

Bond Market Review and Outlook

By Craig Burrelle, VP, Macro Analyst

KEY TAKEAWAYS

- **Brexit increases financial market uncertainty, which is unlikely to abate in the near term.**
- **We expect global economies to muddle along with low growth and inflation.**
- **The current mix of expansionary policy and mediocre economic data could be a catalyst supporting credit outperformance relative to equities in the months ahead.**

The uncertainty that Brexit introduces to global markets is unlikely to abate in the near term. A complete resolution, whether leave, remain or limbo, could take up to five years or longer. Immediately after the referendum, global market volatility spiked but has since eased as investors digest new developments and implications.

Brexit headline risk will remain a source of bond market volatility, but volatility can create opportunities for long-term investors. The decision to leave or remain sounds binary, but a result somewhere in between is possible. While this process runs its course, market volatility will create disconnects between bond prices and fundamental value that provide buying opportunities. Ebbs and flows are to be expected, but volatility may remain elevated going forward.

Seeking a Borrower of Last Resort

The Brexit vote caused quite a disturbance during the final days of June, but the familiar theme of yield curve flattening predominately characterized the quarter. Demand for long-duration developed market government bonds pushed US Treasury yields lower and sent 10-year Japan and Germany yields into negative territory. Inflationary forces are limited in most developed countries, which offers investors the prospect of higher real returns. Global growth expectations have been cut significantly, even in the United States where 2016 real growth consensus estimates fell to 1.9% from 2.8% a year ago. The fallout from Brexit is a factor pushing global growth estimates lower, but at present, those reductions are very modest. We remain in a demand-deficient world looking for the next sector, country or region with decent balance sheets willing to borrow and spend surplus savings. Without a borrower of last resort, we expect demand to continue to fall short, and economies to muddle along with slow growth and low inflation.



A Favorable Backdrop for Fixed Income

This complex set of global economic conditions is likely to provide a favorable backdrop for fixed income markets. A combination of mediocre economic data, financial market conditions and Brexit should remove the risk of Federal Reserve (Fed) over-tightening. Throughout the past six months, the Fed has walked back hiking expectations, and federal funds futures markets have pushed the next 25 basis point hike further out. A slightly dovish tilt by the Fed, paired with European Central Bank (ECB) and Bank of Japan (BOJ) easing activity, should prevent long-term developed market interest rates from rising rapidly, suggesting fixed income investors can continue to earn positive returns. Slow growth and low inflation have been a headwind for corporate profits over the past two years, but a modest rebound is expected moving into the latter half of 2016. In the US, energy companies should begin to regain profitability in 2017, while the financial sector stands to benefit from any pickup in capital markets activity. The current mix of expansionary policy and mediocre economic data could be a catalyst supporting credit outperformance relative to equities in the months ahead.



Second Quarter Review

By Craig Burelle, VP, Macro Analyst

INDEX RETURNS BY SECTOR as of June 30, 2016

INDEX					
	US BROAD MARKET	1 MONTH	3 MONTH	6 MONTH	1 YEAR
	BARCLAYS US AGGREGATE BOND	1.80	2.21	5.31	6.00
	BARCLAYS US GOVERNMENT/CREDIT	2.20	2.67	6.23	6.70
	S&P 500®	0.26	2.46	3.84	3.99

Strong credit risk and duration appetite supported fixed income markets throughout the second quarter. High-quality benchmarks with intermediate duration, like the Barclays US Aggregate Index, performed well and provided excess returns over US Treasuries. The demand for low- and high-quality credit remained strong as a greater percentage of global government bond yields moved negative.

	US GOVERNMENTS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
	BARCLAYS US TREASURYS	2.21	2.10	5.37	6.22
	3-MONTH T-BILLS	0.04	0.08	0.16	0.21
	2-YEAR TREASURY	0.63	0.51	1.33	1.13
	5-YEAR TREASURY	1.85	1.35	4.35	4.70
	10-YEAR TREASURY	3.29	3.02	7.95	9.50
	30-YEAR TREASURY	7.12	7.24	16.82	20.22
	BARCLAYS US TIPS	2.08	1.71	6.24	4.35
	BARCLAYS US AGENCY	1.19	1.22	3.28	3.71

A broad rally in risk assets and perceived safe havens like US Treasuries and gold took place during the quarter. A complex set of global economic conditions and monetary policies created a backdrop where nearly all assets could move higher. The US yield curve flattened further as 10- and 30-year yields declined, while front-end yields rose modestly. The United States has become a global source for yield as rates in developed nations like Japan and Germany have gone negative out to the 10-year maturity. The long bond, a 30-year US Treasury, is one of the top-performing assets over the past twelve months, up an astounding 20%.

	US MUNICIPALS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
	BARCLAYS US MUNICIPALS	1.59	2.61	4.33	7.65

The credit rally and a decline in long-term US Treasury yields supported the Barclays Municipal Bond Index. Municipals are backed by revenue streams from US state or local governments. The municipal index provided a yield advantage of nearly 50 basis points over the US Treasury Index and slightly less duration, which is advantageous if interest rates begin to rise.

	US SECURITIZED	1 MONTH	3 MONTH	6 MONTH	1 YEAR
	BARCLAYS MBS	0.81	1.11	3.10	4.34
	BARCLAYS ABS	0.83	1.17	2.54	2.72
	BARCLAYS CMBS	1.72	2.24	5.92	6.22

The US MBS Index rallied along with US Treasuries and provided a modest excess return for the quarter. The ABS Index, which is more cyclically tied to the US economic expansion, posted a positive excess return over like-duration Treasuries. The credit rally lifted the CMBS Index, where performance tends to correlate with the US investment grade corporate market. The CMBS Index had more than twice the duration of the ABS Index, a characteristic that drove outperformance as the long end of the US yield curve rallied. The CMBS benchmark also posted a positive excess return of 37 basis points.

Data Sources: Barclays indices from Barclays Live; currency returns, JPMorgan and Citigroup indices from Bloomberg; and S&P 500 Index from FactSet.

All returns in US dollars, unless noted. Past Performance is no guarantee of future results.



**INDEX RETURNS
BY SECTOR**
as of June 30, 2016

INDEX					
	CORPORATES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US INVESTMENT GRADE		2.25	3.57	7.68	7.94
	AAA	2.35	3.32	8.14	11.29
	AA	1.89	2.61	6.29	7.76
	A	2.11	3.04	7.04	8.57
	BBB	2.45	4.25	8.55	7.25
BARCLAYS EUROPEAN INVESTMENT GRADE (LOCAL CURRENCY RETURNS)		0.96	1.57	4.08	5.15
	AAA	2.45	3.15	7.23	9.63
	AA	1.17	1.40	4.25	5.71
	A	0.99	1.47	3.86	5.19
	BBB	0.86	1.67	4.17	4.89
BARCLAYS STERLING INVESTMENT GRADE (LOCAL CURRENCY RETURNS)		2.72	4.71	8.04	9.76
	AAA	6.79	9.31	16.74	19.50
	AA	3.68	5.53	9.70	11.16
	A	3.09	5.25	8.81	10.72
	BBB	2.13	4.00	6.91	8.51

Declining long-term yields supported the US and Sterling Investment Grade Indices. As interest rates fell, duration impact on total return benefited investment grade corporates more than high yield, where index duration is significantly shorter. The US corporate option-adjusted spread (OAS) tightened by 7 basis points, while the Sterling Aggregate OAS jumped higher immediately after Brexit vote results were announced. At 5.3 years, the duration of the European Investment Grade Index is materially less than the US index at 7.5 years and the Sterling index at 8.3 years. An additional impediment for the European index this quarter was the index weight of financials at 43%. The sector posted a positive total return, but financial companies are facing operating headwinds from negative interest rate monetary policy. One positive is the incremental bid for European investment grade corporates now that the ECB has initiated the corporate sector purchase program (CSPP).

	CORPORATES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US HIGH YIELD		0.92	5.52	9.06	1.62
	BB	0.70	3.60	7.60	4.11
	B	0.81	4.83	7.41	-0.65
	CCC	1.50	11.83	16.03	-0.51
BARCLAYS PAN-EURO HIGH YIELD (LOCAL CURRENCY RETURNS)		-2.00	0.71	1.19	0.42
	BB	-1.52	1.00	1.66	2.08
	B	-3.03	-0.10	0.23	-3.82
	CCC	-3.08	0.76	-0.14	-0.37

US high yield remained a sought-after asset class and easing financial conditions provided support. The US high yield OAS tightened 62 basis points to 594 basis points as investors moved out the credit risk spectrum. Total return in the CCC credit quality, which dominated other fixed income benchmarks, is evidence of strong credit risk appetite. Additionally, the US high yield CCC segment provided greater than 1,000 basis points of excess return over similar-duration Treasuries. The uncertainty Brexit brings to the remaining European Union (EU) countries impacted Pan-Euro high yield total returns. The Pan-Euro OAS spiked 20 basis points higher for the quarter. The OAS of each index have been tightening since the mid-February highs but remain significantly elevated relative to the lows reached prior to 2014's taper tantrum.

Data Sources: Barclays indices from Barclays Live; currency returns, JPMorgan and Citigroup indices from Bloomberg; and S&P 500 Index from FactSet.

All returns in US dollars, unless noted. Past Performance is no guarantee of future results.



INDEX RETURNS BY SECTOR

as of June 30, 2016

INDEX				
BANK LOANS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US HIGH YIELD LOANS	-0.04	3.06	4.91	1.05
BB	-0.21	1.45	2.99	3.25
B	-0.26	2.78	4.66	0.90
CCC	-0.44	9.45	1.94	-6.27

Performance in the high yield loan market is highly correlated with that of the high yield corporate bond market, despite fundamental differences between the two asset classes. As a lower-beta proxy to high yield corporates, the high yield loan index posted similar total returns, only less. The CCC credit quality segment provided a significantly higher return than B and BB qualities but represents less than 6% of the total index.

DEVELOPED COUNTRIES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
CITIGROUP WGBI (LOCAL CURRENCY RETURNS)	2.31	2.66	6.44	8.47
CITIGROUP NON-USD WGBI	2.35	2.92	6.98	9.62
UNITED STATES	2.22	2.11	5.33	6.17
CANADA	1.65	1.99	3.13	4.93
JAPAN	1.48	3.06	7.90	10.13
AUSTRALIA	1.87	3.51	6.01	8.27
UNITED KINGDOM	6.12	6.74	12.37	14.55
EUROPEAN GBI	2.32	2.20	5.71	8.91
FRANCE	2.90	2.90	7.10	9.18
GERMANY	2.76	2.85	6.75	8.26
IRELAND	1.58	1.63	4.27	7.55
ITALY	1.11	0.45	3.03	9.04
SPAIN	2.10	2.23	4.90	9.19

Global government bond markets continued to make history as a growing percentage of securities within the WGBI Index now carry negative yields to maturity. With interest income extremely low, positive 3-month returns for the WGBI and individual countries are predominantly due to price appreciation. Investors continued to bid up bond prices despite negative yields. The lowest-yielding countries within the table, Japan and Germany, provided two of the highest total returns. Expectations for developed market inflation are not rising fast enough to significantly hamper demand for developed market government bonds.

EMERGING MARKET BONDS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
JP MORGAN EMBIG (SOVEREIGN/QUASI-SOVEREIGN, USD)	3.73	5.40	10.90	10.32
JP MORGAN CEMBI BROAD DIVERSIFIED (CORPORATES, USD)	1.79	3.77	7.80	5.30
JP MORGAN GBI-EM GLOBAL DIVERSIFIED (GOVERNMENTS, LOCAL CURRENCY)	2.35	3.18	8.33	9.42

A moderation of US dollar strength helped relieve some financial stress felt by emerging market governments and companies that funded operations through US-dollar-denominated bonds. The commodity rally, which began in the first quarter, has proved to be quite durable. The consistent improvement in commodity prices has supported emerging market nations that export those materials including oil, gold or agricultural products. Brazil has been a top-performing country within each of the three emerging market benchmarks as global investors embrace the potential for meaningful political reform.

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INDEX RETURNS BY SECTOR

as of June 30, 2016

INDEX				
CURRENCY MARKETS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
DOLLAR BLOC				
CANADIAN DOLLAR	1.31	0.62	7.08	-3.33
AUSTRALIAN DOLLAR	3.00	-2.69	2.26	-3.32
NEW ZEALAND DOLLAR	5.49	3.26	4.44	5.45
WESTERN EUROPE				
EURO	-0.23	-2.41	2.25	-0.37
NORWEGIAN KRONE	0.19	-1.13	5.74	-6.10
SWEDISH KRONA	-1.49	-4.04	-0.22	-2.04
SWISS FRANC	1.83	-1.45	2.67	-4.15
BRITISH POUND	-8.09	-7.31	-9.67	-15.28
EMERGING EUROPE & AFRICA				
CZECH KORUNA	-0.47	-2.56	1.99	0.35
HUNGARIAN FORINT	-0.88	-2.92	2.18	-0.57
POLISH ZLOTY	-0.08	-5.43	-0.48	-4.61
RUSSIAN RUBLE	4.26	4.82	15.05	-13.57
SOUTH AFRICAN RAND	6.67	0.28	5.04	-17.37
TURKISH NEW LIRA	2.49	-2.10	1.37	-6.81
ASIA				
JAPANESE YEN	7.30	9.08	16.49	18.70
CHINESE RENMINBI	-0.94	-2.92	-2.32	-6.72
INDONESIAN RUPIAH	3.31	0.30	4.30	0.85
MALAYSIAN RINGGIT	2.41	-3.27	6.47	-6.41
PHILIPPINE PESO	-0.71	-2.16	0.18	-4.24
SINGAPORE DOLLAR	2.26	0.09	5.29	0.01
SOUTH KOREAN WON	3.47	-0.72	1.80	-3.16
LATIN AMERICA				
ARGENTINE PESO	-7.03	-2.26	-14.05	-39.60
BRAZILIAN REAL	12.40	11.83	23.39	-3.41
CHILEAN PESO	4.25	0.68	6.72	-3.64
COLOMBIAN PESO	5.84	2.80	8.70	-10.75
MEXICAN PESO	1.02	-5.48	-5.87	-13.90
PERUVIAN NEW SOL	2.78	0.84	3.91	-3.23

Foreign exchange market performance shows mixed results across regions. In Asia, the Bank of Japan failed to announce additional monetary stimulus plans even as measures of economic growth and inflation remained uninspiring. The resulting 9.0% pop in the Japanese yen indicated the market expected more easing. In China, the renminbi/US dollar cross recently weakened to the same levels that created global market turbulence last January, but the pace of weakening has been more gradual. The Bank of China is also managing the renminbi relative to a basket of developed and emerging market currencies, with less emphasis on the US dollar. In Latin America, the Mexican peso struggled as political uncertainty and security concerns remained headline issues. The US dollar index (DXY) has been bumping around in the middle of its 18-month range. Market expectations for the next federal funds rate hike have eased, which should prevent the US dollar from rallying aggressively. Late-quarter weakness in the British pound can be attributed to the political and economic uncertainties created by the referendum vote to leave the EU.

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Disclosure

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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 prerefunded bonds.

Barclays Mortgage-Backed Securities (MBS) Index is a component of the Barclays US Aggregate Index covering mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC). The MBS Index is formed by grouping the universe of over 600,000 individual fixed rate MBS pools into approximately 3,500 generic aggregates.



Barclays Asset-Backed Securities (ABS) Index is a component of the Barclays US Aggregate Index including pass-through, bullet and controlled amortization structures. The ABS Index includes only the senior class of each ABS issue and the ERISA-eligible B and C tranche. Constituents must have an average life of at least one year and a deal size of at least 500 million.

Barclays Commercial Mortgage-Backed Securities (CMBS) ERISA-Eligible Index is a component of the Barclays US Aggregate Index and the ERISA-eligible component of the Barclays CMBS Index. This index, which includes investment grade securities that are ERISA eligible under the underwriter's exemption, is the only CMBS sector that is included in the US Aggregate Index.

Barclays US Corporate Index contains publicly issued US corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity and quality requirements. To qualify, bonds must be SEC-registered. The index includes both corporate and non-corporate sectors. The corporate sectors are Industrial, Utility, and Finance, which include both US and non-US corporations. The non-corporate sectors are Sovereign, Supranational, Foreign Agency, and Foreign Local Government.

Barclays Euro-Aggregate Corporate Index consists of bonds issued in the euro or the legacy currencies of the 16 sovereign countries participating in the European Monetary Union (EMU). All issues must be investment grade-rated, fixed-rate securities with at least one year remaining to maturity. The Euro-Aggregate Index excludes convertible securities, floating rate notes, perpetual notes, warrants, linked bonds, and structured products.

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). Securities 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 Loans Index, also known as the Bank Loan Index, provides broad and comprehensive total return metrics of the universe of syndicated term loans. To be included in the index, a bank loan must be dollar denominated, have at least \$150 million funded loan, 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 approximately 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 performance of fixed-rate, local currency, investment grade sovereign bonds. The WGBI is a widely used benchmark that currently comprises sovereign debt from over 20 countries, denominated in a variety of currencies. The WGBI provides a broad benchmark for the global sovereign fixed income market.

***JPMorgan Emerging Markets Bond Index Global (EMBIG)** tracks total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, Eurobonds.*

***JPMorgan Corporate Emerging Markets Bond Index (CEMBI Broad Diversified)** tracks total returns of US dollar-denominated debt instruments issued by corporate entities in emerging markets countries. The CEMBI Broad is the most comprehensive corporate benchmark followed by the CEMBI, which consists of an investable universe of corporate bonds.*

***JPMorgan Government Bond Index—Emerging Markets (GBI-EM Global Diversified)** provides a comprehensive measure of local currency denominated, fixed rate, government debt issued in emerging markets.*