Monthly Market Review

Fixed Income | August 2023

pfm asset management

"Soft Landing Nirvana."

Economic Highlights

► The Federal Reserve (Fed) increased the overnight federal funds rate by 0.25% at its July meeting, to a new target range of 5.25% to 5.50%. This comes after the central bank left rates unchanged at its June meeting. Fed Chair Jerome Powell highlighted that the Fed is no longer forecasting a U.S. recession and said that "we do have a shot" for inflation to return to target without high levels of job losses.

► On a year-over-year (YoY) basis, headline CPI rose 3.0% as of June, the lowest annual increase in over two years and another step lower from the 4.0% YoY pace in May and 6.5% in December 2022. Meanwhile the core CPI rate registered 4.8% over the year in June, a full half-percent decline from May. On a monthly basis, core CPI, which excludes food and energy, increased just 0.2% in June, marking the smallest one-month increase since August 2021. Shelter costs remain the largest contributor to the monthly headline CPI number, accounting for 70% of the increase.

► Non-farm payrolls increased by 187,000 in July, and the unemployment rate fell slightly to 3.5%. Employment continued to trend up in healthcare, social assistance, finance activities, wholesale trade and construction. Employment openings totaled 9.58 million in June, edging lower from 9.62 million in May. The labor market remains a tailwind to the U.S. economy.

► Advanced estimates for second quarter real gross domestic product (GDP) increased at an annual rate of 2.4%, compared to a 1.8% initial estimate and 2.0% in the first quarter. The results reflected increases in consumer spending, nonresidential fixed investment, state and local government spending, private inventory investment, and federal government spending that were partly offset by decreases in exports and residential fixed investment.

► Unlike manufacturing activity, which has been in contractionary territory for nine consecutive months, the services sector expanded in July for the seventh consecutive month.

► As 30-year mortgage rates have remained over 7% for two consecutive months, the divergence between existing and new home sales deepened. Current home buyers are less willing to sell their home, creating further pressure on inventory and robust increases in new home construction, resulting in existing home sales continuing its 18-month trend lower.

Bond Markets

► U.S. Treasury yields were a tale of three curves during July as short- and long-term tenors increased 10 to 20 basis points (bps) over the month, while intermediate-term maturities (one to five years) were relatively unchanged.

► The benchmark 3-month, 2-, and 10-year U.S. Treasuries finished the month at 5.40%, 4.88%, and 3.96%, moving up 12, down 2, and up 12 bps during July, respectively.

► As a result, U.S. Treasury index returns were positive in July, with the exception being the longest duration indices. The ICE BofA 3-month, 2-, and 10-year U.S. Treasury indices returned 0.40%, 0.28%, and -0.79%, respectively.

Equity Markets

► Equity markets have had the best seven months to start a year since 1997, with the S&P 500 Index up 20.6% through July. Markets took comfort in the prospect of a soft landing, and the Fed nearing the final stages of the current hiking cycle. For the month, the Dow Jones Industrial average ended up about 3.4%, while the Nasdaq added 4.1%, and the S&P 500 was up 3.2%.

► International stocks (measured by the MSCI ACWI ex-U.S. index) were up 4.1% in July and 14.4% on the year. The U.S. dollar Index (DXY) retreated 1.0% during the month as "higher for longer" Fed rhetoric remained.

PFMAM Strategy Recap

► Markets seem to be converging to PFMAM's long-standing view that the U.S. would avoid recession and short-term rates will remain elevated for the foreseeable future. As rates have continued to gravitate higher and the yield curve remains deeply inverted, we plan to maintain a modestly defensive duration bias.

► Incremental yields on agencies, supranationals, and municipals remain low, and new issue buying opportunities are sporadic and limited.

► Corporate spreads have continued to narrow from mid-March wides, ending July at their lowest levels in three months. As a result, they generated attractive excess returns for the month. We will likely maintain our current exposure as portfolios continue to benefit from incremental spread income while risks of recession have declined, and corporate fundamentals remain firm. Fitch's August 1 downgrade of the U.S. government had virtually no impact on rates, but did push spreads a touch wider.

► Asset-backed security (ABS) spreads have also steadily narrowed from recent wides, although they remain only modestly elevated compared to pre-banking crisis levels, resulting in strong excess returns for the month. We expect tighter lending standards, strong demand from investors, and less volatility in rates to be supportive of the sector over the medium term.

► Positive excess returns from mortgage-backed securities (MBS) across most collateral and coupon structures underscored the "risk-on" sentiment across investment markets in July.

► Short-term credit markets (commercial paper and certificates of deposit) remain attractive as rates are high and the money market credit curve is quite steep.

U.S. Treasury Yields

Duration	Jul 31, 2022	Jun 30, 2023	Jul 31, 2023	Monthly Change
3-Month	2.36%	5.30%	5.42%	0.12%
6-Month	2.86%	5.43%	5.47%	0.04%
2-Year	2.89%	4.90%	4.88%	-0.02%
5-Year	2.68%	4.16%	4.18%	0.02%
10-Year	2.65%	3.84%	3.96%	0.12%
30-Year	3.01%	3.86%	4.01%	0.15%

Yields by Sector and Maturity

Maturity	U.S. Treasury	Federal Agency	Corporates-A Industrials	AAA Municipals
3-Month	5.42%	5.37%	5.54%	-
6-Month	5.47%	5.43%	5.50%	-
2-Year	4.88%	4.94%	5.10%	2.91%
5-Year	4.18%	4.27%	4.74%	2.48%
10-Year	3.96%	4.24%	4.84%	2.73%
30-Year	4.01%	4.52%	5.13%	3.31%

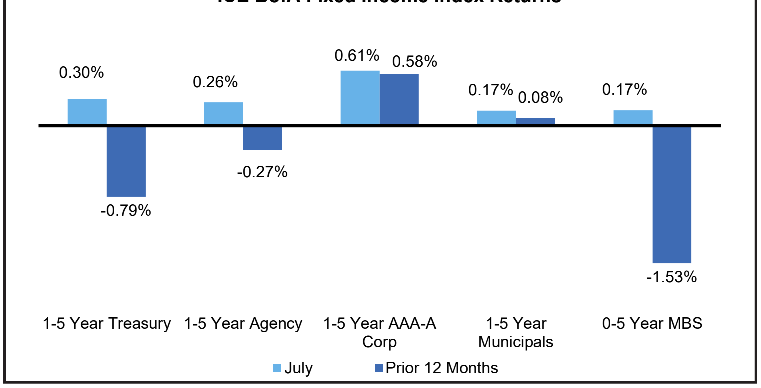
Spot Prices and Benchmark Rates

Index	Jul 31, 2022	Jun 30, 2023	Jul 31, 2023	Monthly Change
1-Month LIBOR	2.36%	5.22%	5.43%	0.21%
3-Month LIBOR	2.79%	5.55%	5.63%	0.08%
Effective Fed Funds Rate	2.32%	5.08%	5.33%	0.25%
Fed Funds Target Rate	2.50%	5.25%	5.50%	0.25%
Gold ($/oz)	$1,763	$1,929	$1,971	$41
Crude Oil ($/Barrel)	$98.62	$70.64	$81.80	$11.16
U.S. Dollars per Euro	$1.02	$1.09	$1.10	$0.01

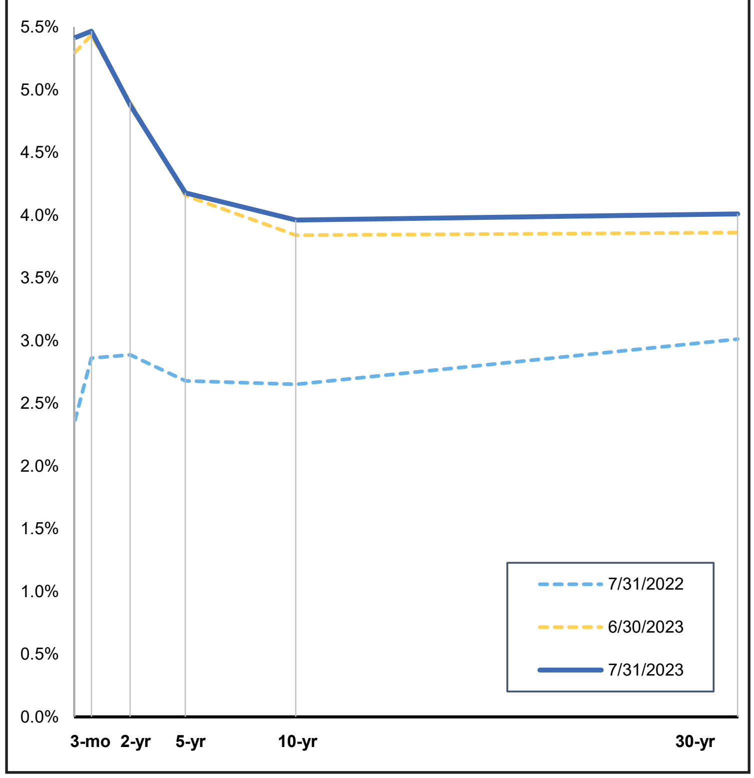
Economic Indicators

Indicator	Release Date	Period	Actual	Survey (Median)
Unemployment Rate	7-Jul	Jun	3.60%	3.60%
CPI YoY	12-Jul	Jun	3.00%	3.10%
FOMC Rate Decision	26-Jul	26-Jul	5.50%	5.50%
GDP Annualized QoQ	27-Jul	2Q A	1.80%	2.40%
U. of Mich. Consumer Sentiment	28-Jul	Jul F	71.6	72.6
PCE Core Deflator YoY	28-Jul	Jun	4.10%	4.20%
ISM Manufacturing	1-Aug	Jul	46.4	46.9

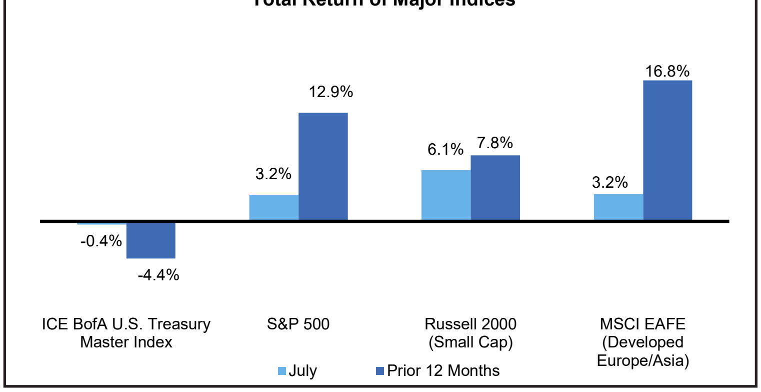
ICE BofA Fixed Income Index Returns



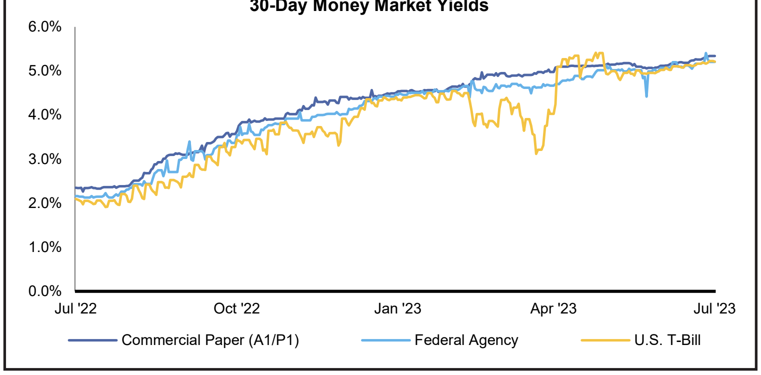
U.S. Treasury Yield Curve



Total Return of Major Indices



30-Day Money Market Yields



Source: Bloomberg. Data as of July 31, 2023, unless otherwise noted.

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