Week Ending **January 6, 2017**

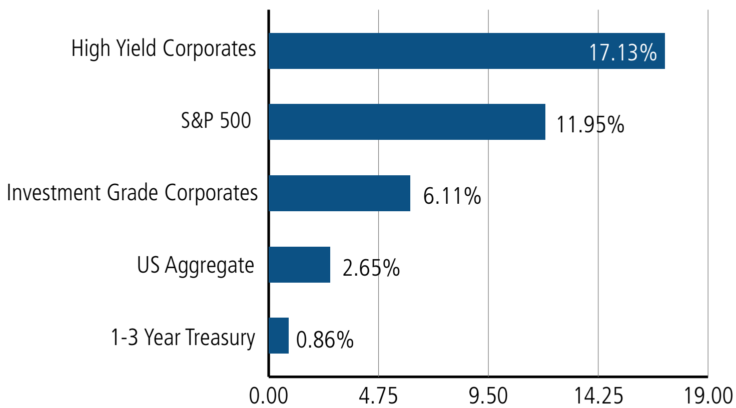
Deflation Fears Subside

Economic Overview:

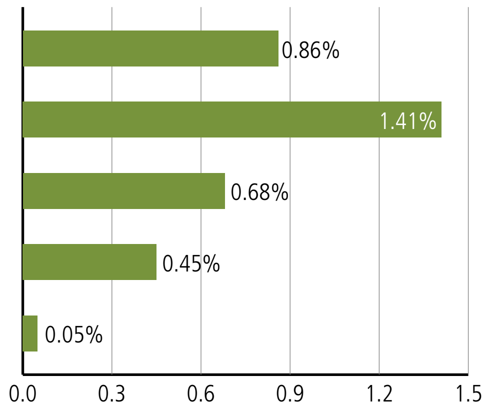
At long last Europe may escape the clutches of deflation, or so the data suggest. This week's release of German CPI data surprised the market, with year-over-year price gains of 1.7% compared with just 0.4% in December a year ago. Energy prices are to blame for at least some of the surge. Core measures of inflation, which exclude food and energy, have hovered around 1% for the better part of the last decade and show little sign of surging. That said, the downward price pressures appear to be waning and along with them the haze of global deflationary pessimism.

Total Returns by Asset Class

2016 Year to Date Total Return



Month to Date Total Return



Highlights of the Week:

- **Treasuries:** Treasuries started the new year by rallying 15 basis points (bps) due to positioning and lack of confidence in the timely enactment of President-elect's Trump policies. Mixed FOMC minutes and slightly lower headline nonfarm payroll figures did not allow the rally to continue. Stronger average hourly earnings and positive revisions to prior months payroll reports had Treasuries retrace the yield move from earlier in the week by approximately 50%. The 5/30 yield curve remained flatter and close to the lows of the past 12 months at 107 bps. Two rate hikes are currently 100% priced in for 2017, with the Fed's "median dot" signaling three hikes.
- **Equities:** The new year kicked off with a new record high for US equities fueled by risk-on sentiment. However, brick-and-mortar Macy's and Kohl's, which have been facing increased competition from e-commerce, stumbled out of the gates as weak holiday sales sent shares of M and KSS down by more than 13% for the week.
- **Corporates:** Corporates started the year with a bang with heavy issuance right out of the gate. Total new issuance for the week was $53 billion, well above the $20-$25 billion anticipated for the week and reflective of strong sentiment among issuers. Last year was the heaviest year of issuance ever, but 2017 is forecast to decline by 5-10% by many analysts.
- **Securitized Products:** Agency mortgages oscillated with the US Treasury market with modest tightening with lower yields. The Agency/GSE credit risk transfer (CRT) market has been the beneficiary of stronger housing conditions and a steady employment picture. Spreads on long-cash flow CRT bonds compressed 25 basis points or 1.2% price improvements to kick off 2017.
- **High Yield:** In recent years, high yield issuers have taken advantage of low rates to refinance their balance sheets. As a result, only 2% of the high yield universe will mature in 2017. Headed into the new year, we believe this financial cushion will provide a measure of security for the asset class.
- **Emerging Markets:** Emerging markets saw a constructive start to 2017, with spreads tightening and most local currencies holding up against the U.S. dollar, though Mexico was an outlier. Despite the Mexican central bank's direct intervention to support the embattled peso, the currency lagged after President-elect Donald Trump spoke out against Ford's decision to open a production facility in Mexico, causing the automaker to cancel the investment.
- **Currencies:** The Chinese renminbi's unexpected surge this week caught many investors off-guard. A combination of thin liquidity, weaker US Dollar and better than expected economic data in China led to the renminbi's biggest ever two-day gain. While many believe that this event is unlikely to reverse the long-term renminbi weakness trend, recent curbs on capital outflows from China are likely to continue to impact the exchange rate.
- **Municipals:** The municipal market continued to see heavy mutual fund outflows over the holiday period; however, municipal/Treasury ratios actually rallied, and the market delivered strong positive performance for the month of December. With limited supply and strong demand in the new year, we expect the "January effect" to provide support for municipals in the coming weeks.