Monthly Market Review

Look beyond the rhetoric and...

Tough trade talk and tariffs could slow the economy. Trump's calls for easy money could move the Federal Reserve (Fed). Many investors see this as a win for bonds. Never mind if it calls into question how free the free market is.

Economic Highlights

- Trade talk and tariff disputes ruled the day in May as a new front in the trade war emerged with Mexico on top of unresolved disputes with China. This has begun to take its toll on economic conditions, triggering a slowdown in manufacturing activity and sharp declines in measures of CEO optimism.
- Second quarter U.S. gross domestic product (GDP) growth estimates are now in the 1.5%-2% range, far below the first quarter which was revised in May to 3.1% (vs. initial estimate of 3.2%).
- The World Bank reduced its global growth forecasts for both 2019 and 2020. Global growth in real GDP is now expected to be 2.6% in 2019 and 2.7% for 2020. Downward revisions were especially noteworthy for the Euro area and Emerging Market economies.
- The latest Fed-speak turned more dovish, revealing a shift in the Fed's stance on monetary policy from "patient" to "appropriate." At a recent conference, Fed Chair Jerome Powell acknowledged the consequences of escalating trade tensions and affirmed that the Fed will "act as appropriate to sustain the expansion." The market's expectation is now for two to three rate cuts by year end.
- Inflation pressures remain low. The Consumer Price Index (CPI) indicates inflation at 2%, while the Fed's preferred inflation gauge, the Personal Consumption Expenditure (PCE) Price Index, has weakened over the last several months and is now well below the Fed's target of 2%.
- The U.S. jobs report for May was a huge disappointment as non-farm payrolls grew by only 75,000, well below expectations of 175,000. Monthly job gains have averaged just 164,000 this year, compared with average gains of 223,000 per month in 2018. Wage growth slowed, but the labor market remains tight with the unemployment rate holding at 3.6%.

Bond Markets

- U.S. Treasury yields declined across the curve with the yield on longer maturities falling more than 30 basis points (bps) (0.30%) in May. Long maturity yields are now down more than 100 bps from their highs of last November.
- The yield curve reached its greatest level of inversion since 2007 as the spread between the 10-year and 3-month Treasuries reached -25 bps (-0.25%). The shorter-term Treasury Bill curve is also now inverted, reinforcing the market's expectation for a lower Fed rate policy in the near term.
- As a result of falling yields, bond returns were very strong in May, with Treasury benchmarks generating some of their best monthly performance over the last five years. The increasing inversion also meant that longer duration indexes outperformed shorter ones. For example, the 2-year Treasury Index returned 0.77%, while the 10-year index returned 3.35% for the month.
- Investment grade corporate bonds, mortgage-backed securities (MBS) and asset-backed securities all under-performed comparable Treasury securities in May as the unsettled economic outlook and rising market volatility took a toll on these sectors.

Equity Markets

- U.S. equities halted their strong advance year-to-date on the heels of possible disruptions in global trade. Over the month, the S&P 500 Index fell 6.6%, the Dow Jones Industrial Average retreated 6.7%, and the NASDAQ posted a loss of 7.9%. Global equities followed suit.
- After reaching a two-year high at the end of April, the U.S. Dollar Index (DXY), measured against a basket of international currencies, moved sideways in May.

PFM Outlook

- Our asset allocation and duration recommendations are largely unchanged from April. We continue to construct and balance portfolios seeking to achieve superior income and reduce risk when compared with benchmarks.
- We believe neutral durations are appropriate due to the uncertainty with regard to the timing and magnitude of Fed actions to affect interest rates. While it may be obvious that the Fed will cut rates if the economy indeed weakened, the key questions of "when?" and "how much?" remain unanswered.
- The prospect of a weaker economy has pushed corporate bond spreads wider, and dragged performance vs. Treasuries, but the equity market strength and the modest widening do not signal an exit sign to us. We are maintaining a modest over-weight to credit, but we have a bias to higher quality issuers as a counter-weight to the slowing. Our emphasis will be on the debt of companies with strong balance sheets and lesser exposure to potential fall-out from tariffs and trade disputes.
- In an oft-repeated theme, spreads of federal agency securities and supranationals remained tight during the month amid little new issuance. The sectors offered only modest incremental income, but just enough to eke out positive excess returns.
- Rising volatility and the sharp rally in Treasuries had a negative impact on the returns of MBS. Recent underperformance, however, may provide an attractive entry point to increase allocations to MBS in portfolios. Our preference is for issues with less prepayment volatility risk, such as more seasoned issues and commercial MBS (CMBS).
- In the money market space much of the juice has evaporated from the high quality credit sector, but issue-specific opportunities remain.

U.S. Treasury Yields

Duration	May 31, 2018	Apr 30, 2019	May 31, 2019	Monthly Change
3-Month	1.90%	2.42%	2.34%	-0.08%
6-Month	2.08%	2.45%	2.35%	-0.10%
2-Year	2.43%	2.27%	1.92%	-0.35%
5-Year	2.70%	2.28%	1.91%	-0.37%
10-Year	2.86%	2.50%	2.13%	-0.37%
30-Year	3.03%	2.93%	2.57%	-0.36%

Yields by Sector and Maturity as of March 31, 2019

Maturity	U.S. Treasury	Federal Agency	Corporates-A Industrials	AAA Municipals
3-Month	2.34%	2.32%	2.34%	--
6-Month	2.35%	2.28%	2.36%	--
2-Year	1.92%	2.02%	2.43%	1.42%
5-Year	1.91%	2.03%	2.59%	1.53%
10-Year	2.13%	2.36%	3.02%	1.86%
30-Year	2.57%	2.76%	3.82%	2.49%

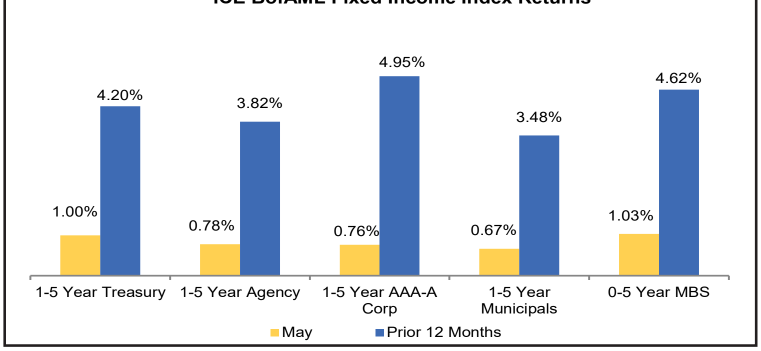
Spot Prices and Benchmark Rates

Index	May 31, 2018	Apr 30, 2019	May 31, 2019	Monthly Change
1- Month LIBOR	2.00%	2.48%	2.43%	-0.05%
3- Month LIBOR	2.32%	2.58%	2.50%	-0.08%
Effective Fed Funds Rate	1.70%	2.45%	2.40%	-0.05%
Fed Funds Target Rate	1.75%	2.50%	2.50%	0.00%
Gold ($/oz)	$1,300	$1,286	$1,306	$20
Crude Oil ($/Barrel)	$67.04	$63.91	$53.50	-$10.41
U.S. Dollars per Euro	$1.17	$1.12	$1.12	$0.00

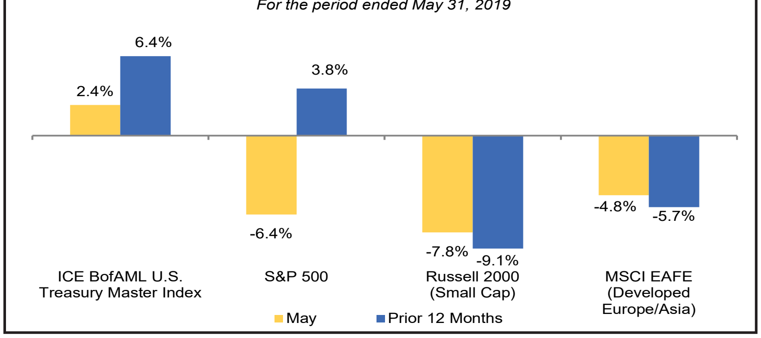
Economic Indicators

Indicator	Release Date	Period	Actual	Survey (Median)
Retail Sales MoM	15-May	Apr	-0.2%	0.2%
New Home Sales MoM	23-May	Apr	-6.9%	-2.5%
Consumer Confidence	28-May	May	134.1	130
GDP Annualized QoQ	30-May	1Q S	3.1%	3.0%
ISM Manufacturing	3-Jun	May	52.1	53.0
Non-farm Payrolls	7-Jun	May	75k	175k
Unemployment Rate	7-Jun	May	3.6%	3.6%

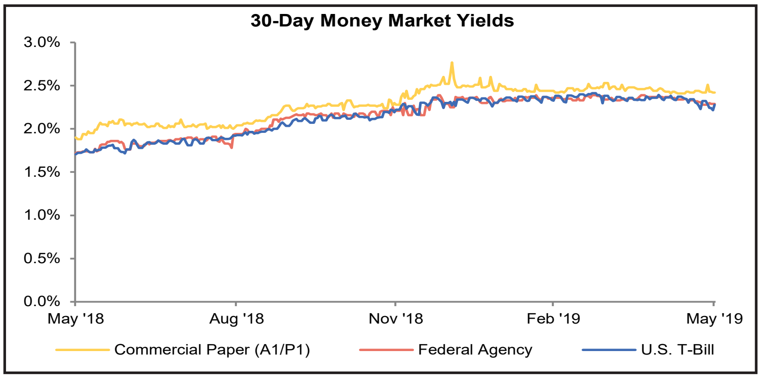
ICE BofAML Fixed Income Index Returns



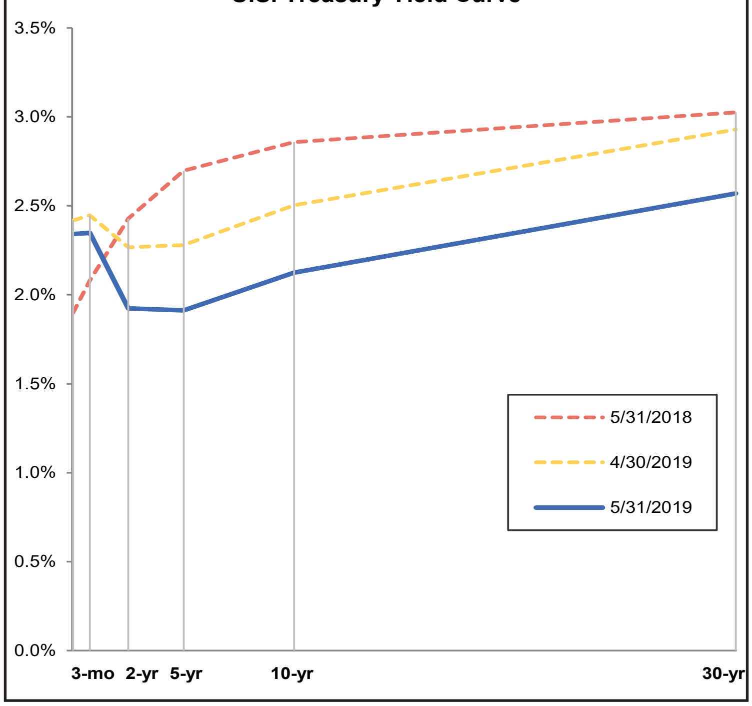
Total Return of Major Indices
For the period ended May 31, 2019



30-Day Money Market Yields



U.S. Treasury Yield Curve



Source: Bloomberg. Data as of May 31, 2019, unless otherwise noted.