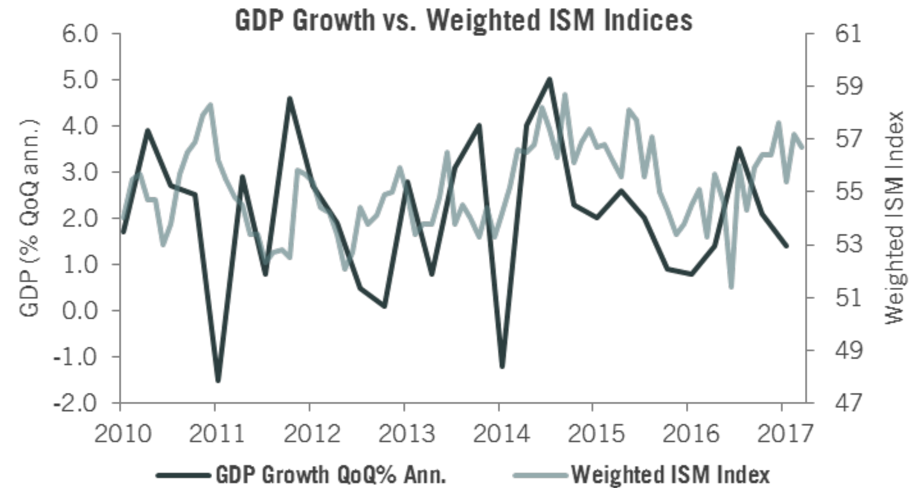
MARKET REVIEW
SECOND QUARTER 2017

First Quarter GDP Growth Pause Follows Familiar Pattern

- U.S. GDP growth dipped to +1.4% in 1Q17 following a +2.1% pace in the final quarter of 2016. Growth in the first quarter was hampered by a pullback in consumer spending.
- Sluggish growth in the first quarter relative to subsequent quarters has become a well-established pattern. Over the last seven years (2010-2016), the initial quarter's growth rate marked the weakest quarter of the year in four of those seven years.
- Surveys of economic activity, including the Institute for Supply Management (ISM) survey of activity in the manufacturing and non-manufacturing (services) sectors, remains solid. The ISM manufacturing index for June stood at 57.8 (readings above 50 indicate expansion).



Source: Bloomberg, U.S. Bureau of Economic Analysis, The Institute for Supply Management

Unemployment Rate – How Low Can it Go?

- Labor market gains continued in the second quarter. Employers added an average of 150,000 jobs per month over Q2, and the unemployment rate fell to 4.3% in May before ticking up slightly to 4.4% in June.
- The broader "U-6" measure of underemployment, which includes discouraged workers and those who are working part-time but want a full-time job, also declined meaningfully this quarter and ended at 8.6% in June.
- Workers' average hourly earnings rose at a 2.5% annualized pace during the quarter.

Source: Bloomberg, U.S. Bureau of Labor Statistics

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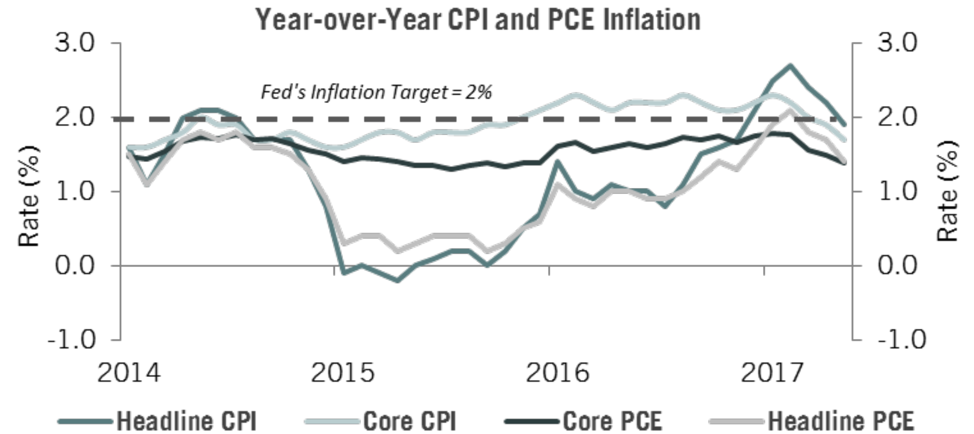
Fed Sticks to Normalization Path Despite Inflation Pullback

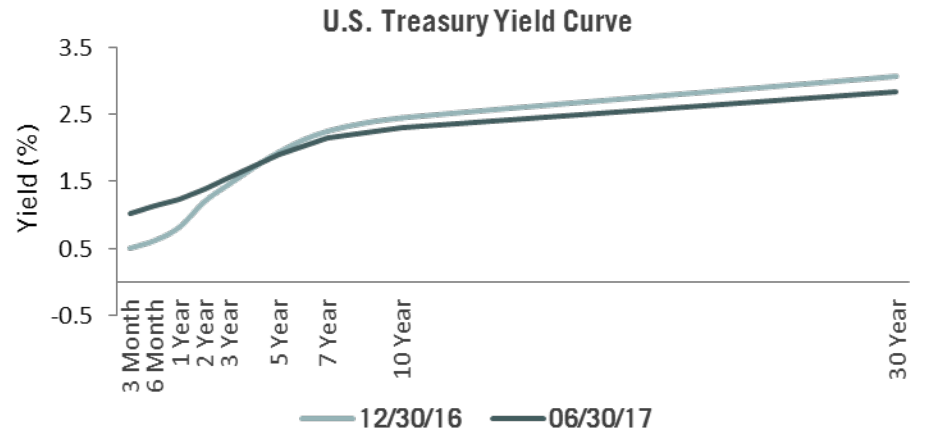
- The Federal Reserve (Fed) raised its policy rate by a further 25 basis points (0.25%) at its June meeting. The Fed's policy rate range now stands at 1.00% to 1.25%.
- On a year-over-year basis, core inflation measured by the Consumer Price Index (CPI) ex Food and Energy declined to 1.7% in May from 2.3% in January. Declines in the cost of housing, medical care goods and services, and wireless data services contributed to the pullback in inflation.
- The Fed acknowledged recent softness in inflation data relative to its 2% inflation target, but chalked up most of the decline in core inflation to transitory factors.
- The Fed also provided additional details on its plan to begin reducing the size of its holdings of U.S. Treasuries and Agency MBS, and reinforced its intention to begin phase-in later this year. Given the modest size and gradual nature of the reduction plan, the market's reaction has thus far been quite muted.

U.S. Yield Curve Flattens as Bond Market Suggests Fed Estimates Too Optimistic

- While short-term rates rose to price-in the Fed's recent hike and expectation for an additional hike in 2017, yields on longer maturities declined and the yield curve flattened appreciably. This suggests the risks to growth and inflation are skewed to the downside.
- The significant flattening of the yield curve also suggests the market remains skeptical that the Fed's forecast for additional rate hikes over the next 1-2 years will come to fruition.



Source: Bloomberg, U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics



Change in Yields Since 12/31/16

3 Mth	6 Mth	1 Year	2 Year	3 Year	5 Year	7 Year	10 Year	30 Year
0.51	0.52	0.42	0.19	0.10	(0.04)	(0.11)	(0.14)	(0.23)

Source: Bloomberg

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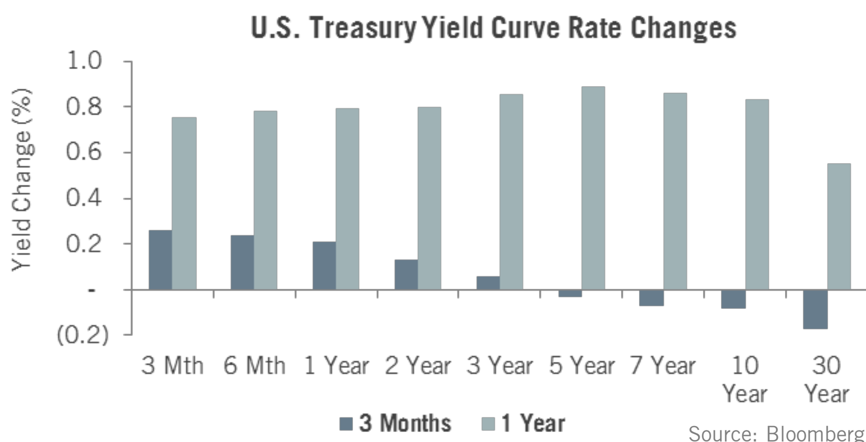
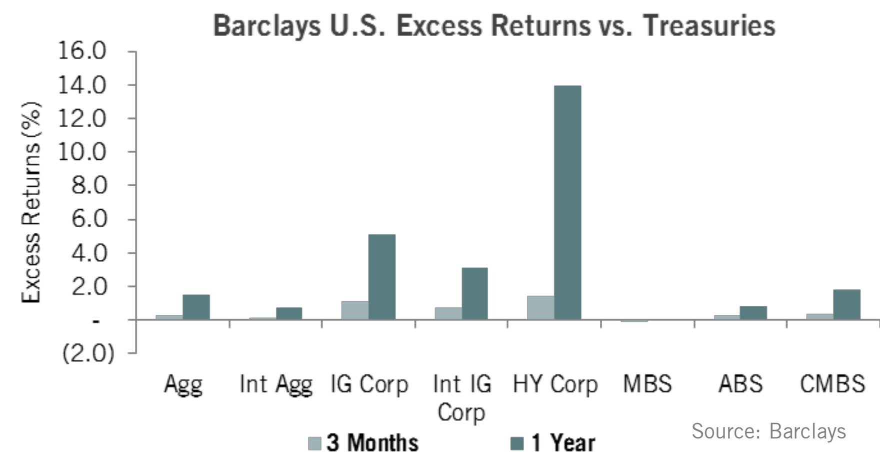
Short Rates Rise During Quarter, Spread Sectors Outperform





- The Fed followed its rate normalization path and raised its policy rate by 25 basis points (bps) at its June policy meeting. The target range for the Fed Funds rate now stands at 1.00% to 1.25%.
- Short rates rose in reaction to the Fed's move; intermediate maturities were little changed out to 10 years, while the yield on the 30-year Treasury declined nearly 18 bps.
- Inflation measures pulled back during the quarter and Q1 GDP growth was somewhat muted, providing bond bulls with ammunition to "fade the Fed" and bet on a decline in longer-term yields.
- Both equity and interest rate volatility remained very muted over the quarter. Swap spreads declined materially on the front-end of the curve, providing a boost to those sectors priced relative to swaps, like ABS, CMBS and other structured assets

- Investment grade corporate bonds outperformed Treasuries during the quarter (+112 bps of excess return). Lower quality and longer maturities generally outperformed, with the exception of energy names, which felt the pressure of a sharp decline in crude oil prices. Financials outperformed industrials and utilities.
- Agency MBS lagged other spread sectors and modestly underperformed Treasuries on the quarter (-4 bps excess returns). To some extent, uncertainty over the Fed's plan to begin curtailing reinvestment in its asset portfolio has weighed on investor demand for MBS.
- ABS posted solid excess returns for the quarter (+32 bps) as the rally in the front-end swap spreads aided returns relative to Treasuries. Short, high quality consumer ABS remain attractive on a risk-adjusted basis.
- CMBS also benefitted from the decline in swap spreads during the quarter, as well as a relative lack of new supply. CMBS outperformed similar-duration Treasuries by +34 bps during the quarter.

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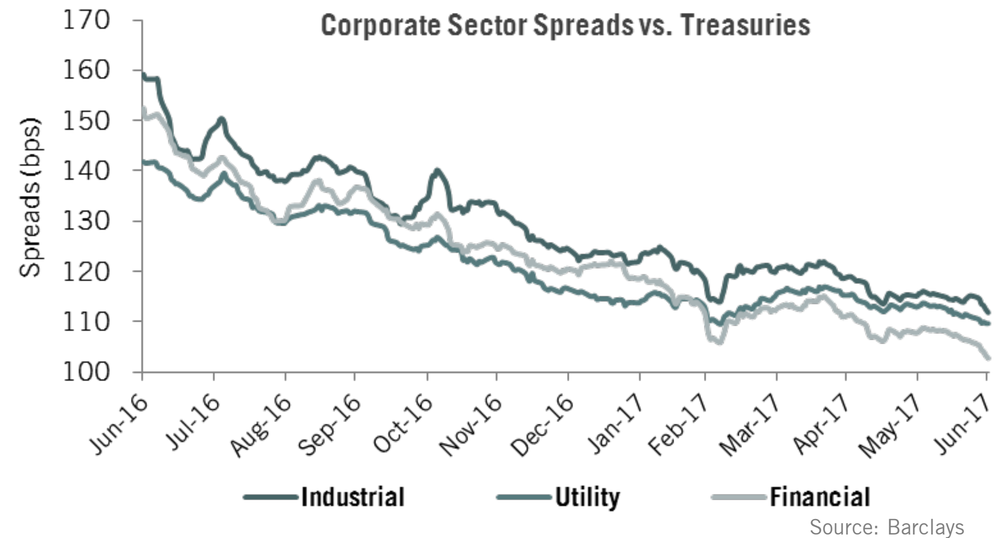
Credit Spreads Tighten Further, Led by Financials; Oil Price Drop Weighs on Energy Names

- Commodity prices were mixed during the quarter, although crude oil continued the downward slide that had started during the latter days of 1Q17.
- Credit spreads on energy names started widening in June, but fared much better than the stock prices of these companies. Despite the spread widening, energy credits have made solid progress reestablishing balance sheet strength and improving liquidity.
- Away from energy, credit risk generally paid during the quarter with the BBB-rated credits outperforming higher quality names. Autos and non-discount retailers underperformed on the quarter.
- Despite the rally in long Treasuries, longer credit outperformed, with long financials outperforming industrials and utilities.

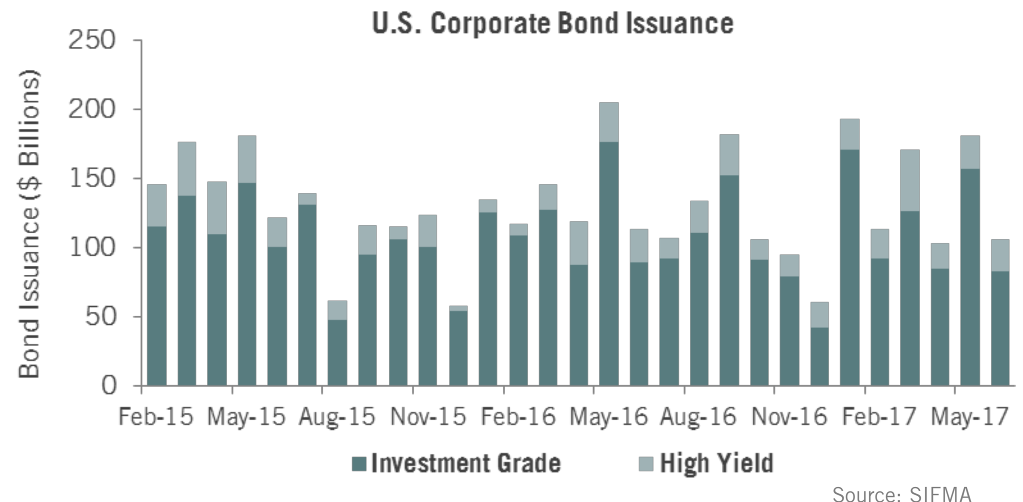


Source: Barclays

Issuance Slows Somewhat in Second Quarter, Remains Strong

- Investment grade new issuance totaled just over $325 billion in the second quarter according to SIFMA. While this is a slower pace than 2Q16, year-to-date issuance ($714 billion) remains in-line with the prior year.
- High yield new issuance was $65 billion in Q2 versus $85 billion for the same period last year; however, issuance remains up year-to-date thanks to strong issuance in 1Q17.
- Year-to-date, non-financial short (3-year) corporate issuance was 20% of supply versus 15% last year; meanwhile longer (30-year) issuance remains subdued1.
- Floating rate issuance continues to be strong, representing 17% of supply year-to-date versus 8% for the full year 2016[1].

[1] *J.P. Morgan*



Source: SIFMA

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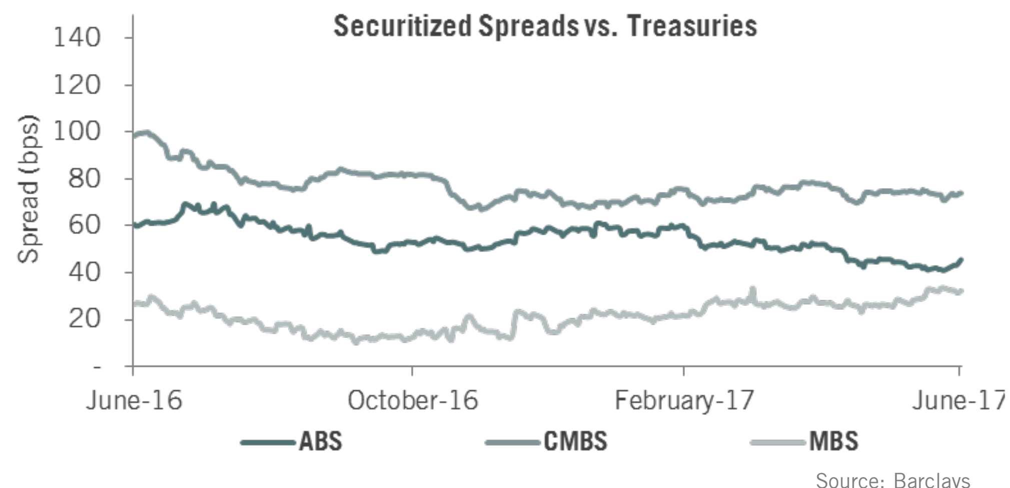
Fed's Balance Sheet Reduction Plan Keeps MBS Valuations in Check

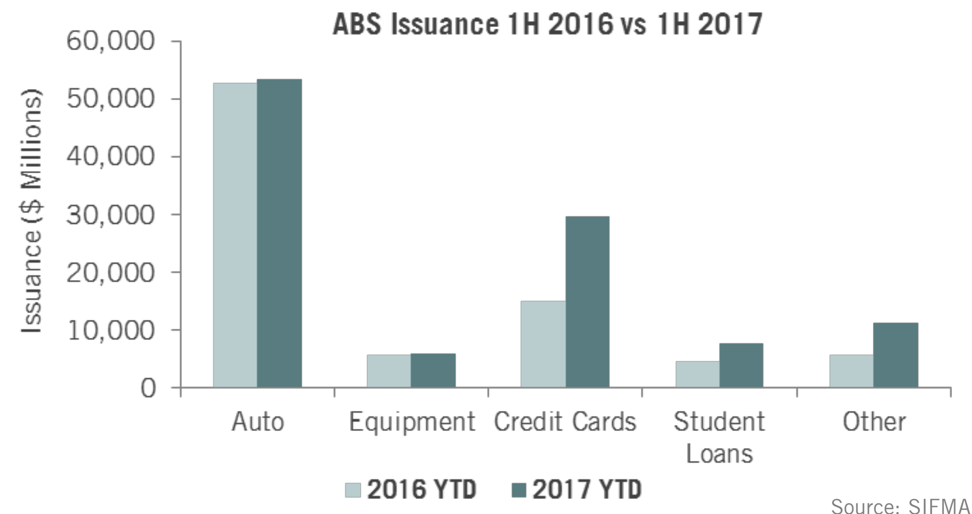
- Mortgage supply has been robust as the residential housing market enters peak season. Additionally, at its June meeting, the Fed outlined its plan for balance sheet reduction. Once started, the taper plan calls for MBS running off at $4 billion per month initially, gradually building to $20 billion per month.
- The S&P CoreLogic Case-Shiller 20-City Home Price Index registered another year-over-year increase, 5.67%, for the month of April. After almost five years of consistent monthly growth, the Case-Shiller Index is now only 5% below the peak set back in 2006. Mortgage rates, as measured by the Freddie Mac Weekly Survey Rate, have been hovering around 4.00% since early April and the National Association of Realtors Existing Home Supply Index remains at multi decade lows.



Source: Barclays

Securitized Credit Issuance Picks Up Versus 2016

- ABS new issue supply is 29% higher year-to-date versus the same time period last year. At almost $30 billion, credit card ABS supply has been approximately double what it was during the first six months of last year. From a credit perspective, all eyes are on the auto sector as delinquencies and defaults are on the rise. A confluence of events involving off-lease vehicles, historically high new vehicle production, and looser underwriting is poised to put upward pressure on cumulative net losses in the auto ABS space.
- After a lackluster first quarter, the CMBS primary market rebounded to end of the first half of the year approximately 19% higher than 1H2016. The retail property sector continues to grab headlines with Sears announcing more store closures in May.



Source: SIFMA

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