Monthly Market Review

Fixed Income | October 2023

pfm asset management

"The 80's are calling, they want their high rates back."

Economic Highlights

► At its September meeting, the Federal Reserve (Fed) kept the overnight target rate unchanged in its current range of 5.25% to 5.50%. They did, however, signal that interest rates may still need to be a bit higher to counteract inflationary pressures, as reflected by the half-percent increase in the year-end 2024 and 2025 median projections for overnight rates compared to June estimates. Fed Chair Jerome Powell noted that the Fed can now "proceed carefully" thanks to its aggressive tightening early in this cycle.

► Inflation, as measured by CPI, posted a second straight significant monthly increase in September (+0.4%). This was in large part due to an increase in both shelter costs and gasoline prices. Overall, the CPI increased 3.7% from a year ago, holding at higher levels than June and July. However, core inflation, excluding food and energy prices, continue to moderate, rising 4.1% year-over-year (YoY), down from 4.3% in August and 4.7% in July. The most recent core inflation reading was the weakest since September 2021.

► The employment report for September was surprisingly strong, with the U.S. economy adding 336,000 new jobs. Job gains occurred in leisure and hospitality; government; health care; professional and technical services; and social assistance. The unemployment rate held at 3.8% as the labor force continued to grow. Average hourly earnings, an important gauge of wages, rose 4.2% YoY, the slowest pace in two years.

► The final estimate for second quarter gross domestic product was unchanged at 2.1%. Some concerns have emerged as consumer spending advanced at only half the pace as previously reported, largely due to weaker services outlays. Stronger business fixed investment helped offset the slowdown in consumer spending, however; all eyes are on the ability of the consumer to support the desired economic soft landing.

Bond Markets

► The 10-year U.S. Treasury yield closed September above 4.5% for the first time since October 2007. Sticky inflation, a "higher-for-longer" market consensus, increased Treasury borrowing, and reduced holdings by China and Japan weighed on the long end of the curve.

► The Treasury yield curve remained inverted despite the notable increase in the 10-year yield in the third quarter. But, the yield curve inversion became far less severe, falling from a peak of -108 basis points (bps) in early July to -47 bps by quarter end.

► Tracking Treasury yields higher, 30-year mortgage rates climbed further, closing the month at a new cycle high of 7.74%, further impairing home affordability.

► The benchmark 3-month, 2- and 10-year U.S. Treasuries finished the month at 5.45%, 5.05% and 4.57%, moving up 0, 18 and 46 bps, respectively, during September.

► As a result of higher yields and a steeper curve over the month, longer duration strategies underperformed. The ICE BofA 3-month, 2- and 10-year U.S. Treasury indices returned +0.46%, -0.08% and -3.49%, respectively, for the month.

Equity Markets

► The S&P 500 dropped 4.8% in September, bringing year-to-date (YTD) total returns down, but still firmly positive at 13.1%. Stocks were negatively impacted by rising long-term rates and growing concern about political and geopolitical risks. For the month, the Dow Jones Industrial Average declined 3.4% and the Nasdaq declined 5.8%.However, the Nasdaq ended the month up 27% YTD.

► International stocks, measured by the MSCI ACWI ex-U.S. index, fell -3.1% in September, but are up 5.8% YTD.

► The U.S. dollar Index (DXY), which measures the greenback against six major peers, rose 2.5% in September primarily on higher Treasury bond yields.

PFMAM Strategy Recap

► Markets continue to recalibrate expectations for Fed policy with the consensus coalescing around rates being "higher for longer." At the same time, the inverted yield curve makes duration extension less attractive, so we plan to maintain a modestly defensive duration bias relative to benchmarks.

► Spreads on agencies, supranationals, and municipals remain tight amid sparce issuance. Since new attractive buying opportunities have been limited, we will likely continue to lighten allocations in these sectors.

► Corporates generated slightly negative excess returns in September as spreads widened modestly, closing the month near 12-month averages. Income earning capacity, including reasonable credit spreads, will be a significant contributor to returns going forward. Good fundamentals, modestly attractive spreads, and a positive economic outlook also make credit attractive.

► Asset-backed security (ABS) spreads were relatively stable in September and as a result were a top-of-class performer in terms of positive excess returns for the month. Although consumer credit fundamentals appear to be weakening, senior tranche ABS benefit from strong credit enhancements that support AAA ratings and continued collateral performance, as expected.

► Mortgage-backed securities (MBS) performance for the month diverged as agency-backed commercial MBS generated positive excess returns while the more volatile pass-through sector underperformed badly. We view the general weakening in spreads as a decent opportunity to add modestly to allocations.

► Short-term credit, including commercial paper and bank CDs, offer the highest yields in over 15 years, and provide excellent earnings opportunities for cash investors.

U.S. Treasury Yields

Duration	Sep 30, 2022	Aug 31, 2023	Sep 30, 2023	Monthly Change
3-Month	3.27%	5.45%	5.45%	0.00%
6-Month	3.93%	5.51%	5.55%	0.04%
2-Year	4.28%	4.87%	5.05%	0.18%
5-Year	4.09%	4.26%	4.61%	0.35%
10-Year	3.83%	4.11%	4.57%	0.46%
30-Year	3.78%	4.21%	4.70%	0.49%

Yields by Sector and Maturity

Maturity	U.S. Treasury	Federal Agency	Corporates-A Industrials	AAA Municipals
3-Month	5.45%	5.39%	5.75%	-
6-Month	5.55%	5.45%	5.74%	-
2-Year	5.05%	5.13%	5.46%	3.59%
5-Year	4.61%	4.72%	5.24%	3.28%
10-Year	4.57%	4.88%	5.43%	3.50%
30-Year	4.70%	5.17%	5.78%	4.07%

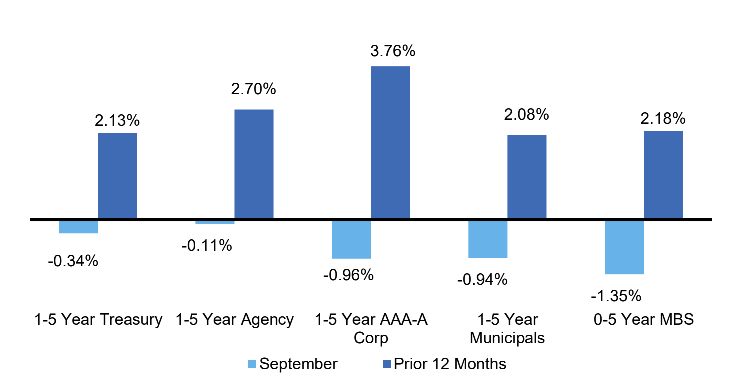
Spot Prices and Benchmark Rates

Index	Sep 30, 2022	Aug 31, 2023	Sep 30, 2023	Monthly Change
1-Month LIBOR	3.14%	5.44%	5.43%	-0.01%
3-Month LIBOR	3.75%	5.66%	5.66%	0.00%
Effective Fed Funds Rate	3.08%	5.33%	5.33%	0.00%
Fed Funds Target Rate	3.25%	5.50%	5.50%	0.00%
Gold ($/oz)	$1,662	$1,947	$1,848	-$99
Crude Oil ($/Barrel)	$79.49	$83.63	$90.79	$7.16
U.S. Dollars per Euro	$0.98	$1.08	$1.06	-$0.02

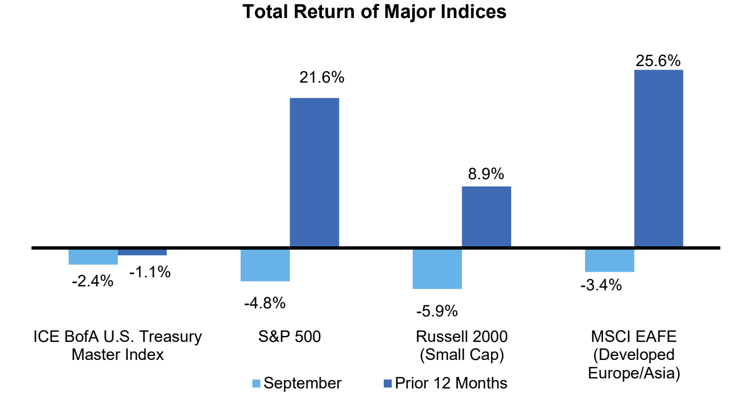
Economic Indicators

Indicator	Release Date	Period	Actual	Survey (Median)
CPI YoY	13-Sep	Aug	3.70%	3.60%
U. of Mich. Consumer Sentiment	15-Sep	Sep P	67.7	69.0
FOMC Rate Decision	20-Sep	20-Sep	5.50%	5.50%
GDP Annualized QoQ	28-Sep	2Q T	2.10%	2.20%
PCE Core Deflator YoY	29-Sep	Aug	3.50%	3.50%
ISM Manufacturing	2-Oct	Sep	49.0	47.9
Change in Non-farm Payrolls	6-Oct	Sep	336K	170K

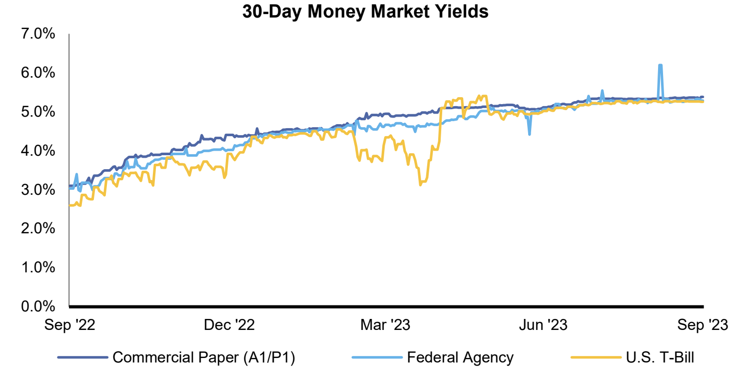
ICE BofA Fixed Income Index Returns



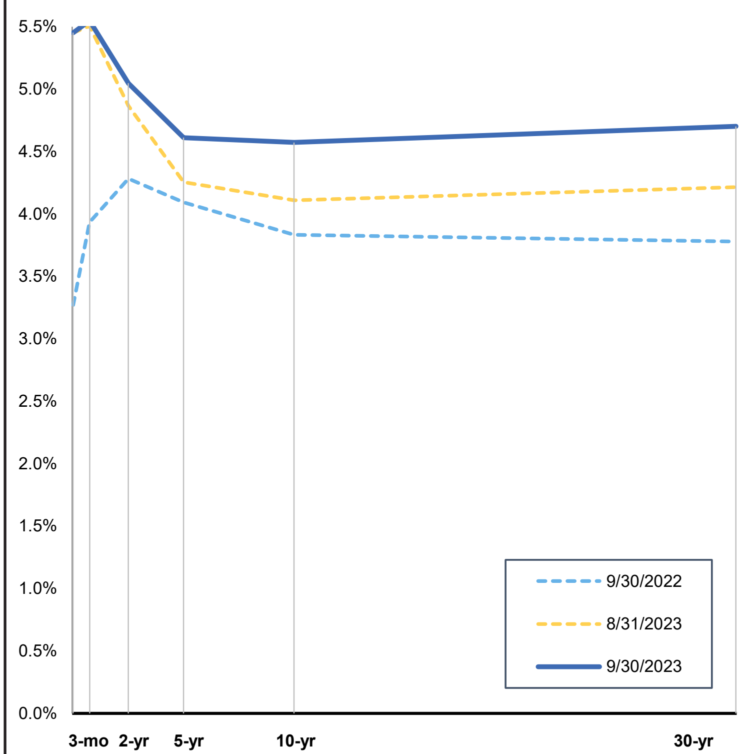
Total Return of Major Indices



30-Day Money Market Yields



U.S. Treasury Yield Curve



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

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