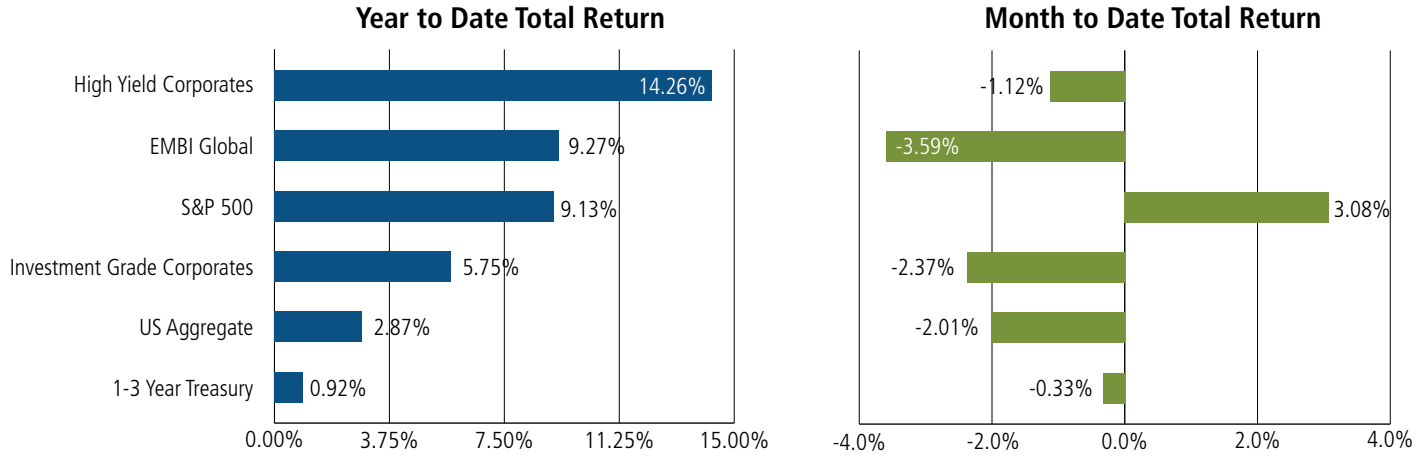
Week Ending **November 18, 2016**

Making America Inflate Again

Economic Overview:

Since Donald Trump became the President-elect of the United States, inflation expectations have soared. As a proxy for long-term inflation expectations, we plot 5-year, 5-year inflation swaps denominated in USD. A 5-year, 5-year inflation swap is a derivative trade where one party agrees to pay a fixed rate, receiving the floating future inflation rate for five years, starting five years in the future (see chart). On this measure, inflation expectations hit their highest levels in the past two years last week, with the market now expecting inflation to average ~2.5% annually five to ten years in the future. Central bankers should take note—Trump's election moved inflation expectations more effectively than large doses of QE. (N.B. We are not endorsing inflation as a policy. We merely seek to highlight the market's reaction to expected policies.)

Total Returns by Asset Class



Highlights of the Week:

- **Treasuries:** The US 5s/30s curve flattened this week back to pre-election levels of 125 bps. The Trump victory steepened the curve out to 145 bps. Yields still remain at elevated levels with 2-year Treasury yields comfortably above 1%. The market implied probability of a December rate hike is now 95%. Two additional rate hikes are priced in for 2017.
- **Equities:** Cisco Systems reported better-than-expected quarterly results, but struggled to keep pace with the broad equity market this week. Investors were disappointed after the company lowered forward guidance citing the uncertainty in the political and regulatory environment. Shares of CSCO fell nearly 5% on the news.
- **Corporates:** $1 billion flowed out of corporates, mostly via ETFs, while spreads tightened one basis point to an OAS of +129 this week. The week also marked the fourth weekly outflow so far this year. New issue came alive with $41 billion across 17 different issuers with the notable deal of the week being Abbott Laboratories. Abbott brought $15.1 billion across the curve which happened to be the year's fourth-largest deal to fund its $25 billion acquisition of St. Jude Medical Inc.
- **Securitized Product:** As interest rates continue to rise, mortgage-backed securities continue to extend and underperform as the refinance option goes further and further out of the money. "Dodd-Frank, You're Fired" was one of the most interesting headlines of the week. With the new administration, the market has begun to speculate on the possible easing of the Dodd-Frank Act and other recent regulatory actions such as "skin-in-the-game" risk retention requirements.
- **High Yield:** Expectations that the Trump administration will pursue deficit-financed infrastructure spending and tax cuts have driven Treasury rates higher over the past week. So although High Yield (HY) spreads have tightened since the election, yields have increased. Expect more volatility in the rate-sensitive parts of the HY universe, especially in longer-dated and higher quality bonds.
- **Emerging Markets:** Fitch upgraded the Dominican Republic to 'BB-' from 'B+,' reflecting strong growth, a reduction in external vulnerabilities, and greater fiscal prudence. The rating change is another step forward in the country's effort to improve its macroeconomic policy framework since President Medina assumed office in 2012. The Dominican Republic is now rated 'BB-' by two rating agencies, S&P and Fitch.
- **Municipals:** Municipal credit-rating upgrades outpaced downgrades in Q3 2016, the first time since 2015. Of the 163 issuers with raised ratings, California issuers led the pack with 46 ratings increases. In contrast, there were 96 ratings decreases.
- **Currencies:** The euro broke a record this week after sustaining ten consecutive losing trading sessions. The single currency was one of the worst performers among the G10 currencies as the post-election strength of the US dollar weighed on the euro. Political uncertainty surrounding the outcome of the impending Italian referendum also undermined the euro and it reached its lowest level against the greenback this year.

© 2016 Payden & Rygel All rights reserved.