

**July 1, 2016**

## MARKET LEVELS

	Friday*	Last week	Dec. 31, 2015	One year ago
Dow Jones Industrial Avg	17,991	17,401	17,425	17,730
S&P 500	2,108	2,037	2,044	2,077
NASDAQ	4,878	4,708	5,007	5,009
Russell 2000	1,159	1,128	1,136	1,248
DJ STOXX Europe 600 (€)	333	322	366	385
Nikkei Index (¥)	15,682	14,952	19,034	20,523
MSCI EM Index	425	415	411	462
Fed Funds Target	0.25%-0.50%	0.25%-0.50%	0.25%-0.50%	0.00%-0.25%
2-Year Treasury Yield	0.59%	0.63%	1.05%	0.63%
10-Year Treasury Yield	1.46%	1.56%	2.27%	2.38%
U.S. \$ / Euro	1.11	1.11	1.09	1.11
U.S. \$ / British Pound	1.33	1.37	1.47	1.56
Yen / U.S. \$	102.66	102.22	120.22	123.07
Gold (\$/oz)	\$1,336.67	\$1,315.45	\$1,061.42	\$1,166.20
Oil	\$48.12	\$46.94	\$37.04	\$56.93

*\*Levels reported as of 7:55 a.m. PDT*

## MARKET RETURNS

Year-to-date (12/31/15 – 07/01/16)\*

Year-to-date (12/31/15 – 06/30/16)

Dow Jones Indus Avg.	4.69%	90 Day T-Bill	0.16%
S&P 500	4.31%	2-Year Treasury	1.33%
NASDAQ	-1.89%	10-Year Treasury	7.95%
Russell 2000	2.87%	ML High Yield Index	9.20%
MSCI World Index	-0.58%	JPM EMBI Global Diversified	10.31%
DJ STOXX Europe 600	-6.57%	JPM Global Hedged	6.92%
MSCI EM Index	3.45%		

*\*Returns reported as of 7:55 a.m. PDT*

## RECAP OF THE WEEK'S ECONOMIC RELEASES

Date	Report	Survey	Actual	Prior	Details
06/29	(US) PCE Core YoY	1.60%	1.60%	1.60%	US core PCE inflation picked up slightly during May, but it still remains below the Fed target.
07/01	(EC) Unemployment Rate	10.10%	10.10%	10.20%	Eurozone unemployment fell further to its lowest level since July 2011.
	(US) ISM Manufacturing	51.3	53.2	51.3	US ISM manufacturing index recovered to levels last seen in June 2015.

## ECONOMIC OVERVIEW

This week the fallout from Brexit continued to work its way through the market. Uncertainty about the outcome of the UK's historic decision remains high. In a speech given on Thursday entitled, "Uncertainty, the economy and policy," Mark Carney, governor of the Bank of England, made clear his views on the deleterious effects of uncertainty. Carney reviewed measures suggesting that uncertainty across UK politics and the economy have been elevated and rising since 2008. His musings resulted in the guidance that "some monetary policy easing will likely be required over the summer." After an initial assessment at the July meeting, the Monetary Policy Committee, in Carney's view, will most likely offer its policy remedy in August. Whether the Bank of England cuts rates 25 basis points, announces additional asset purchases or both, markets cheered the news. Some segments of the global equity markets erased nearly all Brexit-related losses, while global bond market yields reposed at or near historic lows across the developed world.

## US MARKETS:

### TREASURIES

- The Treasury market definitely doesn't like uncertainty and that's exactly what we have from the fallout of Brexit. The truth is no one really knows what happens from here but we probably will not see accelerated growth which the global economy so desperately needs. That uncertainty will continue to benefit government bonds and dips will continue to be bought until one of the major central banks announces the next round of easing.
- That happened on Thursday when comments from the Bank of England's Carney suggested that the bank will most likely need to cut rates this summer. 10-year and 30-year Treasuries hit record low yields on Friday as the global story becomes a bull flattening move/reach for yield rather than pricing out the Fed. Turning to Fed pricing, the implied probability of one 25 basis point interest rate hike by the end of 2017 (not 2016) sits at 40%. Positioning across the curve is long (with some exceptions) according to the JPM survey (longest since 2010) as managers continue to be "stopped into" positions rather than short coverings. Near off-the-run securities were hit the hardest on the implied Treasury curve as asset managers moved into currents, especially in 5s-10s.

### LARGE-CAP EQUITIES

- The U.S. Equity Market unexpectedly rose for the week as fears of a post-Brexit tantrum failed to materialize. Broad equities staged a dramatic recovery from Monday's lows, helped by increased M&A activity, after posting three consecutive days of greater than 1% gains. The S&P 500 index ended the week up 3.3%, which snapped a streak of three consecutive weekly losses. The Dow Jones Industrial Average and NASDAQ Composite indices also ended the week up approximately 3.3%. Large-cap stocks

outperformed small-cap stocks. In terms of style, large-cap growth stocks outperformed large-cap value stocks. All sectors finished higher for the week with health care and consumer staples the best performers, while materials and info tech lagged.

- In fund flow news, domestic equity mutual funds continued to face redemptions as Lipper reported investors redeemed \$288 million for the week. This was the 21st consecutive week of redemptions, but the smallest in the last four months. International equity mutual funds also saw redemptions with investors redeeming \$2.4 billion for the week.

## **CORPORATE BONDS** \_\_\_\_\_

- After the announcement of Brexit, the primary market took a break for a few days while spreads recalibrated and rates rallied. But on Tuesday some spirit finally returned to the market and issuance finally picked up its pace. Only \$10-\$20 billion was expected for the week, but Wednesday alone totaled more than \$20 billion and priced \$24 billion on the week. The biggest deal of the week was \$14 billion issued by Oracle on Wednesday across five tranches. Oracle had surprisingly little demand given the trickle of new paper in the market of late – tranches averaged just 2.3x subscription, below the typical mega deal's demand. Given the moderate demand, bonds priced 10 basis points inside of initial price talk and tightened another 5-10 on the break.
- In corporate news, Brexit has had large implications for many companies in the UK. European and especially UK Banks have underperformed the rest of the corporate market as investors fear economic weakness due to the vote. Meanwhile, some companies are wary of the unknown and are holding off on investments in the UK, considering redomiciling to other countries, and cutting UK jobs. The Corporate Index Option-Adjusted Spread (OAS) finished the week at +156, four wider on the week. This was a much smaller move than some had expected for a Brexit outcome. Overall metals/mining were eight wider; energy was five wider. Senior financials were 10 wider and subordinated financials were 12 wider. Industrials were four wider and utilities were wider by three.

## **MORTGAGE-BACKED SECURITIES** \_\_\_\_\_

- Agency mortgages lagged US Treasuries as long-term rates drifted lower into uncharted territory. The fallout from Brexit has been a downgrade of global growth forecasts and dovish tendencies by central banks. Lower interest rates from this point is bad for the mortgage market as refinancing risk leads to price compression for the outstanding mortgage universe. Prepayment speeds were expected to be faster but now the concern is a major refinance tsunami is on the horizon. Despite the sound of alarm bells, mortgage investors did enjoy higher prices as consolation. Within the market, conventionals trumped Ginnie Mae MBS. 15-year MBS put on a good performance versus 30-years on a hedged adjusted basis. Mortgage originations remain tame as borrowers focus on the July 4th holiday versus interest cost savings. That may change next week if the trend continues.
- For the week, the 30-year current coupon versus the 10-year US Treasury widened by four basis points to 88 basis points. According to Freddie Mac, the 30-year mortgage rate edged lower to 3.48%.

## **ASSET-BACKED SECURITIES** \_\_\_\_\_

- Brexit had little if any impact on short on-the-run ABS, and limited impact on lower rated ABS and CLOs. The much anticipated inaugural Verizon smartphone ABS deal is scheduled for announcement on July 11th. It will be 144a, with a 2-year revolving period (no principal, interest only) followed by a 1-year principal amortization period. The weighted average life is anticipated to be 2.5 years. S&P and Fitch are expected to rate the senior class AAA/AAA and the subordinated class AA/AA. The A-rated class will be retained. Official price talk to follow.

- Year-to-date performance is in line with expectations with the BAML ABS index returning 1.94%, the BAML 1-3 year Corporate AAA-A index returning 1.93% and the BAML 1-3 Treasury index returning 1.43%. In CLOs, AAAs returned 1.26% and BBBs returned 0.56% according to the JP Morgan CLOIE index.

## **MUNICIPAL BONDS** -----

- The municipal market has historically lagged periods of sharp movements in interest-rates. However, municipal yields reacted strongly in sympathy with the post-Brexit rally in Treasuries; demonstrating the inclusion of munis in the flight-to-safety bid and underpinning the strength of the technical environment.
- Activity this week has been spotty as some participants rush to soak up cash while others remain less convinced in the sustainability of the recent rally in interest-rates. This was also the case for new issue deals as some deals saw heavy participation while others were lighter. The market saw a number of taxable deals once again this week which were easily absorbed as supply continues to lag demand.
- This week could mark a milestone as Puerto Rico is likely to miss its first General Obligation debt service payment due on July 1. The widely anticipated debt restructuring legislation, called PROMESA, was signed into law on Thursday. While the legislation eliminates some of the potential for chaos, it will do nothing to avoid a default this week. We continue to anticipate little reaction in the broader market as a result of this occurrence but continue to monitor it closely.

## **HIGH-YIELD BONDS** -----

- The BofA Merrill Lynch BB/B cash pay constrained index was down +0.73% this week as spreads tightened by nine basis points to an option-adjusted-spread of +499 basis points. The BofA Merrill Lynch BB/B index that excludes utilities and energy was up +0.67% for an OAS of +484 as the spread of that index also tightened by nine basis points. The BofA Merrill Lynch Euro BB/B constrained index was up +0.67% as the spread of that index tightened by eight basis points for an OAS of +438.
- The high-yield market traded lower and wider along with other risk markets on Friday of last week and on Monday of this week after the surprising “Leave” outcome of the Brexit vote. The selloff on Friday in high-yield was described by most as orderly as those trying to shed risk found ready buyers looking to deploy cash or cover shorts, albeit at lower levels than sellers would have preferred. Finding clearing levels for trades was problematic throughout the trading session and the result was lower than average secondary trading volumes in cash bonds as \$11 billion traded on Friday versus a year-to-date daily average of \$12.9 billion.
- Monday saw more selling and high-yield move lower with underperformance noted in credits with exposure to the British Pound and Britain in general. Trading volumes were lower despite the volatility as the price mismatch between buyers and sellers exacerbated as \$10.3 billion in bonds changed hands and the market closed at the lows of the day.
- Tuesday saw the beginning of a relief rally which continued throughout the week and into the early market close on Friday ahead of the long Fourth of July holiday weekend. The tone of the market saw a sharp reversal from the fear and apprehension of Friday and Monday as buyer's rushed back in and drove prices higher and most high-yield bonds recovered all the losses of the short lived Brexit breakdown. Fears of an extended selloff were replaced by the more standard dynamic of this past quarter of accounts trying to source bonds and spend down cash as the high-yield new-issue calendar is currently bare and dealer inventories continue to be low.
- The final new issue tally for June was \$30 billion during a busy first three weeks as the new issue market has been dormant since 6/20. This leaves May as the active month for new issue in 2015 as \$41.8 billion was priced. High-yield new issuance year-to-date stands at \$155.3 billion and the pace is 19% less than at the halfway point for the year in 2015.

- Fund flows were negative for the third consecutive week as \$1.6 billion left the asset class for the reporting week that ended Wednesday 6/29. Flows reversed course later in the week and Thursday saw an estimated positive flow of \$878 million back into the high-yield market. Year-to-date inflows for high-yield mutual funds total \$3.6 billion as compared to an inflow of \$1.1 billion at this time in 2015.

## INTERNATIONAL MARKETS:

### GLOBAL BONDS AND CURRENCIES

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- After markets digested the initial shock of the outcome of the UK's EU referendum on Monday, a relatively calmer tone prevailed during the rest of the week. Developed government bonds benefitted at first from the risk-off environment that ensued following the unexpected British vote to leave, but gave up some of the gains later in the week after the initial Brexit concerns subsided.
- In Europe, the rally in government bond prices came to a halt after European equity prices, and financials in particular, stabilized somewhat. The benchmark 10-year Bund yield finished the week only marginally lower by 1 basis point, while peripheral European spreads to Bunds tightened. UK Gilts outperformed European bonds after Bank of England's Governor Carney laid the ground for further monetary stimulus, as well as an interest rate cut, this summer. The recent UK credit rating cut by S&P from AAA to AA additionally weighed on risk appetite and Gilt yields touched record lows across the board. The March 2018 Gilt touched negative territory for the first time, while the yield on the 10 year note finished the week 6 basis points lower after touching a new record low earlier in the week.
- In the currency markets, the UK pound took center stage again; sterling lost some serious ground against all major currencies early on Monday but recouped some of the losses by mid-week. However, Mark Carney's statement on Thursday sent the pound tumbling again as investors priced in the likelihood of a rate cut in the UK before the end of the summer. The euro rose against the US dollar and Japanese yen as risk appetite returned to the market. As risk sentiment improved, the Japanese yen lost some ground against the greenback on the week.

### EMERGING-MARKET BONDS

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- Emerging market (EM) dollar-pay spreads widened 8 basis points (bps) to 388 bps over US Treasuries, while local debt yields fell 14 bps to 6.28%. EM currencies were generally stronger against the US dollar, with the Brazilian real strengthening by 5.3% following the publication of the central bank's inflation report which was interpreted as hawkish. The Mexican peso also appreciated significantly (+4.2%) following a central bank hike. The weakest performers over the period included the Chinese renminbi (-0.5%) and the Argentine peso (-0.6%).
- Argentina released a much-anticipated revision to its GDP series which indicated that growth increased by 0.5% y/y in Q1-16. Under the last administration, Argentine statistics were believed to be misreported due to political pressures. In Vietnam, second quarter GDP printed +5.6% y/y. After registering an expansion of 6.7% y/y in 2015, economic activity slowed in H1-16 (5.5% y/y) on a drought which weighed on the agricultural sector. In China, high frequency PMI manufacturing data was released, exhibiting a slightly weaker outturn relative to May. The Caixin and official PMI readings registered 48.6 and 50.0, respectively.
- Turning to monetary policy, the central bank of Mexico (Banxico) surprised markets by hiking 50 bps points, leaving its policy rate at 4.25%. In its statement, Banxico underscored the risks of pass through—associated with sharp peso depreciation—on inflation expectations. In the Middle East, the central bank of Israel (BOI) left its policy rate at 0.1%, in line with expectations. The BOI has been on hold since February 2015.
- In other news, Indonesia passed a tax amnesty bill which will be implemented over the next nine months. The move was greeted positively by markets given the country's low tax burden. Separately, Mongolia held parliamentary elections this week, with the Mongolian People's Party (MPP; social democrats) winning a

solid victory; it garnered 65 out of 76 seats in the parliament. The MPP ran on a platform of fiscal responsibility and reinvigorating foreign direct investment (FDI).

- In Turkey, the terrorist attack at Ataturk International Airport dominated headlines; it is expected to weigh further on the country's tourism sector which has suffered in the last year due to increased concerns about security. In other political developments, Turkish President Erdogan moved to normalize the country's relationship with Russia and Israel.

## HIGHLIGHTS OF NEXT WEEK'S ECONOMIC RELEASES

Date	Report	Consensus	Last
07/04	(EC) PPI YoY	-4.10%	-4.40%
07/05	(EC) Retail Sales YoY	1.70%	1.40%
	(US) Durable Goods Orders	-2.20%	-2.20%
	(RU) CPI YoY	7.40%	7.30%
07/06	(US) Markit US Composite PMI	--	51.2
	(US) ISM Non-Manf. Composite	53.3	52.9
07/07	(GE) Industrial Production WDA YoY	1.50%	1.20%
	(UK) Halifax House Prices MoM	0.30%	0.60%
	(UK) Halifax House Price 3Mths/Year	7.80%	9.20%
	(UK) Industrial Production YoY	0.50%	1.60%
	(UK) Manufacturing Production YoY	0.60%	0.80%
	(US) ADP Employment Change	156k	173k
07/08	(UK) Unit Labor Costs YoY	1.60%	1.30%
	(CA) Unemployment Rate	7.00%	6.90%
	(US) Change in Nonfarm Payrolls	180k	38k
	(US) Change in Private Payrolls	170k	25k
	(US) Unemployment Rate	4.80%	4.70%
	(US) Average Hourly Earnings YoY	2.70%	2.50%
	(US) Average Weekly Hours All Employees	34.4	34.4
	(US) Labor Force Participation Rate	--	62.60%
	(US) Underemployment Rate	--	9.70%