

August 12, 2016

## MARKET LEVELS

	Friday*	Last week	Dec. 31, 2015	One year ago
Dow Jones Industrial Avg	18,598	18,544	17,425	17,408
S&P 500	2,183	2,183	2,044	2,083
NASDAQ	5,224	5,221	5,007	5,034
Russell 2000	1,229	1,231	1,136	1,205
DJ STOXX Europe 600 (€)	346	341	366	387
Nikkei Index (¥)	16,920	16,254	19,034	20,596
MSCI EM Index	454	447	411	429
Fed Funds Target	0.25%-0.50%	0.25%-0.50%	0.25%-0.50%	0.00%-0.25%
2-Year Treasury Yield	0.69%	0.72%	1.05%	0.71%
10-Year Treasury Yield	1.48%	1.59%	2.27%	2.19%
U.S. \$ / Euro	1.12	1.11	1.09	1.12
U.S. \$ / British Pound	1.30	1.31	1.47	1.56
Yen / U.S. \$	101.04	101.82	120.22	124.43
Gold (\$/oz)	\$1,352.35	\$1,335.55	\$1,061.42	\$1,115.15
Oil	\$43.80	\$41.80	\$37.04	\$42.23

\*Levels reported as of 7:27 a.m. PDT

## MARKET RETURNS

Year-to-date (12/31/15 – 08/12/16)\*

Dow Jones Indus Avg.	8.55%
S&P 500	8.27%
NASDAQ	5.20%
Russell 2000	9.14%
MSCI World Index	4.39%
DJ STOXX Europe 600	-2.52%
MSCI EM Index	10.53%

Year-to-date (12/31/15 – 08/11/16)

90 Day T-Bill	0.19%
2-Year Treasury	1.10%
10-Year Treasury	7.28%
ML High Yield Index	12.19%
JPM EMBI Global Diversified	13.37%
JPM Global Hedged	7.14%

\*Returns reported as of 7:27 a.m. PDT

## RECAP OF THE WEEK'S ECONOMIC RELEASES

Date	Report	Survey	Actual	Prior	Details
08/12	(EC) GDP SA YoY	1.60%	1.60%	1.60%	Euro-area GDP stayed in positive territory for the 13th consecutive quarter with the domestic consumer being the largest driver of growth.
	(US) Retail Sales Advance MoM	0.40%	0.00%	0.60%	Retail sales in the US slowed due to declines in gasoline and department store sales.

## ECONOMIC OVERVIEW

Retail sales were flat in July compared to June, disappointing investors. Should we be worried about the US consumer? Over the last year, retail spending is up 2.3%. What's holding back retail spending? Over the last 12 months two key categories exerted major drags on topline retail spending: department stores and gasoline stations. Department stores' woes are well known, with sales down 4% over the last 12 months. Meanwhile, nonstore retailers (online included) saw their sales soar 14%. Gasoline stations sales are down, but that's due to the fall in gasoline prices over the last 12 months—saving consumers \$4 billion at the pump this July compared to last. Excluding those two categories—department stores and gas—retail sales are up an admirable 4% over the last year. Us worry? No.

## US MARKETS:

### TREASURIES

- Treasuries performed well throughout the week as global quantitative easing led sovereign bond yields lower and curves flatter. The correlation between G4 sovereign curves remain elevated this time with UK Gilts leading the move flatter after the first week of purchases out of the Bank of England.
- The long end buyback was uncovered as investors clearly did not want to sell their positions to the central bank which took long end Treasuries for a ride. On a currency hedged basis, long duration Treasuries remain attractive which should continue to push long-end forwards lower as term premia falls. Adding to the bid in fixed income was poor consumption data out of the US which had many economists revising their Q3 growth forecasts lower. This time the belly of the curve benefited the most as Fed normalization pricing came out of the market. The probability of a Fed hike by year end implied by the futures market sits below 40%. The Treasury auction approximately \$67 billion worth of 10-year note equivalent duration which was well received in the market. Despite a concession into the bond auction, all three auctions came at or through their pre-auction level and demand statistics were in line or better than the 12-month average.

### LARGE-CAP EQUITIES

- The U.S. Equity Market ended the week unchanged as better-than-expected 2nd quarter corporate earnings results from major department stores offset the disappointing July's retail sales report. With a relatively quiet week of trading and market fears suppressed for the time being, broad equity indices continued to push to new price highs.
- In fact, the S&P 500, Dow Jones Industrial Average and NASDAQ Composite indices all made a new all-time high on Thursday, which was the first time that all three major U.S. stock indices have posted a record high on the same day since 1999.

- The S&P 500 and NASDAQ Composite indices finished the week unchanged, while the Dow Jones Industrial Average inched +0.2% higher. Large-cap stocks outperformed the higher beta small-cap stocks. In terms of style, large-cap growth performed in-line with large-cap value stocks. The best performing sectors were energy and consumer staples, while the worst performing sectors were materials and financials.

## CORPORATE BONDS

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- The second week of August was another busy week for the primary market despite being a characteristically slow summer month. Issuance came in at \$31 billion, beating expectations of \$20-\$25 billion. Even excluding Microsoft's \$20 billion issue from last week, supply has already hit average August issuance based on the last five years. One heavily subscribed deal was issued by utility company Duke Energy. The company issued almost \$4 billion in new bonds and was nearly five times subscribed; bonds priced 35 basis points inside of price talk, tightening another five basis points on the break.
- Corporate news was quiet during the second week of August even if issuance wasn't. Delta made headlines for a power outage that canceled flights across their airline empire, causing issues from Monday through Wednesday. The majority of S&P companies have reported their earnings, showing better-than-expected growth, albeit still negative year over year. The Corporate Index Option-Adjusted Spread (OAS) finished the week at +142, four tighter on the week. Overall metals/mining were four tighter and energy was 20 tighter despite relatively small gains in oil prices. Senior financials were two tighter and subordinated financials were four tighter. Industrials were six tighter and utilities were wider by one.

## MORTGAGE-BACKED SECURITIES

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- The summer doldrums are here. In very light volume, agency mortgages trailed US Treasuries as rates drifted to the low end of the recent trading range. Economic reports have been mixed leaving the market directionless. Pass-through spreads softened a couple basis points on a buyers' strike or let us call it a buyers' vacation.
- For example, Japan was out mid-week for 'Mountain Day' celebrations. We don't expect any major market changes until after Labor Day as top-tier events (Presidential election, the peak prepayment report for the cycle, and the Federal Open Market Committee Meeting) take center stage. In the sub markets, the entire coupon stack posted positive price action but higher coupons outperformed on a hedged basis. Despite the bond market rally, conventionals lagged Ginnie Maes as prepayment speeds converge. In the credit sensitive markets, both commercial MBS, non-agency MBS, and single family rental products are enjoying their best environments of 2016. Prices continue to rise reflective of limited supply and insatiable demand for yield. The latest CMBS conduit priced with a 10-year AAA-rated class inside of 90 basis points versus US Treasuries.
- For the week, the 30-year current coupon versus the 10-year US Treasury widened by two basis points to 80 basis points. According to Freddie Mac, the 30-year mortgage rate edged higher to 3.45%.

## ASSET-BACKED SECURITIES

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- The WSJ reported this week that total household debt rose \$35 billion quarter over quarter to \$21.3 billion in Q2 2016, fueled by increases in credit card and auto loans. Auto loans have been rising steadily since 2010, while credit cards have experienced the opposite trend. Consumers pulled back on credit card use in the wake of the recession until 2014.
- Balances have risen by \$70 billion in the past two years, and credit card activity is now picking up among those with low credit scores. Of those with FICOs between 620 and 660, 58.8% hold a credit card, up from 54.3% in 2013, and the highest level since 2008. Of those with a credit score below 620, those holding a credit card rose to 50%, up from 45.6% in 2014, which is also the highest level since 2008.

## MUNICIPAL BONDS

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- The new issue calendar cooled off this week after the \$12.5 billion priced last week. Though the volume last week was easily absorbed, the \$8 billion calendar this week was much more manageable and was dominated by two \$1 billion deals from The University of California Regents and the State of Pennsylvania.
- We continue to see deals oversubscribed and it seems as though the strong Treasury performance drove municipal demand higher as investors raced to lock in yields before they moved lower. Despite the continued strength, overall municipal yields have underperformed modestly and pushing relative value ratios higher. The SIFMA swap rate followed Libor's march higher pricing 2 basis points higher on the week to 46 basis points; the highest since May of 2009.

## HIGH-YIELD BONDS

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- The BofA Merrill Lynch BB/B cash pay constrained index was up +0.68% this week as spreads compressed 14 basis points to an option-adjusted-spread of +416 basis points. The BofA Merrill Lynch BB/B index that excludes utilities and energy was up +0.59% for an OAS of +394 as the spread of that index tightened by 13 basis points. The BofA Merrill Lynch Euro BB/B constrained index was up +0.52% and the spread of that index tightened by 10 basis points this week, resulting in an OAS of +362.
- High yield is grinding higher this week as crude oil prices appear to have stabilized in the low- to mid-40s and the market digested a strong payroll print last Friday. Earnings reports have generally surprised to the upside, while lower quality names like California Resources and Platform Specialty have been the top performers this week. Valeant Pharmaceuticals rallied despite an earnings miss as the company reaffirmed guidance following several quarters of guidance cuts.
- Inflows for the week are an estimated \$1.65 billion, unwinding some of last week's \$2.46 billion outflow and adding to the massive inflows seen in July. Secondary volumes remained elevated as \$13.4 billion traded on Thursday versus a year-to-date average of \$12.7 billion. The new issue market remains robust and helps explain higher-than-normal secondary activity.
- \$5.6 billion across ten issuers has priced so far this week. Seven out of ten of this week's issuers are accessing the market to refinance outstanding debt as companies take advantage of a primary market that remains wide open. Issuer quality deteriorated somewhat during the week, opening with mostly double-B issuers in the market and closing with issuance out of several single-B and triple-C names.

## INTERNATIONAL MARKETS:

### GLOBAL BONDS AND CURRENCIES

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- In a week that was light on macroeconomic data, global bond markets benefitted from the prevailing expectations of further accommodative policy from central banks worldwide. The week started cautiously but sentiment reversed by Thursday following a strong equity rally in the US and some stabilization in the oil prices. However, risk appetite dipped once again on Friday after a lower than expected US retail sales print made some investors question the likelihood of a US rate hike before the end of the year.
- In Europe, UK Gilts outperformed German Bunds for yet another week as the Bank of England started its asset purchasing program. The lack of supply in the long-dated Gilt space resulted in the latest long-dated auction falling short of its purchase target by about \$50 million. As a result, the Gilt yield curve flattened, particularly in the longer end. The 10-year Gilt yield touched a new low before finishing the week 10 basis points lower, while the yield on the 30-year note dropped by 20 basis points. In comparison, the benchmark 10-year German Bund yield fell by 4 basis points.
- The currency markets were relatively muted this week. The UK pound lost some ground on the back of falling gilt yields, touching a new low against the euro and selling off against the greenback. The US Dollar rose against the euro and Japanese yen in the beginning of the week but gave up most of the gains by Friday

after a lower than expected US retail sales report. The kiwi dollar rose against most major currencies despite the 0.25% rate cut on Thursday as many had expected more aggressive measures by the central bank.

## EMERGING-MARKET BONDS

- Emerging market (EM) dollar-pay spreads tightened 20 basis points (bps) to 341 bps over US Treasuries, while local debt yields declined by eight bps to 6.16%. EM currencies were stronger against the US dollar, led by the Colombian peso (+6.6%), Mexican peso (+3.7%), and South African rand (+2.3%).
- In Thailand, a referendum for a new constitution was approved by 61.4% of the electorate. The constitution is expected to set the stage for parliamentary elections, possibly in late 2017, which would transition Thailand away from the military junta that has been in control since a coup in 2014. However, the constitution appears to give the military significant ongoing influence in politics by allowing it to appoint the upper house of parliament and giving that body the ability to vote for Prime Minister.
- China reported weaker economic activity in July, with most data underperforming consensus estimates. Fixed asset investment fell to 4.0% year-over-year (y/y) from 7.4% in June, while industrial production eased to 6.0% y/y from 6.2%. Retail sales decelerated to 10.2% y/y, from 10.6% the prior month. Aggregate measures of lending and financing also fell substantially. In addition, trade data showed imports and exports declining by 12.5% y/y and 4.4% y/y, respectively, more than anticipated. Finally, consumer price inflation came at 1.8% y/y, slowing from 1.9% in June.
- Countries continued to release second quarter GDP growth figures. Poland grew 3.1% y/y, up from 3.0% in Q1 but below analyst estimates. Hungary's 2.6% y/y expansion was ahead of expectations, led by services, industry and agriculture. Romania reported a strong 6.0% y/y advanced growth reading, up from 4.3% in Q1, likely propelled by strong household consumption. Russia's economic contraction continued to ease; the -0.6% y/y print improved from -1.2% in Q1. In Malaysia, GDP decelerated mildly to 4.0% y/y, with weaker results in the agriculture and mining sectors.
- Among monetary policy decisions, Raghuram Rajan led his final meeting as governor of the Reserve Bank of India, holding the benchmark rate at 6.5%. Rajan's replacement has yet to be announced. A trio of Latin American central banks kept policy rates steady, including in Mexico (4.25%), Peru (4.25%) and Chile (3.5%). The Philippines' central bank also held its overnight rate at 3%, but continued to revise down its inflation forecasts for 2016-2017.
- The IMF announced it had reached a staff-level Extended Fund Facility with Egypt that would provide \$12 billion of financing over three years, pending approval by the IMF's Executive Board. Egyptian officials are aiming to address balance-of-payments pressure, which would include a more flexible currency, and will embark on a much-needed fiscal consolidation.

## HIGHLIGHTS OF NEXT WEEK'S ECONOMIC RELEASES

Date	Report	Consensus	Last
08/14	(JN) GDP SA QoQ	0.20%	0.50%
08/15	(JN) Industrial Production YoY	--	-1.90%
	(US) NAHB Housing Market Index	60	59
	(RU) Industrial Production YoY	0.80%	1.70%
08/16	(UK) CPI YoY	0.50%	0.50%
	(UK) CPI Core YoY	1.40%	1.40%
	(GE) ZEW Survey Current Situation	50.2	49.8
	(US) Housing Starts	1180k	1189k
	(US) Building Permits	1160k	1153k

	(US) CPI YoY	0.90%	1.00%
	(US) CPI Ex Food and Energy YoY	2.30%	2.30%
	(US) Real Avg Weekly Earnings YoY	--	1.20%
	(US) Industrial Production MoM	0.30%	0.60%
08/17	(UK) ILO Unemployment Rate 3Mths	4.90%	4.90%
08/18	(UK) Retail Sales Ex Auto Fuel MoM	0.30%	-0.90%
	(EC) CPI YoY	0.20%	0.20%
	(US) Philadelphia Fed Business Outlook	2	-2.9
	(US) Leading Index	0.30%	0.30%
08/19	(CA) Retail Sales MoM	0.60%	0.20%
	(CA) Retail Sales Ex Auto MoM	0.40%	0.90%
	(CA) CPI YoY	1.40%	1.50%
	(CA) CPI Core YoY	2.10%	2.10%