Monthly Market Review

"It's the fundamentals, stupid." This was the lesson of the last month as brief scares of an equity market sell-off and the recent announcement of new tariffs on steel and aluminum gave way to the solid underlying economic fundamentals. Stocks up, bonds down (in price) remains the trend.

Economic Highlights

- Despite the turmoil, the major macroeconomic themes of synchronized global growth, a strong U.S. labor market and rising inflation remained intact.
- Recent economic data has been generally favorable. The U.S. employment report for February showed 313,000 new jobs, many in manufacturing and construction. The upbeat report corresponded with strong readings on factory orders, a 34-year high for small business optimism, and a 17-year high for consumer confidence. However, interest-rate-sensitive sectors, like housing and auto sales, showed some weakness.
- Inflation also began to emerge as unit labor costs, prices paid by manufacturers for raw materials, home prices, the Consumer Price Index (CPI) and the Producer Price Index (PPI) all rose more than expected.
- Jerome Powell made his first public address as Chair of the Federal Reserve (Fed), presenting the semiannual monetary policy report to Congress. His testimony hinted at a continuance of the Fed's gradual but steady rate hikes. He acknowledged that "economic outlook remains strong," and noted that the Fed expects inflation to increase and approach the central bank's 2% objective.

Bond Markets

- Interest rates across the U.S. Treasury yield curve increased in February, with yields on the majority of benchmark Treasury notes reaching multi-year highs. For example, the yield of the two-year Treasury note rose 11 basis points (bps) to end the month at 2.25%, while the 10-year rose 16 bps to 2.86%. As a result, returns of most Treasury indices were uniformly negative.
- The increase in equity market volatility and "risk-off" sentiment of investors in the first weeks of February pushed investment grade (IG) credit spreads noticeably wider. The result was underperformance of most credit sectors during the month relative to comparable U.S. Treasuries.
- The mortgage-backed security (MBS) sector continued to feel the pressures of future supply expectations and the wind down of MBS holdings from the Fed's balance sheet. The result was a second consecutive month of underperformance.
- The one exception to February's adverse fixed income returns was in the municipal sector, as short- to intermediate-term municipal bonds provided positive returns on both an absolute and Treasury-relative basis. The weight of the year-end supply surge appears to have abated.

Equity Markets

- After 15 consecutive months of positive total returns, the S&P 500 Index (S&P) posted a loss of -3.7% for the month. This reflects a solid rebound from the 10% drop that occurred early in the month.
- Amid the global equity sell-off, the Chicago Board Options Exchange (CBOE) Volatility Index spiked to a near five-year high after months near all-time record low levels.
- Sector performance within the S&P was mostly negative with 10 of the 11 sectors posting negative returns. Information Technology was the only sector to post a positive return, 0.10% in February. Energy and Consumer Staples were the worst performing sectors, declining 10.82% and 7.76%, respectively.
- Following three consecutive months of decline, the U.S. Dollar Index bounced off a three-year low. The recent increase in the value of the dollar can largely be contributed to the relative declines of both the Euro and British Pound over that period which, in aggregate, makes up 70% of the U.S. Dollar Index.

PFM Outlook

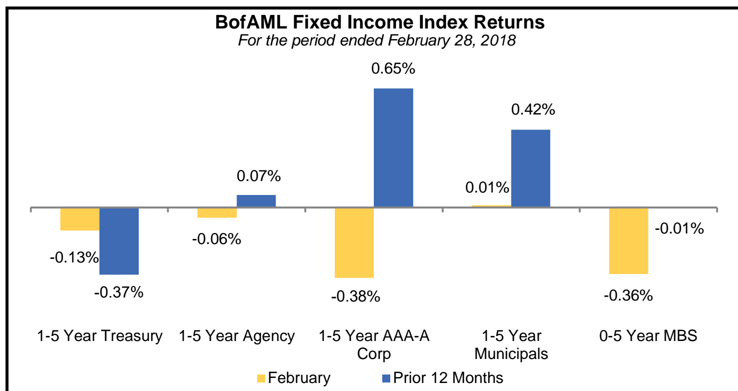
- In the face of rising rates and a strong expectation that the Fed would continue to increase short-term rates over the next 12 months, we believe a modestly defensive duration bias is warranted for longer-strategy mandates.
- While we expect rates to continue to march higher, the pace of increase is likely to slow. In addition, yields on maturities less than two years represent a reasonable investment opportunity, as they have priced in three Fed rate increases in 2018 and in 2019.
- We continue to view Federal Agencies as overly rich, as spreads for maturities less than five years remained within a few bps of comparable-maturity Treasuries during the month. However, supranationals continue to provide an excellent government alternative as issuers are high quality (AAA) and offer an incremental yield advantage to both Treasuries and Agencies.
- After a trend of tightening, IG credit spreads ended the month wider. Since our view of the fundamentals of Corporates remains unchanged, we view the recent spread widening as an opportunity to cautiously increase allocations on an issuer-specific basis.
- We remain cautious of the MBS sector as the Fed is expected to reduce its MBS holdings at a quicker pace in the coming months. However, similar to Corporates, recent spread widening may offer an opportunity to add incremental allocations in specific structures.
- Cash and money market investment yields continue to climb on large increases in supply and hawkish future Fed rate hike expectations. At current levels, we believe investors in Treasury bills, commercial paper and negotiable certificates of deposit are well-compensated relative to expected changes to future overnight rates (as measured by Fed Funds futures) in 2018.

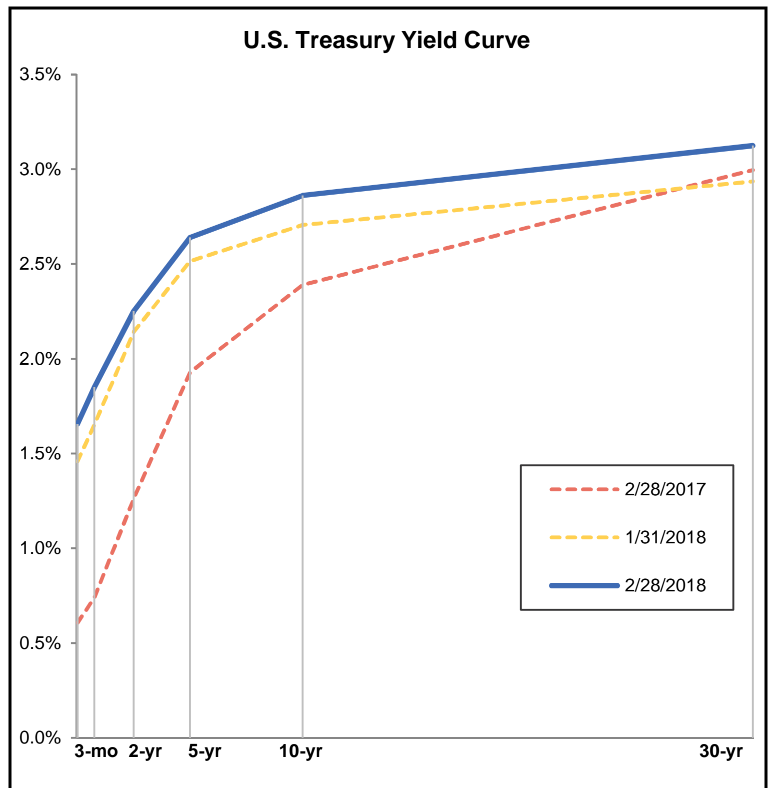
U.S. Treasury Yields				
Maturity	**Feb 28, 2017**	**Jan 31, 2018**	**Feb 28, 2018**	**Monthly Change**
3-Month	0.61%	1.46%	1.66%	0.20%
6-Month	0.74%	1.65%	1.85%	0.20%
2-Year	1.26%	2.14%	2.25%	0.11%
5-Year	1.93%	2.52%	2.64%	0.12%
10-Year	2.39%	2.71%	2.86%	0.15%
30-Year	3.00%	2.94%	3.13%	0.19%

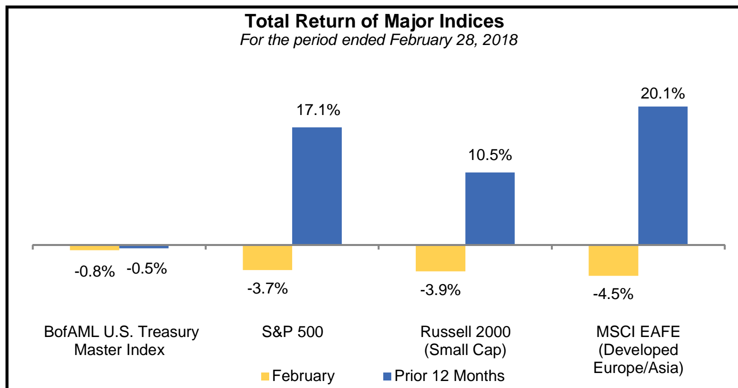
Yields by Sector and Maturity as of February 28, 2018				
Maturity	**U.S. Treasury**	**Federal Agency**	**Corporates-A Industrials**	**AAA Municipals**
3-Month	1.66%	1.65%	1.80%	-
6-Month	1.85%	1.75%	2.28%	-
2-Year	2.25%	2.32%	2.65%	1.61%
5-Year	2.64%	2.72%	3.12%	1.91%
10-Year	2.86%	3.14%	3.71%	2.45%
30-Year	3.13%	3.40%	4.10%	3.09%

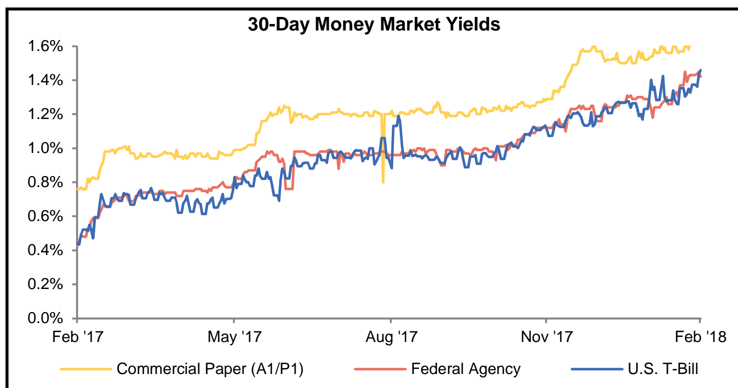
Spot Prices and Benchmark Rates				
Index	**Feb 28, 2017**	**Jan 31, 2018**	**Feb 28, 2018**	**Monthly Change**
1-Month LIBOR	0.79%	1.58%	1.67%	0.09%
3-Month LIBOR	1.06%	1.78%	2.02%	0.24%
Effective Fed Funds Rate	0.57%	1.34%	1.35%	0.01%
Fed Funds Target Rate	0.75%	1.50%	1.50%	0.00%
Gold ($/oz)	$1,254	$1,339	$1,318	-$21
Crude Oil ($/Barrel)	$54.01	$64.73	$61.64	-$3.09
U.S. Dollars per Euro	$1.06	$1.24	$1.22	-$0.02

Economic Indicators				
Indicator	**Release Date**	**Period**	**Actual**	**Survey (Median)**
Nonfarm Payrolls	9-Mar	Feb	313k	205k
CPI ExFood&Energy YoY	14-Feb	Jan	1.8%	1.7%
Retail Sales MoM	14-Feb	Jan	-0.3%	0.2%
Consumer Confidence	16-Feb	Feb	99.9	95.5
GDP Annualized QoQ	28-Feb	4Q	2.5%	2.5%
New Home Sales MoM	26-Feb	Jan	-7.8%	3.5%
Leading Indicators	22-Feb	Jan	1.0%	0.7%









Source: Bloomberg. Data as of February 28, 2018 unless otherwise noted.
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