Week Ending **July 7, 2017**

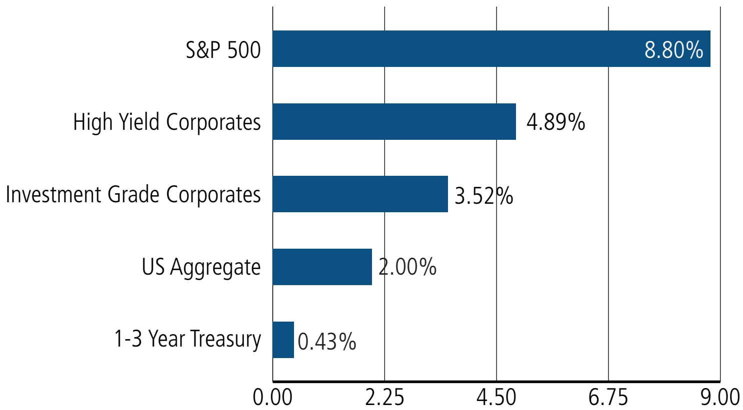
# Deflationary Oblivion or Just Noise?

## Economic Overview:

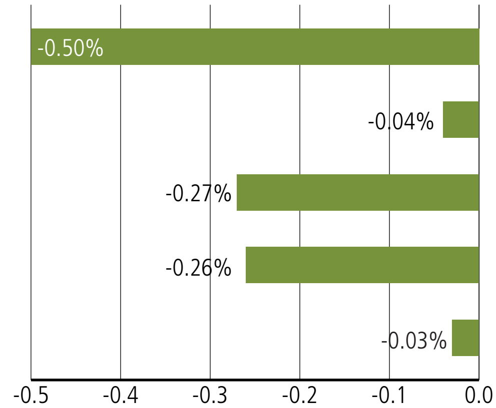
The minutes of the June FOMC meeting were released this week and showed monetary policy makers wrestling with a key dilemma: inflation continues to undershoot their 2% target. Indeed, the 3-month annualized rate of inflation in May was the 4th lowest in history! Should the Fed proceed with plans to hike again and begin the unwind of its balance sheet or should the central bank stand pat in light of softening price pressures? We think the recent inflation readings have been incredibly noisy, held down by categories like wireless services and used vehicles. With a tightening labor market as a backdrop, we suspect inflation readings will bounce in the second half of the year, allowing the Fed to begin its balance sheet unwind (September) and hike at least once more before year end.

## Total Returns by Asset Class

**Year to Date Total Return**




**Month to Date Total Return**




## Highlights of the Week:

- **Treasuries:** U.S. Treasuries were held captive to their European cohorts this week, as Bunds broke thru 0.50% (not seen since Jan 2016), dragging other developed markets along for the ride. 2/10's curve bear steepened by 5-6 basis points (bps), with 10's backing up another 10 bps this week. FOMC minutes and nonfarm payrolls were uneventful, not altering the Fed's current balance sheet and rate hike paths. 2018 probabilities moved up slightly to 1.4 hikes. Next week is 3/10/30 year supply.
- **Corporates:** Hope everyone enjoyed Tuesday's festivities since we don't anticipate any fireworks out of the corporate market over the summer. We expect this low volatility environment to linger. And this, combined with strong global demand for corporates, will continue to exert a downward pressure on spreads, or at a minimum put a lid on any meaningful widening. While equities may not be so lucky, we expect corporates to remain largely immune to whatever political instability and lack of progress we see on the corporate tax front out of this Administration.
- **Equities:** The U.S. Equity Market posted modest gains for the week as growth stocks continued its year-to-date dominance over value stocks. The spike in global interest rates and the recent approval of bank institutions' capital plans have fueled a multi-week rally in financial stocks, which ended the week as the best performing sector.
- **Emerging Markets:** India rolled out its much-anticipated Goods and Services Tax on July 1, marking the fruition of one Prime Minister Narendra Modi's major reform priorities. The reform is designed to streamline India's complicated tax system, improve consumer efficiency and increase government revenues.
- **Securitized Products:** Remember all of those poorly underwritten mortgage bonds that were the catalyst for the financial crisis? That non-agency mortgage-backed securities market still exists with $500 billion outstanding. This niche market hit a road bump as litigation risk popped up again. This time it's a bond trustee that is trying to claw back indemnity from the deals they are supposed to be watching over. Trading activity slowed as participants sort through how to apply this latest development to valuations.
- **Currencies:** After the sovereign credit rating downgrade last month, the South African rand's woes seem to be far from over. A proposal by the ruling ANC party to nationalise the central bank and expropriate land without compensation raised fresh concerns about the political stability and economic outlook in the country. While some believe the currency move this week might have been exaggerated, the market reaction was clear – the rand was down by more than 2% against the U.S. dollar.
- **Municipals:** This week the State of Illinois passed a budget for the first time since mid-2015. Several Republican legislators joined their Democratic counterparts to override Governor Rauner's veto, passing a budget that included individual and corporate tax increases. The State's municipal debt staged a strong rally on the news, with long-dated taxable debt being the best performer.
- **High Yield:** For the first time since the fourth quarter of 2015, BB-rated bonds outperformed B-rated bonds during the second quarter, and B-rated bonds outperformed CCC-rated bonds. Outperformance was due in part to falling rates in the intermediate- to long-part of the curve, but was driven primarily by greater spread tightening among these higher quality bonds.