# Monthly Market Review

**Fixed Income | September 2022**

pfm asset management

**"It's a bird! It's a plane! It's…interest rates"**

## Economic Highlights

► Federal Reserve (Fed) officials doubled down on their inflation-fighting mantra, highlighted by Fed Chair Jerome Powell's comments at the annual economic symposium in Jackson Hole, WY. Powell said the Fed's "overarching focus right now is to bring inflation back down," adding "restoring price stability will take some time and requires using our tools forcefully."

► Powell also noted, "The labor market is particularly strong, but it is clearly out of balance, with demand for workers substantially exceeding the supply of available workers." This was confirmed by the recent employment report, which showed that the U.S. economy added 315,000 jobs in August, modestly exceeding expectations. The unemployment rate rose to 3.7% from 3.5%, driven by improvements in the labor force participation. Average hourly earnings, an important measure of wages, grew by a solid 5.2% over the past year but continued to lag surging inflation. Weekly unemployment claims have also fallen for five straight weeks.

► Inflation remained sticky, with the overall consumer price index (CPI) rising 8.3% over the past year (down from 8.5% last month), while core CPI increased to 6.3% year-over-year (YoY). The report showed gasoline and energy prices fell sharply, but rents rose the most since 1991 and food has continued to rise at roughly 1% per month.

► First-time home buyers continue to face tough conditions as home prices and borrowing rates remain historically elevated. Building activity continued to slow while pending home sales plunged by more than 20% from a year ago.

► The final August results from the University of Michigan Survey of Consumers showed consumer sentiment improved from the prior month, perhaps reflecting the strong jobs market and falling gasoline prices.

► The Bloomberg recession probability index, which measures the chance of a recession in the U.S. over the next year, has risen to 50%. Growth in Europe is an even more serious emerging concern, considering the impact of elevated European natural gas prices headed into winter.

## Bond Markets

► The Fed's consistently hawkish tone pushed U.S. Treasury yields sharply higher in August, setting the stage for another 75 basis point (0.75%) (bps) rate hike at the Fed's September meeting and pushing back against the possibility of eventual rate cuts next year. By mid-September, expectations for Fed funds pointed to a terminal rate of nearly 4.5% by March 2023.

► The benchmark 6-month, 2-year, and 10-year Treasury yields finished August at 3.33%, 3.49%, and 3.19%, up 49, 61, and 54 bps (0.49%, 0.61%, and 0.54%), respectively.

► Fixed income U.S. Treasury index total returns were mostly negative in August. The ICE BofA 6-month, 2-year, and 10-year Treasury indices returned 0.15%, -0.78%, and -1.90%, respectively, for the month.

## Equity Markets

► What began as a strong month for the three major averages ended on a decidedly weaker note, cementing the weakest August performance in seven years as worries about aggressive interest rate hikes from the Fed hurt valuations. The S&P 500 finished August down 4.1%, while the Dow and Nasdaq posted monthly losses of 3.7% and 4.5%, respectively.

► The U.S. dollar continued its trend higher as the U.S. Dollar Index (DXY) advanced 3.0% in August to a new 20-year high.

## PFMAM Strategy Recap

► Given persistently elevated inflation and expectations for more Fed rate hikes, we plan to maintain our modest defensive duration bias relative to benchmarks. But, we recognize that 2-5 year Treasury yields at 14-15 year highs offer solid income potential and are beginning to shift the risk/reward dynamic. Historically, yields tend to peak before the last rate hike of a cycle.

► While federal agency non-callable securities continue to offer limited value relative to U.S. Treasuries, callable agencies have become attractive, offering wider than normal yield spreads.

► Investment-grade (IG) corporate yield spreads vs. Treasuries narrowed in August and generated outperformance. While value in the sector remains, certain industries and maturities offer much better value than others, making issue selection more important. We continue to seek issuers that can benefit from higher rates, can weather a modest economic downturn, and are better insulated from input cost pressures.

► Asset-backed security (ABS) spreads also narrowed in August, but remained wide relative to similarly-rated corporate notes. Higher energy costs, increasing rents, and negative real wage growth are potential headwinds for the consumer sector, but collateral performance remains solid and within rating parameters.

► Mortgage-backed securities (MBS) remained under pressure and were one of the few investment grade fixed income sectors to post negative excess returns for the month. Given increased Fed balance sheet reductions beginning in September, we remain defensive in the sector.

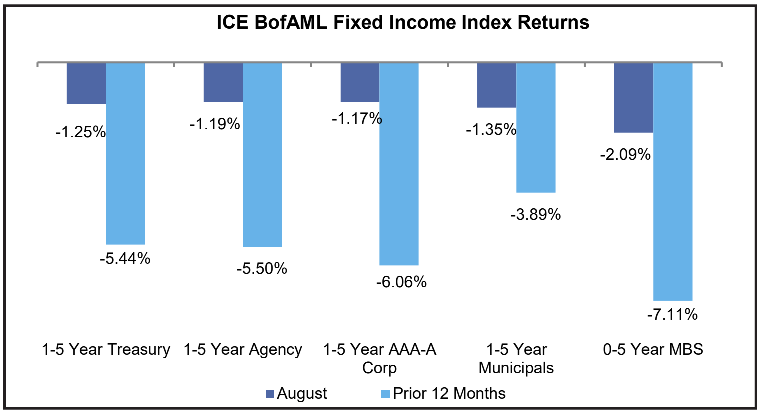
► Rates on short-term commercial paper, bank CDs and agency discount notes surged in lock-step with the Fed's expected rate hikes. Short-term investments now offer excellent income opportunities.

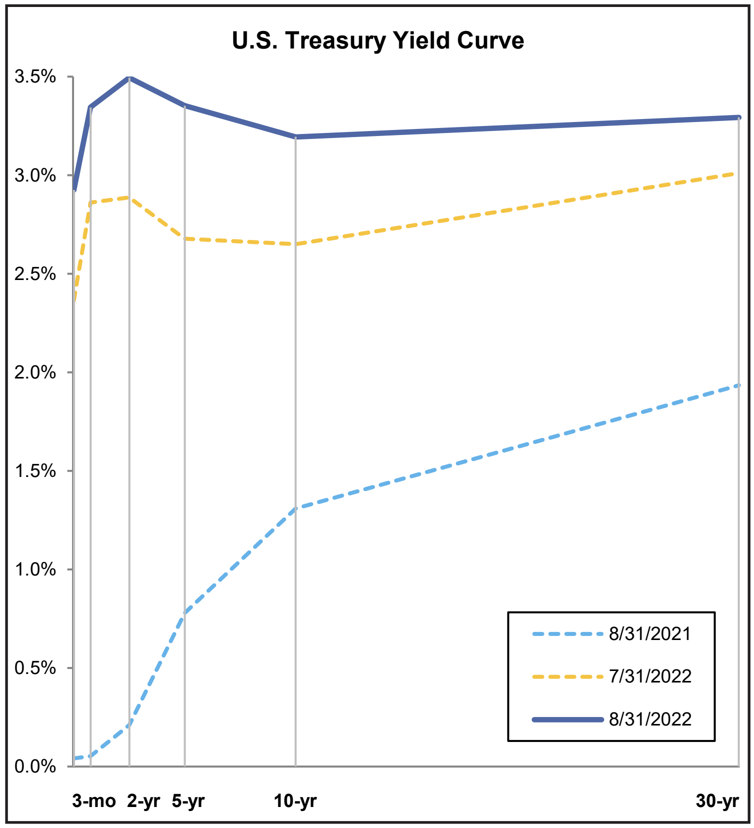
| U.S. Treasury Yields | | | | |
|---|---|---|---|---|
| Duration | Aug 31, 2021 | Jul 31, 2022 | Aug 31, 2022 | Monthly Change |
| 3-Month | 0.04% | 2.36% | 2.93% | 0.57% |
| 6-Month | 0.05% | 2.86% | 3.35% | 0.49% |
| 2-Year | 0.21% | 2.89% | 3.50% | 0.61% |
| 5-Year | 0.78% | 2.68% | 3.35% | 0.67% |
| 10-Year | 1.31% | 2.65% | 3.20% | 0.55% |
| 30-Year | 1.93% | 3.01% | 3.29% | 0.28% |

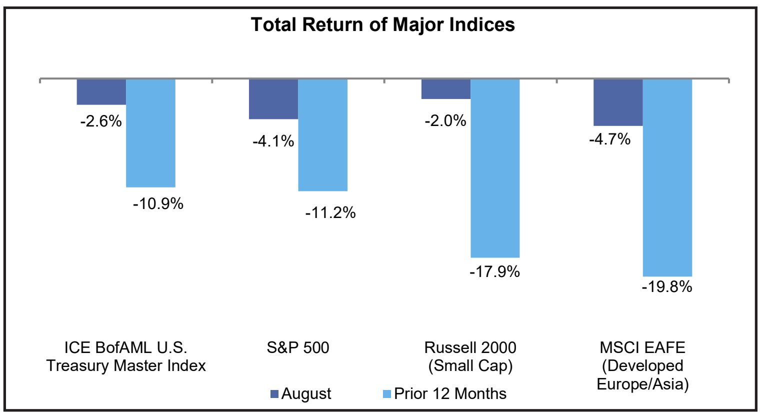
| Yields by Sector and Maturity | | | | |
|---|---|---|---|---|
| Maturity | U.S. Treasury | Federal Agency | Corporates-A Industrials | AAA Municipals |
| 3-Month | 2.93% | 2.92% | 3.28% | -- |
| 6-Month | 3.35% | 3.27% | 3.37% | -- |
| 2-Year | 3.50% | 3.54% | 3.76% | 2.22% |
| 5-Year | 3.35% | 3.45% | 3.98% | 2.32% |
| 10-Year | 3.20% | 3.52% | 4.26% | 2.80% |
| 30-Year | 3.29% | 3.91% | 4.69% | 3.40% |

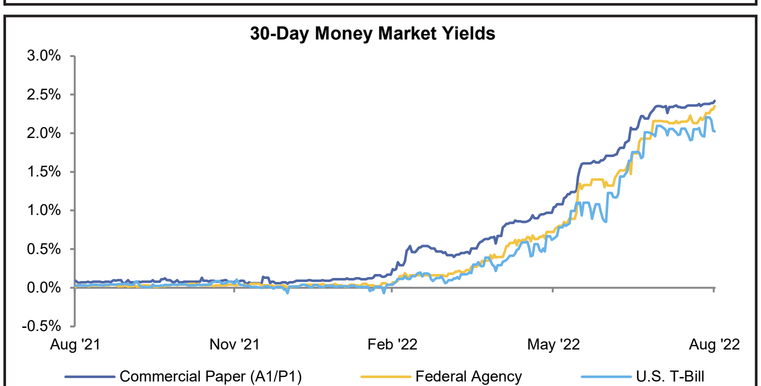
| Spot Prices and Benchmark Rates | | | | |
|---|---|---|---|---|
| Index | Aug 31, 2021 | Jul 31, 2022 | Aug 31, 2022 | Monthly Change |
| 1-Month LIBOR | 0.08% | 2.36% | 2.55% | 0.19% |
| 3-Month LIBOR | 0.12% | 2.79% | 3.10% | 0.31% |
| Effective Fed Funds Rate | 0.06% | 2.32% | 2.33% | 0.01% |
| Fed Funds Target Rate | 0.25% | 2.50% | 2.50% | 0.00% |
| Gold ($/oz) | $1,816 | $1,763 | $1,717 | -$46 |
| Crude Oil ($/Barrel) | $68.50 | $98.62 | $89.55 | -$9.07 |
| U.S. Dollars per Euro | $1.18 | $1.02 | $1.01 | -$0.01 |

| Key Economic Indicators | | | | |
|---|---|---|---|---|
| Indicator | Release Date | Period | Actual | Survey (Median) |
| Retail Sales Advance MoM | 17-Aug | Jul | 0.0% | 0.1% |
| GDP Annualized QoQ | 25-Aug | 2Q S | -0.6% | -0.7% |
| PCE Core Deflator YoY | 26-Aug | Jul | 4.6% | 4.7% |
| U. of Mich. Consumer Sentiment | 26-Aug | Aug | 58.2 | 55.5 |
| ISM Manufacturing | 1-Sep | Aug | 52.8 | 51.9 |
| Change in Non-farm Payrolls | 2-Sep | Aug | 315k | 298k |
| Unemployment Rate | 2-Sep | Aug | 3.7% | 3.5% |




*Source: Bloomberg. Data as of August 31, 2022, unless otherwise noted.*

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