Monthly Market Review

Fixed Income | May 2023

pfm asset management

"To pause or not to pause."

Economic Highlights

► With the widely anticipated 25 basis point (bp) rate hike on May 3, the Federal Open Market Committee (FOMC) has now increased rates by a cumulative 500 bps since March 2022, taking the fed funds target rate to a range of 5.00% to 5.25%. Federal Reserve (Fed) Chair Jerome Powell has made it clear that taming inflation remains the Fed's top priority, despite regional banking concerns and mounting recession risks. While the Fed did not officially pause, it is not yet clear if that was the last hike of the cycle.

► Consumer prices (CPI) rose 5.0% in March from a year ago and a full percentage point from the 6.0% reading in February. The pace of price increases in March was slowed by gasoline prices, which fell 17% year-over-year. Core inflation, which strips out food and energy, increased 0.1% to 5.6%. Prices remain elevated for food, transportation, shelter and new vehicles, underscoring the persistent challenge for the Fed.

► The April employment report showed job gains of 253,000, firmly outpacing expectations of 185,000 and reinforcing the strength of labor markets. The unemployment rate ticked lower to 3.4%, matching its 40-year low, highlighting just how far the labor market is from the Fed's March projections of 4.5% by year-end 2023.

► March retail sales declined -1.0% over the month, worse than the expected fall of -0.5%, and posting back-to-back monthly declines. The main driver of recent declines was spending at U.S. retailers, as consumers pulled back after banking sector woes re-fueled recession fears.

► April ISM Manufacturing PMI signaled a sixth straight month in which economic activity contracted.

Bond Markets

► After a historical plunge in March, the U.S. Treasury yield curve inverted further in April as shorter tenors (less than one year) increased, while those beyond two years declined by 5 to 10 bps.

► The benchmark 3-month, 2-year, and 5-year U.S. Treasury yields finished the month at 5.03%, 4.00%, and 3.48%, moving up 34, down 2, and down 9 bps during April, respectively.

► As a result, U.S. Treasury index returns were firmly positive in April. The ICE BofA 3-month, 2-year, and 5-year U.S. Treasury indices returned 0.31%, 0.20%, and 0.66%, respectively, for the month.

Equity Markets

► The S&P 500 Index is up 9.2% for the year after gaining 1.6% in April, as equities have broadly shrugged off recent market-souring headlines, and were reinforced by the eerily calm volatility index (VIX), which closed the month near a three-year low. For the month, the Dow Jones Industrial average rose 2.6%, while the Nasdaq was unchanged for the month and is up 17.1% year-to-date. International stocks, measured by the MSCI ACWI ex-US index, rose 1.8% in April and are up 9% on the year.

► The U.S. Dollar Index (DXY) fell 0.8% during the month, on expectations the Fed is nearing the end of its hiking cycle. The combination of a weaker dollar and lower Treasury yields has pushed gold to near an all-time high.

PFMAM Strategy Recap

► The FOMC delivered what many participants expect to be the final rate hike of this cycle. Despite expectations for a pause, the "higher for longer" narrative remains the Fed's message. In contrast, the market has been pricing in 2023 rate cuts since the announcement of two large bank failures in March. Our view is that pricing rate cuts is premature, and intermediate-term yields are too low. We plan to maintain a modestly defensive duration bias relative to benchmarks, but we do not want portfolio durations to drift too short given economic uncertainties.

► Following several weeks of attractive federal agency valuations, the sector retreated from near-term wides. Recent additions have performed well and were additive to portfolio performance in April.

► Spreads on supranational issues are notably tight and offer limited return prospects over the near-term.

► Corporate spreads have tightened compared to March, although the gap between industrials and financials remains near all-time wides. Industrials appear tight, while financials appear cheap, but challenges in the regional banking sector explain current market pricing. We will likely maintain allocations over the near-term and focus on selectivity. Spreads appear priced for a soft landing, as they are nowhere near prior recession levels.

► AAA-rated asset-backed security (ABS) spreads remain elevated relative to high-quality corporates. With fundamentals remaining solid for prime ABS, we continue to view the sector as attractive and plan to maintain or add to allocations over the near-term. Expectations for modest declines in new issuance versus 2022 levels should be supportive of spreads, absent a deep recession, which we do not expect.

► After underperforming by 50 bps during the first quarter, the MBS sector lost an additional 10 bps of relative performance in April. Valuations have cheapened markedly and now present opportunities.

► Pressures in the front end of the curve are complicated by uncertainty around future Fed hikes as well as the debt ceiling impasse. Treasury bill yields on maturities near the "x-date", when the Treasury has said it will exhaust all extraordinary measures to fund the U.S. government, have surged. The effect is most pronounced in the June-August timeframe. At the same time, money market credit (commercial paper and certificates of deposit) remains quite attractive and offers yield advantages of as much as 50 bps in longer 6-12 month maturities.

U.S. Treasury Yields

Duration	Apr 30, 2022	Mar 31, 2023	Apr 30, 2023	Monthly Change
3-Month	0.83%	4.75%	5.06%	0.31%
6-Month	1.41%	4.88%	5.02%	0.14%
2-Year	2.72%	4.03%	4.01%	-0.02%
5-Year	2.96%	3.58%	3.49%	-0.09%
10-Year	2.94%	3.47%	3.43%	-0.04%
30-Year	3.00%	3.65%	3.68%	0.03%

Yields by Sector and Maturity

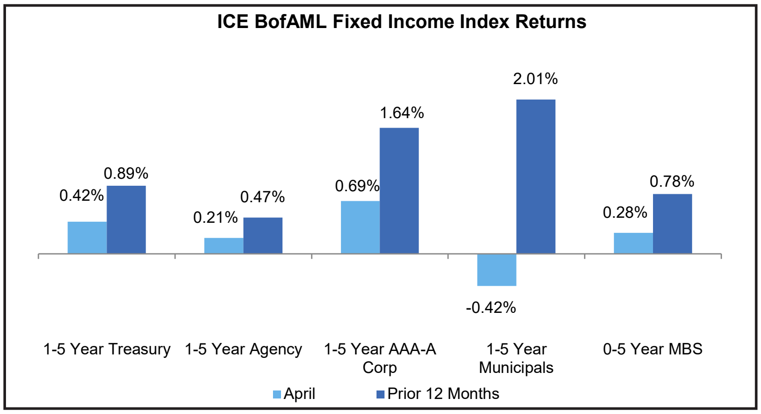
Maturity	U.S. Treasury	Federal Agency	Corporates-A Industrials	AAA Municipals
3-Month	5.06%	4.93%	4.77%	-
6-Month	5.02%	5.01%	4.74%	-
2-Year	4.01%	4.24%	4.46%	2.57%
5-Year	3.49%	3.66%	4.21%	2.31%
10-Year	3.43%	3.78%	4.38%	2.73%
30-Year	3.68%	4.17%	4.89%	3.29%

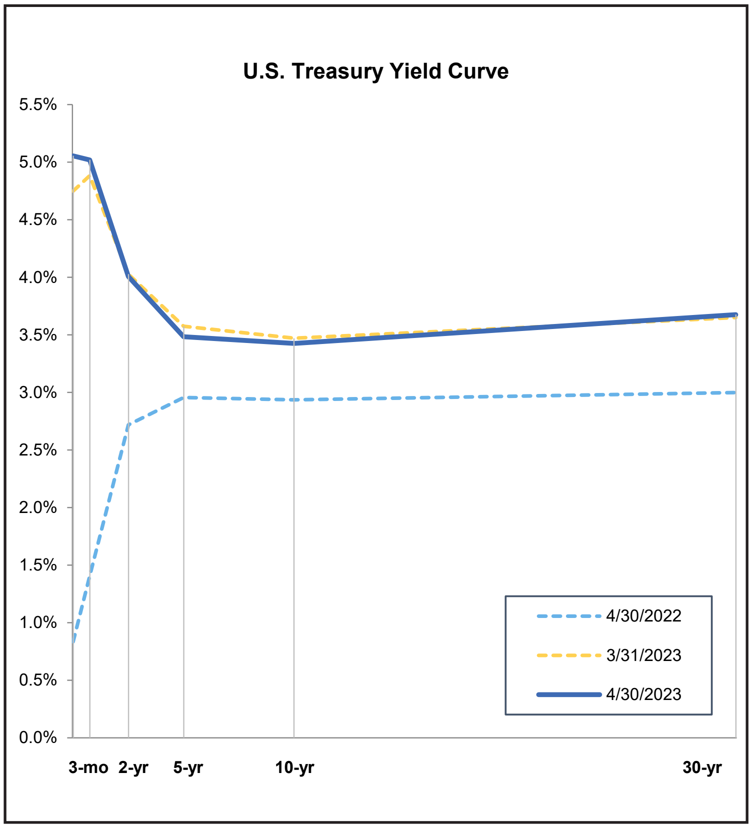
Spot Prices and Benchmark Rates

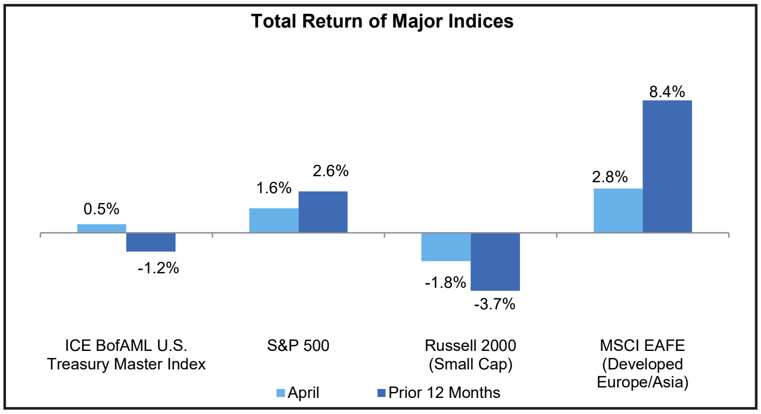
Index	Apr 30, 2022	Mar 31, 2023	Apr 30, 2023	Monthly Change
1-Month LIBOR	0.80%	4.86%	5.06%	0.20%
3-Month LIBOR	1.33%	5.19%	5.30%	0.11%
Effective Fed Funds Rate	0.33%	4.83%	4.83%	0.00%
Fed Funds Target Rate	0.50%	5.00%	5.00%	0.00%
Gold ($/oz)	$1,912	$1,969	$1,999	$30
Crude Oil ($/Barrel)	$104.69	$75.67	$76.78	$1.11
U.S. Dollars per Euro	$1.05	$1.08	$1.10	$0.02

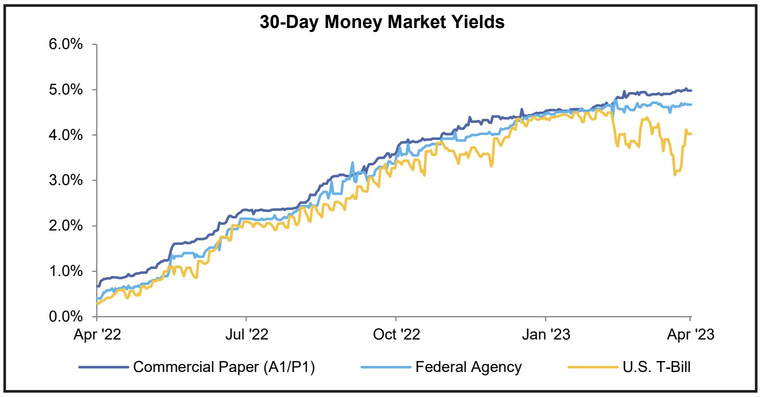
Economic Indicators

Indicator	Release Date	Period	Actual	Survey (Median)
CPI YoY	12-Apr	Mar	5.00%	5.10%
Retail Sales Advance MoM	14-Apr	Mar	-1.00%	-0.50%
GDP Annualized QoQ	27-Apr	1Q A	1.10%	1.90%
U. of Mich. Consumer Sentiment	28-Apr	Apr F	63.5	63.5
ISM Manufacturing	1-May	Apr	47.1	46.8
FOMC Rate Decision	3-May	M-23	5.00%	5.00%
Unemployment Rate	5-May	Apr	3.40%	3.60%









Source: Bloomberg. Data as of April 30, 2023, unless otherwise noted.

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