LOOMIS | SAYLES

IF THE DOLLAR WEAKENS, YOU MAY WANT TO OWN A GLOBAL BOND STRATEGY

VIEWS FROM

THE LOOMIS SAYLES
GLOBAL FIXED INCOME TEAM

THE BLOOMBERG BARCLAYS GLOBAL AGGREGATE IS A FLAGSHIP INDEX FOR THE WORLD'S INVESTMENT GRADE BOND MARKETS. THE INDEX IS CAPITALIZATION-WEIGHTED, WITH OVER $64 TRILLION IN BONDS FROM OVER 70 COUNTRIES.[1] IN ITS UNHEDGED, MULTI-CURRENCY FORM, IT IS ALSO AN INDEX THAT MANY US INVESTORS HAVE BEEN HAPPY TO IGNORE.

This ignorance has been profitable until recently. Domestic US bond indices, as well as US dollar-hedged global or international indices, have beaten global unhedged returns for the past five years. As the world changes, we believe that this may not be the case for much longer. The long US dollar bull market may be coming to an end. From deficits to Fed policy to geopolitics, a number of factors could bring the dollar

[1] *Source: Bloomberg Barclays, data as of September 30, 2020.*

MANAGER INSIGHT

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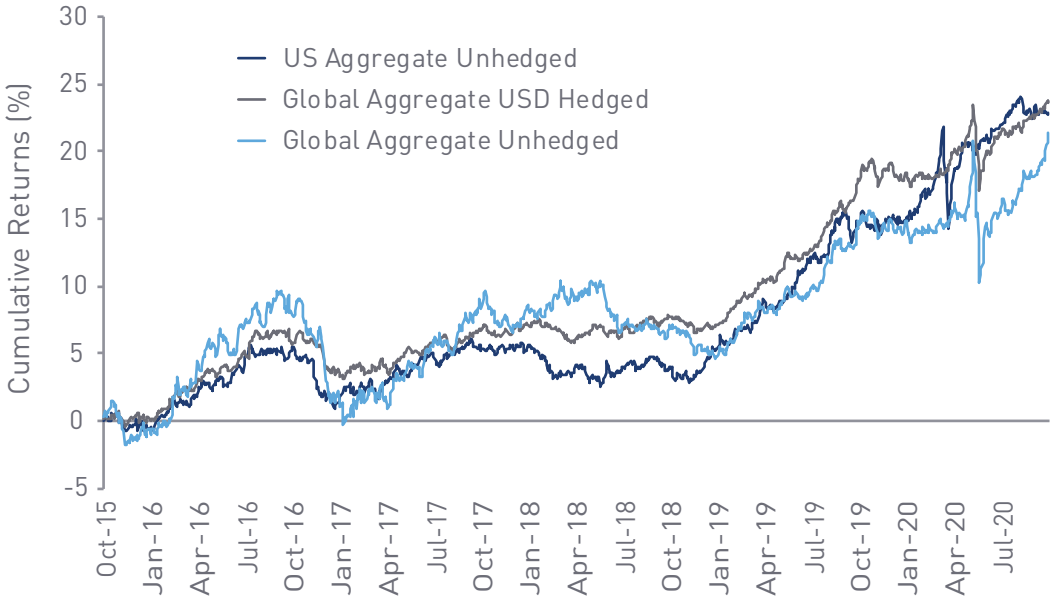
bear out of hibernation, and we'll detail them later in this paper. For now, the takeaway is that unlike the past five years, we believe the next five years may see unhedged global benchmarks and active global managers dominate the returns of either dollar-hedged or purely domestic fixed income return indices. If the US dollar (USD) weakens, future investors may wish they had included an unhedged global bond strategy in their asset allocations.

Q: Who Needs Currency Risk?

Chart 1 shows the five-year returns of three indices, the Bloomberg Barclays (BBG BARC) US Aggregate, the BBG BARC Global Aggregate, and the BBG BARC Global Aggregate Hedged to US dollars through September 30, 2020.

CHART 1

Source: Bloomberg Barclays, data October 1, 2015 through September 30, 2020.



Past performance is no guarantee of future results.

Indices are unmanaged and do not incur fees. It is not possible to invest directly in an index.

In our assessment, US investors did not really miss much if they skipped the international bond market during this period. By calendar year, only in 2017 did the unhedged global market outperform US bonds. If investors did own foreign bonds, they would have outperformed by owning a USD-hedged global or international strategy. This would have given them a positive USD hedge gain, provided favorable exposure to the bond rallies in the European and Japanese bond markets, and avoided currency return volatility.

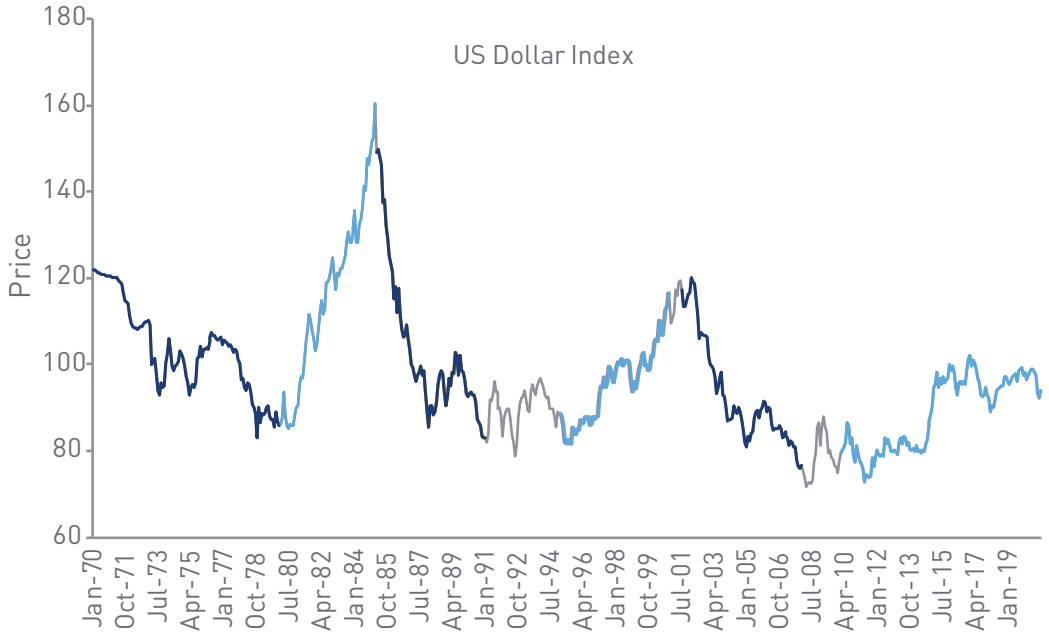
Why should investors now change what has been a winning strategy? Why do we like the prospects for unhedged global indices now? In one sentence, we believe that the risks of a US dollar bear market have multiplied and are now too numerous and too large to ignore in allocating fixed income assets.

A: Investors in Dollar Bear Markets

Chart 2 shows 50 years of history for the trade-weighted US dollar index DXY. The dollar is trendy. There have been distinct periods of bull markets, bear markets and sideways markets. Unfortunately, for much of this 50-year period, currency forecasters have often been better at explaining what just happened than what will happen next. This lack of forward visibility, as well as a somewhat loose relationship between currency movements and economic fundamentals, has made foreign currency exposure a disappointment for many US investors.

CHART 2

Source: Bloomberg Barclays, data January 30, 1970, through September 30, 2020.



We believe, however, that big dollar movements are the result of big global portfolio changes that reflect a shift in broad investor preferences. When we look at this chart, we recall:

1970-80: USD BEAR MARKET. The adjustment to the end of Bretton-Woods fixed exchange rates and a decade of rising US inflation and investor flight from it.

1980-85: USD BULL MARKET. The Reagan equity bull market. The US claims the highest real interest rates in the OECD. Paul Volcker slays inflation. A massive rally in bonds follows.

1986-90: USD BEAR MARKET. The Plaza Accord to arrest the rise of an overowned and overvalued US dollar. Japan as Number One. The Tokyo equity bull market.

1995-2000: USD BULL MARKET. Cold War victory aftermath. The internet equities boom. Janus Twenty!

2001-2007: USD BEAR MARKET. The rise of China and the associated commodity super-cycle and emerging market boom.

2010-?: Arguably, the recent strength in the USD can be ascribed to (1) disappointment in the global growth recovery and a haven bid for USD, plus (2) a second tech-centered equity boom. The S&P 500® Index has massively outperformed most other global equity markets. Lastly, (3) the euro and the yen have suffered from recessionary or deflationary local fundamentals and the lowest interest rates in recorded history.

What do Dollar Bear Markets Look Like?

In past bear markets, the USD has typically followed the opposite path of Hemingway's bankrupt character; it first fell quickly, then slowly. Average declines in the first three years of a sustained bear market have been about 7% per year.[2] We see this as an opportunity for owners of non-US securities: currency could potentially be an attractive return generator compared to the low yields that most investment grade fixed income opportunities currently offer.

What Could Trigger a Dollar Bear Market?

Our thesis is that a major shift in global investor preferences could trigger a dollar bear market. There needs to be something big that investors want either to buy outside the US or to sell in the US. What follows is not a currency forecast; rather it is a list of possible triggers we see for sustained USD weakness.

Twin Deficits

The US currently runs a current account deficit of about 2.5% of GDP. This is modest, unthreatening and easily financed. However, the federal budget deficit is about 16% of GDP this year and is projected to be about 10% of GDP next year, plus whatever effects a new stimulus plan brings. The presidential election remains uncertified as we write this, but President-elect Joseph Biden's fiscal plan spends far more in outlays than it raises in taxes. If this additional expenditure finds its ways to consumers or businesses, then the current account deficit may be about to explode. This has been bearish for the USD in the past.

[2] *James Malcolm, Lefteris Farmakis, Moritz Diller, Vassili Serebriakov, "The FX Weekly," UBS Global Research, October 5, 2020 Figure 1.*

Too Many Dollars

The Federal Reserve (Fed) has come to the rescue of the US economy and US asset markets during the COVID-19 pandemic. The short-term policy rate has been cut to just above zero, and the Fed balance sheet has jumped from 19% of GDP to 34% (or by more than $2.5 trillion). It is still growing. Once the precautionary demand for USD ebbs in a recovery, this may be a problem.

Inflation?

We almost hate to mention the possibility of higher inflation. First, higher inflation is the dog that has not barked for the past ten years. The Phillips Curve may not be dead, but it is not just resting; it is in a coma. Going underweight or short US duration has hurt many fixed income managers. Nonetheless, we bravely note that the Fed has officially changed policy on inflation to tolerate, nay, encourage an overshoot of its 2.0% core consumer inflation target. Beyond this, if money multipliers and velocity return to their 2017-2019 averages, we believe it's possible that the degree of Fed liquidity already provided might increase the price level over time by as much as 60%. Combining all three factors above, we suspect that a combination of record deficits and zero or negative inflation-adjusted yields may be a problem for the USD.

Equity Bull Market Pause or Reversal Complacency

Equity bull markets do not last forever. We believe elevated multiples and index concentration may change some investors' attitudes toward the US equity market. If foreign investors decide to sell or merely diversify out of US equities, the dollar may weaken in our view. Regulatory changes could also be a factor here. Even a change in capital gains taxation might lead to pre-emptive selling by investors to front-run a higher future tax rate.

Taiwan

This is our least favorite USD bear market scenario. In 1956, UK Sterling was a casualty of the Suez Crisis. The Suez fiasco marked the end of Sterling's reserve currency perception as the UK was rerated down as a global power. A successful occupation of Taiwan by the People's Republic of China would be seen as a geopolitical failure for the US of the first magnitude. It would also likely be a humanitarian disaster, a massive destroyer of lives and wealth and a possible trigger for a war between the superpowers. USD weakness might be a trivial issue.

Global Recovery

This is our favorite dollar bear scenario. The USD has been a haven asset to a degree, in that it seems to do well when the rest of the world's economies disappoint (2019). We believe if we reach the optimistic scenario

of an ebbing pandemic, a vaccine and a global activity rebound, there may be more interest in investment opportunities in growing economies around the world.

One Problem

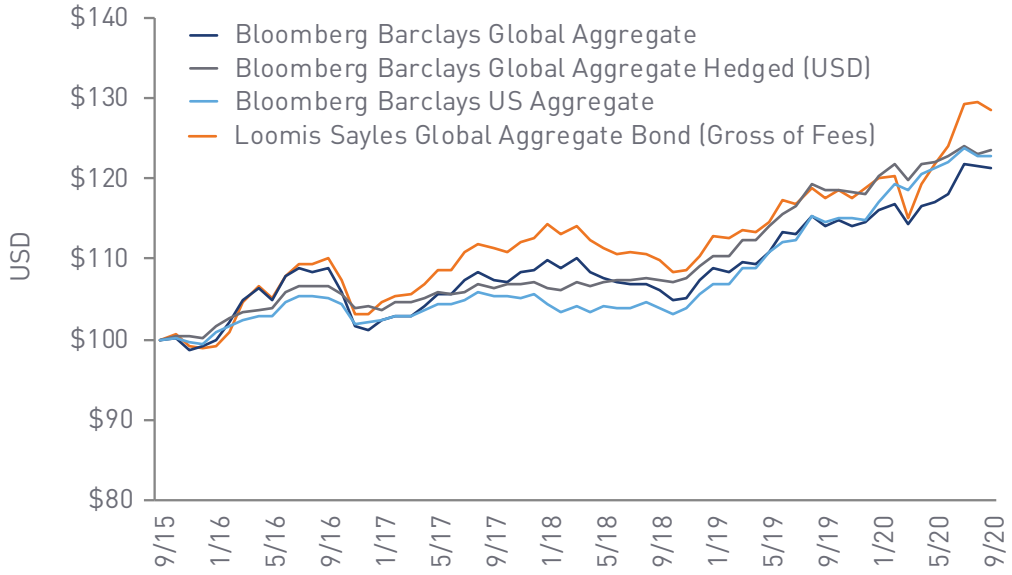
For the USD to fall, someone else's currency must rise. As real exchange rate strength correlates with growth and productivity over time, our favorite candidates for potential outperformance are found in non-Japan Asia. The DXY Index would likely fall more and faster if Japan and the eurozone were to perk up a bit. But this would require these two economies to overcome their deflationary tendencies, weak growth and low yields. Any progress on that front remains hypothetical. We believe this is actually an argument for a global bond strategy rather than an international bond strategy.

Looking for a Global Bond Strategy Yet?

In closing, we recognize that US domestic bond strategies have outperformed currency-active global bond strategies for the last five years, but we believe the next five years are likely to be different, and relative global outperformance may be substantial. As food for thought, we include the five-year performance chart of the Loomis Sayles Global Aggregate Bond strategy. With more than half of the strategy in non-dollar currencies, we believe we are well positioned for a dollar bear market, if one were to occur. While we wait, we have even been able to outperform the US domestic and USD-hedged global indexes as well as our own index over the last five years. Please see the chart at the end of this paper for up-to-date performance data of the Loomis Sayles Global Bond Strategy.

CHART 3

Source: Bloomberg Barclays, Loomis Sayles. Data from 9/30/2015 to 9/30/2020.



Source: Bloomberg Barclays, Loomis Sayles. Data from 9/30/2015 to 9/30/2020.

Past performance is no guarantee of future results.

Indices are unmanaged and do not incur fees. It is not possible to invest directly in an index.

TABLE 1 – COMPOSITE PERFORMANCE

	AVERAGE ANNUALIZED RETURN (%)				
	1 YEAR	3 YEARS	5 YEARS	7 YEARS	10 YEARS
Loomis Sayles Global Aggregate Bond (Gross)	6.58	6.11	4.14	2.97	3.03
Loomis Sayles Global Aggregate Bond (Net)	6.32	5.84	3.88	2.70	2.74
Bloomberg Barclays Global Aggregate	2.63	4.23	2.34	2.16	2.05
Bloomberg Barclays Global Aggregate Hedged (USD)	0.08	4.59	2.98	3.75	3.87
Bloomberg Barclays US Aggregate	-0.33	5.31	3.03	3.48	3.39

Data as of 6/30/2021

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Indices are unmanaged and do not incur fees. It is not possible to invest directly in an index. Gross Returns are shown before deduction of advisory fees, which would lower returns. For example, a 10 year annualized hypothetical gross return of 3.50% would be lowered to 3.09% assuming the deduction of a management fee at the annual rate of 0.40%. Please see the Loomis Sayles ADV for more complete fee information.

Returns may increase or decrease as a result of currency fluctuations.

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