

Quarterly Macro Insights: October 2016

By James Balfour, CFA, VP, Senior Global Economist

With global savings and investment having peaked recently, we remain in a demand deficient world, looking for the next region, country or sector to increase borrowing and spending. Until then, demand will likely fall short, and we'll muddle through.

In this environment, markets have performed well, maybe too well, driven by financial repression and the thirst for yield. We're in a "lower for longer" bond yield environment as inflation in advanced economies decelerates and major central banks—the Bank of England, European Central Bank and Bank of Japan—pursue quantitative easing (QE). The search for yield has pushed investment flows toward riskier assets such as high yield and emerging markets (EM). Spreads have tightened and stocks have done well. But we fear markets may be disappointed if we miss 3% global GDP growth expectations and S&P 500® index operating profits rebounding by 10% to 13% in 2017.

We need economic execution and an exit from the profits recession to justify the recent rally in risk assets. If we're right, and EM growth is bottoming while developed market growth is steady, then market valuations should eventually line up.

MACRO THEMES FOR OCTOBER 2016

1

A World Lacking In Demand

2

Markets Have Performed Well, Maybe Too Well

3

Economic Execution And Exit From Profits
Recession Are Paramount

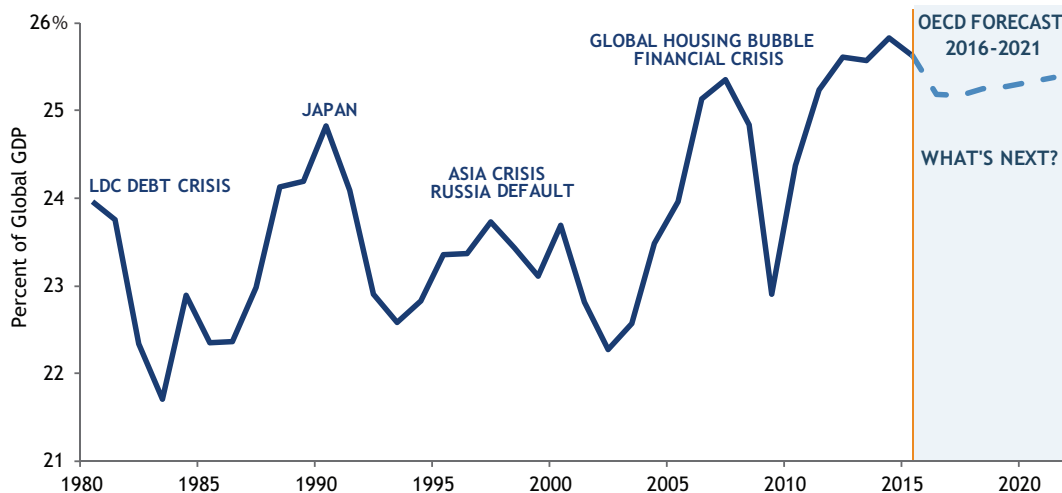
1. A World Lacking In Demand

TOO MUCH SAVING IS A LEAKAGE OF DEMAND UNLESS IT IS BORROWED AND SPENT

Savings as a % of Global GDP

Source: OECD, Thomson Reuters Datastream, Lombard St. Research. Data as of 6/30/2015.

— Gross National Savings (% of GDP)
— OECD Forecast (2016-2021)

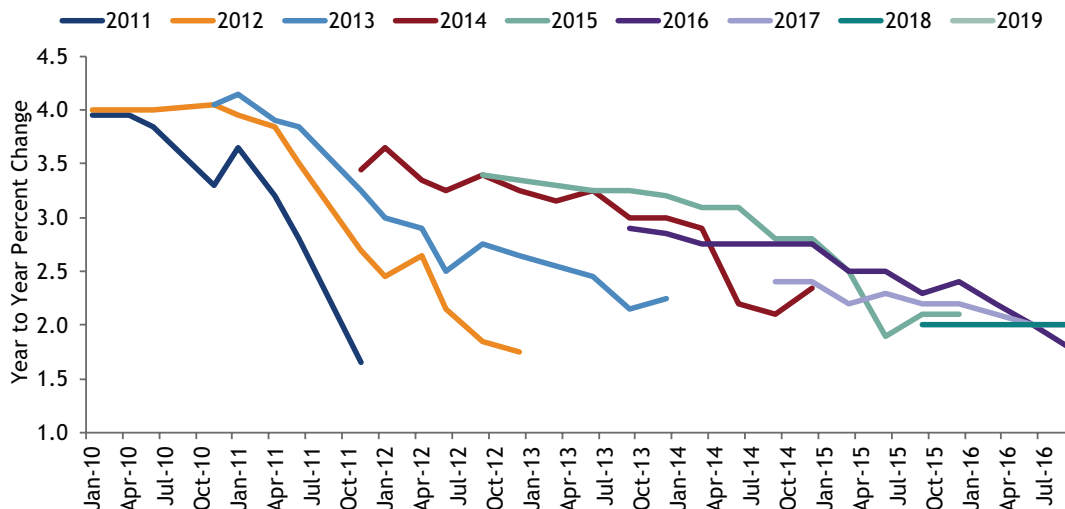


- Global savings and investment have peaked, leaving the world looking for a new engine of growth. China's investment engine is slowing (but not crashing given that China is a planned economy), and commodities investment, led by massive cutbacks in the energy and metals and mining sectors, has been plunging. Can other economies pick up the slack?

THE CONSEQUENCE: GROWTH HAS CONTINUALLY DISAPPOINTED

FOMC Finally Forecasts a More Modest Growth Rate of 2% US Real GDP

Source: FOMC. Data as of 9/30/2016. Projections of change in real GDP and projections for both measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated.



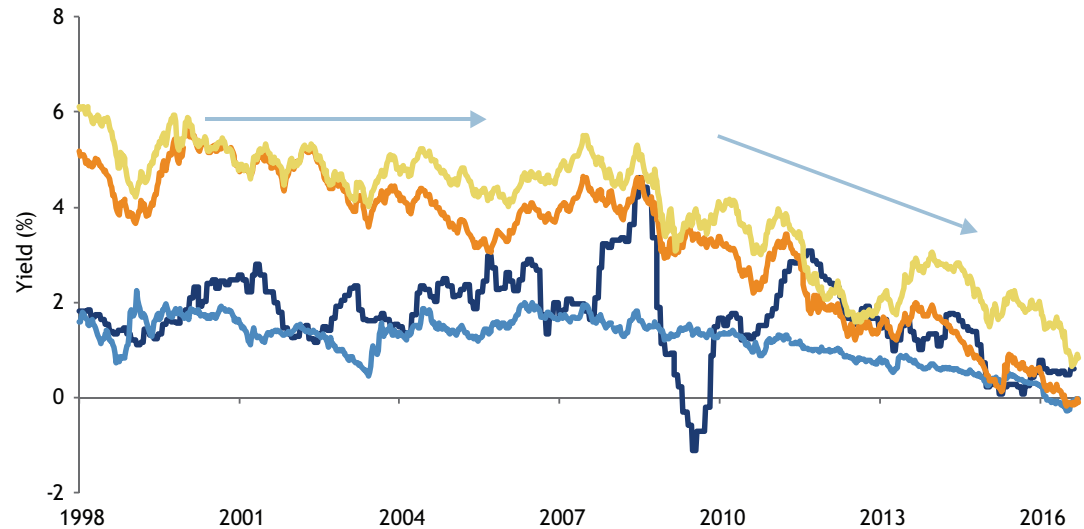
- Since the financial crisis, the US Federal Reserve (the Fed) has continuously been disappointed by the reality of weaker economic growth compared to its prior optimistic expectations. Still, with easy money policies globally, growth has been steady enough to support risk appetite. We forecast growth of 1.5% in 2016, improving to 2.1% in 2017. We think the Fed will hike rates in December and then, on average, once every six months until the fed funds rate reaches 2%.
- There's been lots of talk about the global potential for heightened fiscal policy to help get economic traction, but we are not expecting a fiscal surge. We have to wait and see. Tough political environments and policy lags limit the near-term impact.

2. Markets Have Performed Well, Maybe Too Well

THE CONSEQUENCE: LOW INFLATION AND QE CONTINUE TO DRIVE YIELDS LOWER

Source: IMF, Reuters, FT,
BoE, Haver. Data as of
9/6/2016.
*Past performance is no
guarantee of future results.*

- Advanced Economies:
Consumer Prices
(% Change YoY, NSA)
- Japan: 10-Year Government
Bond Yield (Average %)
- Germany: 10-Year
Government Bond Yield (%)
- United Kingdom:
Government Securities:
10-Years (% P.A.)



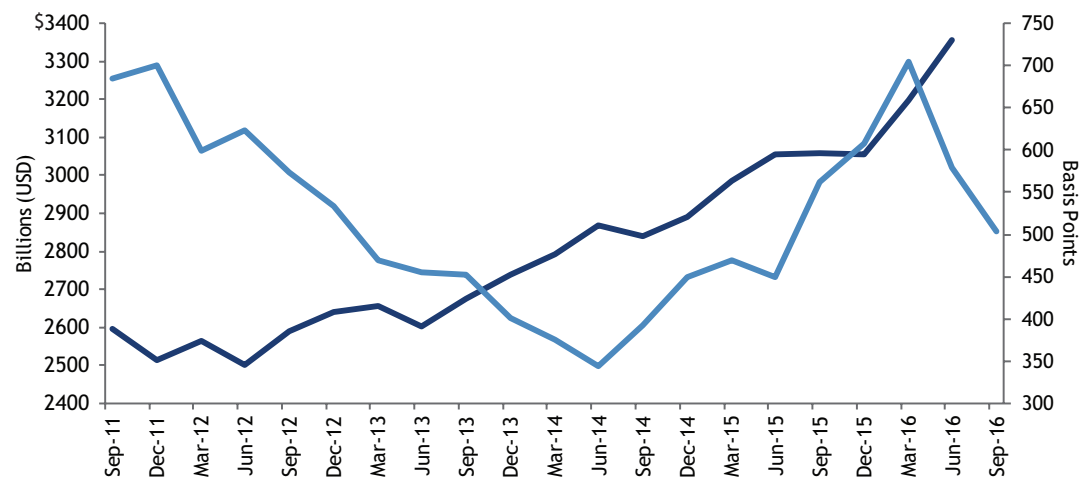
- As inflation in advanced economies decelerates and major central banks around the world pursue quantitative easing, the best way to characterize the current bond yield environment is “lower for longer.” In the government market, central bank buying is huge, keeping yields low. We don’t see this changing imminently.

RESPECT FUNDAMENTALS: FLOWS DIDN'T STOP SPREAD WIDENING IN 2014-2015

Foreign Private Holdings of US
Corporate Bonds

Source: Department of Treasury.
Data as of 9/30/2016..

- Foreign Private Holdings of
US Corporate Bonds, USD \$B
(Left Scale)
- High Yield Spread
(Right Scale)



- It’s not new. Investment flows, especially from Asia and Europe, have been gradually increasing for several years. And the search for yield has pushed investment flows toward riskier assets like high yield and EM. But remember that flows generally do not trump fundamentals, leaving credit spreads vulnerable to late cycle corporate leveraging.

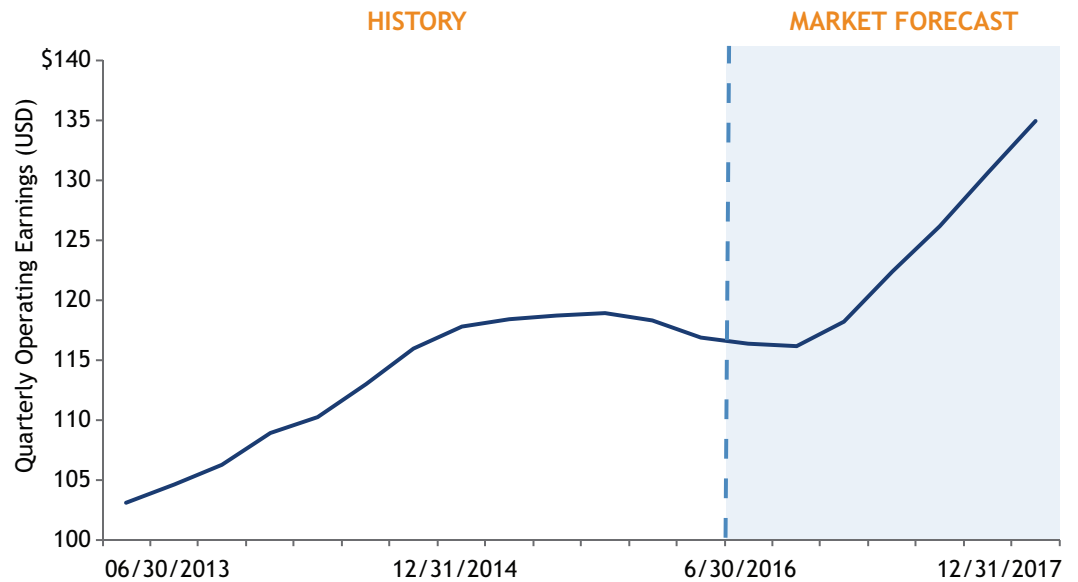


BOTTOM-UP EARNINGS EXPECTATIONS ARE EXUBERANT

Source: Factset Operating Earnings Estimates Q3 2016 through Q4 2017, Loomis Sayles & Co. Data as of 9/19/2016.

Past performance is no guarantee of future results.

- S&P 500 Index Quarterly Operating Earnings (USD)
- Market Forecasts Represent Factset Operating Earnings Estimates



- Price-earnings (P/E) multiples have expanded during this profits recession. Stocks have done well and spreads have tightened. Maybe too well. We think the markets may be disappointed if we fail to meet 3% global GDP growth expectations and S&P 500 consensus estimates for a 10% to 13% rebound in operating profits in 2017. We believe we need to escape this profits recession, which we expect we will, but our 6% to 8% S&P 500 operating earnings growth expectation falls somewhat short of what the market is looking for.

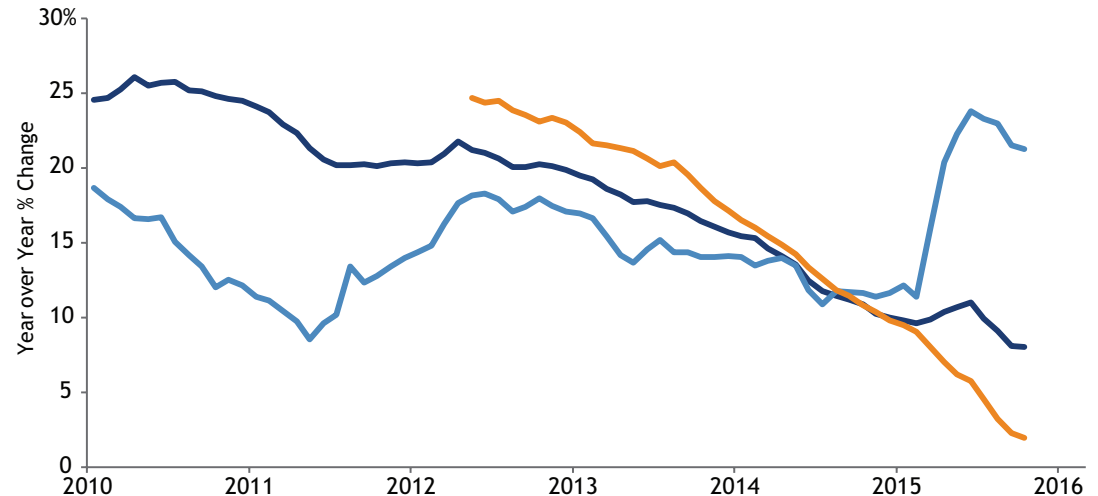
3. Economic Execution And Exit From Profits Recession Are Paramount

CHINESE FIXED-ASSET INVESTMENT HAS TURNED DOWN ACROSS ALL MAJOR CATEGORIES

YoY % Change

Source: China National Bureau of Statistics/Haver Analytics.
Data as of 9/14/2016.

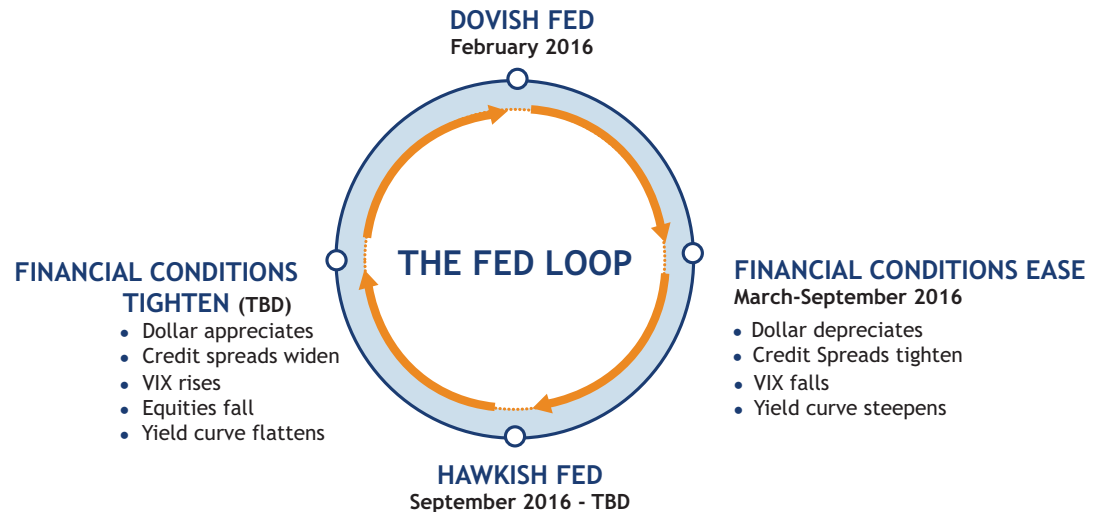
- China: Total Investment in Fixed Assets
- China: State-Owned Enterprise Investment in Fixed Assets
- China: Private Sector Investments in Fixed Assets



We expect growth in China to continue slowing, but not crash. While fixed-asset investment has turned down across all assets, government spending will partially offset that, leading to a gradual slowing. We do, however, worry about a financial accident in China. Overall, EM growth may be bottoming, with large economies such as Brazil and Russia potentially exiting recession in 2017.

FED UNDERSTANDS THE GLOBAL CONSTRAINTS BUT IS TURNING HAWKISH

Source: Information from BCA Research. Data as of 9/22/2016, Loomis Sayles illustration.



- The US economy is strong enough that the Fed may hike rates in December, but we believe we need to hit at least 2% GDP growth in 2017 for markets to be satisfied and to avoid entering the Fed Loop syndrome again. Globally, developed market growth is okay. Growth in Europe is slow but steady, supported by domestic demand. UK growth is also slow but could have been worse; fallout from Brexit, so far, has not been as bad as feared.

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Disclosure

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