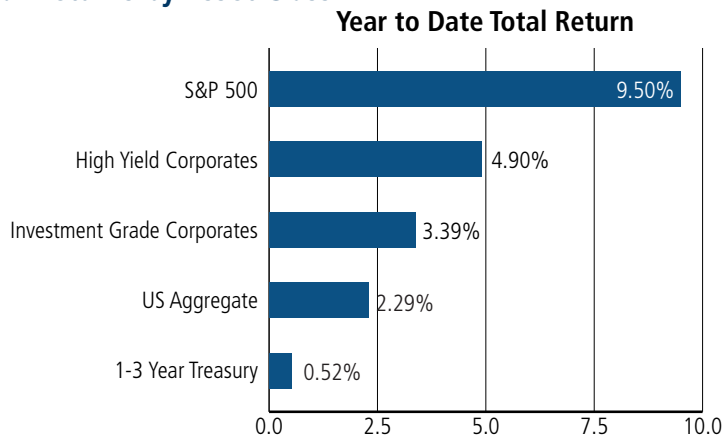
Week Ending **June 2, 2017**

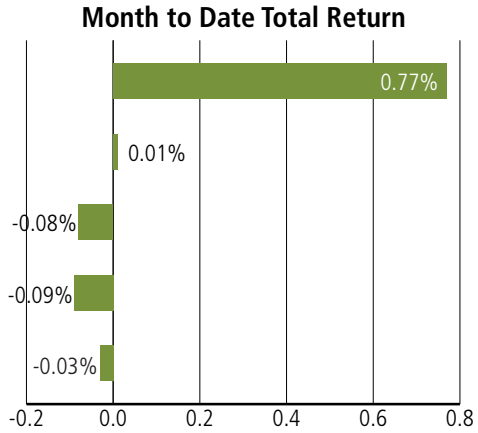
The Rock in the Fed's Shoe

Economic Overview:

Have you ever found yourself ambling on a beautiful day without a care in the world only to be interrupted by a pesky pebble in your shoe? Disappointing reads on inflation are the proverbial pesky pebble in the Fed's otherwise care-free shoe. With the unemployment rate below its "natural rate" and core PCE on an upward trend throughout 2016, the Fed felt confident hiking interest rates. However, core PCE peaked at 1.8% in January 2017 and has since stumbled back to 1.5%. Will this pebble ruin the Fed's hiking plans? We doubt it. In the words of Fed Governor Lael Brainard this week, "if the lack of progress on inflation persists, it may lead me to reassess the expected path of policy in the future—although it's premature to make that call today." The recent strength in the labor market makes a June rate hike likely. As for the rest of the year? The trajectory of the chart above may dictate that outcome.

Total Returns by Asset Class





Highlights of the Week:

- **Treasuries:** Treasuries tested and found support at 2017 yield lows (2.15% on 10's and 1.70% on 5's) with a weaker headline non-farm payroll number and revisions lower for the previous two months. Average hourly earnings were in line with expectations. However, earnings have continued to trend lower since the start of the year. Curves have continued to flatten. Fed policy dot plots and rate hike expectations are being challenged aggressively with a June hike priced at almost 100%. After that, the market believes the Fed is done for the year, and only one hike is priced in for 2018.
- **Corporates:** May was a month of heavy issuance totaling $154 billion, made up of many deals over $5 billion in size. Still, this was below May 2016 when $168 billion was issued. Between this and a busy first quarter, total issuance is still 2% ahead of issuance at this point last year.
- **Equities:** Equities rallied this week with the S&P 500 breaking to new all-time highs on positive investor sentiment despite lackluster macroeconomic data and headlines. This was the first week in over a month where small cap stocks outperformed large cap stocks.
- **Emerging Markets:** With inflation falling to the slowest pace in almost ten years, Banco Central do Brasil cut the Selic rate a further 100 basis points to 10.25%. However, amid the recent increase in political noise, the central bank signaled that the outlook for policy reforms had become less certain, and stated that the pace of monetary easing may need to be reduced going forward. Echoing concerns about the country's reform momentum, Moody's moved the outlook on Brazil's Ba2 credit rating to negative, from stable.
- **Securitized Products:** Despite concerns around retail, the commercial mortgage-backed market readily digested debt on Del Amo Mall, located in Torrance, CA. The mall's revenue stream has been diversifying with an expansion of quality dining and entertainment options to complement its retail mix. This resulted in robust demand for the $185 million CMBS, a partial piece of the entire first mortgage loan. The balance of the $585 million first mortgage will be issued in future CMBS deals.
- **High Yield:** Frontier Communications and Hertz both face operational challenges. Nonetheless, each issued more than $1 billion this week to refinance their short-maturity debt in deals that were well-received by the market. As markets remain open to issuers seeking to improve balance sheet flexibility, we expect default rates to remain low over the intermediate-term.
- **Currencies:** With less than a week to go until the snap general election in the UK, the previously anticipated triumphant victory of Theresa May has now become much more questionable. After the latest polls indicated shrinking support for the incumbent Prime Minister, investors quickly reassessed their foreign exchange bets resulting in the sterling experiencing some volatility this week. While the polls still indicate a likely Tory majority, the prospect of the elections weakening Mrs. May's position, should she win fewer seats than originally forecast, is likely to undermine the pound ahead of polling day.
- **Municipals:** Municipal bond funds experienced minimal outflows of $51 million, after seven consecutive weeks of inflows that added $3.6 billion to muni funds. Municipal performance remains strong, with ratios to U.S. Treasuries at YTD lows for all key benchmark rates. The municipal yield curve continues to flatten, as investors look to attain the maximum available yield and strong new issue demand compresses credit spreads.