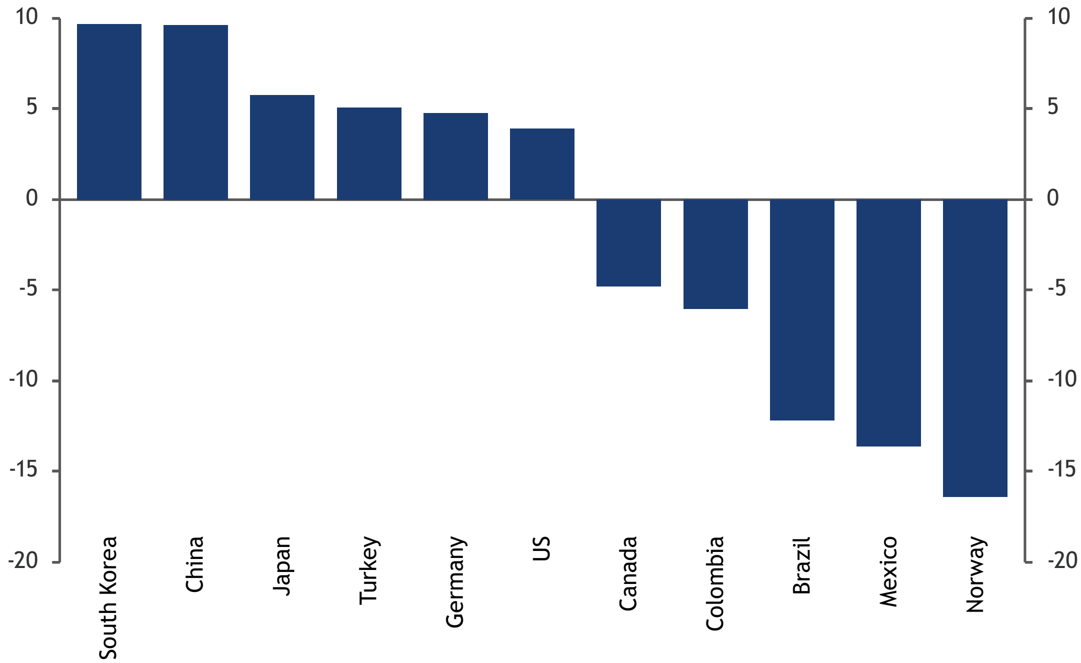
- After the financial crisis, the US was quick to recognize bad loans, allow defaults, recapitalize the banking sector and implement aggressive monetary easing. Though the recovery and subsequent expansion have been halting and sluggish at times, the US economy has outperformed its major developed peers post-crisis thanks largely to this tough prescription. More recently, the strong dollar has knocked the US export sector down a few notches and contributed to slight downward revisions in US growth, but domestic demand, particularly in the services sector, remains very robust.
- US dollar strength typically exerts downward pressure on commodity prices, a coincident relationship that dominated in the late 1990s. Though the dollar has followed a near straight-line trajectory since the second half of 2014, our bias is for dollar strength and commodity price declines to persist throughout 2015. Commodity producers, many of which are emerging market economies, are likely to feel the pinch.

3. Income Redistribution and Rebalancing from the Commodity Collapse

TERMS OF TRADE REFLECTS RELATIVE PRICES OF EXPORTS TO IMPORTS

YoY % Change

Source: Thomson Reuters Datastream, National Sources, data as of January 15, 2015.



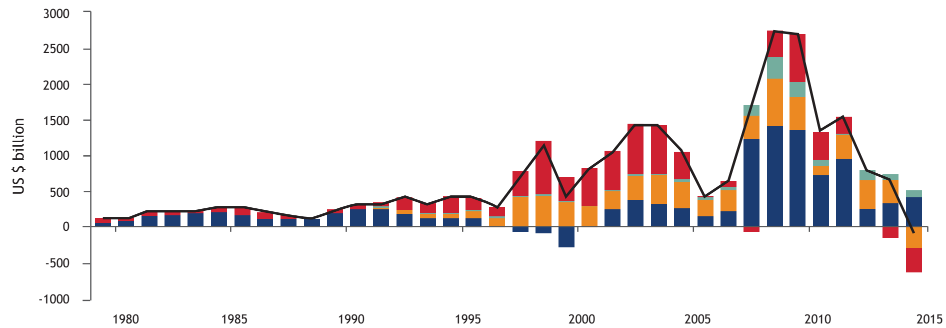
- Lower prices for oil and other major commodities are changing economic fortunes around the world and reshuffling terms of trade in favor of net commodity importers. Terms of trade expresses the ratio of a country's export prices to its import prices. As a country's terms of trade deteriorate, profits in resource-related industries decline creating fewer tax revenues for the government, ultimately squeezing incomes in the broader economy.
- Major commodity exporters such as Norway, Mexico and Brazil have seen a negative shock to their terms of trade, impairing their growth prospects. Meanwhile, net importers of oil, including the US and major economies in Asia (such as China and Japan) and Europe (such as Germany and Spain), have experienced a positive boost in their terms of trade.

4. From Zero to Sub-Zero: Global Central Banks Stay Easy

US, EUROPE AND JAPAN SOVEREIGN BOND NET ISSUANCE

Source: Morgan Stanley Research, net of central bank purchases, data as of March 3, 2015.

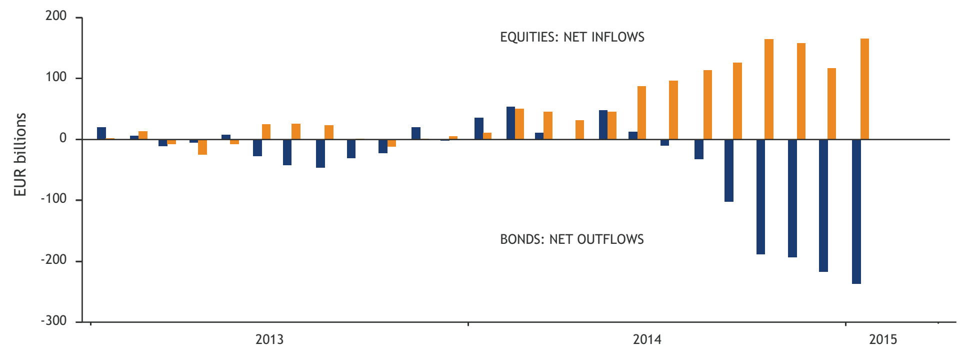
US Euro Area
UK Japan Total



EURO ZONE NET PORTFOLIO FLOWS
Cumulative since 2013

Source: Thomson Reuters Datastream, ECB, data as of January 1, 2015.

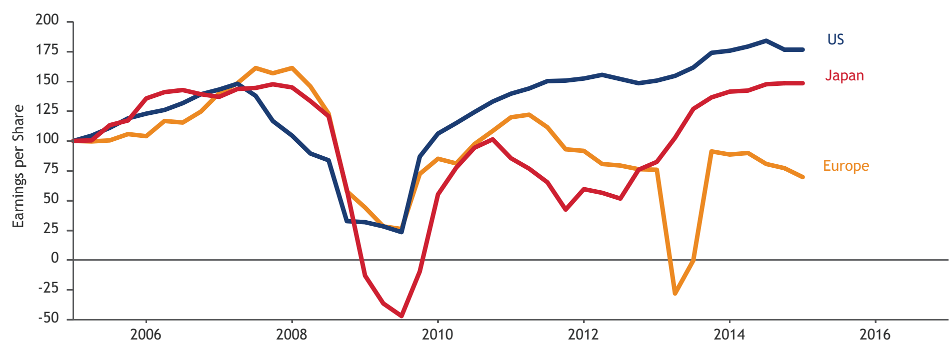
Bonds: Net Outflows
Equities: Net Inflows



MORE CATCH-UP IN EUROPEAN EQUITIES?

Source: Thomson Reuters Datastream, Bloomberg, data as of January 1, 2015.

S&P 500® Trailing EPS
MSCI Japan Trailing EPS
MSCI Europe Trailing EPS



- The ECB and the Bank of Japan (BOJ) have picked up the quantitative easing (QE) baton from the Fed, and global financial markets continue to receive unprecedented monetary policy support. After central bank purchases, net global sovereign bond issuance[1] is projected to be negative in 2015, and the dearth of high-quality fixed income securities is driving euro area and Japan sovereign yields ever lower. Forty percent of euro zone sovereign bonds now have negative yields.[2]
- In a world of paltry bond yields, equity earnings yields are enticing some investors into stocks despite new highs in global stock markets.
- In Europe, ECB QE has diverted a torrent of capital out of bonds and into equities, sparking a strong price move since last December. But corporate earnings remain well below their 2007 pre-crisis peak. If Europe's economic recovery gets going and earnings improve, it could mean a multi-year bull run for euro equity markets.

[1] *Includes Japan, UK, euro zone and US.*
[2] *Source: RBS, data as of March 17, 2015.*

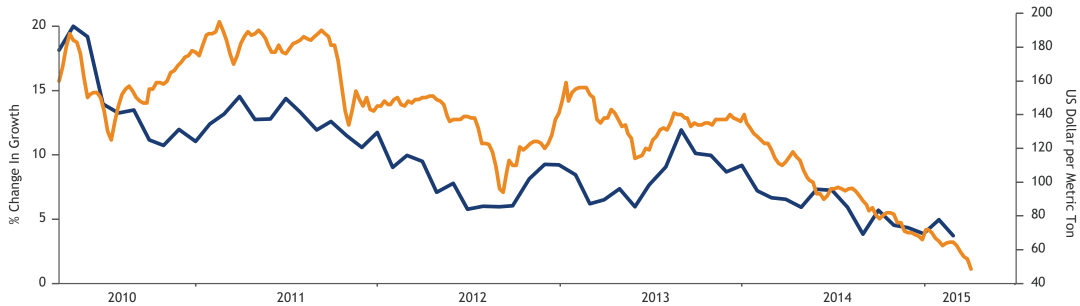
5. Triple Threat for Emerging Markets: China, Commodities and US Dollar Leverage

CHINA'S DRAG ON EM VIA COMMODITIES

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

"Li Ke Qiang" Index (China GDP Proxy)

Iron Ore (right hand scale)

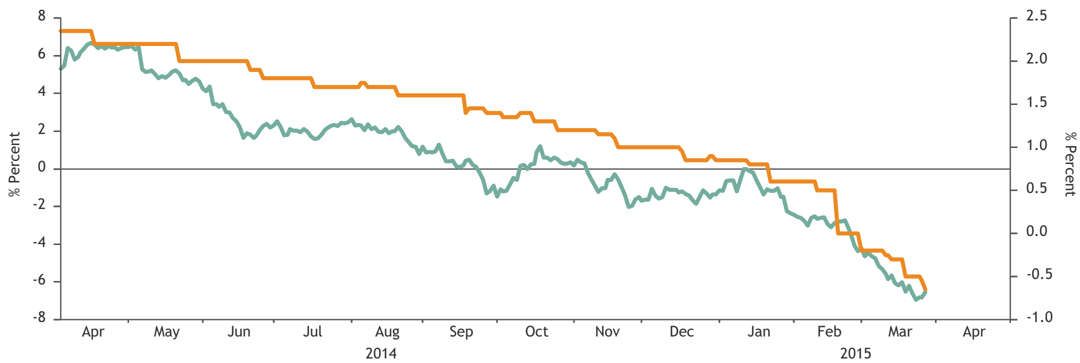


CONSENSUS FORECASTS FOR BRAZILIAN GROWTH IN 2015 VS. TERMS OF TRADE

Source: Bloomberg, data as of March 27, 2015.

Brazil Terms of Trade

Brazil GDP Consensus Forecasts (right hand scale)

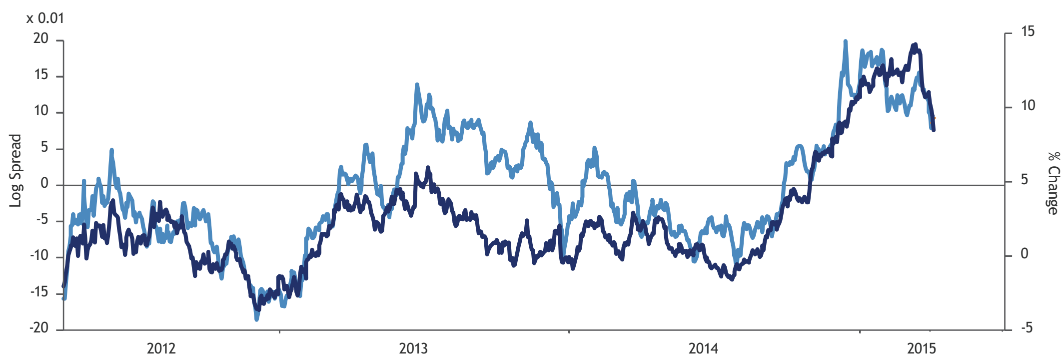


US DOLLAR & EM SOVEREIGN CREDIT SPREADS

Source: Thomson Reuters Datastream, JPM, Federal Reserve, data as of March 27, 2015.

6 month % change of US dollar (right scale)

6 month change of JPM EMBI Spread (left scale)



- Chinese GDP growth is slowing, and the economy is struggling to transition from an investment-driven model to a consumption-driven one. The once-edacious commodity consumer is demanding fewer and fewer base metals and industrial materials each year, bad news for iron-ore exporters like Australia, Brazil and South Africa. China recently cut its official GDP growth target to 7.0%, but high-frequency growth indicators we monitor are significantly undershooting even that lower rate.
- A strong dollar over the long term could challenge the creditworthiness of some EM sovereigns that have borrowed in dollars. Sovereigns may see their balance sheets deteriorate as dollar-denominated liabilities increase in value while lower commodity prices and tepid demand cause commodity revenues to lose their natural "dollar hedge."
- EM credit spreads have widened in acknowledgement of these risks, offering selective investors the opportunity to capture pockets of value and an attractive yield over developed market sovereigns.

AUTHOR

RICK HARRELL
VP, Senior Sovereign Analyst

Disclosure

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

Li Ke Qiang Index: *A proxy for China growth calculated using the weighted average of annual growth rates in outstanding bank loans (40%), electricity production (40%) and rail freight volume (20%); Bloomberg.*

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.

This commentary is provided for informational purposes only and should not be construed as investment advice. Any opinions or forecasts contained herein reflect the subjective judgments and assumptions of the authors only and do not necessarily reflect the views of Loomis, Sayles & Company, L.P., or any portfolio manager. Investment recommendations may be inconsistent with these opinions. There can be no assurance that developments will transpire as forecasted and actual results will be different. Data and analysis do not represent the actual or expected future performance of any investment product. We believe the information, including that obtained from outside sources, to be correct, but we cannot guarantee its accuracy. The information is subject to change at any time without notice.

LS Loomis | Sayles is a trademark of Loomis, Sayles & Company, L.P. registered in the US Patent and Trademark Office.

MALR013173