LOOMIS | SAYLES

APRIL 2022

Investment Outlook

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The tide is going out on the great wave of liquidity that flooded markets in the aftermath of the pandemic.

Many central banks, including the US Federal Reserve, have responded to high inflation with a shift toward tighter monetary policy. We expect the credit cycle to press on in late expansion, which may expose points of stress within the financial system. Market volatility is typical at this stage of the cycle, and we expect that to continue in the face of inflation fears and geopolitical turmoil. However, we see plenty of potential security-specific opportunities in assets backed by solid corporate fundamentals and above-trend real economic growth rates.

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Special Situation: Russia-Ukraine War

Even in the unlikely event of a quick resolution, we expect sanctions to remain in place for an extended period of time.

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Macro Drivers

The Fed is seeking a soft landing while hiking to fight inflation, which will be challenging.

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Credit

We think solid bottom-up fundamentals underscore the case to own credit and earn carry.

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Government Debt & Policy

The cost to borrow capital has been rising globally.

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Currencies

The US dollar should continue rising into summer.

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Equities

We believe double-digit annual performance will be tougher to come by as monetary policy tightens globally.

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Potential Risks

Major central banks may not be able to ease to the degree needed if inflation remains elevated.

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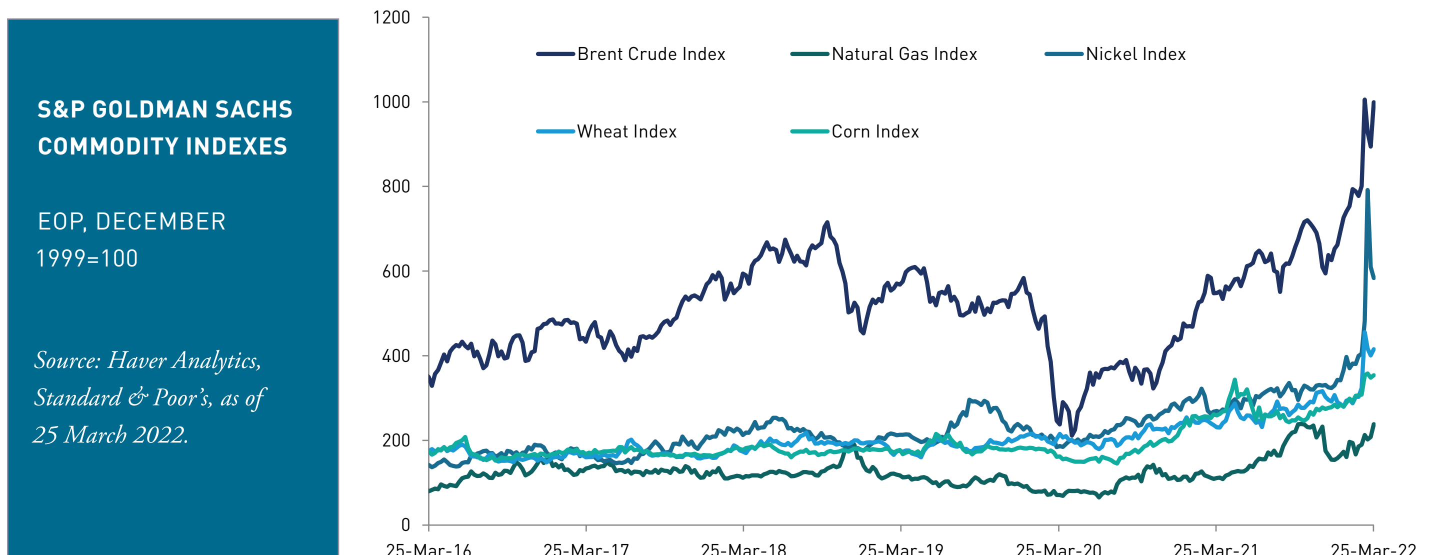
Asset Class Outlook

Special Situation: Russia-Ukraine War

We anticipate the war in Ukraine will be drawn out and intensify further

- We are extremely skeptical about a peaceful resolution to the war in Ukraine in the near term. Russian rhetoric and advances in the south of Ukraine suggest to us that Russia sees no strategic incentive to earnestly negotiate before capturing the port cities of Odessa and Mariupol.
- Our base case assumes a prolonged war that lasts months, if not years, and near-term intensification.
- We anticipate sanctions on Russia will lead to a material tax on global growth. Further, we expect sanctions and "self-sanctions" (i.e., corporates taking it upon themselves to restrict activity beyond what sanctions have called for) to remain in place indefinitely, even if a quick resolution is reached.
- We believe the impacts of this war—aside from the catastrophic humanitarian toll—will add pressure to importers of fuel, food and minerals. We expect significant stress on global supply chains, which is likely to be inflationary. Exporters of commodities in Latin America, South Africa, and the GCC are likely to benefit from the current environment.



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Macro Drivers

Markets appear to be in late expansion and inflation is running hot

- Rising consumer and producer prices, tightening financial conditions, risk asset volatility and rising interest rates underpin our view that markets are in the late expansion phase of the credit cycle. We believe the late expansion phase could persist for several quarters on the back of solid employment metrics and aggregate demand.
- Market-based inflation expectations have moved higher, but broadly suggest markets believe the Fed will effectively bring inflation down. We generally agree, but do not expect core PCE[1] to reach 2.0% to 2.5% until early 2024.
- Economic growth expectations have moderated after a V-shaped rebound off the pandemic lows, which is consistent with our view that the credit cycle is entering a more mature stage.
- We worry about the inflation issue across developed and emerging economies. Most major central banks will not be able to ease policy with inflation running this hot, even if the growth outlook deteriorates.
- Despite the risks, our credit analysts project key indicators like profit margins, credit outlook and pricing power will moderate at healthy levels.

Macroeconomic Indicators: **Base Case Expectations**

EXPANSION LATE CYCLE

Base Case

GLOBAL GROWTH
Slowing toward long-run trend levels

LABOR FORCE PARTICIPATION
Very modest improvement

FED FUNDS FORECAST
Terminal rate of 2.75% – 3.00%, potential for 50 bp hikes

US DOLLAR VIEW
Buoyed by mixed risk appetite and slowing global growth

US CORE PCE INFLATION
Above Fed target until early 2024

CREDIT SPREADS
Finding a new higher range

RISK APPETITE
To ebb and flow in a high-volatility regime

[1]PCE: Personal Consumption Expenditures Price Index, a measure of inflation.

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Credit

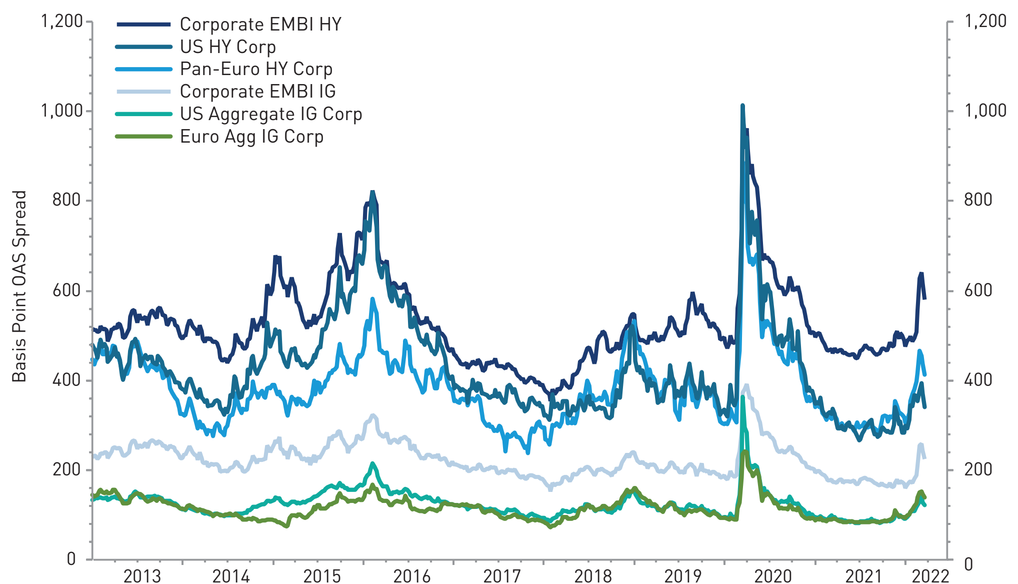
We anticipate a less-robust, but still favorable, operating environment for corporates

- The long-duration nature of investment grade corporates can be challenging for total returns in a rising rate environment. However, we believe the bulk of the rise in long-end US Treasury yields is likely behind us.
- We anticipate an uptick from near-zero defaults in the high yield credit sector as markets continue to digest late-cycle conditions. Widespread credit rating downgrades or negative outlook revisions do not seem likely.
- Total return dispersion is likely to increase within emerging market (EM) corporate credit during 2022. We think commodity producers should continue to perform well while higher input costs may lead to margin erosion within consumer-related industries.
- An uncertain and high-volatility environment will likely persist within US securitized credit over the near term. We believe defaults are likely to remain low among corporate-oriented securitized sectors as many companies have been able to pass higher input costs on to end consumers.
- Rising interest cost on bank loans shouldn't threaten balance sheet health at forecasted levels, which have priced in several Fed rate hikes throughout 2022 and into 2023. Bank loan maturities have been largely pushed out to 2025 and beyond.

GLOBAL CREDIT SPREADS

We think spikes in credit spreads should be viewed as buying opportunities given solid bottom-up fundamentals.

Source: Bloomberg/Barclays, JP Morgan, data as of 29 March 2022.



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Government Debt & Policy

The stockpile of negative yielding debt outstanding has plummeted 75% since the start of 2022[2]

- US inflation is elevated across goods and services while the labor market is healthy. We think the Fed is likely to deliver 25 basis point hikes at each of the remaining six meetings in 2022. If inflation shows limited signs of easing, the Fed may increase the magnitude of hikes to 50 basis points.
- After a sharp spike to start the year, we believe Treasury yields may begin to consolidate over the next few quarters. A significant amount of monetary tightening has been priced into US and global fixed income markets.
- We advocate remaining underweight duration through 2022 and into next year, but caution that tactically the yield advance has already been quite sizable.
- The US yield curve is likely to continue flattening as the Fed hikes and the cycle progresses. Remember, yield curve inversion often precedes a downturn by several months or even years.
- Yields across developed Europe are likely to remain under upward pressure though European Central Bank (ECB) expectations are relatively less hawkish than Fed expectations.
- We think EM government yields are beginning to look attractive after a volatile start to the year. Several EM central banks have already raised rates to combat inflation.

BLOOMBERG GLOBAL AGGREGATE NEGATIVE YIELDING DEBT

The shift away from ultra-accommodative monetary policy is restoring normalcy.

Source: Bloomberg/ Datastream, data as of 30 March 2022.

[2]Source: Bloomberg, BNYDMVU Index, as of 29 March 2022.

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Currencies

This is a challenging macro backdrop for non-US-dollar exposure

- When the Fed initiates a hiking cycle, the broad US dollar indices tend to trade weaker on average during the following six months.
- We believe this cycle is different because global growth is decelerating, rather than powering ahead in line with or ahead of the US as it has in past cycles.
- Our view is that dollar strength will continue as fixed income markets price more hikes into 2023.
- Once it becomes clear that Fed expectations have been fully priced into markets, the dollar may begin to retreat. Global growth could surprise to the upside relative to the US and boost non-US currencies, but that is not our base case view.
- We believe emerging market countries that export commodities could see their currencies outperform non-exporting peers. We have a favorable view of exposure to Latin America, Mexico and South Africa.

US TRADE-WEIGHTED DOLLAR INDEX PERFORMANCE SIX MONTHS AFTER FIRST FED TIGHTENING

Accelerating global growth often coincides with the beginning of a Fed tightening cycle, but that is not the case this time.

Source: Bloomberg, as of 25 March 2022.

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Equities

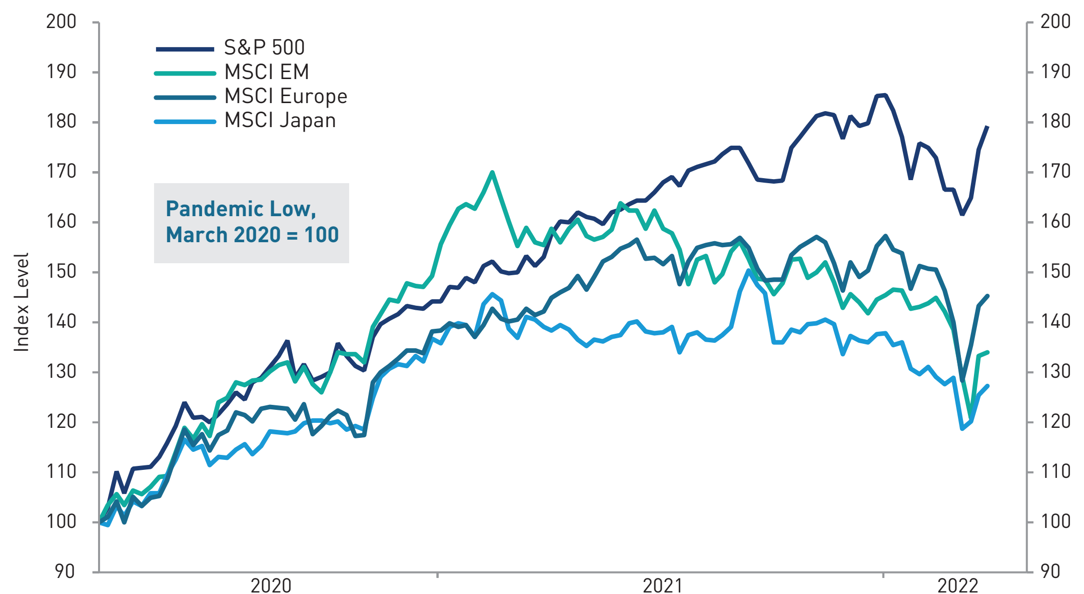
Corrections in equities can offer opportunity for patient investors

- Equity market valuations corrected meaningfully to start the year as it became clear that inflation was more sticky than expected and central banks began to hike rates.
- Our US earnings outlook remains strong, albeit less robust than in 2021. We think US large caps represented by the S&P 500® Index are likely to generate 10% earnings growth. Cyclical sectors of the market like energy, materials and industrials are likely to drive growth, along with technology and communication services.
- Small-cap valuations compressed meaningfully in recent quarters and now trade at a discount to large caps. While not a timing tool or catalyst, we believe small-cap valuations have reached attractive levels.
- US corporates have been able to pass higher input costs on to end users and preserve or even improve profit margins. Some erosion of margins is expected as the cycle progresses, but a breakdown in solid fundamentals is not on our horizon.
- The war in Ukraine has disrupted global equity markets. Outside the US, we believe downward revisions to earnings are likely.

GLOBAL EQUITY PERFORMANCE IN US DOLLARS

US equities are likely to remain a top performer driven by fundamentals.

Source: Datastream, as of 29 March 2022.



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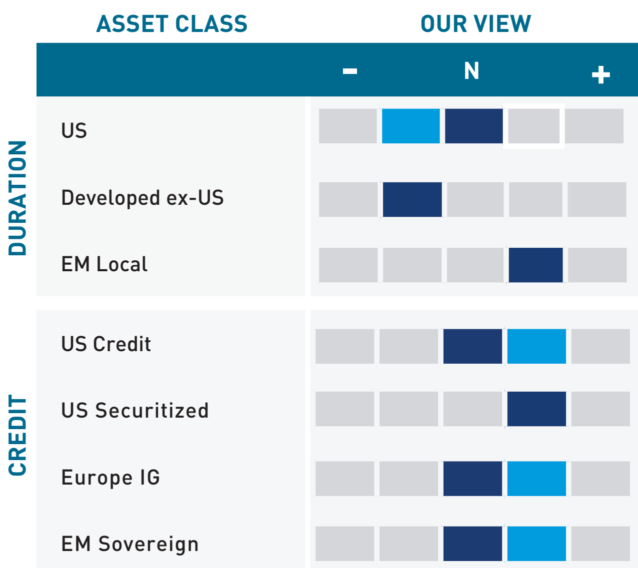
Potential Risks

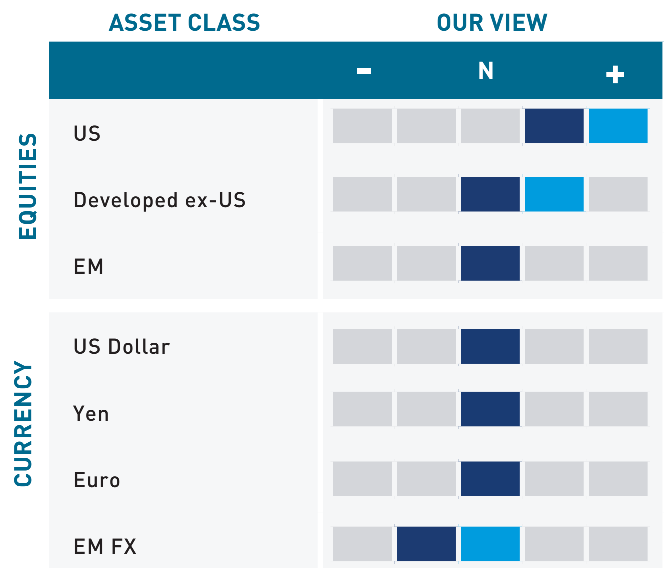
Fed tightening may not ease inflation if supply chain bottlenecks persist

- Hiking interest rates may not be the right prescription to unclog supply chain bottlenecks and goods shortages. Inflation could remain elevated despite central banks' efforts.
- The global growth outlook has been declining, particularly in China and Europe. Severe cuts to growth forecasts would put those major economies closer to the downturn phase of the cycle.
- We believe the risk of stagflation—which we characterize as below-trend or negative economic growth, inflation in excess of central bank targets and a rising unemployment rate—is on the rise.
- The labor market remains healthy. However, if labor markets start to crack and unemployment creeps higher, central banks may find themselves in a serious bind, fighting inflation with rate hikes while job losses pick up and economic activity slows.
- The growth outlook remains critical to our view because elevated levels of inflation would give central banks little room to ease policy if a downturn emerges.

Asset Class Outlook

Current View   Previous View





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MALR028786