



bond market review & outlook

By Thomas Fahey, Associate Director of Macro Strategies

second quarter
2014

SO FAR, SO GOOD

It's been a great year to date for fixed income investors. Surprisingly, global bond yields have almost universally declined since the start of the year, resulting in both price and income gains. Investors should enjoy it while it lasts. We do not expect a brutal bond bear market such as we saw after last year's "taper tantrum." At the same time, we do not expect much more bond price inflation in the developed government bond markets. Credit spreads have tightened and might have some room left to rally, but we are now in what we would call a "collect-the-carry" type of environment. Emerging markets bonds had a great run during the last quarter, correcting after the bear market in the spring of 2013. In our first-quarter review, we talked about the frustrating global expansion and the low inflation that led to solid bond returns. These trends continued into the second quarter. But this quarter's bond returns were further driven by the European Central Bank's (ECB's) more aggressive monetary policy easing and by the US Federal Reserve's (the Fed's) continued dissatisfaction with the pace of economic expansion, even though the US economy has added an average of 200,000 non-farm payrolls per month. The ECB, Bank of Japan (BoJ) and even the Bank of China have maintained or eased monetary policy in the last year. While the slow pace of economic growth has remained frustrating, super-easy monetary policies continue to be a critical support for global risk appetite, the thirst for yield and the low-volatility environment.

KEY TAKEAWAYS

- We neither expect a brutal bear market nor much more price inflation in developed bond markets.
- If, as expected, the global economy accelerates, central banks raise rates and bond yields start to drift higher, capital appreciation in bond prices should start to fade.
- High-quality, long duration securities provided the top returns, but investors were also compensated for holding low-quality credits.

TREADING WATER

Fixed income investors seem notably uncomfortable with low yields, tight credit spreads, strong risk appetite and solid returns so far in 2014. Investors remember that a similar low-volatility environment sowed the seeds for ballooning leverage in the 2005-to-2007 period, which ended so horribly. However historically, systemic financial crises have usually happened once in a generation. Additionally and perhaps more importantly, we do not yet see leverage approaching pre-financial crisis levels. US bank credit growth is currently only expanding around 3.5%, compared with a 10% expansion in 2005 to 2008. We are not being complacent; we absolutely are seeing more shareholder-friendly actions, such as companies issuing debt for share buybacks. While banks have loosened some underwriting standards, they have remained cautious, and mortgage underwriting standards continue to be very tight. In Europe, banks are still shrinking their loan books, and credit growth remains negative. Volatility and leverage in the banking system has been kept in check by banks that remain fearful of new regulations and the threat of lawsuits.

We acknowledge that there is not great value in the credit markets, and since the financial crisis of 2008, there has been an annual volatility shock to knock credit spreads wider. Even so, we believe spread widening could be a buying opportunity.

LOOKING TOWARD RATE RISE

So 2014 has been great for fixed income returns, but capital appreciation in bond prices should start to fade if, as expected, the global economy accelerates, central banks raise rates and bond yields start to drift higher. Markets should begin to look forward to 2015 when a few key central banks, such as the Fed and Bank of England (BoE), are expected to begin hiking short-term interest rates. Credit spreads could experience some widening in anticipation of tighter monetary policy but otherwise should be well supported in this low-yield environment.





SECOND QUARTER REVIEW

RETURNS BY SECTOR¹ as of June 30, 2014

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US Broad Market				
Aggregate	0.05	2.04	3.93	4.37
Government/Credit	(0.04)	1.92	3.94	4.28
S&P 500®	2.07	5.23	7.14	24.61

After a strong start to the year, US fixed income markets continued to rally throughout the second quarter. A benign low-volatility environment persisted; investors were therefore encouraged to take duration and credit risk. The major US indices representing government, municipal, securitized and corporate securities provided positive total returns for the second quarter.

US Governments				
US Treasurys	(0.14)	1.35	2.72	2.04
3-month T-bills	0.00	0.01	0.04	0.07
2-year Treasury	(0.07)	0.26	0.44	0.74
5-year Treasury	(0.25)	1.18	1.92	1.70
10-year Treasury	(0.31)	2.66	6.14	2.86
30-year Treasury	(0.19)	5.24	13.77	6.25
US TIPS	0.30	3.81	5.83	4.44
US Agency	(0.03)	1.18	2.21	2.32

US Treasurys continued to defy market consensus throughout the second quarter as rate volatility remained muted and yields moved lower across the curve. Within the Treasury index, sectors with the highest duration, like the 30-year, 10-year and TIPS indices provided the highest total returns. The emergence of faster inflation also helped the US TIPS index rally for a nearly 400-basis point gain. The Fed continued to taper US Treasury and MBS purchases but pledged to maintain the current Fed funds target range for a considerable time after asset purchases cease. US Treasury volatility, as measured by the Merrill Option Volatility Estimate (MOVE) Index, is currently at its lowest point since the “taper tantrum” of 2013. Weaker-than-expected economic data and dovish comments from Fed Chair Janet Yellen and other central bank governors have helped keep US-rate volatility muted.

US Municipals	0.09	2.59	6.00	6.14
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Investors were able to capture spread over US Treasurys by holding municipal bonds during the second quarter. Returns across sectors were generally consistent, but healthcare-related municipal bonds offered the best performance. The healthcare component of the municipal index typically has slightly higher duration relative to other sectors. This characteristic fueled its outperformance. At the state level, California and Texas, whose bonds represent over 25% of the total benchmark, outperformed the municipal index. However, smaller allocations within the index provided the highest total returns. The bonds of Guam, the Virgin Islands and Puerto Rico each returned well over 400 basis points for the quarter.

US Securitized				
MBS: Mortgage-Backed	0.26	2.41	4.03	4.66
ABS: Asset-Backed	0.04	0.77	1.31	1.80
CMBS: Commercial Mortgages	0.18	1.31	2.62	4.22

As the quarter progressed, markets became increasingly convinced that the Fed will complete asset purchases by the end of October 2014. However, that rising probability did not adversely affect securitized asset prices. All three securitized indices earned positive total and excess returns over duration-matched US Treasurys in the second quarter. Option-adjusted spreads on each benchmark trended flat to lower, but ABS spreads rose a few basis points during the final two weeks of June.

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).



RETURNS BY SECTOR¹ as of June 30, 2014

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Corporates				
US Investment Grade	0.08	2.66	5.68	7.73
AAA	(0.17)	2.41	5.92	5.77
AA	(0.10)	1.86	4.09	4.87
A	0.03	2.35	4.94	6.79
BBB	0.18	3.18	6.81	9.41
European Investment Grade (local currency returns)				
AAA	0.56	2.39	4.81	7.20
AA	0.96	3.51	7.27	7.50
AA	0.50	2.23	4.27	5.15
A	0.50	2.21	4.40	6.08
BBB	0.64	2.63	5.38	9.00
Sterling Investment Grade				
AAA	(0.37)	2.25	4.63	7.62
AAA	(0.59)	2.28	4.25	5.61
AA	(0.42)	1.61	3.87	5.24
A	(0.46)	2.09	4.14	6.55
BBB	(0.26)	2.57	5.35	9.35

Global investment grade corporates earned positive total and excess returns during the second quarter. Option-adjusted spreads on all three investment grade indices continued to make multi-year lows throughout the quarter. Taking credit risk was rewarded as lower-rated BBB corporates outperformed higher-quality bonds in the US, Europe and UK. With declining global yields, longer-duration US and European bonds produced the strongest returns. In the US, corporates rated BBB had the highest duration and posted the highest total return. Highly rated AAA euro-corporates, which have the highest duration in the European index, posted the highest return. Duration-risk appetite was not as prevalent in the Sterling Aggregate Index, where lower-quality BBB corporates earned the highest total return but had the lowest duration. A more hawkish-than-usual message from BoE Governor Mark Carney seems to have UK investors reconsidering the attractiveness of interest-rate sensitive assets.

Corporates				
US High Yield	0.84	2.41	5.46	11.73
BB	0.78	2.65	5.85	11.13
B	0.78	2.19	5.00	11.30
CCC	1.27	2.42	5.80	14.37
Pan-Euro High Yield (local currency returns)				
BB	0.78	2.66	6.03	14.71
BB	0.84	2.94	6.11	14.05
B	0.61	2.17	5.37	14.99
CCC	0.91	2.68	7.65	18.33

Investors pursued global high yield credit risk throughout the second quarter. This pursuit helped push option-adjusted spreads to seven-year lows. Relative to its investment grade counterpart, European high yield produced a greater return with lower duration. Bonds rated BB within the US index had the highest duration and earned the highest total return over the quarter. Returns were generally in-line across different quality segments of the Pan-Euro Index. In early June, the US high yield yield-to-worst ratio fell below 5.00% for the first time in history. The yield on the Pan-Euro Index also hit a new record low of 4.24%.

Bank Loans				
US High Yield	0.59	1.40	2.53	5.53
BB	0.44	0.84	1.15	3.18
B	0.55	1.10	2.30	5.72
CCC	1.12	2.81	5.30	6.55

The low-volatility environment that prevailed over the second quarter encouraged bond investors to take credit risk. Consequently, the bank loan index remained stable and provided a positive total return during the period. Lower-quality bank loans, particularly the CCC-rated debt, offered the best performance. On the sector level, electric utilities led the group with a 6.24% return for the quarter. The weakest industry sector was food and beverage, but the group still returned positive 0.81%.



RETURNS BY SECTOR¹ as of June 30, 2014

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Developed Countries				
World Government Bond Index (WGBI) <i>(local currency returns)</i>	0.42	1.84	3.99	4.87
Non-USD WGBI	0.63	2.05	4.53	6.06
United States	(0.13)	1.31	2.62	1.97
Canada	0.06	1.58	3.85	3.51
European GBI	1.08	3.05	7.00	9.24
France	1.00	3.08	6.09	6.98
Germany	0.60	2.21	4.87	4.11
Ireland	1.70	4.24	8.61	15.06
Italy	1.50	3.52	9.00	14.62
Spain	1.25	3.32	9.52	15.53
United Kingdom	(0.56)	1.17	3.48	2.49
Japan	0.32	0.80	1.65	3.23
Australia	0.94	3.59	4.93	5.26

Developed market government bonds had another strong quarter, fueled by stable-to-accelerating economic growth and low-to-moderate inflation. Risk taking was also supported by the global expansion and easy monetary policy maintained by many central banks. The rally in European peripheral debt accelerated in early June after ECB President Mario Draghi announced additional monetary easing measures and rate cuts. Even with ultra-low yields, Japanese government bond performance has been consistent and positive on a quarterly basis. The Japanese economy has been gaining traction, and the BoJ is unlikely to adjust monetary policy in the near term. In early June, BoE Governor Mark Carney suggested that market participants may be too complacent about the path of BoE rate hikes. Despite the more hawkish comments, UK government bonds provided positive returns.

Emerging Market Bonds				
Emerging Market Government (EMBIG) <i>(Sovereign/Quasi-Sovereign, USD)</i>	0.59	5.43	9.10	11.05
Corporate Emerging Market Bond (CEMBI) <i>(Corporates, USD)</i>	0.64	3.46	6.34	9.55
Emerging Market Government (GBI-EM) <i>(Governments, local currency)</i>	0.96	3.51	5.35	6.62

Emerging market fixed income assets spent the last four quarters recovering from a "taper talk"-inspired sell-off that began in May 2013. The EMBI Global Index, which has the longest duration among the three above emerging market indices, provided the highest return this quarter. It took a year, but the EMBIG, CEMBI and GBI-EM have all surpassed their pre-taper tantrum highs on a total return basis. As of June 25th, \$4.9 billion of emerging market flows had moved into debt funds in 2014. According to JPMorgan, hard currency cumulative flows were \$10.9 billion, while local currency experienced a net outflow of \$6 billion. In a low-volatility environment, the search for yield appeared to lead many investors to emerging markets.



RETURNS BY SECTOR¹ as of June 30, 2014

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Currency Markets²				
Dollar Bloc				
Canadian Dollar	1.64	3.55	(0.45)	(1.42)
Australian Dollar	1.32	1.82	5.79	3.23
New Zealand Dollar	3.05	1.10	6.62	13.18
Western Europe				
Euro	0.42	(0.56)	(0.37)	5.24
Norwegian Krone	(2.60)	(2.36)	(1.01)	(1.03)
Swedish Krona	0.08	(3.15)	(3.67)	0.25
Swiss Franc	0.95	(0.25)	0.69	6.56
British Pound	2.09	2.66	3.32	12.44
Emerging Europe & Africa				
Czech Koruna	0.56	(0.55)	(0.78)	(0.27)
Hungarian Forint	(1.83)	(1.34)	(4.40)	0.28
Polish Zloty	0.08	(0.40)	(0.47)	9.46
Russian Ruble	2.69	3.51	(3.27)	(3.36)
South African Rand	(0.61)	(0.99)	(1.36)	(7.12)
Turkish New Lira	(1.02)	1.05	1.40	(8.99)
Asia				
Japanese Yen	0.43	1.88	3.93	(2.16)
Chinese Renminbi	0.71	0.23	(2.40)	(1.06)
Indonesian Rupiah	(1.68)	(4.33)	2.49	(15.76)
Malaysian Ringgit	0.06	1.67	2.01	(1.58)
Philippine Peso	0.27	2.66	1.70	(1.19)
Singapore Dollar	0.61	0.87	1.32	1.71
South Korean Won	0.83	5.22	3.75	12.87
Latin America				
Argentine Peso	(0.66)	(1.59)	(17.38)	(33.76)
Brazilian Real	1.23	2.60	6.67	0.79
Chilean Peso	(0.56)	(0.63)	(4.97)	(8.05)
Colombian Peso	1.05	4.99	2.77	2.41
Mexican Peso	(0.85)	0.69	0.53	(0.29)
Peruvian New Sol	(1.18)	0.36	(0.06)	(0.58)

The US Dollar Index (DXY) weakened by 0.41% in the second quarter as strength in the British pound, Canadian dollar and Japanese yen outweighed weakness in Swedish krona, euro and Swiss franc. The British pound was aided by Governor Carney's rate hike comments, while the euro slipped after the ECB cut interest rates and extended long-term refinancing operations. While volatility in the US dollar was muted, there was substantial activity in emerging market currencies. In emerging Europe, the Russian ruble spent the quarter rebounding from the Ukraine-related selloff, and the Turkish new lira rallied over 1.0%. Emerging Asian currencies, particularly the South Korean won, performed very well, but the Indonesian rupiah sold off over the period. Latin American currencies were broadly positive with the exception of the Argentine peso, which is facing its own idiosyncratic issues, and the Chilean peso. In the region, the Colombian peso and Brazilian real were stand-out leaders, while the Mexican peso and Peruvian new sol made only marginal gains.

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 represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the US investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

Barclays US Government/Credit Index includes securities in the government and credit indices. The government index includes treasuries (i.e., public obligations of the US Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of US Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the US Government). The credit index includes publicly issued US corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

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 consists of inflation-protection securities issued by the US Treasury that have at least one year to maturity and at least \$250 million par amount outstanding.

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 USAID securities).

Barclays US Municipal Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. The index has four main sectors: general obligation bonds, revenue bonds, insured bonds (including all insured bonds with a Aaa/AAA rating), and preredempted 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 publically issued securities from industrial, utility, and financial companies that meet specified maturity, liquidity and quality requirements.

Barclays US Corporate High-Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

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, also known as the bank 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.