US stocks have performed reasonably well through June, with small back-to-back gains in the first two quarters. Performance has been better than we anticipated back in February, when the S&P 500® Index touched a low and was down over 10%. The three factors contributing to this performance were the rally in oil prices, a pullback in the US dollar and ongoing efforts by central banks to spur growth. We believe the bull market is intact, although given the advanced age of the rally and sluggish global growth, returns are likely to be confined to single digits. This would still be considered an excellent outcome in this low inflation and low interest rate environment.

We began 2016 with the possibility of four rate hikes this year. Many feared the global economy was not strong enough to withstand that many hikes. As investors priced in this possibility, the US dollar continued to strengthen, putting pressure on US companies that do business overseas. Fortunately, the Federal Reserve (the Fed) has pulled back from the scenario of multiple rate hikes. Post-Brexit, it is anyone’s guess when the Fed will be in a position to hike rates again after the lone initial hike in December 2015.

US growth disappointed in the first quarter, although incoming data suggests that the second quarter was stronger. In fact, the US employment report for June showed an acceleration in jobs growth following a weak May report. It will take several months of better results for rate hikes to be back on the table.
Fundamentals outside the US are not as strong. The Brexit decision may lead to a recession in the UK later this year and contribute to a slowing in Europe. While Europe had picked up slightly, it will take time for conditions in Europe to sort themselves out, perhaps measured in quarters or years.

Growth in Japan has disappointed. The recent sharp rise in the yen versus major currencies has weighed on Japan’s exporters and lowered earnings forecasts for many companies. Both Europe and Japan equities have posted mid-single-digit losses in US dollar terms year to date.

Stocks in China were off marginally in the second quarter. They have remained firmly lower over the past year as growth prospects remain under a cloud and there is uncertainty over the currency as the government continues to inject stimulus. Emerging market equities (excluding China) have been a bright spot this year, led by a recovery in Latin America, particularly Brazil. It will take more time to convince investors that emerging market equities are back on track for the longer term; however, recent outperformance may reflect a recovery in energy prices rather than a long-term change for the better.

Taken as a whole, the US remains a region with one of the most durable fundamental outlooks, which is reflected in S&P 500 outperformance.

**S&P 500 Earnings Should Turn Up in the Second Half of 2016**

When looking at the progress of S&P 500 earnings over the past few quarters, it is easy to see why stocks in aggregate have made little progress. S&P 500 operating earnings per share were roughly flat in 2015 compared to 2014 and we do not expect much growth in earnings this year either.

The median S&P 500 company continues to report low- to mid-single-digit earnings growth. By contrast, the top quartile S&P 500 company is reporting double-digit earnings growth. While there are winners in terms of earnings and revenue growth, the economy has not been strong enough to generate positive results across the board.

During more normal times, the energy sector typically contributes more than 10% of index earnings. In 2016, we believe the contribution will be well below 5% of index earnings. The financial sector is also having a challenging stretch, with earnings down about 15% year over year in the first quarter. Financials have been aggravated by weak capital markets and low net interest margins, but the recovery in commodity markets has eased fears over credit quality.

S&P 500 earnings were down 5.2% year over year in the first quarter. With second quarter reporting on tap, analysts expect a year-over-year decline of 4.4%. We would not be surprised to see earnings come in a little better than that, but it will be another down quarter. Looking ahead, analysts have third quarter earnings fractionally higher than one year ago. If the economy does not stumble, commodity prices maintain their nascent recovery and slowing in Europe can be contained, an acceleration to mid-single-digit growth in the fourth quarter seems entirely plausible.
If earnings per share begin to turn positive again and investors begin to discount the prospects of mid-single-digit or better growth in 2017, we will have the foundations to propel stocks higher. In fact, the touching of a record high by the S&P 500 in early July is a welcome development and a sign investors may be accepting a more constructive fundamental outlook. For those who firmly believe that earnings growth drives stocks, the path to new highs is clear—beginning and ending with better growth.

The Case for Equities Remains Constructive

For investors seeking returns in the mid- to high-single-digit range over a full market cycle, there are few other alternatives to investing in equities. The dividend story remains positive, even though 2016 will mark the end of the S&P 500’s multiple years of 10%+ dividend growth (in part due to reduced payouts in the energy sector). The S&P 500 is yielding more than 2% today. While modest, this is higher than the yield available on most sovereign debt, some of which are offering negative yields.

We think the effective yield of the S&P 500 is above 4%—about half from cash dividends and the other half from the positive effect of net share repurchases lowering the outstanding share count. With returns on cash at essentially zero, buybacks are a good way to put excess cash to work without the risks associated with alternative methods, like mergers and acquisitions (M&A). We maintain our view that cash dividends can grow in the mid-single-digits annually on a sustainable basis.
GLOBAL EQUITY MARKETS
as of June 30, 2016

Second Quarter Review

INDEX TOTAL RETURNS (%)

<table>
<thead>
<tr>
<th>INDEX</th>
<th>3 MO</th>
<th>YTD</th>
<th>1 YEAR</th>
<th>3 YEAR</th>
<th>5 YEAR</th>
<th>10 YEAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500®</td>
<td>2.46</td>
<td>3.84</td>
<td>3.99</td>
<td>11.66</td>
<td>12.10</td>
<td>7.42</td>
</tr>
<tr>
<td>MSCI ALL COUNTRY WORLD</td>
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<td>6.60</td>
<td>5.95</td>
<td>4.82</td>
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<tr>
<td>MSCI EMERGING MARKETS</td>
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<td>6.60</td>
<td>-11.71</td>
<td>-1.21</td>
<td>-3.44</td>
<td>3.88</td>
</tr>
<tr>
<td>MSCI EUROPE</td>
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<td>-10.67</td>
<td>2.52</td>
<td>1.62</td>
<td>2.13</td>
</tr>
<tr>
<td>MSCI JAPAN</td>
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<td>-5.41</td>
<td>-8.64</td>
<td>3.00</td>
<td>4.45</td>
<td>0.33</td>
</tr>
</tbody>
</table>

Longer-term outperformance of US equities has been substantial, and the S&P 500 posted a respectable gain in the second quarter. This is even as the Brexit vote of June 23 was followed by the largest losses over a two-day period in global equity value in US dollar terms in history...before a massive recovery into the end of the quarter.

The MSCI All Country World Index edged higher, with emerging market equities making a positive contribution for the quarter and year to date. Early signs of potential policy reforms in South America have been a positive catalyst and Latin American currencies have firmed up versus the dollar. China equities on the other hand have been weak all year. The recovery in energy and basic materials shares since February has been a key driver for sentiment toward emerging market equities.

Currency movement played a major role in equity performance in US dollar terms in the quarter. For example, the MSCI Japan Index in dollars posted a small gain for the quarter and only a moderate decline of 5.4% for the year. However, in yen terms, equity performance has been much worse. The MSCI Japan Index in yen fell nearly 8% in the quarter and is down nearly 20% for the year to date. Lack of progress of the Japan economy coupled with a strong flight-to-quality rally in the yen has significantly pressured the earnings outlook of Japan’s key exporters.

Europe is a complex story as a moderately weaker euro versus the dollar meant in US dollar terms that Europe equities were down for the quarter. In euro terms, however, the MSCI Europe Index posted a fractional gain. All global markets recovered dramatically following the initial Brexit spasm. Even UK equities were about flat in US dollar terms in the second quarter, although the pound did weaken after Brexit. In local currency terms, UK stocks rose nearly 7% in the second quarter and also for the year to date.

Value indices have assumed a lead over growth indices this year across the market cap spectrum. On a longer-term basis, growth maintains a performance advantage. 2016 has been challenging in many respects, with the positive inflection in the energy sector in the first quarter coupled with dramatically lower interest rates among the keys. Investors have demonstrated a strong preference for dividend-oriented equities. This has provided a tailwind to value indices as the indices tend to have a higher weight in income-oriented equities.

Small- and mid-cap shares outperformed modestly for the quarter. In fact, mid caps are the top index class year to date. Small cap growth was down modestly in the second quarter, the only index posting a decline for the period. Index composition across the capitalization spectrum can be a source of much differentiation. For example, the Russell 2000® Growth Index healthcare sector was down nearly 15% for the quarter and is highly weighted (22%) in the index. Within the Russell 1000® Value Index, healthcare was up over 9%, reflecting the stable, high-quality dividend payers in the value index in contrast to a biotechnology-heavy and recently underperforming weighting in small cap growth.

On a longer-term basis, small caps have underperformed large caps. In this slow-growth environment, the economy has not been strong enough to generate small-cap leadership. This environment has favored large caps with strong balance sheets and the ability to complement dividend payments with share repurchases as well.

Data Source: FactSet. All returns quoted in US dollars. Performance for one and multi-year periods is annualized. Past performance is no guarantee of future results.
The recovery of the S&P 500 energy sector this year has been remarkable. It was the top sector for the quarter and the third-best year to date. This contrasts with the fact that on a one-year basis the sector is negative! Large cap energy stocks, in contrast to some of the smaller caps, have relatively high and safe dividend yields, and additionally are benefiting from the recovery in commodity prices. Utilities and telecom have also been very strong due to the attractiveness of their yields, although the combined weight of these two sectors is less than 7% of the S&P 500 overall.

Index returns have been held back by weak performance in consumer discretionary. Among other concerns, we see that brick and mortar retailers continue to be challenged by online competitors. Technology had a weak quarter and has made no progress this year. On the other hand, consumer staples have been dependable performers all year across the market cap spectrum, supported by an active M&A environment as well as stable fundamental prospects. Many consumer staples companies may be positioned to benefit from a somewhat weaker US dollar compared to the past few quarters.

It was good to see healthcare generate respectable results in the quarter, but political crosscurrents and questions about future pricing power have held back the sector for over a year now. Post-election, we should have a better sense of the outlook for the sector from a regulatory perspective.
Disclosure

All data as of June 30, 2016, unless otherwise noted.

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**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.

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**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.

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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.

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