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## Global Fixed Income

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# Update on the US Election

### Overview

Republican candidate Donald J. Trump has claimed victory in the November 8 US presidential election, and the Republican Party has secured both houses of Congress. Though many polls reflected a tight race, the result was a surprise for markets. The initial reaction included a drop in the S&P futures index, weakening in the Mexican peso versus the US dollar and rallies in assets that have traditionally performed well in periods of volatility, such as the Japanese yen, Swiss franc, US treasuries and gold. The following is a summary of our positioning and key takeaways for our strategies in fixed income and currency markets.

- We think the election result may discourage the Federal Reserve (Fed) from raising interest rates in the near term. Increased expectations for the Fed to remain on hold December are likely to drive US short-term rates lower.
- We believe spreads will remain under pressure as the market digests this outcome and what it means for policy. If tighter financial conditions lead to a slowdown in the US economy, we expect pressure on corporate revenues and earnings.
- Heading into the election we were short the dollar versus emerging market currencies, including the Mexican peso. The peso position was based on our fundamental view that the currency is undervalued and would likely benefit from improving US growth. In sizing the position we were mindful of the likelihood of increased volatility should Trump win the election.

### Fixed Income Investment Implications

#### Interest Rates

We did not hold directional exposure to US interest rates going into the US election. We believe interest rates are likely to rise in 2017 on a combination of higher inflation and gradual tightening by the Fed, but we considered the market reasonably valued given the uncertainty around the election and other factors.

- On a relative value basis, we held limited exposure to short US rates versus Canada and Australia. Interest rates have trended higher in most developed markets, with limited dispersion across rate markets. The UK has underperformed, but we reduced a short UK versus long US position prior to the election. Japan has outperformed, but 10-year Japanese rates remain pinned at zero by the Bank of Japan. As a result, we have seen limited opportunity in relative value positioning in developed rate markets.
- We think the Fed is likely to take a wait-and-see approach following the election. Market volatility leads to tighter US financial conditions, reducing the Fed's need to tighten monetary policy. We think the Fed will take time to see if volatility is short-term or continues, while keeping open the possibility of a hike in December or March 2017. We think reduced potential for a near-term Fed rate hike is likely to cause US short-term rates to decline.

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## Currency

Heading into the election we were short the dollar overall, including a long position versus developed market currencies and a larger short position versus emerging market currencies. Within emerging markets, we held a long position in the Mexican peso. We were negative on Asian currencies.

- In the near term, we expect the dollar to weaken versus core currencies such as the euro, Japanese yen and Swiss franc. We see the dollar strengthening versus emerging market currencies, based on Donald Trump's stance on Mexico and China.
- Our peso position is based on a high-conviction fundamental view that the currency is underpriced and would likely benefit from improving US growth. In sizing the position we were mindful of the likelihood of increased volatility should Trump win the election.

## Investment Grade Credit

In multi-sector portfolios, we were generally underweight corporate credit risk heading into the election. Within investment grade, overweight positions include banks, pipelines and consumer products and underweight positions include technology, diversified manufacturing and healthcare. We believe spreads will remain under pressure as the market digests this outcome and what it means for policy. If tighter financial conditions lead to a slowdown in the US economy, we expect pressure on corporate revenues and earnings. We continue to monitor the key political themes of 1) mergers, as political risk could mitigate supply or incentivize buybacks; 2) regulation, specifically in the healthcare, pharmaceuticals, energy and financial sectors; and 3) tax policy, and the chances of legislation allowing companies to repatriate profits with a one-off tax.

- Earnings pressure may cause management teams to scale back on buybacks, M&A and capital spending given broader uncertainty. Ordinarily, fewer equity-friendly measures should benefit credit investors. However balance sheet leverage among non-financial companies remains at multi-decade highs, so we see little room for balance sheets to absorb additional shocks.
- Sectors we believe could benefit include defense, as well as companies exposed to the infrastructure cycle (i.e., pipelines and select manufacturers). Fossil fuel producers could benefit to the extent regulation around emissions and fracking were to decline.
- We believe Trump's policies create risks for multi-nationals, especially if he is successful in "tearing up" trade agreements as this could pressure earnings.

## High Yield

In multi-sector portfolios, we were generally underweight corporate credit risk heading into the election. In high yield portfolios, we were positioned relatively neutral to the beta of the market, with key exposures including: underweight Healthcare, Electric Utilities and Retail/Apparel; overweight Cable, Media and Telecoms. In commodity-related sectors we have a modest overweight to Energy (ex Pipelines), and a small underweight to Metals & Mining. We are overweight intermediate-maturity bonds that we believe offer attractive carry and roll-down potential, and are nearly 2% underweight triple-C rated credits in full risk portfolios. Europe-domiciled exposures represent roughly 11% of our US-benchmarked portfolios.

- Since October 25, spreads on the benchmark high yield index (BofA Merrill Lynch High Yield Master II Index) have widened roughly 60bps over US Treasuries. High Yield mutual funds experienced a near-record outflow of over \$4bn in the week ended November 3, most of which was from exchange-traded funds. We anticipate a further selloff, primarily due to higher risk premia related to a lack of transparency in the policy agenda, and to the likely negative impact on trade relations.
- Consumer confidence reaction will be mixed, but as college-educated voters favored Clinton and can be expected to control a higher proportion of the nation's pocketbook, we see a risk of declining consumer spending. We are skeptical that a materially lower corporate tax rate 1) can be passed and 2) would generate more robust corporate spending/hiring.
- We are reluctant to position in anticipation of higher infrastructure spend, despite reference to this during Trump's victory speech, given the likely delayed timeframe and the limited historical evidence that such policies translate to meaningful additional spending.

- Trump's platform favors shale "fracking", imposing more tariffs on imports, encouraging domestic manufacturing, and reducing regulation. We may contemplate trades to reduce portfolio beta and to focus on defensive sectors against the risk of an earlier-than-anticipated recession, while also maintaining a modestly long US energy exposure.

### **Securitized Markets: Non-agency securities**

We remain overweight triple-A rated collateralized loan obligations (CLOs) and FFELP student loan-backed securities, in keeping with our focus on high quality instruments offering carry opportunities that have relatively low price sensitivity to spread movements.

- We consider these sectors better insulated than most from potential volatility-inducing events such as the election and December's Fed decision. That said, we believe securitized asset performance can be correlated with corporate bond performance, and we are monitoring risks at this late stage of the corporate credit cycle.

### **Securitized Markets: Agency securities**

Our overall positioning in agency mortgage backed securities is close to neutral. Agency MBS returns are impacted by interest rate risk, and we have favored positions we consider least exposed to election-related volatility in rates. We are also overweight higher-coupon Ginnie Mae mortgage-backed securities.

- A rally in rates back toward mid-summer levels would most likely be negative for MBS, as a potential catalyst for faster prepayments.

### **Emerging Markets**

The positions we consider most likely to be subject to a higher degree of volatility from the election result are our long exposures in the Mexican peso and Mexican local-currency rates. In sizing the positions we were mindful of the likelihood of increased volatility should Trump win the election.

- We expect near-term moves in emerging market bonds and currencies to mirror the moves in volatility more broadly i.e. an immediate rise in volatility which we think will subside over the medium term.
- Markets may start to price concerns about the impact of a potentially more protectionist stance from the US. This could continue to pressure emerging market sectors, which are levered to US trade channels and to a lesser extent countries dependent on global export growth.
- Our positioning in the Mexican peso and rates are based on the view that the currency is underpriced and would likely benefit from improving US growth, and local rates pricing in a more aggressive central bank hiking cycle than we anticipate. A Trump victory may lead to some downside risk for Mexican assets, but we believe adjustments in fundamentals, which include improvements in the current account, oil price stabilization and fiscal discipline, continue to support our positioning. We also believe the market may be overestimating the willingness and ability of a Trump administration to implement the more aggressive policies outlined on the campaign trail once he is in office.

### **Municipals**

- The municipal market is unlikely to see an immediate impact from the US presidential election. However, one important topic is tax rates, as their level weighs on the potential attractiveness of the asset class. Our view is that tax rates will ultimately trend lower, which could lead to municipals offering a lower tax-exempt benefit for investors.
- While we expect to see an increase in infrastructure spending over the coming years, approval for a federally funded program will likely take time. At the state and local level, voter approvals of ballot initiatives for infrastructure projects are expected to increase municipal issuance.

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