Monthly Market Review

The end of summer seems to have jolted fixed-income investors awake to the fact that the Federal Reserve (Fed) is firmly on a path to raise short-term rates. The result: rates across the interest rate curve have risen, stocks have fallen and market volatility has turned sharply upward. Oh, for the days of summer.

Economic Highlights

- U.S. equities had a great quarter, registering the best returns in nearly five years, as the S&P 500 (S&P) rose more than 7% and hit new all-time highs in September, before plummeting after quarter-end. Stocks benefitted from tailwinds of robust economic fundamentals, strong corporate earnings and business optimism. But the outlook clouded in October, threatening valuations and raising uncertainty.
- The Federal Open Market Committee (FOMC) increased the overnight lending rate by 0.25% to a new target range of 2% to 2.25% at its September meeting, marking the third hike this year. Perhaps more significantly, the Fed ended the use of the word "accommodative." This suggests additional hikes in coming months, but also adds uncertainty to rate forecasts.
- The U.S. economy added 134,000 new jobs in September, but this seemingly weak number was offset by sharp upward revisions in prior month estimates. Overall, the pace has averaged a healthy 200,000 jobs per month, enough to push the unemployment rate to 3.7%—a 48-year low.
- On the inflation front, many gauges of price increases are now at or near the Fed's 2% target. Wage growth has ticked up; oil prices have spiked on supply constraints and tariffs threaten to push up the cost of imported goods—all factors that could portend higher inflation in the future.
- The final update to second-quarter gross domestic product (GDP) indicated the U.S. economy grew at an annual rate of 4.2%—the fastest pace since the third quarter of 2013. At the same time, growth in Europe and some key emerging market economies, such as China, are slowing, posing a risk to the "synchronized global growth" story of the past few years.
- The U.S., Canada and Mexico reached agreement on updates to NAFTA. While the deal revises some country-of-origin, intellectual property and environmental rules, the biggest result is the resolution of one significant source of market uncertainty. Meanwhile, however, trade with China showed signs of worsening.

Bond Markets

- The U.S. Treasury yield curve is showing signs of steepening, while short-term rates rose in lockstep with the Fed.
- As a result of higher yields, the majority of investment-grade (IG), fixed-income benchmarks generated negative returns for the month, with shorter-term maturities significantly outperforming their longer-term counterparts. For example, the three-year, five-year and 30-year constant maturity indices returned -0.30%, -0.70% and -3.34%, respectively.
- Among the few positively performing fixed-income sectors for the month were corporates and asset-backed securities (ABS) with maturities of less than three years. These sectors captured incremental income, while credit spreads were stable. Over the last several quarters, income has been a critical component of fixed-income total returns.

Equity Markets

- The quarter-end highs on domestic equities proved short-lived, while non-U.S. developed market equities struggled and stocks in many emerging markets hit distress levels.
- Following a surge of appreciation in the first half of the year, the U.S. dollar index (DXY) generally moved sideways over the past three months and ended September relatively unchanged.

PFM Outlook

- We have become a bit more defensive of late, tapping lightly on the risk brake by again reducing durations a tad and seeking to improve the quality and reduce the risk of our corporate and mortgage-backed allocations. The backdrop for this perspective is the solid performance of the U.S. economy, rising global economic uncertainty and a Fed that remains publicly committed to higher rates, whether bond markets fully believe it or not.
- Credit sectors, including corporate notes and negotiable bank certificates of deposit (CDs), were the star performers in September and for all of the third quarter. While our view of corporates is still positive, we have become more defensive and selective. We will maintain the majority of current holdings, but may strategically reduce holdings where yields offer little advantage to comparable-maturity Treasuries.
- Federal agencies appear to have little value relative to U.S. Treasury securities. The flat yield curve, however, has made callable agency structures relatively more attractive. As a result, we may opportunistically add cheaper new issues or callables. While supranationals have been a good alternative this year, we will likely limit additions to the sector until supply picks up and spreads widen.
- The mortgage-backed security (MBS) sector suffers from higher long-term rates that lead to duration extensions and to the Fed program reducing its MBS balance sheet holdings. We will likely limit new purchases.
- AAA-rated ABS continue to generate positive excess returns. The sector offers a defensive alternative to corporate bond and bank deposit allocations.
- Money market fund and ultra-short-term, fixed-income investors now reap the benefit of an effective federal funds rate of more than 2% for the first time in a decade. While short-term credit spreads have narrowed to near-one-year tights, commercial paper (CP) and negotiable CDs still offer incremental earnings potential versus similar-maturity Treasuries.

U.S. Treasury Yields

Maturity	Sep 30, 2017	Aug 31, 2018	Sep 30, 2018	Monthly Change
3-Month	1.05%	2.10%	2.20%	0.10%
6-Month	1.19%	2.27%	2.37%	0.10%
2-Year	1.49%	2.63%	2.82%	0.19%
5-Year	1.94%	2.74%	2.95%	0.21%
10-Year	2.33%	2.86%	3.06%	0.20%
30-Year	2.86%	3.02%	3.21%	0.19%

Yields by Sector and Maturity as of September 30, 2018

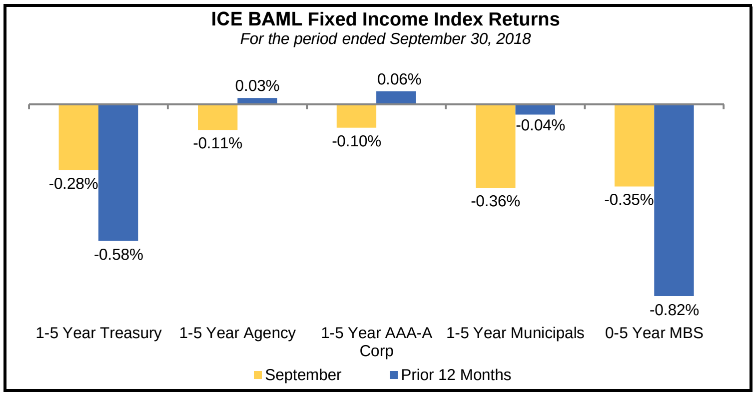
Maturity	U.S. Treasury	Federal Agency	Corporates-A Industrials	AAA Municipals
3-Month	2.20%	2.17%	2.57%	-
6-Month	2.37%	2.32%	2.65%	-
2-Year	2.82%	2.85%	3.12%	1.84%
5-Year	2.95%	3.05%	3.46%	2.16%
10-Year	3.06%	3.31%	3.87%	2.58%
30-Year	3.21%	3.49%	4.28%	3.19%

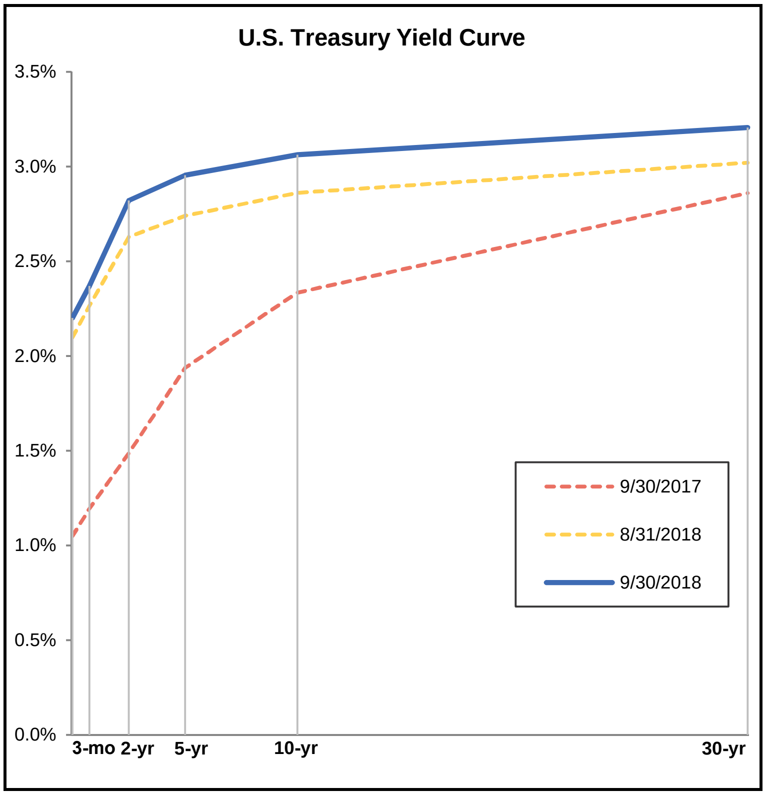
Spot Prices and Benchmark Rates

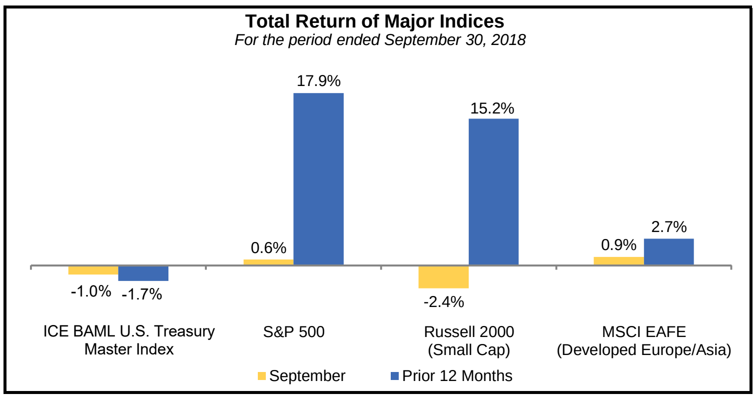
Index	Sep 30, 2017	Aug 31, 2018	Sep 30, 2018	Monthly Change
1-Month LIBOR	1.23%	2.11%	2.26%	0.15%
3-Month LIBOR	1.33%	2.32%	2.40%	0.08%
Effective Fed Funds Rate	1.06%	1.91%	2.18%	0.27%
Fed Funds Target Rate	1.25%	2.00%	2.25%	0.25%
Gold ($/oz)	$1,282	$1,202	$1,192	-$10
Crude Oil ($/Barrel)	$51.67	$69.80	$73.25	$3.45
U.S. Dollars per Euro	$1.18	$1.16	$1.16	$0.00

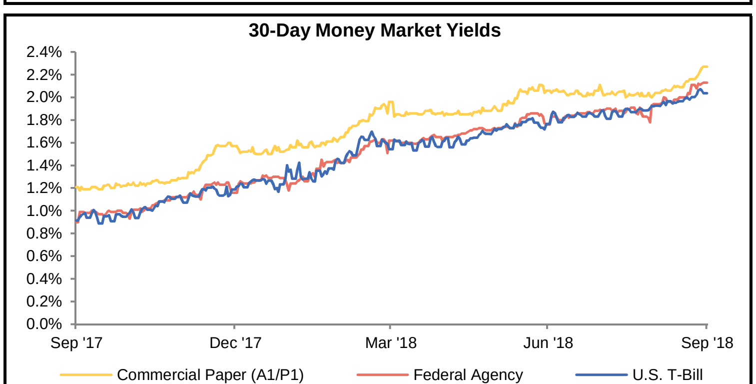
Economic Indicators

Indicator	Release Date	Period	Actual	Survey (Median)
Nonfarm Payrolls	5-Oct	Sep	134k	185k
CPI ExFood&Energy YoY	11-Oct	Sep	2.2%	2.3%
Retail Sales MoM	13-Sep	Aug	0.1%	0.4%
Consumer Confidence	25-Sep	Sep	138.4	132.1
GDP Annualized QoQ	27-Sep	2Q	4.2%	4.2%
New Home Sales MoM	26-Sep	Aug	3.5%	0.5%
FOMC Rate Dec. (Upper)	26-Sep	Sep	2.25%	2.25%









Source: Bloomberg. Data as of September 30, 2018, unless otherwise noted.

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