Monthly Market Review

The sudden, violent rise in market volatility in early February likely signals the end of a decade of easy money, and fear that the Trump tax cuts and expanding Federal budget deficit will over-stimulate the U.S. economy. Lest we forget, market sentiments can change in a day.

Economic Highlights

- Building on the themes of 2017, the global economy began 2018 with positive momentum marked by strong consumer spending and improving business investment. Yields rose and equity prices surged before an early February jolt.
- The initial reading of fourth quarter Gross Domestic Product (GDP) indicated that the U.S. economy grew at an annual pace of 2.6% and 2.3% for the year. Economists' projections for the four quarters are similar, with estimates for GDP growth in the 2.4% to 2.6% range.
- The U.S. economy added 200,000 jobs in January, outpacing both expectations (180,000) and the December reading (revised up to 160,000). The headline unemployment rate remained unchanged at 4.1%, matching a 17-year low. The surprise of the Labor Department's jobs report was a surge in wages, as average hourly earnings rose 2.9% over the past 12 months, the highest level since 2009.
- At its January meeting, the Federal Open Market Committee (FOMC) left the overnight federal funds target rate unchanged at its current range of 1.25% to 1.50%, but signaled that a rate increase is likely in March, with additional tightening to follow.
- The January FOMC meeting marked the final one for Janet Yellen, as she passed the Federal Reserve (Fed) Chair seat to Jerome Powell. Powell is expected to continue much in the Yellen mold, continuing the gradual pace of tightening and balance sheet reduction.
- The Treasury announced plans to borrow $441 billion in the first quarter, and the amount may rise if Congress agrees on a 2018 budget that expands the limits on defense and domestic spending.

Bond Markets

- The trend of rising interest rates continued as rates on Treasuries maturing from three to 10 years rose by 30 basis points (bps) or more, while yields on maturities of one year or less rose by only eight to 15 bps. Thus, for the first time in three months, the yield curve steepened.
- The increase in yields pushed fixed income prices down over the month. As a result, the majority of fixed income indices posted negative returns. Higher yields, however, will provide increased earnings potential for new investments and reinvestments.
- Diversification again proved beneficial, as a majority of investment-grade fixed income sectors outperformed similar-maturity Treasury securities. Incremental income on corporates, negotiable certificates of deposit (CDs), and asset-backed securities (ABS) cushioned the negative market value impact of rising rates.
- The mortgage-backed security (MBS) sector underperformed Treasuries during the month. Investors expect additional supply and reduced Fed buying as it reverses its quantitative easing throughout 2018.

Equity Markets

- The S&P 500 Index (S&P) logged 14 new record highs in January, ultimately tallying a 5.7% return for the month before abruptly selling off in the first days of February. January represented the 15th consecutive month of positive total return for the index. Despite this momentum, stock valuations were stretched, even with the tailwind from the massive tax cuts.
- Sector performance within the S&P was mostly positive with nine of the 11 sectors posting positive returns. Consumer Discretionary was the best-performing sector, with a 9.3% return. Utilities and Real Estate were the only two sectors that finished negative, declining 3.1% and 1.9%, respectively.
- In the wake of a third consecutive month of decline, the U.S. Dollar Index reached a three-year low, boosting international equities. Despite the recent decline, the dollar index is currently in line with its 30-year average.

PFM Outlook

- For years, policymakers have worked hard to boost incomes and inflation. With desired results in sight, investors are grappling with the prospects of rising rates and central bank policies that could become significantly less accommodative. We anticipate that the Fed will continue to ratchet rates higher over the next year or two, and we will manage portfolio durations in a modestly defensive position to respond.
- We continue to reduce allocations to Federal Agencies as their yield spreads narrowed further over the month. They now offer less than five bps of incremental income relative to a similar maturity U.S. Treasury in maturities of five years or less.
- Supranationals are an excellent government alternative as issuers are high quality (AAA) and offer an incremental yield advantage to both Treasuries and Agencies – on average 10-15 bps across much of the yield curve.
- Corporate credit spreads tightened slightly over the month, reflecting overall market strength, positive economic trends, solid earnings and guidance. In the face of the early February volatility, we have turned more cautious and suggest reducing risk in the sector by shortening the duration of corporate credit exposure in portfolios.
- With the Fed expected to become more active in reducing its MBS holdings in coming months, we recommend underweighting the MBS sector.
- Cash and money market yields increased in lockstep with recent Fed rate hikes and should continue to rise if the Fed tightens again in March. After nine-and-a-half years of the "financial repression" with near-zero rates, short-term investors can now enjoy a reasonable return on their cash.

U.S. Treasury Yields

Maturity	Jan 31, 2017	Dec 31, 2017	Jan 31, 2018	Monthly Change
3-Month	0.52%	1.38%	1.46%	0.08%
6-Month	0.63%	1.53%	1.65%	0.12%
2-Year	1.21%	1.89%	2.14%	0.25%
5-Year	1.91%	2.21%	2.52%	0.31%
10-Year	2.45%	2.41%	2.71%	0.30%
30-Year	3.06%	2.74%	2.94%	0.20%

Yields by Sector and Maturity as of January 31, 2018

Maturity	U.S. Treasury	Federal Agency	Corporates-A Industrials	AAA Municipals
3-Month	1.46%	1.40%	1.80%	-
6-Month	1.65%	1.52%	2.05%	-
2-Year	2.14%	2.18%	2.44%	1.56%
5-Year	2.52%	2.57%	2.90%	1.81%
10-Year	2.71%	2.97%	3.46%	2.31%
30-Year	2.94%	3.15%	3.85%	2.98%

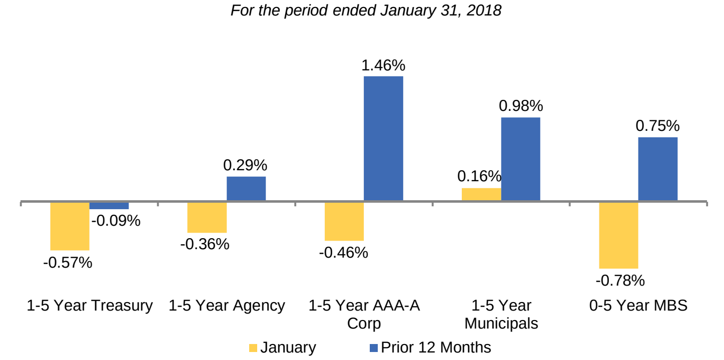
Spot Prices and Benchmark Rates

Index	Jan 31, 2017	Dec 31, 2017	Jan 31, 2018	Monthly Change
1-Month LIBOR	0.78%	1.56%	1.58%	0.02%
3-Month LIBOR	1.03%	1.69%	1.78%	0.09%
Effective Fed Funds Rate	0.56%	1.33%	1.34%	0.01%
Fed Funds Target Rate	0.75%	1.50%	1.50%	0.00%
Gold ($/oz)	$1,209	$1,309	$1,339	$30
Crude Oil ($/Barrel)	$52.81	$60.42	$64.73	$4.31
U.S. Dollars per Euro	$1.08	$1.20	$1.24	$0.04

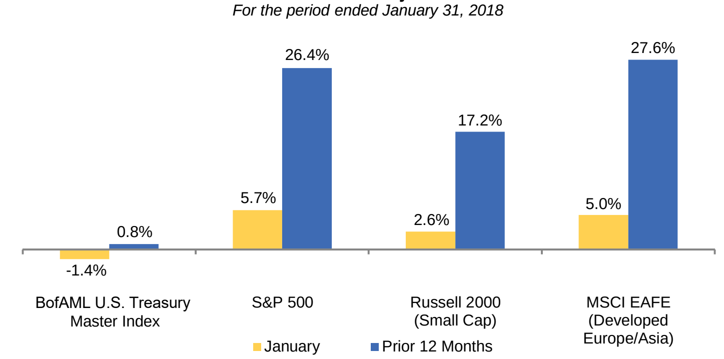
Economic Indicators

Indicator	Release Date	Period	Actual	Survey (Median)
Nonfarm Payrolls	2-Feb	Jan	200k	180k
CPI ExFood&Energy YoY	12-Jan	Dec	1.8%	1.7%
Retail Sales MoM	12-Jan	Dec	0.4%	0.5%
Consumer Confidence	19-Jan	Jan	94.4	97.0
GDP Annualized QoQ	26-Jan	4Q	2.6%	3.0%
New Home Sales MoM	25-Jan	Dec	-9.3%	-7.9%
FOMC Rate Dec. (Upper)	31-Jan	Jan	1.50%	1.50%

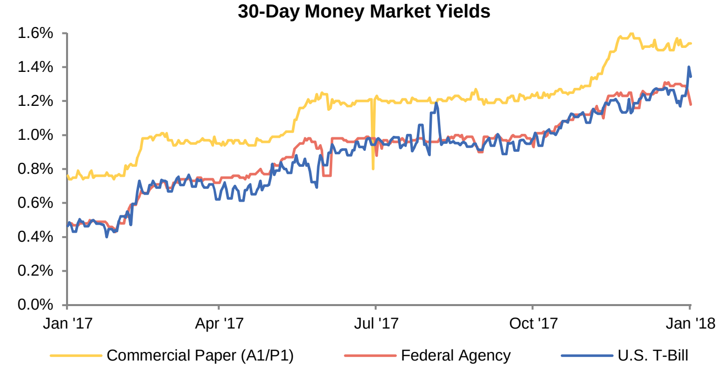
BofAML Fixed Income Index Returns
For the period ended January 31, 2018



Total Return of Major Indices
For the period ended January 31, 2018



30-Day Money Market Yields



U.S. Treasury Yield Curve