

# INVESTMENT OUTLOOK

JULY 2018

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CONSUMER AND BUSINESS CONFIDENCE HAVE BEEN POWERING THE UNITED STATES ECONOMY TOWARD THE FASTEST NOMINAL GDP GROWTH RATES OF THIS EXPANSION.

In the rest of the world, growth remains solid and many economies are likely to grow above long-term trend levels this year despite the recent slowdown in positive momentum. Somewhat tighter monetary policy is in the pipeline, particularly in the United States, but global financial conditions are unlikely to turn restrictive and limit growth in the near term.



## ■ **MACRO DRIVERS**

US economic momentum remains strong while acceleration in the rest of the world has eased. This, in conjunction with short-term interest rate differentials, should support the US dollar.

page 3

## ■ **CREDIT**

Moderately wider spreads have improved valuations in a sector that had become quite rich.

page 4

## ■ **US DOLLAR AND EMERGING MARKETS**

Periodic bouts of volatility can interrupt positive trends, but opportunities remain.

page 5

## ■ **EQUITY**

Valuations have become more attractive on the back of double-digit earnings growth paired with strong top-line revenue.

page 6

## ■ **POTENTIAL RISKS**

Expansionary fiscal policies are temporarily boosting an already strong US economy, which if taken at face value, could lead a short-sighted Federal Reserve to over-tighten.

page 7

## ■ **ASSET CLASS OUTLOOK**

Our view of the asset classes in one line or less.

page 7



## MACRO DRIVERS

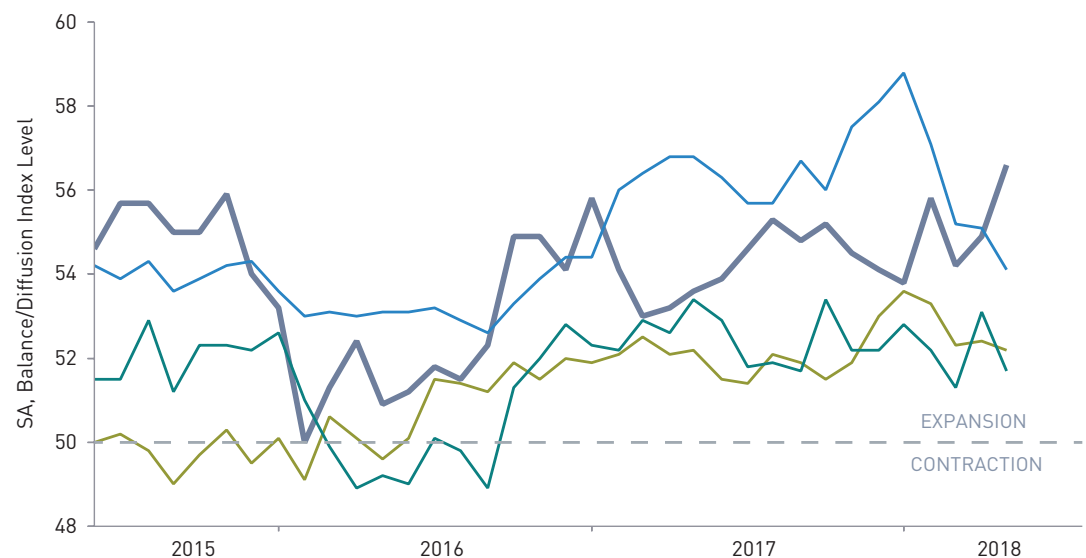
### US Nominal GDP Likely to Run 5.0% or Better This Year and Next

- The **US economy** is running strong and prosperity is on the rise, driven by strong gains in **employment** and improving **wage growth**.
- Despite recent easing in positive momentum, **global growth** remains firm. Many countries are likely to grow above long-term trend this year.
- With the exception of a few countries, **inflationary pressure** has been largely contained. The spread between developed and emerging market inflation should continue to tighten.
- The market has discounted at least two more **Federal Reserve (Fed) rate hikes** over the next year, while the **European Central Bank (ECB)** and the **Bank of Japan (BoJ)** are not expected to adjust policy rates for quite some time.
- Momentum in the US economy relative to the rest of the world should keep the Fed on its current path to higher short-term interest rates, while other developed market central banks should remain more accommodative.

#### US ECONOMIC ACTIVITY CONTINUES TO RISE

Markit Composite PMI Indicators

- United States
- Eurozone
- Emerging Markets
- Japan



Source: Thompson Reuters Datastream, data as of May 18, 2018.  
SA= Seasonally Adjusted



## CREDIT

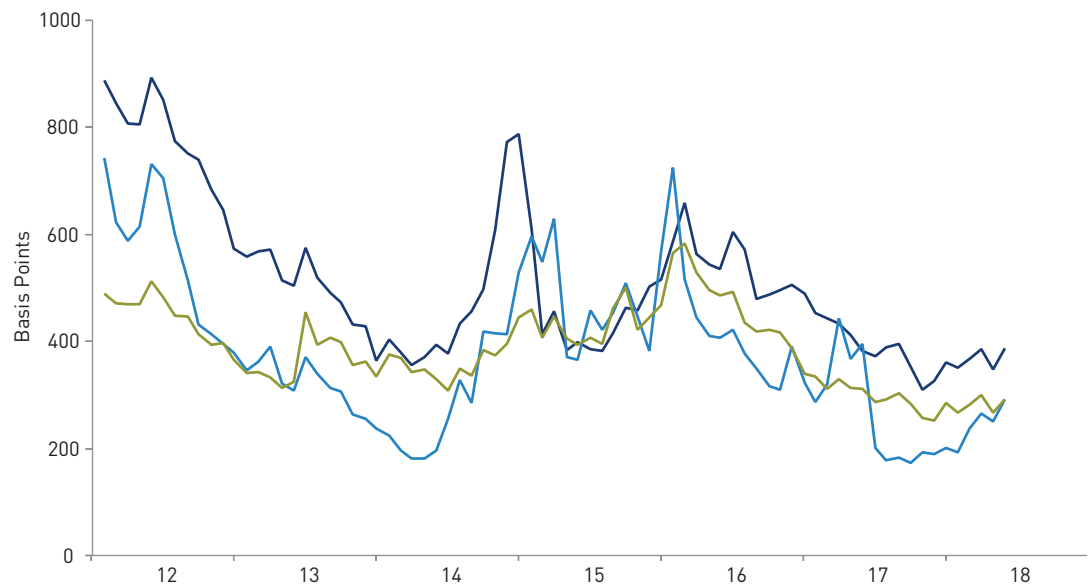
### Spread Widening Improved Forward Valuations

- Higher-quality US credit spreads are unlikely to leak much wider given strong nominal GDP, which has been translating into solid top- and bottom-line growth.
- Lower-quality segments of the corporate bond market may see marginal spread widening over the next twelve months, but total and excess returns will likely remain positive. In our view, floating-rate high yield bank loans remain a preferred sector.
- More than half of US industries have a stable credit outlook, while another third carry a moderately improving or outright improving outlook.
- Multinational corporations have started to repatriate cash held overseas but only a modest portion of the capital is expected to fund debt repayment.
- Global financial sector spreads have ticked higher along with geopolitical risk, but underlying fundamentals remain strong as banks continue to de-lever. Severe financial sector spread widening, especially in the high yield sector, can signal trouble for the broader economy but the indicator is not flashing red at this point.
- Credit markets are not immune to political uncertainty, broad market volatility or late-cycle yield curve dynamics. Therefore, we think a certain degree of caution will be warranted as the cycle progresses.

#### GLOBAL FINANCIAL SECTOR SPREADS HAVE WIDENED, BUT NOT TO ALARMING LEVELS

Global High Yield Financial Sector Spreads

- UK High Yield Financials Senior OAS
- Europe High Yield Financials Senior OAS
- US High Yield Financials Senior OAS



Source: Thompson Reuters Datastream, data as of May 18, 2018.



## US DOLLAR STRENGTH & EMERGING MARKETS

### The US Dollar's Advance Looks Durable for Now

- The dollar began to appreciate relative to most developed and emerging market currencies at the start of this year, when the US economy started to pick up steam and accelerating economic activity in other countries began to ease.
- US economic outperformance relative to the rest of the world is likely to continue, which supports the case for additional Fed tightening and higher short-term interest rates, increasing the attractiveness of holding US dollars.
- Eventually the Fed will reach a neutral rate and pause, likely at a time when the ECB (and possibly the BoJ) has begun to remove accommodation and slowly raise policy rates.
- US dollar bull markets tend to coincide with material deterioration somewhere in the global economy, which leads capital back into relatively safe assets like the US dollar. However, global financial conditions have been stable and most economies are expanding. Significant dollar appreciation due to risk aversion appears unlikely.
- Emerging market assets face the headwind of a firmer US dollar, but valuations have improved and the potential to earn relatively higher yields remains attractive. Security selection is likely to grow increasingly important.

**STRONG ECONOMIC  
MOMENTUM AND  
HIGHER SHORT-TERM  
RATES DRIVING THE  
DOLLAR HIGHER**

US Broad Trade  
Weighted Dollar Index

— US Broad Trade Weighted  
Dollar Index  
— 200 Day Moving Average



Source: *Thompson Reuters Datastream, data as of June 20, 2018.*



## EQUITY

### Impressive Earnings Growth Seen Globally

- US earnings growth has been outpacing the rest of the world on the back of tax cuts, favorable foreign currency translation and buybacks. Even with one-time boosters excluded, we believe the S&P 500® Index is likely to deliver double-digit operating EPS growth this calendar year.
- Companies that generate a large proportion of revenue within the US, like domestic small and mid-caps, should be in a strong position to weather the storm of global trade negotiations and potential tariff announcements.
- Global companies outside the US have also been producing solid revenue and earnings. Bloomberg consensus estimates signal EPS growth of 13.3% and 8.9% this year and next, respectively, for the MSCI All Country World Index ex US.
- Financial sector relative performance continues to struggle on a global basis, which introduces a structural impediment for many equity indices where the sector is heavily weighted. The subdued interest rate environment around the world has been keeping profit margins compressed.
- Growth outperformed value for the majority of this expansion, driven in large part by the technology sector, where earnings growth and total returns have outpaced financials, a sector heavily weighted in value indices. Growth-style valuations are nowhere near the highs of the dot-com era and forward earnings expectations continue to look favorable. The relationship between growth and value has become somewhat parabolic in favor of growth, but forward expectations suggest the current trend can continue.

**GROWTH IS LIKELY TO CONTINUE OUTPERFORMING VALUE**  
MSCI All Country World Equities

— MSCI All Country World Growth Index (USD)  
■ US Recession



Source: Thomson Reuters Datastream, data as of June 20, 2018.



## POTENTIAL RISKS

### An Overly Aggressive Fed and Trade Tensions Could Dampen the Outlook

- Expansionary fiscal policies are temporarily boosting an already strong domestic economy. If the economic data is taken at face value, the Fed could ramp up the pace of tightening over the next two years.
- Overly aggressive hiking would likely invert the yield curve, spur credit spread widening and create broad risk asset volatility while slowing the underlying economy. The Fed is likely to continue hiking, but should remain cognizant of the sizeable risks of overtightening.
- Protectionist rhetoric reduces risk appetite because the global economy is so deeply connected through trade. Even without enacting new policies, the uncertainty of the situation could delay capital expenditures and other investments, reducing potential economic growth.
- Disrupting the flow of goods and services has the potential to impact households and corporates, which is another reason why additional tariffs and restrictions could limit risk appetite.
- Trade developments are unlikely to leave the headlines any time soon, which should keep market volatility a bit elevated. However, we do not expect an all-out trade war. Global export volume, which rebounded recently, will be monitored closely for the foreseeable future.

## ASSET CLASS OUTLOOK

	ASSET CLASS	OUR VIEW
FIXED INCOME	Government Bonds	Developed market government rates unlikely to rise substantially higher in the medium term.
	IG Corporates	Spread widening has restored value to the sector. Most industries have stable to improving credit trends and fundamentals.
	HY Corporates	The sector's low-duration profile can improve total return potential as yields rise, even if only marginally.
	EM Debt	Local-currency EM debt may remain under pressure as the US dollar holds firm. Hard-currency debt valuations have improved significantly.
EQUITIES	US	We favor domestic-oriented small to mid-cap equities, as well as large-cap growth where earnings have been impressive.
	Global	Somewhat lackluster trends in global developed market equities may persist unless the financial sector can find firmer footing.
	EM	A steady to stronger dollar would impede performance, but EM equity valuations have improved substantially since the beginning of 2018.



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## Disclosure

*All data as of June 30, 2018, unless otherwise noted.*

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