# Monthly Market Review

**Fixed Income | January 2023**

pfm asset management

**"Message to the Fed: Try not to break anything."**

## Economic Highlights

► There are accumulating signs of a slowdown, including the steeply inverted yield curve, a sharp reversal in the housing market, weakening in both the manufacturing and services sectors, declining personal savings, tepid consumer confidence, retreating commodity prices and a now falling U.S. dollar. On the positive side, employment remains strong, household income is rising, and inflation has begun to moderate. The latter forces are significant and may keep the economy out of a deep recession, but uncertainty is high.

► At its December meeting, the Federal Open Market Committee (FOMC) raised the fed funds rate by 50 basis points (bps) to a new target range of 4.25% to 4.50%, which was a downshift following four consecutive 75 bp hikes. The updated summary of economic projections points toward lower growth, higher inflation and a higher unemployment rate in 2023. Chair Jerome Powell commented that the Federal Reserve (Fed) has "more work to do" and that "restoring price stability will likely require maintaining a restrictive policy stance for some time."

► The year-over-year change in the Consumer Price Index (CPI) fell to 6.5% in December, down from 7.1% a month earlier. Overall prices declined for the month, the first such decrease since May 2020. Falling gasoline, fuel oil and car prices were the largest contributors. Shelter costs remained elevated, but they typically lag. After peaking at 9.1% in June, headline CPI has now moderated for six consecutive months.

► The labor market remained strong, as the economy added 223,000 jobs in December. The unemployment rate fell back to 3.5%, matching a 50+ year low. Wage growth moderated, but remained above trend, while the labor force participation rate improved.

► The housing market continued to cool. Existing home sales declined by nearly 8% in November, falling for the tenth consecutive month to a 12-year low (outside of one month during the pandemic). Building permits fell precipitously and were down 29% through November.

► Business activity slowed, as the services sector joined the manufacturing sector in contraction, as measured by the Institute for Supply Management (ISM) purchasing manager surveys.

## Bond Markets

► Treasury yields generally traded within their broader Q4 ranges in December, but ended higher on the month. That reversed quickly in the first two weeks of January, as lower expectations for inflation combined with growing concerns about an economic slowdown pushed longer-term rates to the lower end of the range. For all of 2022, rates were sharply higher. For reference, the yield on the 2-year Treasury was 369 bps higher for the year.

► The benchmark 3-month, 2-year, and 10-year U.S. Treasury yields finished December at 4.34%, 4.43%, and 3.88%, up 5 bps, up 12 bps, and up 27 bps for the month, respectively.

► Fixed income U.S. Treasury index total returns were mixed in December. The ICE BofA 6-month and 2-year indices generated positive returns of 0.43% and 0.13%, respectively. The longer 5-year and 10-year Treasury indexes returned -0.44% and -1.12%, respectively.

## Equity Markets

► Stock market returns in December added salt to the wound as all three major domestic averages suffered their worst year since 2008. The Dow Jones Industrial Average fell 4.1% in December, while the S&P 500 Index decreased 5.8% and the Nasdaq was down 8.7%. For the year, the Dow was down 6.9%, the S&P fell 18.1% and the tech-heavy Nasdaq plunged 32.5%.

► International stocks, as measured by the MSCI ACWI ex-U.S. Index, nearly broke even in December, falling just 0.8%, but ended the year down 15.6%. Q4 was a strong quarter for international markets, buoyed by a weaker U.S. dollar and a less bleak global economic outlook.

## PFMAM Strategy Recap

► Amid economic growth uncertainty with additional Fed rate hikes still expected, we plan to maintain our modestly defensive posture, with portfolio durations shorter than benchmarks for now. The market's expectation for rate cuts in late 2023 conflicts with the Fed's publically stated position of holding rates in restrictive territory. That battle will play out in 2023.

► Federal agency yield spreads widened a touch, presenting some opportunities, but weaker liquidity (wide bid/ask spreads) persists as a headwind. Supranational issuance is expected to pick up in the first quarter.

► The 1-10 year A-rated corporates widened from 58 bps at the beginning of 2022 to a peak of 135 bps before moving back under 100 bps. We believe current spreads are attractive. Spreads have not been wider than the recent peak outside of crisis periods, like the dot com bubble, GFC, and the pandemic. Combined with the highest yields in 14-15 years, absolute yields are around 5%, and the positive credit curve means there is additional value in longer corporates. But, the risk is that spreads are not priced for a deep recession (which we do not expect).

► Asset-backed security (ABS) spreads narrowed significantly in December after lagging the move in investment-grade (IG) corporates, but continue to offer value.

► The mortgage-backed securities (MBS) sector eeked out a slightly positive excess return for the month to end a solid rebound quarter. We continued to see value in shorter, higher coupon structures.

► Money market spreads narrowed in December, but continue to offer excellent value and very attractive absolute yields, in many cases fully compensating for additional potential rate hikes.

## U.S. Treasury Yields

| Duration | Dec 31, 2021 | Nov 30, 2022 | Dec 31, 2022 | Monthly Change |
|---|---|---|---|---|
| 3-Month | 0.04% | 4.35% | 4.37% | 0.02% |
| 6-Month | 0.19% | 4.68% | 4.76% | 0.08% |
| 2-Year | 0.73% | 4.31% | 4.43% | 0.12% |
| 5-Year | 1.26% | 3.74% | 4.01% | 0.27% |
| 10-Year | 1.51% | 3.61% | 3.88% | 0.27% |
| 30-Year | 1.90% | 3.74% | 3.97% | 0.23% |

## Yields by Sector and Maturity

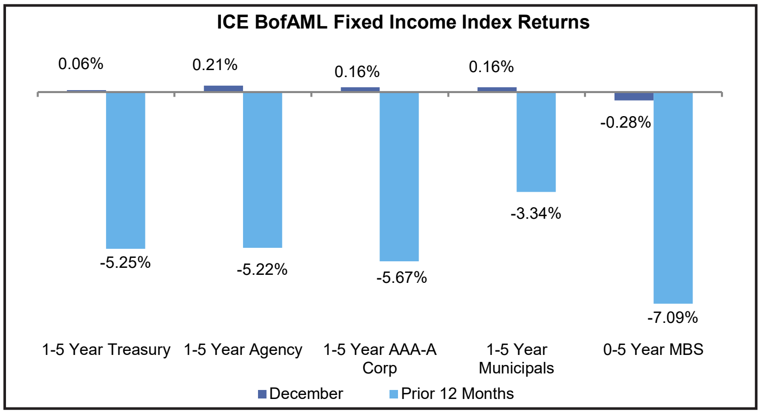
| Maturity | U.S. Treasury | Federal Agency | Corporates-A Industrials | AAA Municipals |
|---|---|---|---|---|
| 3-Month | 4.37% | 4.46% | 4.70% | - |
| 6-Month | 4.76% | 5.16% | 4.73% | - |
| 2-Year | 4.43% | 4.56% | 4.77% | 2.60% |
| 5-Year | 4.01% | 4.14% | 4.73% | 2.59% |
| 10-Year | 3.88% | 4.14% | 4.88% | 2.97% |
| 30-Year | 3.97% | 4.34% | 5.22% | 3.53% |

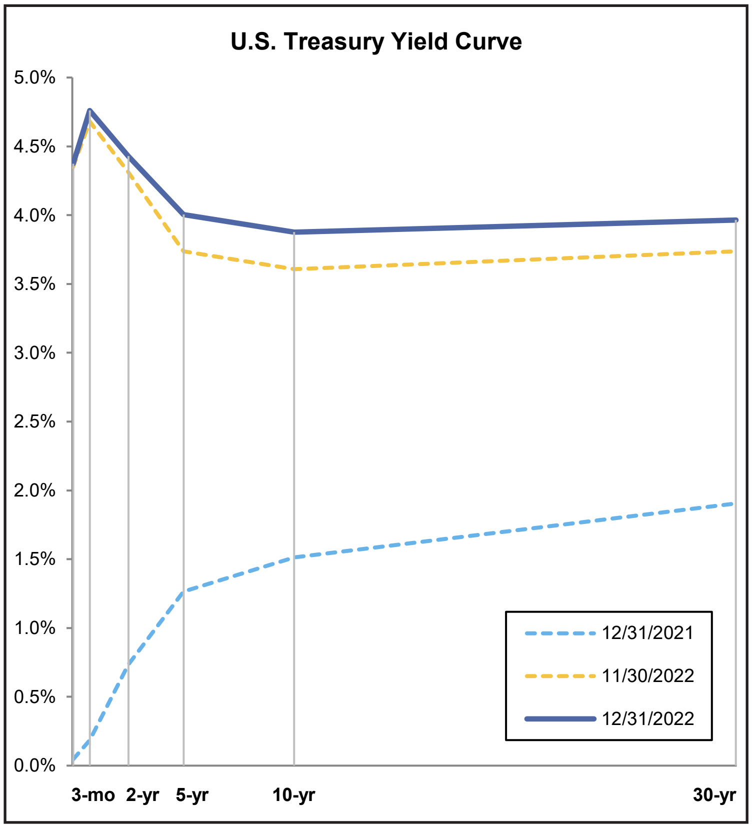
## Spot Prices and Benchmark Rates

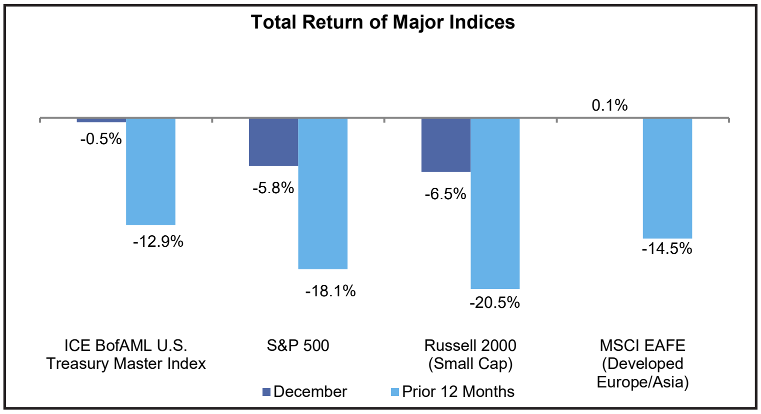
| Index | Dec 31, 2021 | Nov 30, 2022 | Dec 31, 2022 | Monthly Change |
|---|---|---|---|---|
| 1-Month LIBOR | 0.10% | 4.14% | 4.39% | 0.25% |
| 3-Month LIBOR | 0.21% | 4.78% | 4.77% | -0.01% |
| Effective Fed Funds Rate | 0.07% | 3.83% | 4.33% | 0.50% |
| Fed Funds Target Rate | 0.25% | 4.00% | 4.50% | 0.50% |
| Gold ($/oz) | $1,829 | $1,746 | $1,826 | $80 |
| Crude Oil ($/Barrel) | $75.21 | $80.55 | $80.26 | -$0.29 |
| U.S. Dollars per Euro | $1.14 | $1.04 | $1.07 | $0.03 |

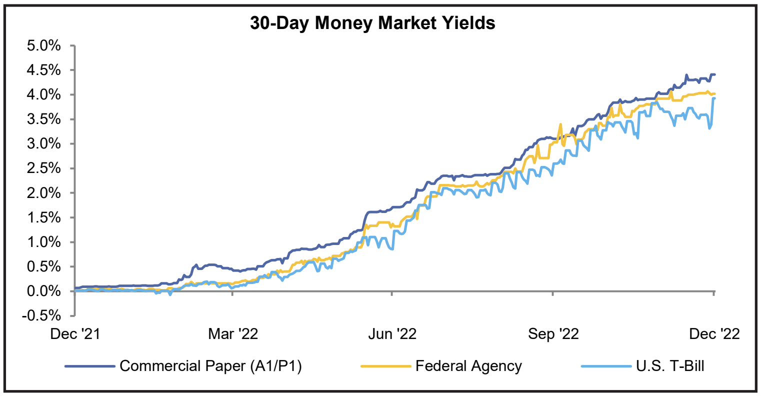
## Key Economic Indicators

| Indicator | Release Date | Period | Actual | Survey (Median) |
|---|---|---|---|---|
| CPI YoY | 13-Dec | Nov | 7.1% | 7.3% |
| FOMC Rate Decision | 14-Dec | Nov | 4.5% | 4.5% |
| Existing Home Sales MoM | 21-Dec | Nov | -7.7% | -5.2% |
| GDP Annualized QoQ | 22-Dec | 3Q T | 3.2% | 2.9% |
| U. of Mich. Consumer Sentiment | 23-Dec | Dec F | 59.7 | 59.1 |
| ISM Manufacturing | 4-Jan | Dec | 48.4 | 48.5 |
| Unemployment Rate | 6-Jan | Dec | 3.5% | 3.7% |




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

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