NATIXIS
INVESTMENT MANAGERS

Market Insights

January 2018

Outlook 2018: Where's the Value in Fixed Income?

Central banks' normalizing monetary policies, synchronized global growth for the first time in a decade, and an overhaul for the US tax system are all part of a colorful backdrop for fixed income investing in 2018.

Views on the investment environment, valuations and yield opportunities for short-duration securities, municipal bonds, and multisector fixed income are shared by three portfolio managers.

Christopher Harms
Vice President and Portfolio Manager
Loomis, Sayles & Company

As we head into 2018, we believe we are in the late expansion phase of the credit cycle in the United States. This means that corporations' growth is slowing down and leverage is increasing. Additionally, we expect the Federal Reserve (Fed) will continue on its path of tightening monetary conditions in a gradual and measured way. The Fed began balance sheet reductions in October and has signaled three rate hikes are in store for 2018, most of which will come from the front end (short-term rates) of the yield curve.

Flattening yield curve

Flattening of the yield curve (when there is little difference between short-term and long-term rates for bonds of the same credit quality) has already had an effect on the bond market since Sept. 30th. A flattening or reversing yield curve is often seen as a precursor to a recession. However, we are not of that belief, and think that there are a lot of technicals going on in the market right now, especially in the US treasury market with short-term bill issuance high and inflation under control at around 2%.

US treasuries have been finding some demand from two schools of investors. One school is investors who don't believe inflation is a problem and have been buying long-term treasuries. For example, liability-matched pension funds appear to be going long in duration, around 15 years. The other area of demand has been in the two-year duration space, all the way out to the five-year. Overall, we are less concerned with risk in the short-end as we move into 2018, and really look at the 10- to 30-year range as the area of caution.

With that backdrop, we believe yields of US governments in the short end of the curve (1- to 5-year durations) are still not offering much value at 1.5% to 2%. We are finding more value in asset-backed securities, as well as Triple A quality corporate bonds with short durations. 2018 should also be a year to focus on security selection opportunities, buying new issues with concessions and secondary bonds that can offer favorable risk-return profiles.

Policy shifts at the Fed?

In February, new Fed Chair Jerome Powell is set to replace Janet Yellen. We don't expect there to be any big surprises or any major shifts in policy under Powell. However, there could be as many as five Fed governor seats that will become vacant and need to be filled in 2018.

The Fed has done a good job communicating to the market what its moves would be to deleverage its balance sheet thus far. This has been especially helpful within the mortgage-backed securities market. That said, we currently believe valuations in commercial mortgage-backed securities (CMBS) are fair. However, we think many parts of the mortgage-backed market appear overvalued and do not adequately compensate for prepayment risk. At this phase, we are focused on securities with limited prepayment risk.

James Grabovac, CFA®
Managing Director and Investment Strategist
McDonnell Investment Management

Supportive US fundamentals

Economic fundamentals continue to occupy solid ground as investors approach 2018 with the added twist of evolving tax legislation now winding its way through Congress. The US economic recovery and subsequent expansion will reach the 8½- year mark at the end of 2017, and we expect a continuation of growth over the medium-term horizon.

The US labor market continues to experience gains in employment, although wage growth remains remarkably tepid, particularly in light of the mature stage of the economic cycle and generally low level of unemployment. Inflation remains well contained and continues to hover below the Federal Reserve target of 2% despite a recovery in energy markets over the past year.

Interest rates

Against this backdrop, interest rate markets have been remarkably stable, confined within a tight range of only 60 basis points throughout 2017. The feature characteristics of the US fixed income markets have been flattening yield curves and quality spread (the difference in yield between non-Treasury and Treasury securities of similar maturity) compression. Investor behavior has largely focused on adding income by reaching for yield both by adding longer-maturity exposure as well as buying lower-quality holdings.

The rising tide has tightened quality and sector spreads across markets and has been accompanied by buoyant equity markets and extremely low levels of market volatility. We expect this narrative may continue to be operative unless and until either a correction of significance occurs in risk markets, or the Fed steps on the brake pedal more vigorously than investors anticipate.

Fed in transition

The Federal Reserve is currently undergoing an unprecedented transition with the nomination of new Fed Chair Jerome Powell and the ultimate appointment by the President of as many as five new Fed governors after Fed Chair Yellen steps down in February. The unusual degree of turnover is largely the result of retirements as the seven governor positions were originally created with staggered tenures to help avoid the potential politicization of the Board. In addition to retirements, however, two positions have been vacant as Congress has refused to approve nominees from the President of an opposing party. It is likely that the full Board will eventually be constituted as that obstacle is no longer in place.

The Fed has been the most effective driver of economic policy since the Great Recession as Congress largely abdicated its policy role after its initial response to the economic downturn. Fed initiation of the zero-lower bound interest rate policy, in conjunction with its Large-Scale Asset Purchase program, was instrumental in paving the road to economic recovery. Investors should expect, but not necessarily assume, that a newly constituted Board will operate as effectively in the event of the next downturn. We remain hopeful that the administration will be cognizant of the vital role assumed by the Federal Reserve as it considers candidates for nomination to the most important central bank in the world economy.

Municipal bond market year in review

Rate markets spent most of the past year recovering from the sharp, but ultimately short-lived, sell-off they underwent during the 4th quarter of 2016. The US municipal market registered strong relative performance as it outperformed the US Treasury market across most of the yield curve. Limited new issue supply characterized much of the year, although a late quarter onslaught of issuance was brought about by the passage of companion tax bills in Congress, both of which seek to restrict tax-exempt municipal issuance. Municipal market performance mirrored returns in the corporate market with lower quality, longer-maturity segments of the market registering the strongest relative returns. Demand was steady, if not robust, as reflected in consistent US mutual fund inflows throughout most of the year as well as a modest expansion of institutional holdings by commercial bank and insurance company portfolios. Valuations versus Treasuries tightened, but remained attractive in comparison to longer-term historical averages.

Tax reform could mean change for muni market
The final tax reform legislation is expected to have significant impact on municipal market issuance. The new law will prohibit state and local issuers from refinancing outstanding debt with tax-exempt issuance, via the process known as Advance Refunding. The amount of this type of issuance varies depending upon several factors, including the general level of municipal and Treasury rates, but it can represent more than a quarter of total annual issuance during periods of extensive refinancing activity.

Private activity bonds (PABs), which were proposed to be eliminated in the House version of the tax reform bill, were saved in the final legislation. PABs make up a large portion of the municipal market and include issuers involved in healthcare, housing, airports, water and sewer facilities and redevelopment projects, among others. Industry analysts estimated that as much as 20% to 40% of municipal new issue financing would no longer qualify for tax-exempt treatment if the Advance Refunding and PABs provisions were enforced. The inclusion of either provisions places the tax legislation at odds with the stated administration goal of creating a large infrastructure investment program as an important piece of its legislative agenda.

Prior to President Trump's signing of the Tax Cuts and Jobs Act into law on December 22, issuers had been rushing to market before year-end to qualify for tax-exempt treatment. We anticipate a sharp drop-off in supply at the beginning of 2018 in any eventuality.

What's ahead for muni bonds?
Despite the new tax legislation, we anticipate relatively benign conditions for municipal investors heading into 2018. Our outlook is centered around expectations of continued economic growth, stable inflation and reduced supply of tax-exempt issuance.

As mentioned, we expect a reduction of municipal and corporate issuance over the period ahead. We would expect a diminution, but not elimination, of demand from institutions subject to the lowered corporate tax rate; but anticipate a strengthening of demand from individual investors, particularly in high-tax states, as the potential elimination of the deductibility of state and local taxes amplifies demand as investors seek to generate income exempt from federal and state taxation.

Finally, aside from the potential impact of changes in the tax code, we believe that fundamental issuer credit quality across the broad municipal market continues to improve as the economic expansion lengthens. While individual fiscally stressed issuers still face significant challenges, we expect most issuers will be able to adapt to a changing landscape with flexibility and creativity as they continue to provide the critical essential services that serve as the backbone of our economy.

Matthew Eagan, CFA®
Vice President and Portfolio Manager
Loomis, Sayles & Company

Our outlook calls for stable economic growth and an uptick in inflation. US and global growth are steadily improving, and US inflation indicators are below Federal Reserve (Fed) and consensus expectations.

We do see the Fed walking a tightrope. They want to continue to normalize monetary policy as quickly as they can. They have been getting support from the US economy which certainly seems like it is normalizing. We think the Fed will most likely implement three interest rate hikes in 2018. But really, the deciding factor will be how much inflation heats up. As mentioned, the economy appears to be humming right now, especially when you look at the Purchasing Manager Index.

We believe steady economic growth is also supporting risk assets, and continue to like opportunities in corporate bonds. While spreads (the difference in yield between non-Treasury and Treasury securities of similar maturity) have tightened significantly and the risk premiums for the investment-grade and high-yield markets are lower with increasing downside risks, we see further upside potential given the outlook for earnings growth and the low probability of defaults or economic recession.

High-yield advantage
Valuations appear fair, and with a growing economy we expect lower default rates in the high-yield sector. We think global demand for US high-yield credit should remain, due largely to attractive relative yields.

When you're looking at an investment-grade bond, spreads are so tight that the dominant risk factor is the term-structure risk (the risk to Treasury and interest rates). So overall, in the corporate space, we find high yield the most attractive – where defaults are declining, profits are rising, and the fundamentals look pretty good.

By the way, I would also say that the debt buildup and issuance we've seen in the third and fourth quarters of 2017 has been more dominant in the investment-grade space than high yield. In fact, we haven't really seen a lot of issuance in the last three years in high yields.

Currency calls
The US dollar was weak versus a lot of reserve currencies, particularly the euro, in 2017. But we think the euro is overshot to a certain degree. In 2018, we think the US dollar will strengthen versus the euro.

The weaker US dollar fueled currency rallies in many emerging and developed markets. Emerging markets also benefited from the search for yield, positive risk sentiment and improving fundamentals. We believe some value remains in local-currency emerging debt and are being selective in our security selection while focusing on attractive real yields.

Overall, investment themes we believe make sense for fixed income investing in 2018 are broadening diversification, generating income, lowering duration and reducing overall interest rate sensitivity.

Asset-backed securities (ABS) *are bonds or notes back by financial assets. Typically, these assets consist of receivables such as credit card receivables, auto loans, and home-equity loans.*
Commercial mortgage-backed securities (CMBS) *are a style of mortgage-backed security backed by commercial mortgages rather than residential real estate.*
Credit cycle *is a cyclical pattern that follows credit availability and corporate health.*
Credit Quality *reflects the highest credit rating assigned to a bond among Moody's, S&P or Fitch; ratings are subject to change. Bond credit ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest).*
Duration *is a measure of the sensitivity of the price -- the value of principal -- of a fixed income investment to a change in interest rates. Duration is expressed as a number of years.*
High-yield bonds *are rated below BBB/Baa. Ratings are determined by third-party rating agencies such as Standard & Poor's or Moody's and are an indication of a bond's credit quality.*
Investment grade *refers to bonds rated BBB/Baa or higher. Ratings are determined by third-party rating agencies such as Standard & Poor's or Moody's and are an indication of a bond's credit quality.*
Mortgage-backed securities (MBS) *are bonds secured by home and other real estate loans. They are created when a number of these loans, usually with similar characteristics, are pooled together.*
Prepayment risk *is the risk associated with the early unscheduled return of principal on a fixed-income security.*
Purchasing Managers' Index (PMI) *is an indicator of the economic health of the manufacturing sector. The* ***PMI*** *is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.*
Risk assets *refer to assets that have a significant degree of price volatility, such as equities, high-yield bonds, real estate, and currencies.*
Secondary market *is where investors buy and sell securities, such as bonds or stocks, they already own.*
Valuation *can be defined as the process of determining the current worth of an asset or company.*
Yield curve *is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates.*

Diversification does not guarantee a profit or protect against a loss.

RISKS:

Fixed income securities *may carry one or more of the following risks: credit, interest rate (as interest rates rise bond prices usually fall), inflation and liquidity.*

Mortgage-related and asset-backed *securities are subject to the risks of the mortgages and assets underlying the securities. Other related risks include prepayment risk, which is the risk that the securities may be prepaid, potentially resulting in the reinvestment of the prepaid amounts into securities with lower yields.*

Municipal markets *may be volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issuers of municipal securities.*

Below investment-grade fixed income securities *may be subject to greater risks (including the risk of default) than other fixed income securities.*

Currency *exchange rates between the US dollar and foreign currencies may cause the value of the fund's investments to decline.*

The views and opinions expressed are as of December 8, 2017, and may change based on market and other conditions. This material is provided for informational purposes only and should not be construed as investment advice. There can be no assurance that developments will transpire as forecasted. Actual results may vary.

Natixis Investment Managers does not provide tax or legal advice. Please consult with a tax or legal professional prior to making any investment decisions.

Outside the United States, this communication is for information only and is intended for investment service providers or other Professional Clients. This material must not be used with Retail Investors. This material may not be redistributed, published, or reproduced, in whole or in part. Although Natixis Investment Managers believes the information provided in this material to be reliable, including that from third party sources, it does not guarantee the accuracy, adequacy or completeness of such information.

In the EU (ex UK): Provided by Natixis Investment Managers S.A. or one of its branch offices listed below. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. France: Natixis Investment Managers Distribution (n.509 471 173 RCS Paris). Registered office: 21 quai d'Austerlitz, 75013 Paris. Italy: Natixis Investment Managers S.A., Succursale Italiana (Bank of Italy Register of Italian Asset Management Companies no 23458.3). Registered office: Via Larga, 2 - 20122, Milan, Italy. Germany: Natixis Investment Managers S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Im Trutz Frankfurt 55, Westend Carrée, 7. Floor, Frankfurt am Main 60322, Germany. Netherlands: Natixis Investment Managers, Nederlands (Registration number 50774670). Registered office: World Trade Center Amsterdam, Strawinskylaan 1259, D-Tower, Floor 12, 1077 XX Amsterdam, the Netherlands. Sweden: Natixis Investment Managers, Nordics Filial (Registration number 516405-9601 - Swedish Companies Registration Office). Registered office: Kungsgatan 48 5tr, Stockholm 111 35, Sweden. Spain: Natixis Investment Managers, Sucursal en España. Registered office: Torre Colon II - Plaza Colon, 2 - 28046 Madrid, Spain.

In Switzerland: Provided by Natixis Investment Managers, Switzerland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich.

In the UK: Provided by Natixis Investment Managers UK Limited, authorized and regulated by the Financial Conduct Authority (register no. 190258). Registered Office: Natixis Investment Managers UK Limited, One Carter Lane, London, EC4V 5ER.

In the DIFC: Distributed in and from the DIFC financial district to Professional Clients only by Natixis Investment Managers Middle East, a branch of Natixis Investment Managers UK Limited, which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients as defined by the DFSA. Registered office: Office 603 - Level 6, Currency House Tower 2, PO Box 118257, DIFC, Dubai, United Arab Emirates.

In Singapore: Provided by Natixis Investment Managers Singapore (name registration no. 53102724D), a division of Natixis Asset Management Asia Limited (company registration no. 199801044D). Registered address of Natixis Investment Managers Singapore: 10 Collyer Quay, #14-07/08 Ocean Financial Centre, Singapore 049315.

In Taiwan: Provided by Natixis Investment Managers Securities Investment Consulting (Taipei) Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C. Registered address: 16F-1, No. 76, Section 2, Tun Hwa South Road, Taipei, Taiwan, Da-An District, 106 (Ruentex Financial Building I), R.O.C., license number 2012 FSC SICE No. 039, Tel. +886 2 2784 5777.

In Japan: Provided by Natixis Investment Managers Japan Co.,Ltd., Registration No.: Director-General of the Kanto Local Financial Bureau (kinsho) No. 425. Content of Business: The Company conducts discretionary asset management business and investment advisory and agency business as a Financial Instruments Business Operator. Registered address: 1-4-5, Roppongi, Minato-ku, Tokyo.

In Hong Kong: Provided by Natixis Investment Managers Hong Kong Limited to institutional/ corporate professional investors only.

Please note that the content of the above website has not been reviewed or approved by the HK SFC. It may contain information about funds that are not authorized by the SFC.

In Australia: Provided by Natixis Investment Managers Australia Pty Limited (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only.

In New Zealand: This document is intended for the general information of New Zealand wholesale investors only and does not constitute financial advice. This is not a regulated offer for the purposes of the Financial Markets Conduct Act 2013 (FMCA) and is only available to New Zealand investors who have certified that they meet the requirements in the FMCA for wholesale investors. Natixis Investment Managers Australia Pty Limited is not a registered financial service provider in New Zealand.

In Latin America: Provided by Natixis Investment Managers S.A.

In Colombia: Provided by Natixis Investment Managers S.A. Oficina de Representación (Colombia) to professional clients for informational purposes only as permitted under Decree 2555 of 2010. Any products, services or investments referred to herein are rendered exclusively outside of Colombia.

In Mexico: Provided by Natixis IM Mexico, S. de R.L. de C.V., which is not a regulated financial entity or an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores) and is not registered with the Comisión Nacional Bancaria y de Valores (CNBV) or any other Mexican authority. Any products, services or investments referred to herein that require authorization or license are rendered exclusively outside of Mexico. Natixis Investment Managers is an entity organized under the laws of France and is not authorized by or registered with the CNBV or any other Mexican authority to operate within Mexico as an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores). Any use of the expression or reference contained herein to “Investment Managers” is made to Natixis Investment Managers and/or any of the investment management subsidiaries of Natixis Investment Managers, which are also not authorized by or registered with the CNBV or any other Mexican authority to operate within Mexico as investment managers.

In Uruguay: Provided by Natixis Investment Managers Uruguay S.A., a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay. Office: San Lucar 1491, oficina 102B, Montevideo, Uruguay, CP 11500.

The above referenced entities are business development units of Natixis Investment Managers, the holding company of a diverse line-up of specialised investment management and distribution entities worldwide. The investment management subsidiaries of Natixis Investment Managers conduct any regulated activities only in and from the jurisdictions in which they are licensed or authorised. Their services and the products they manage are not available to all investors in all jurisdictions.

In Canada: This material is provided by Natixis Investment Managers Canada LP., 145 King Street West, Suite 1500, Toronto, ON M5H 1J8

In the United States: Provided by Natixis Distribution, L.P. 888 Boylston St. Boston, MA 02199. Natixis Investment Managers includes all of the investment management and distribution entities affiliated with Natixis Distribution, L.P. and Natixis Investment Managers S.A.

This material should not be considered a solicitation to buy or an offer to sell any product or service to any person in any jurisdiction where such activity would be unlawful.

WEB21-1217
1972209.2.1
Exp. 1/31/2019