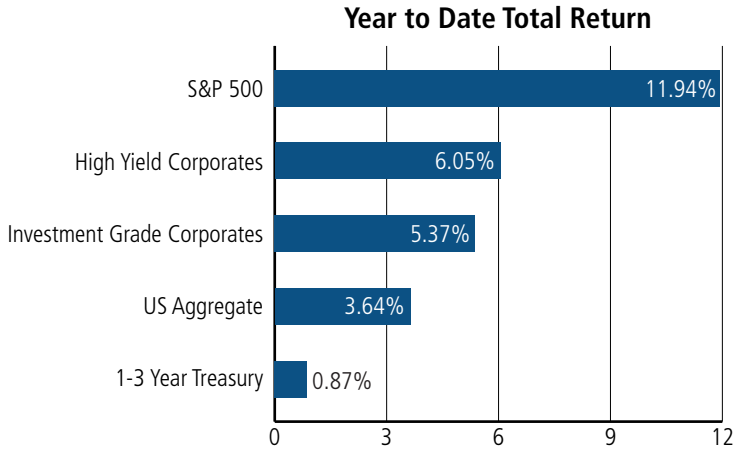
Week Ending **September 1, 2017**

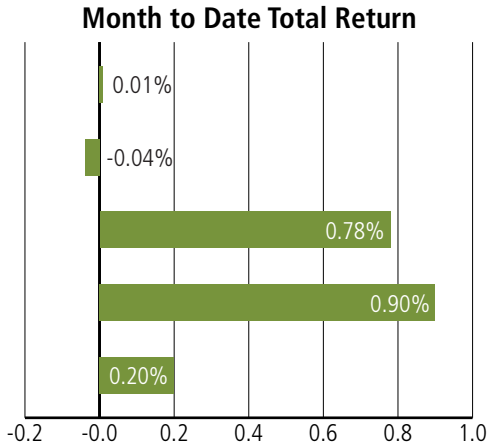
# Don't Short the U.S. Consumer

## Economic Overview:

The U.S. economy grew even faster than initially estimated during the second quarter of this year. Real GDP increased at a 3% annual rate, revised up from 2.6%, with the U.S. consumer providing the largest contribution to topline growth. In fact, for the last seven quarters, consumer spending has been the largest contributor to growth. Economic bears waiting for the U.S. economy to wilt will probably be disappointed in the second half of 2017. And with the unemployment rate at cycle lows and wage growth gradually picking up, we expect the healthy U.S. consumer to continue to power above-trend GDP growth.

## Total Returns by Asset Class




## Highlights of the Week:

- **Treasuries:** Geopolitical risks eased and holiday thin markets ensued with treasuries grinding higher into 1st tier economic data. Inflation remained subdued but some profit taking finally appeared with curves remaining very flat. Talk of large corporate issuance in September, but debt ceiling and budget concerns continue to weigh on yields and market probabilities, with the probability of a rate hike at 40% and 80% for 2017 and 2018 respectively.
- **Corporates:** The start of the week was met with a "risk-off" tone following the firing of a ballistic missile by North Korea over Japan. By mid-week, tensions surrounding N. Korea eased and activity started to pick up with month-end buying. Tropical Storm Harvey continued to wreak havoc in Texas and has prompted at least 14 U.S. refineries to shut down or reduce production. This production slowdown affects roughly 4 million barrels a day of U.S. processing capacity, or roughly 22 percent of the nation's total. Away from P&C insurance, spreads felt better throughout the week. New issue returned to the market, with a sole Yankee bank, Sevenska Handelsbanken, brave enough to bring a $1.5 billion, 2-part deal following four blank sessions in the investment-grade primary market.
- **Equities:** The U.S. Equity Market rallied for the second consecutive week on increased M&A news and largely stronger than expected economic data. Bio-pharmaceutical company Gilead Sciences (GILD) agreed to acquire cancer treatment developer Kite Pharma (KITE) for $11.9 billion in cash, a 29% premium over KITE's prior close. This deal drove a repricing within the industry as health care was the best performing sector for the week.
- **Emerging Markets:** In a surprising decision, the Kenyan Supreme Court nullified the August 8th presidential election which led to the victory of the incumbent, Uhuru Kenyatta. The court ruled that the vote had been electronically manipulated and has ordered that a new election take place within 60 days.
- **Securitized Products:** Earlier this week, Hurricane Harvey made landfall in south Texas, eventually flooding neighborhoods in Houston before moving up the Gulf coast. While our thoughts and support go out to those people in flood zones, we also recognize the effects on Non-Agency RMBS and CMBS. Harvey exposure in those deals is typically in the 1-4% range. Since most properties lack flood insurance, we anticipate modest losses materializing over several months.
- **Municipal:** California successfully sold $2.5 billion worth of State General Obligation debt this week. The 30-year 5% coupon bonds yielded 2.93%, while the 4% coupon bonds yielded 3.27%. With the tailwind of limited supply, municipals turned in the best August performance since 2014, returning 0.76% for the month (5.20% YTD).
- **High Yield:** More bonds were upgraded to investment grade than downgraded to high yield this year. According to a report released by S&P Global Ratings, so-called "rising stars" outnumbered "fallen angels" 23 to 17 through August. This dynamic reflects improving fundamentals across the asset class.