For the first time in quite a while, Washington could prove to be a source of positive earnings catalysts in the months ahead.

Following the US election, the outlook for corporate tax reform and infrastructure spending further lifted equity investor expectations. Both large-cap and smaller-cap stocks are poised to potentially benefit from policy changes.

Stocks were already benefiting from a turnaround in corporate profits in the third quarter as US corporations exited the profits recession, and such positive prospects just bolstered market confidence more.

Still, while investor optimism is running high, much is unknown. Policy changes will take time and require compromise. Challenges could provide buying opportunities in the first half of 2017.

Why 2016's Performance Turned Around From A Very Poor Start

US equities led the way in the fourth quarter, and for all of 2016, turned in a very positive result. The S&P 500® Index returned nearly 12% for the year, and small-cap stocks performed even better. This outcome is certainly stronger than seemed likely early in the year given the market’s very poor start.

At its low point this year on February 11, the S&P 500 was down over 11%, one of the worst starts to a calendar year on record. Small caps fared even worse, down nearly 17% at the February low. What led to the performance turnaround?

Well, first as we began the year, the Federal Reserve (Fed) suggested we might have as many as four rate hikes throughout 2016. Investors were fearful that rapid hiking of interest rates could lead to an even stronger dollar and further depress commodity prices, especially oil.

Fortunately, the price of oil bottomed out somewhat below $30 a barrel and began to rise, and the dollar’s rise, which was pinching multinational company revenues and earnings, slowed. These two positive developments helped stocks put their lows for the year behind them, and the recovery was on.
By mid year, stocks had recouped all the early year losses, posting low single-digit percentage gains. While the Brexit vote outcome led to short-term weakness, that proved to be a buying opportunity with the next major macro event being the US election. Also, supporting the recovery was the Fed’s decision to hold off on rate increases. The second rate hike of this cycle, after the December, 2015 hike, was not implemented until late in 2016.

**Momentum Builds As Stocks Rally Post-Election**

Following the US election results, stocks rallied sharply, led by small caps. Expectations are high that the incoming administration will implement policies which will be beneficial to business in the longer term. Details are certainly lacking but investors have attempted to factor in corporate tax reform into the earnings outlook.

The US has one of the highest statutory corporate tax rates in the world, and if rates could be brought down to just the global average, many companies could benefit. Moreover, pressure for US companies to engage in aggressive global tax structures could be reduced.

Of course, many companies do not pay taxes at the statutory rate so not everyone would benefit from a lower rate, especially if certain tax preferences were reduced or eliminated. However, many companies with a more domestic orientation do have tax rates close to the statutory level of 35%, and for these firms, a reduction to a 15%-25% tax rate would lead to a meaningful increase in earnings when fully phased in.

In our view, much of the rally in stocks post-election can be explained by investors attempting to selectively price in lower corporate tax rates, boosting the earnings outlook when looking ahead two or three years.

**S&P 500 Earnings Have Turned Higher, Supporting The Rally**

Over the past three years, S&P 500 operating earnings had made little net progress until now, mostly because pressure from lower energy and commodity sensitive earnings weighted on aggregate earnings per share (EPS) calculations. Also, in the second half of 2015 and early 2016, foreign currency translation became increasingly challenging for some multinationals.

As we’ve said, these negatives are in the process of getting better with pressure on affected company earnings bottoming out in the first half of 2016. And while the strong dollar remains an issue for some companies, the magnitude of negative pressure year over year is less severe than it was last year. We see a stronger dollar as a reality, and multinationals will simply have to manage through in the quarters ahead.

So the net of this is that S&P 500 earnings in the third quarter posted year-over-year growth of about 4.0%, a modest gain but the best quarter of growth since the fourth quarter of 2014. In our view, even before considering potential favorable legislative action from the new Administration, earnings may grow in the mid-to-high single digits in 2017, compared to 2016 given our plus 2% real growth/no recession base-case economic forecast.

If we assume some measure of corporate tax reform in 2017 and 2018 (there will be losers as well as winners), there is a potential for earnings to post a one-time increase in the 5%-10% range when fully implemented.
The "Cash Return" Case For Equities Remains Strong

Equities continue to have a strong “cash return” story, even with interest rates having moved higher since bottoming out in mid-summer. The S&P 500 sports a current yield of a little over 2.0%, a level which has been fairly consistent in recent years. Dividend increases have been running strong since 2011, with double-digit annual increases in payouts the norm.

However, 2016 saw a smaller increase of just 5.3% year over year, ending the streak of double-digit hikes since the end of the great recession. The main culprit in the lower growth is weak dividend performance from the energy sector, which saw a 15% year-over-year decline in dividends paid in 2016 versus the prior year.

On the other hand, technology has been a bright spot, with dividends rising 15% year over year, but not enough to keep the double-digit growth string at the index level intact. For 2017, we expect energy sector dividends growth will remain muted. We still expect dividend growth in the mid-to-high single digits, in line with expected operating earnings growth.

Share repurchases remain a bright spot in the cash return story. When net share repurchases are included, we see the effective yield of the S&P 500 to be above 4.0%. That is, cash dividends provide about 2.0%, while net share repurchases also provide about 2.0% via a reduction in the share count. With returns on cash close to zero, we believe buybacks are a good way to put excess cash to work without the risks associated with alternative uses such as mergers and acquisitions (M&As). Certainly, M&As can create long-term incremental value in many cases. However, M&As can also extend managements beyond core competencies.

We see little evidence that share repurchase activity this cycle has hindered capital expenditures in this slow growth environment. While the energy sector has seen lower spending, aggregate capital spending combined with research and development spending continues to support innovation and growth at many companies.

One wild card for 2017 and 2018 is that of cash repatriation, which many expect to be part of the tax reform plan of the new Administration. While estimates vary, we believe there is more than $1 trillion held overseas by US multinationals that could be repatriated to the US should a favorable tax rate be legislated.

What will companies do with repatriated cash? While some may forecast a further pick up in share repurchases, we think a balanced approach implemented over time, that includes share repurchases, cash dividends, mergers and acquisitions and capital spending, is the most likely scenario.

Many multinationals have added leverage in recent years to fund share repurchases. Therefore, it is not necessarily correct to assume that all repatriated cash can be promptly distributed to shareholders. But what is expected is that repatriation could be another positive in the investment case for equities, over and above other aspects of tax reform and the potential for faster GDP growth.
Sure There’s A Stock Rally, But What About Economic Growth?

If the new administration’s policies stimulate faster economic growth, that would be all for the better. However, we recognize this business cycle, which began back in 2009, has been steady but slow. Stocks have performed quite well in this backdrop, with the S&P 500 having an average annual return of over 14% during the past five years. Unemployment is low, and economic slack may be limited.

So while some analysts have sharply raised GDP growth forecasts for the coming quarters, we think there is some risk that investors may be getting ahead of themselves. We prefer a wait and see approach on the question of sustained faster real GDP growth above the current level of around 2.0%. Of course, to the extent growth surprises on the upside, the Fed may accelerate rate hikes, with consequences that cannot be fully anticipated in advance.

What About Global Equities?

Emerging market equities posted a strong year, although not quite matching the S&P 500. The recovery which commenced back in January was a critical positive in the global equity story in 2016. Still, from the September 2014 high to the January 2016 low, the MSCI Emerging Markets Index declined over 35% in dollar terms. As such, the three-year return remains negative, and the five-year return is barely positive. Time will tell if better performance is sustainable in 2017; fundamentals in China will have a lot to say about this given the approximate 35% weight of China and Taiwan stocks in this benchmark.

Europe and Japan have had their ups and downs in recent years, tending to perform better when the currencies weaken versus the dollar and decline when the currencies strengthen. Earnings in these regions have been a mixed bag, with financial and commodity sector earnings making little progress. For 2016, in dollar terms, these regions were roughly unchanged. And results over the past three years have been weak. A key to better sustained performance from these markets will be an acceleration in earnings growth. While consensus forecasts are optimistic for 2017, we have a relatively neutral view of these markets for now.

Of course, there are many excellent opportunities in non-US equities looking ahead. However we prefer a stock picking approach to these regions rather than employing a basket model.

We favor US equities relative to global markets for the first half because potentially fundamental developments on the legislative side in the US are expected to keep interest in US equities in number one place with global investors for the medium term.
Fourth Quarter Review

<table>
<thead>
<tr>
<th>INDEX TOTAL RETURNS (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>INDEX</td>
</tr>
<tr>
<td>S&amp;P 500®</td>
</tr>
<tr>
<td>MSCI ALL COUNTRY WORLD</td>
</tr>
<tr>
<td>MSCI EMERGING MARKETS</td>
</tr>
<tr>
<td>MSCI EUROPE</td>
</tr>
<tr>
<td>MSCI JAPAN</td>
</tr>
</tbody>
</table>

US equities were global leaders in the fourth quarter and in all of 2016. In dollar terms, Europe, Japan and emerging markets were all lower in the fourth quarter, with the strong dollar masking healthy gains in Europe (up 6.2%), and Japan, (up 15.0%), in local currencies. The post-election expectation for higher interest rates and stronger growth in the US has pushed the dollar higher. Central banks in Europe and Japan remain in easing mode. The dollar may remain firm in the first half of 2017 as investors await specific legislative actions of the new Administration.

For 2016, emerging markets nearly matched the S&P 500 return. After several years of steady pressure, several emerging market currencies firmed versus the dollar early in the year. And the recovery in key commodity markets, especially oil, was an important driver of better equity performance in commodity sectors. Technology and financial shares also performed very well.

Europe and Japan tend to perform better in local currency terms during periods of currency weakness versus the dollar. That was certainly the case in the fourth quarter. Currency-hedged strategies tend to have a performance advantage when returns are translated back into dollars because of the major trend of long-term dollar strength in place since 2011.

<table>
<thead>
<tr>
<th>INDEX TOTAL RETURNS (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>INDEX</td>
</tr>
<tr>
<td>RUSSELL 1000®</td>
</tr>
<tr>
<td>GROWTH</td>
</tr>
<tr>
<td>VALUE</td>
</tr>
<tr>
<td>RUSSELL MIDCAP®</td>
</tr>
<tr>
<td>GROWTH</td>
</tr>
<tr>
<td>VALUE</td>
</tr>
<tr>
<td>RUSSELL 2000®</td>
</tr>
<tr>
<td>GROWTH</td>
</tr>
<tr>
<td>VALUE</td>
</tr>
</tbody>
</table>

The fourth quarter was exceptional for the Russell 1000 Value, outperforming Growth by about 5.5%. Cyclical sectors led, powered by finance. The Russell 1000 Value index carries a finance weight just above 30% versus Growth with 10%. Financials rallied more than 17% in the fourth quarter. This was the key to Value’s outperformance. Industrial and energy stocks posted high single-digit gains. Value is now even with Growth on a three- and five-year performance comparison. The Growth style has tended to outperform Value in recent periods until now.

Russell 2000 Value’s outperformance was more impressive, topping Growth by over 10% in the quarter, and returning over 30% for 2016. Financials in Small Value carry a weight of over 40%. Within Small Value, healthcare was the only sector to return less than double digits for the full year.

Small caps often have a higher domestic revenue percentage than large caps; many have higher tax rates as well. As such, they may be better positioned for faster domestic growth and corporate tax reform. Also, small caps are less liquid and subject to larger moves than the large caps in both directions when sentiment shifts on the economy. The Russell 2000 total public float is only 10% as large as that of the S&P 500.

Data Source: FactSet. Past performance is no guarantee of future results. All returns quoted in US dollars. Performance for one and multi-year periods is annualized.
In the quarter, the financial sector was the story for both the S&P 500 and the Russell 2000. The prospect of higher interest rates, stronger growth and less onerous regulation led to expanding valuations.

Among the large caps, the fourth quarter was mixed at the sector level. Traditional defensive sectors such as staples, healthcare and the newly carved-out real estate sector posted modest losses. The rise in interest rates late in 2016 was certainly a factor in the relative underperformance of dividend oriented and “slow but steady” stocks that were so much in favor in the first half of the year.

The Russell 2000 performed exceptionally for the quarter and year. Finance, energy, materials and industrials posted double digit returns. Healthcare continues to struggle with political risk and pricing concerns weighing on sector performance.

Last year was an exceptionally volatile year for small caps as the Russell 2000 rallied nearly 50% from the February, 2016 low to the mid-December yearly high. The recovery in economically sensitive sectors across the market-cap spectrum has been a major support to investor confidence. This year begins on far stronger footing in terms of balanced sector performance than we saw one year ago.
Disclosure

All data as of December 31, 2016, unless otherwise noted.

This commentary is provided for informational purposes only and should not be construed as investment advice. Any opinions or forecasts contained herein reflect the subjective judgments and assumptions of the authors only and do not necessarily reflect the views of Loomis, Sayles & Company, L.P., or any portfolio manager. Investment recommendations may be inconsistent with these opinions. There can be no assurance that developments will transpire as forecasted and actual results will be different. Data and analysis do not represent the actual or expected future performance of any investment product. We believe the information, including that obtained from outside sources, to be correct, but we cannot guarantee its accuracy. The information is subject to change at any time without notice.

Past performance is no guarantee of future results.

This is not an offer of, or a solicitation of an offer for, any investment strategy or product. Any investment that has the possibility for profits also has the possibility of losses.

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

LS Loomis | Sayles is a trademark of Loomis, Sayles & Company, L.P. registered in the US Patent and Trademark Office.

Index Definitions

**Standard & Poor’s (S&P 500®) Index** is a market capitalization-weighted Index of 500 common stocks chosen for market size, liquidity, and industry group representation to measure broad US equity performance. S&P 500® is a registered service mark of McGraw-Hill Companies, Inc.

**MSCI All Country World** is a market cap weighted index of stocks from developed and emerging markets providing a broad measure of global equity-market performance.

**MSCI Europe** is a free float-adjusted market cap index measuring equity market performance of the large and mid cap segments across European developed markets.

**MSCI Japan** is a free float-adjusted market cap index measuring equity market performance of the large and mid cap segments of the Japanese market.

**MSCI Emerging Markets Index** is a free float-adjusted market cap index measuring equity market performance of emerging markets.

**Russell 1000® Index** measures the performance of the large cap segment of the US equity universe. It is a subset of the Russell 3000 Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership.

**Russell 1000® Growth Index** measures the performance of the large cap growth segment of the US equity universe. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

**Russell 1000® Value Index** measures the performance of the large cap value segment of the US equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values.

**Russell Midcap® Index** measures the performance of the mid cap segment of the US equity universe. The Russell Midcap is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership.

**Russell Midcap® Growth Index** measures the performance of the mid cap growth segment of the US equity universe. It includes those Russell Midcap Index companies with higher price-to-book ratios and higher forecasted growth values.
Russell Midcap® Value Index measures the performance of the mid cap value segment of the US equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted growth values.

Russell 2000® Index measures the performance of the small cap segment of the US equity universe. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

Russell 2000® Growth Index measures the performance of the small cap growth segment of the US equity universe. It includes those Russell 2000 Index companies with higher price-to-value ratios and higher forecasted growth values.

Russell 2000® Value Index measures the performance of small cap value segment of the US equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

Russell Investment Group is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is a trademark of Russell Investment Group.