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POST-ELECTION PERSPECTIVES

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The markets reacted decisively to the Trump presidential election with a risk-on rally and a notable steepening in the Treasury yield curve. As the markets continue to digest the election outcome, we're taking a look at some of the macro and market implications of a Trump presidency and a Republican controlled Congress.

Macro Implications

Any discussion about policy under a Trump administration comes with the caveat that is difficult to distinguish between what may have been campaign rhetoric from what may ultimately emerge as tangible policies. For example, trade policy was a major campaign platform, but Trump's economic advisors are thought to be generally orthodox, thus the talk regarding restructuring existing trade deals—with the exception of the TPP and T-TIP—could be toned down going forward.

One policy area that appears high on the agenda for next year is tax reform. Trump's policies call for across-the-board personal income tax cuts and a simplification of the system. We also expect Trump could pursue a reduction in the corporate tax rate from 35% to 15% as well as an agreement regarding the repatriation of overseas corporate cash. This could affect segments of the investment grade bond market, as indicated in the following sections.

Another of Trump's more tangible policy platforms regards infrastructure spending. Although we expect relatively quick action on this front, it could also be used as somewhat of a bargaining chip to promote other policies, such as changes to the tax code. While it is difficult to project the potential size of an infrastructure package, it is conceivable its size could reach 2% of GDP—roughly $350 billion—over the course of four years. We would note though, that not all of Trump's discussion of infrastructure involves federal outlays. Incentives for private sector, state, and local infrastructure spending are likely to be emphasized.

The time it takes to pass an infrastructure package could mean that the expected widening of the budget deficit—part and parcel with the expectations for lower tax rates—would not emerge until 2018 when the deficit could reach 4-5% of GDP, if not higher. The potential for a short-term acceleration in growth and inflation may also delay the likelihood of a U.S. recession beyond 2018.

The risks of a Trump presidency are also difficult to ascertain at this point, but in our view, one area of distinct concern regards his stance on International policies, such as questioning the role of NATO, and whether these could ultimately have a destabilizing effect in certain areas of the world.

Federal Reserve Policy: We don't expect the election itself to have much influence on the Fed over the near-to-intermediate term, and our probability for a 25 bp rate hike in December 2016 remains at 70% following Trump's victory. Looking ahead, with the increased likelihood for wider budget deficits and the possibility for faster inflation, our base case is for two rate hikes in 2017, rather than our previous call of one to two hikes in 2017.

Market Reaction and Implications

Most markets had a kneejerk reaction of fear to the initial indications from the U.S. presidential elections, which included lower equity prices, Treasury yields, and U.S. dollar as well as wider credit spreads. However, much of that initial move was retraced or reversed by Wednesday morning as U.S. equities opened slightly lower before moving into positive territory, the Treasury yield curve steepened from the back end, and credit spreads tightened from their wider, overnight levels.

Rates: The potential for faster U.S. GDP growth in the short term may pose a risk to moving the U.S. 10-year yield higher as it did in 2013 and in late 2014. A major difference, however, is that global developed market rates—Bunds and JGBs in particular—are notably lower today than they were during the prior periods of accelerating growth. While the 10-year Treasury yield could rise further from 2.0%, the global search for yield could limit any surge in the 10-year yield. Over the next six to 18 months, we could expect to see a trading range on the 10-year Treasury yield that is centered around 1.75%-to 2.25%. Of note, the increase in longer-term nominal rates thus far has primarily been driven by rising inflation expectations, rather than an increase in real rates. We're closely monitoring when we might see an increase in real rates.

Corporates: As the Treasury curve steepened, cash spreads in the U.S. investment grade market tightened, especially in longer maturities, with many sectors, including energy and pharmaceuticals, seeing notable spread tightening based on policy expectations. Spreads in the energy and pharmaceutical sectors were about 10 bps to 15 bps tighter Wednesday morning amid anticipation for more favorable treatment from the upcoming Trump administration. The back of the corporate curve was as much as 20 bps tighter on the steeper Treasury yield curve. Spreads on 10-year bank issues were about 15 bps tighter about 48 hours after the election and spreads on 30-year bank issues were almost 20 bps tighter.

Of note, the likelihood of a tax agreement allowing for the repatriation of overseas cash appears likely with Republicans in control of the executive branch and Congress. This may have a positive effect on long-term corporates—particularly those issued by pharmaceutical and technology companies—as the incentive to repatriate cash to the U.S. should reduce the supply of long-term corporate debt, while demand from insurers and pensions should remain solid. In addition, it is possible that a substantial portion of the repatriated cash could be used to fund debt and stock buybacks, and we're monitoring whether the consequent possibility of higher stock prices could increase event risk for some segments of the corporate bond market.

Liquidity in the high yield market remained steady in the post-election trading, and there seemed to be more buyers than sellers in the market. Bonds in certain sectors, such as healthcare and hospital bonds, were more impacted in the wake of the election results. This could be in reaction to the election results or due to an unfavorable view on the sector as a number of healthcare credits recently have released weaker than expected earnings.

Liquidity in the bank loan market was unchanged following the election results. While certain sectors in the market may be higher or lower, on average levels and the ability to execute trades was unchanged.

Emerging Markets: The EMD market seemed to focus on the selloff in longer-duration Treasuries following the election. Although long-duration EM hard currency bonds could suffer amid the steepening of the U.S. yield curve,

conditions following the election were largely mixed with long issues from Brazil and Colombia each widening by 5 bps, while long issues from Hungary, Indonesia, and Russia were 2, 3, and 10 bps tighter, respectively.

As expected, Mexico bore the brunt of the negative sentiment with the Trump victory. On Wednesday, it's hard currency issue due in 2044 was quoted 17 bps wider while the PEMEX issue due in 2041 was quoted 37 bps wider. Although the pressure on Mexico-related spreads was anticipated as the Trump victory looked more likely, the administration's ultimate stance toward Mexico is unclear as a tough stance could affect some other policy initiatives, such as immigration.

In the short term, EM hard currency bonds should outperform, in our opinion, as EM sovereign credit risk is still cheaply priced relative to underlying fundamentals.

In terms of EMFX, we could see attractive opportunities in some higher-yielding EMFX crosses as the market digests the news, and higher real yields may become more of a story in the second half of 2017 as they pertain to local rates.

Municipal Bonds: The Trump victory and the prospects for tax cuts and a potential cap on the tax-exempt interest deduction could weaken the demand for tax-exempt bonds. Tax-exempt yields rose and the yield curve steepened as Treasury yields moved higher. Given the significant move in rates we expect mutual fund flows to turn negative. We also expect new issuance to be impacted in the near term as refunding deals get postponed. Approximately 61% of YTD issuance has been refunding related.

Sector Specific Impacts

U.S. money center banks: Generally speaking, we view the impact on the U.S. banking sector as mildly positive given Trump's rhetoric regarding weakening Dodd-Frank regulations. Thus, we're slightly more positive on U.S. money center banks, but generally remain wary regarding European financial institutions.

Healthcare Facility-Based Providers: A Trump win and Republican majority in Congress could have an outsized negative impact on providers given the rhetoric around repealing and potentially replacing the Affordable Care Act—that could result in adverse volume, mix, and/or reimbursement impacts—as well as other potential entitlement reforms and/or reductions in entitlement spending.

Pharmaceuticals: Republican control of the executive branch and Congress largely eliminates some of the scenarios that could have likely affected the pharmaceutical sector, such as switching patients that qualify for both Medicare and Medicaid to cheaper Medicaid drug pricing, or allowing Medicare to negotiate directly with pharmaceutical companies for discounts and rebates.

Technology: We believe the biggest impact to this sector would be the potential for corporate income tax reform, particularly any changes to taxes on foreign earnings/repatriated earnings—either in a one-time situation or in a permanent arrangement.

Building Materials/Construction: We would expect an increase in spending on infrastructure projects, which would likely benefit the Building Material credits in the concrete/aggregates space.

Energy: The Trump victory likely results in the status quo—rather than the potential for a more punitive scenario with a Clinton win—although he has promised to approve the Keystone XL pipeline.

Electric Utilities: The Trump victory will likely remove the threat of additional regulation and/or restrictions on coal-heavy generators, and they may try to extend the option value of their plants for a couple more years; however it is unclear how/if Trump would actually implement such an extension.

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Notice

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