Monthly Market Review

Fixed Income | December 2022

pfm asset management

"Fed hikes were hung by the chimney with care, in hopes that inflation would soon become bare."

Economic Highlights

► All eyes remain on the Federal Reserve's (Fed's) rate-hike trajectory, which remains inexorably linked to the inflation landscape. Markets now expect the next hike in mid-December to step down to a 50-basis point (bps) increase after four consecutive 75-bps hikes. In a recent speech at the Brookings Institute, Fed chair Jerome Powell indicated that "ongoing increases will be appropriate" and "the ultimate level of rates will need to be somewhat higher than thought at the time of the September meeting and [the Fed's last] Summary of Economic Projections."

► The Consumer Price Index (CPI) cooled more than expected in October, rising 7.7% from a year earlier and down from 8.2% the prior month. Shelter costs are still the inflationary boogeyman, but private sector data offers encouraging signs that home prices and rent are on the decline.

► The tight labor market resulted in a boost to job growth and wages. The economy added 263,000 jobs in November, well above expectations, while the unemployment rate held firm at 3.7%. Average hourly earnings, an important gauge of wage growth, rose a stronger-then-expected 5.1% year-over-year, fueling concern about a potential wage-price spiral.

► Sales of existing homes fell for the ninth straight month in October to the lowest level in a decade (outside of one month in the early days of the pandemic) as high mortgage rates combined with elevated home prices continue to scare off potential buyers. The October reading of an annualized pace of 4.43 million units is 28% lower than a year ago.

► Real U.S. gross domestic product (GDP) grew at a revised 2.9% pace in the third quarter, modestly better than the advance release. The second estimate primarily reflected upward revisions to consumer spending and non-residential fixed investment that were partly offset by a downward revision to private inventories.

Bond Markets

► The lower CPI reading triggered a surprise rally in bonds as expectations for a Fed down-throttle spurred a rate decline on longer-maturity issues.

► The benchmark 6-month, 2-year, and 10-year U.S. Treasury yields finished the month at 4.65%, 4.31%, and 3.61%, up 11, down 17, and down 44 bps (+0.11%, -0.17%, and -0.44%) for November, respectively.

► Fixed income U.S. Treasury Index total returns pushed positive in November. The ICE BofA 6-month, 2-year, and 10-year Treasury indices returned 0.36%, 0.54%, and 3.74%, respectively, for the month.

► As a result of the further divergence between short-term yields – which are tracking the Fed rate hikes – and longer-term Treasury yields – which are looking around the corner to perhaps an oncoming recession – caused the yield curve to reach levels of inversion not experienced since 2001. For example, the difference between the 3-month Treasury bill (4.32%) and the longer-term 10-year Treasury note (3.61%) was -71 bps (-0.71%).

Equity Markets

► Equities moved higher on potential Fed moderation as the S&P 500 Index surged 5.6% for the month. The Dow Jones Industrial Average and the Nasdaq Composite also rose, returning 6.0% and 4.5%, respectively.

► The U.S. dollar extended losses in November from its September peak, a multi-decade high, as the U.S. dollar Index (DXY) lost 5% for the month.

PFMAM Strategy Recap

► Given the Fed's commitment to raise short-term rates to "a level that is sufficiently restrictive," then hold policy "at a restrictive level for some time" and "stay the course until the job is done," we plan to maintain our modest defensive duration bias relative to benchmarks. However, given the longer-term uncertainty around Fed rate policy over the next 12 to 18 months, we may look to utilize bouts of oversold market weakness to extend durations closer to benchmarks.

► Federal agency non-callable yield spreads reached multi-year wides and now offer good value, although liquidity remains challenged in the sector. On the other hand, spreads on callable structures narrowed as volatility moderated but still offered decent return prospects.

► After reaching two-year wides in September, investment-grade (IG) corporate yield spreads tightened sharply in October and November. Given reasonably stable fundamentals, we are still constructive on the sector but will be more selective at tighter spread levels.

► Asset-backed security (ABS) spreads continue to diverge from high-quality corporates and remain elevated from a historical perspective. As prime structures continue to offer strong credit enhancement relative to loss expectations, we view elevated ABS spreads as an attractive opportunity to add to the sector, especially for strategies with duration targets less than two years.

► Mortgage-backed securities (MBS) roared back in November, generating substantial positive excess returns for the month on sharply lower bond yields and narrower MBS spreads. However, year-to-date performance remains dismal as the pain of earlier rate increases still weighs on MBS. Although we remain guarded on the sector, select opportunities may exist.

► Short-term investors continue to reap the rewards of the highest yields in 15 years. 3-month T-Bills at 4.32% and 6-month commercial paper at over 5% are just two examples of the excellent income opportunities available in the money market space.

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U.S. Treasury Yields

Duration	Nov 30, 2021	Oct 31, 2022	Nov 30, 2022	Monthly Change
3-Month	0.05%	4.07%	4.35%	0.28%
6-Month	0.10%	4.54%	4.68%	0.14%
2-Year	0.57%	4.49%	4.31%	-0.18%
5-Year	1.16%	4.23%	3.74%	-0.49%
10-Year	1.45%	4.05%	3.61%	-0.44%
30-Year	1.79%	4.17%	3.74%	-0.43%

Yields by Sector and Maturity

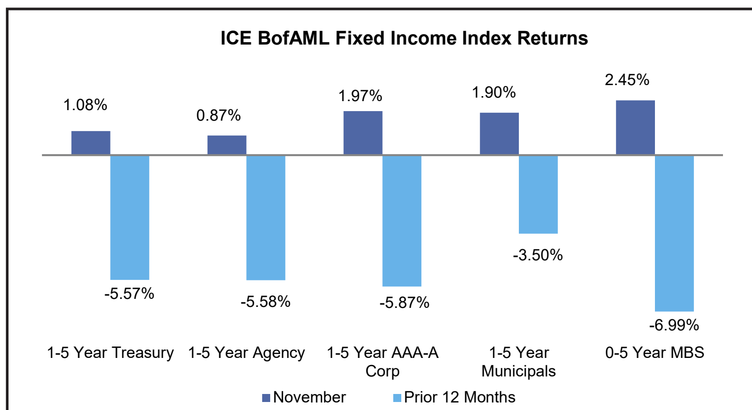
Maturity	U.S. Treasury	Federal Agency	Corporates-A Industrials	AAA Municipals
3-Month	4.35%	4.35%	4.50%	--
6-Month	4.68%	4.59%	4.53%	--
2-Year	4.31%	4.44%	4.57%	2.50%
5-Year	3.74%	4.02%	4.52%	2.62%
10-Year	3.61%	4.07%	4.68%	2.99%
30-Year	3.74%	4.32%	5.04%	3.56%

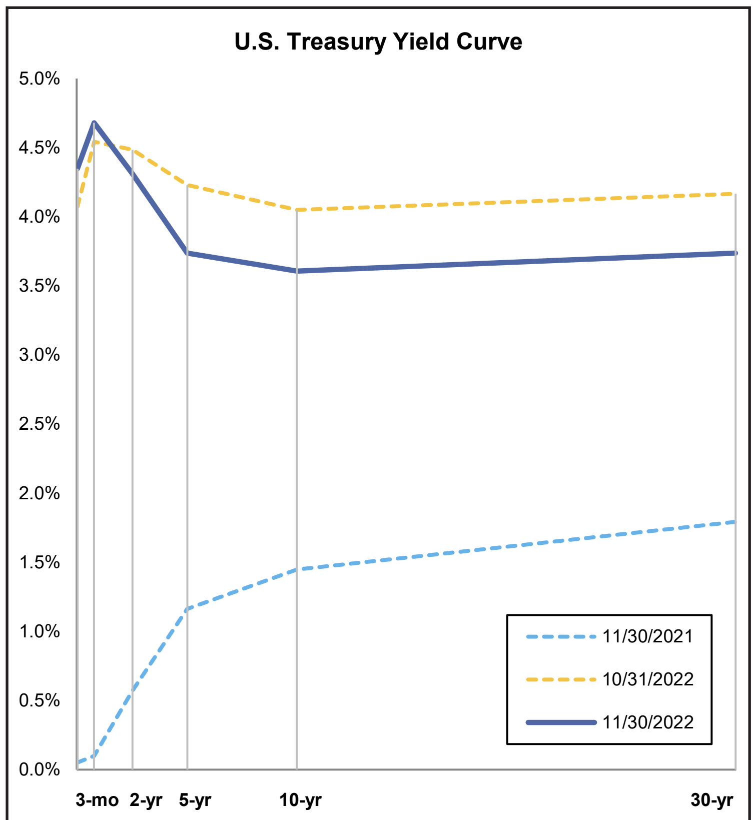
Spot Prices and Benchmark Rates

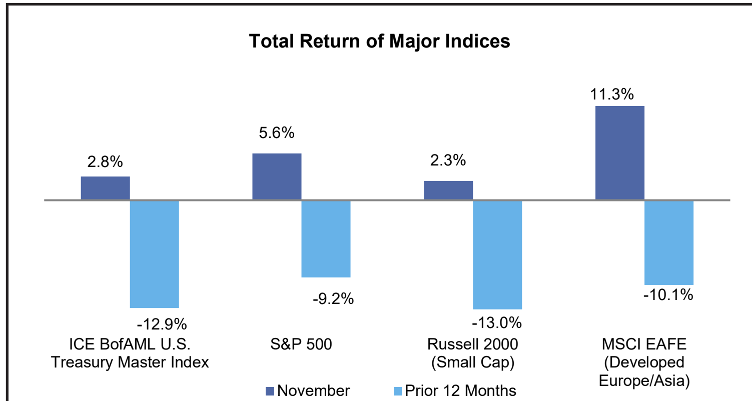
Index	Nov 30, 2021	Oct 31, 2022	Nov 30, 2022	Monthly Change
1-Month LIBOR	0.09%	3.80%	4.14%	0.34%
3-Month LIBOR	0.17%	4.46%	4.78%	0.32%
Effective Fed Funds Rate	0.07%	3.08%	3.83%	0.75%
Fed Funds Target Rate	0.25%	3.25%	4.00%	0.75%
Gold ($/oz)	$1,774	$1,641	$1,746	$105
Crude Oil ($/Barrel)	$66.18	$86.53	$80.55	-$5.98
U.S. Dollars per Euro	$1.13	$0.99	$1.04	$0.05

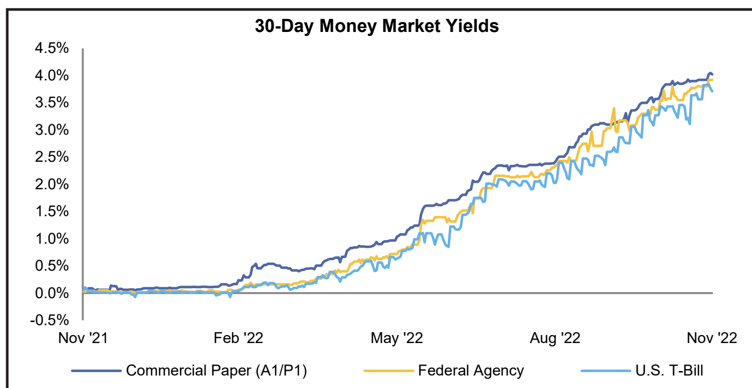
Key Economic Indicators

Indicator	Release Date	Period	Actual	Survey (Median)
CPI YoY	10-Nov	Oct	7.7%	7.9%
Existing Home Sales MoM	18-Nov	Oct	-5.9%	-6.6%
U. of Mich. Consumer Sentiment	23-Nov	Nov	56.8	55.0
GDP Annualized QoQ	30-Nov	3Q	2.9%	2.8%
ISM Manufacturing	1-Dec	Nov	49.0	49.7
Change in Nonfarm Payrolls	2-Dec	Nov	263k	200k
Unemployment Rate	2-Dec	Nov	3.7%	3.7%









Source: Bloomberg. Data as of November 30, 2022, unless otherwise noted.

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