Monthly Market Review

Markets apparently have found their footing after winter brought discontent. Investors plod forward on the slow-growth path.

Economic Highlights

- December was not for the faint of heart as 2018 ended with surging volatility, worldwide equity sell-offs, U.S. Treasury yield curve inversion, trade tensions, and a partial government shutdown. Surprisingly, for the moment, some calm has returned, with the backdrop of "steady-as-she-goes" for the U.S. economy.
- The Federal Reserve (Fed) is recalibrating monetary policy. While the median consensus of Fed governors is for two rate hikes in 2019, the market expectation is for none (as measured by federal funds futures). Fed Chair Jerome Powell tempered expectations in a recent speech, expressing that the Fed is "prepared to adjust policy quickly and flexibly" if necessary, and other Fed policy makers have joined in tempering expectations.
- The U.S. labor market, a pillar of optimism, remains strong. The most recent jobs report showed nonfarm payrolls increased by 312,000 in December, significantly outpacing expectations. And while the unemployment rate moved up from 3.7% to 3.9%, the increase was attributed to more workers joining the labor force, a positive development.
- Geopolitical risks continue to weigh on the markets. Global political uncertainty combined with concerns about slower global growth (especially in the Eurozone and China) triggered wild gyrations in stock prices and bond yields. In particular, yields on intermediate- and longer-term U.S. Treasuries plummeted in December, falling by as many as 34 basis points (0.34%) in the month.
- A protracted U.S. government shutdown could derail the economy and the markets. The shutdown began at midnight on December 21, affecting nine important Federal agencies. The Trump administration and lawmakers have thus far failed to reach an agreement on the necessary appropriations bills to fund the government. The longer it goes on, the more likely it will crimp economic growth well into 2019.
- Around the world, the pace of manufacturing has slowed. The Eurozone PMI Manufacturing Index posted the weakest figure since February 2016, while China's Manufacturing PMI posted a sub-50 percent reading, indicating contraction in the sector and affirming a slowdown in the Chinese economy.

Bond Markets

- In December, the U.S. Treasury yield curve inverted between two- and five-year maturities for the first time since 2007. Yields on maturities greater than two years rallied 25 to 30 basis points, while shorter-term yields were pinned to the steady federal funds rate.
- As a result of falling yields, fixed income returns were strong for the month. For example, the 2-Year and 5-Year Constant Maturity U.S. Treasury Indices returned 0.81% and 1.85%, respectively. Meanwhile, the 30-Year Index generated 5.96% total return just for the month.

Equity Markets

- U.S. equities neared bear market territory in December (they staged a recovery in the first days of 2019). The S&P 500 plummeted 9.2%, the Dow plunged 8.7%, and the NASDAQ tumbled 9.5% over the month.
- The U.S. Dollar Index (DXY) fell by 1.1% in December amid the global equity rout and falling oil prices.

PFM Outlook

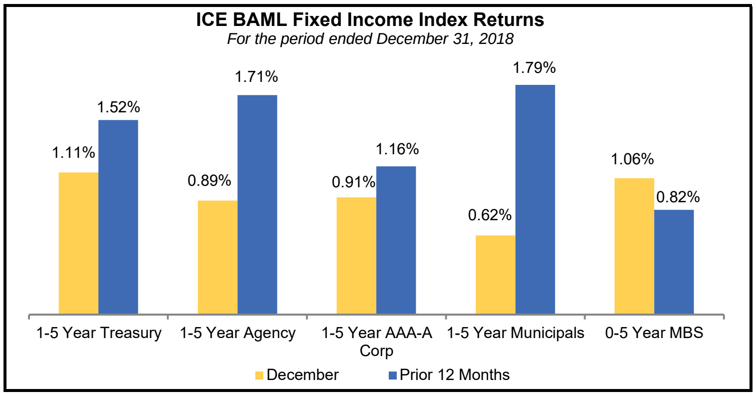
- The pace of Fed rate hikes was well-telegraphed throughout 2018, and the prospect of higher rates down the road rewarded investors who maintained a duration bias shorter than that of benchmarks. Now, the path of future rate hikes is less clear. As a result, we no longer recommend betting on interest rate increases by employing a short duration bias.
- Federal agency and supranational spreads remain narrow, largely due to limited recent supply. While the big three Government Sponsored Enterprises (GSE) – Fannie Mae, Freddie Mac, and Federal Home Loan Banks – expect issuance to remain light moving forward, supranational issuers are gearing up for new fiscal year funding programs. We expect to find opportunity in new, upcoming supranational issuance at more attractive yield spreads.
- Investment-grade corporate spreads widened markedly for the third consecutive month in December. Although economic growth prospects and generally firm credit fundamentals are positive, the sector was at the mercy of widespread de-risking throughout the month. Our recent defensive posture in the sector helped partially insulate portfolio market values, but corporates under-performed badly in the fourth quarter. At today's wider spreads, we believe there are now opportunities to selectively add back allocations to the corporate sector.
- Mortgage-backed securities (MBS) returns continued to lag the U.S. Treasury sector through year-end. Given the sector's recent underperformance, MBS spreads have widened to more attractive levels; however, the sector is expected to face further headwinds in 2019. Interest rate uncertainty, emerging weakness in the U.S. housing market, and the Fed's program to wind-down its balance sheet headline these risks. Our view on MBS remains defensive.
- AAA-rated asset-backed securities (ABS) withstood the whirlwind sell-off over the month. While the sector still generated slightly negative returns compared to Treasuries, the ability to fend-off the brunt of the underperformance experienced by most other credit sectors over the month reinforces our appetite in the sector.
- Cash and money market securities produced the best returns of all sectors in 2018 and were the highest in a decade. This year, supported by the 2.50% overnight federal funds rate, the sector is expected to produce comparable returns.

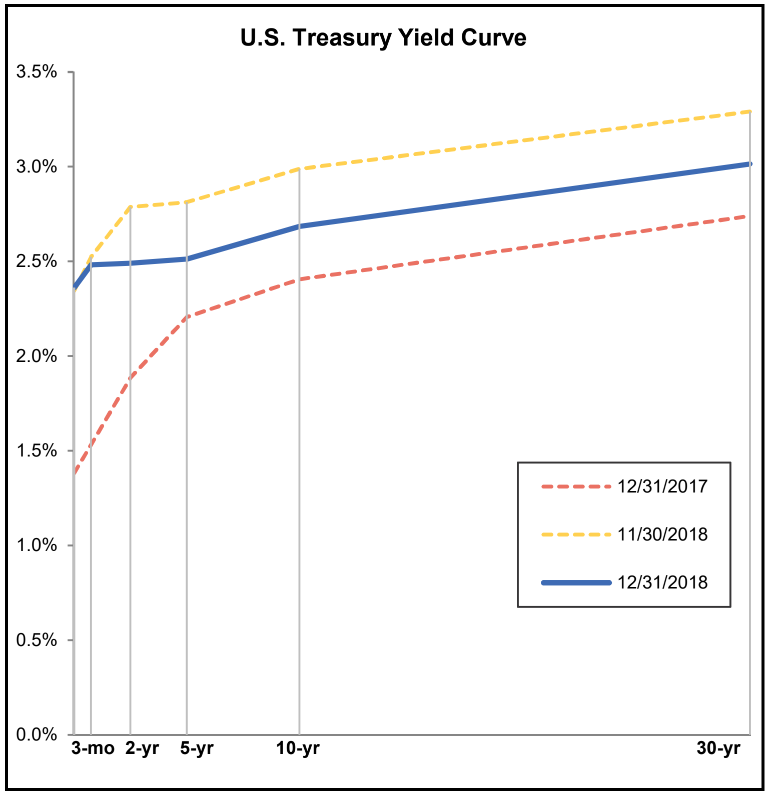
U.S. Treasury Yields				
Maturity	**Dec 31, 2017**	**Nov 30, 2018**	**Dec 31, 2018**	**Monthly Change**
3-Month	1.38%	2.35%	2.36%	0.01%
6-Month	1.53%	2.52%	2.48%	-0.04%
2-Year	1.89%	2.79%	2.49%	-0.30%
5-Year	2.21%	2.81%	2.51%	-0.30%
10-Year	2.41%	2.99%	2.69%	-0.30%
30-Year	2.74%	3.29%	3.02%	-0.27%

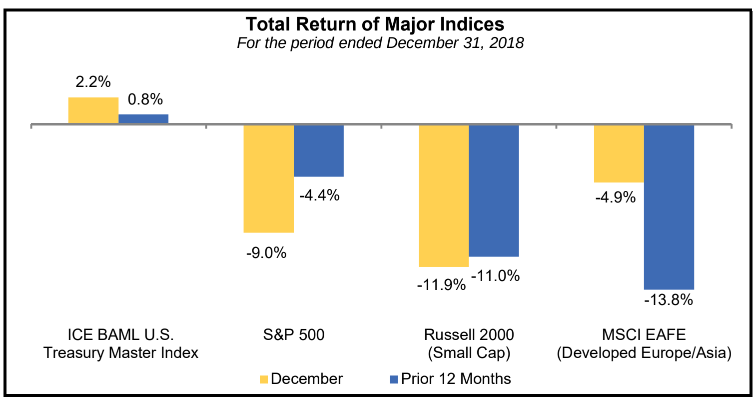
Yields by Sector and Maturity as of December 31, 2018				
Maturity	**U.S. Treasury**	**Federal Agency**	**Corporates-A Industrials**	**AAA Municipals**
3-Month	2.36%	2.38%	2.69%	-
6-Month	2.48%	2.44%	2.74%	-
2-Year	2.49%	2.56%	3.08%	1.82%
5-Year	2.51%	2.66%	3.32%	2.05%
10-Year	2.69%	3.04%	3.71%	2.51%
30-Year	3.02%	3.35%	4.32%	3.17%

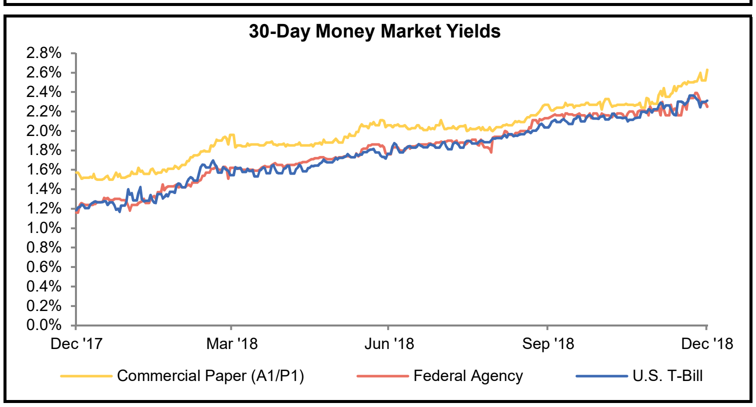
Spot Prices and Benchmark Rates				
Index	**Dec 31, 2017**	**Nov 30, 2018**	**Dec 31, 2018**	**Monthly Change**
1-Month LIBOR	1.56%	2.35%	2.50%	0.15%
3-Month LIBOR	1.69%	2.74%	2.81%	0.07%
Effective Fed Funds Rate	1.33%	2.20%	2.40%	0.20%
Fed Funds Target Rate	1.50%	2.25%	2.50%	0.25%
Gold ($/oz)	$1,309	$1,220	$1,281	$61
Crude Oil ($/Barrel)	$60.42	$50.93	$45.41	-$5.52
U.S. Dollars per Euro	$1.20	$1.13	$1.15	$0.02

Economic Indicators				
Indicator	**Release Date**	**Period**	**Actual**	**Survey (Median)**
Nonfarm Payrolls	4-Jan	Dec	312k	184k
CPI ExFood&Energy YoY	12-Dec	Dec	2.2%	2.2%
Retail Sales MoM	14-Dec	Nov	0.2%	0.1%
Consumer Confidence	27-Dec	Dec	128.1	133.5
GDP Annualized QoQ	21-Dec	3Q Third	3.4%	3.5%
ISM Manufacturing	3-Jan	Dec	54.1	57.5
FOMC Rate Dec. (Upper)	19-Dec	Dec	2.50%	2.50%









Source: Bloomberg. Data as of December 31, 2018, unless otherwise noted.

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