Monthly Market Review

The Federal Reserve (Fed) is on the move, but the bond market? Not so much. While it is nearly certain that the Fed will raise short-term rates by 25 to perhaps 50 basis points (bps) in coming months, interest rates generally do not seem to reflect this, as strong counterforces have kept markets in check.

Economic Highlights

- Strong labor market conditions support Fed tightening. The U.S. economy added 201,000 new jobs in August, modestly beating expectations and in line with the average monthly job gains so far this year. The unemployment rate held at 3.9% for the month, while initial unemployment claims reached their lowest level since 1969.
- Wage growth, as measured by average hourly earnings, also supports Fed tightening. For the previous 12 months through August, wages increased by 2.9%, the fastest pace of growth since June 2009. The increase reinforced the upward trend of other general inflation measures, including the core personal consumption expenditures (PCE) index and the core consumer price index (CPI).
- The trade war clouds the horizon. While the immediate prospects for the U.S. economy are strong, central bankers and leaders of global businesses have begun to warn of the cumulative disruptive effects that could result from protracted trade battles with China, Europe and our nearby North American partners.
- Lagging growth in Europe and growing emerging market (EM) economic woes are counterbalancing U.S. growth momentum, with the interest rates of developed market countries well below those in the U.S., and many global stock markets in bear market territory.
- The Federal Open Market Committee (FOMC) left the overnight target rate of 1.75% to 2% unchanged at its August 1 meeting. At the annual Jackson Hole symposium, Fed Chairman Jay Powell reaffirmed the Fed's positive outlook for growth and employment in the U.S., while laying further groundwork for the Fed to continue on its current path of gradually raising rates.
- Thus, the disconnect: market participants expect another two Fed rate hikes in 2018, and an additional two to four hikes in 2019, which could bring the overnight rate to 3% or more, but 10-year U.S. Treasury rates remain well contained below this threshold level.

Bond Markets

- The U.S. Treasury yield curve twisted a bit over the month as short-term maturities (less than two years) rose, while longer-term maturities (beyond two years) fell modestly.
- The slope of the curve, as measured by the yield difference between 10- and two-year Treasury notes, ended August at 0.23%, just above the decade low of 0.19% reached intra-month.
- For total-return investors, the twisted, flatter yield curve resulted in longer-term securities outperforming their shorter-term counterparts over the month. For example, the three-month and 12-month Treasury indices returned 0.18% and 0.22%, respectively. Meanwhile, the three-year, five-year and 30-year constant maturity indices returned 0.43%, 0.75% and 1.75%, respectively.
- Investment-grade (IG) credit spreads were relatively unchanged for the quarter. As a result of the muted spread impact, outperformance in the credit sector over the month can largely be attributed to the incremental income offered in the sector relative to similar-maturity Treasury securities.

Equity Markets

- The S&P 500 Index (S&P) rose 3.26% in August, the fifth straight monthly increase. The headline domestic equity index is now up 9.94% for the year.
- Sector performance within the S&P was positive overall in August, with nine of the 11 sectors posting positive returns. The Information Technology, Consumer Discretionary and Healthcare sectors led gains with 6.93%, 5.13% and 4.37%, respectively. Energy and Materials lagged during the month, returning -3.30% and -0.45%, respectively.
- By market capitalization, small-caps (Russell 2000 Index) were the best performers during the month, returning 4.31%. The next best performers during the period were large-caps (Russell 1000 Index), returning 3.45%, followed by mid-caps (Russell Midcap Index) with a return of 3.11%. Growth stocks outperformed value stocks within all three market capitalization indices.

PFM Outlook

- With the bond market largely ignoring the likelihood of the FOMC raising rates, we will continue to position portfolios with a defensive duration and yield curve bias.
- In the federal agency sector, spreads relative to U.S. Treasury securities narrowed through August, ending the month near 12-month tights. There is little value in bullet-maturity securities, but the flatness of the yield curve has created some value in callable agencies for the first time in a long while.
- The supranational sector has performed well over the past several quarters, and we foresee a reinvigoration of spreads later this year in advance of a surge in supply that typically occurs at the beginning of each calendar year. We advise reserving some buying capacity for this opportunity.
- Our overall view of the corporate credit sector is positive, and it remains an area of emphasis due to strong underlying fundamentals, including robust profits. New issue supply should pick up later this year, and we have positioned portfolios to participate in new issues that come to market at attractive levels.
- Mortgage-backed securities (MBS) have had lackluster performance for most of the year, and we are not increasing allocations at this point.
- AAA-rated asset-backed securities (ABS) have performed well this year and remain an additional area of focus due to their high-quality, limited credit risk and incremental yield.
- Money market fund and ultra-short-term, fixed-income investors will benefit from higher yields due to multiple Fed rate hikes. Short-term credit (commercial paper and negotiable certificates of deposit) should track these increases and offer incremental income-earning potential relative to short-term government alternatives.

U.S. Treasury Yields

Maturity	Aug 31, 2017	Jul 31, 2018	Aug 31, 2018	Monthly Change
3-Month	0.99%	2.02%	2.10%	0.08%
6-Month	1.08%	2.19%	2.27%	0.08%
2-Year	1.33%	2.67%	2.63%	-0.04%
5-Year	1.70%	2.85%	2.74%	-0.11%
10-Year	2.12%	2.96%	2.86%	-0.10%
30-Year	2.73%	3.08%	3.02%	-0.06%

Yields by Sector and Maturity as of August 31, 2018

Maturity	U.S. Treasury	Federal Agency	Corporates-A Industrials	AAA Municipals
3-Month	2.10%	2.08%	2.48%	-
6-Month	2.27%	2.21%	2.55%	-
2-Year	2.63%	2.68%	2.99%	1.66%
5-Year	2.74%	2.86%	3.31%	1.99%
10-Year	2.86%	3.14%	3.73%	2.46%
30-Year	3.02%	3.31%	4.19%	3.07%

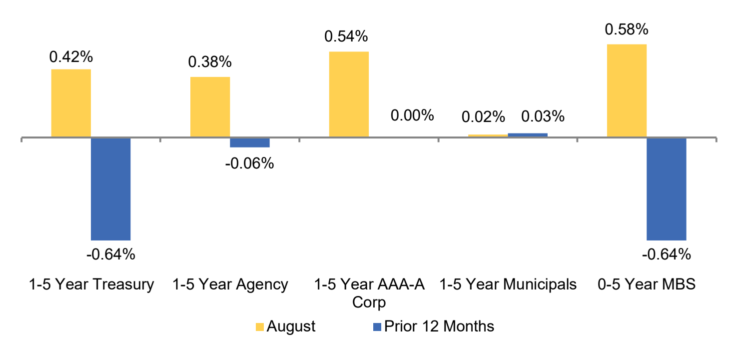
Spot Prices and Benchmark Rates

Index	Aug 31, 2017	Jul 31, 2018	Aug 31, 2018	Monthly Change
1-Month LIBOR	1.23%	2.08%	2.11%	0.03%
3-Month LIBOR	1.32%	2.35%	2.32%	-0.03%
Effective Fed Funds Rate	1.07%	1.91%	1.91%	0.00%
Fed Funds Target Rate	1.25%	2.00%	2.00%	0.00%
Gold ($/oz)	$1,319	$1,224	$1,202	-$22
Crude Oil ($/Barrel)	$47.23	$68.76	$69.80	$1.04
U.S. Dollars per Euro	$1.19	$1.17	$1.16	-$0.01

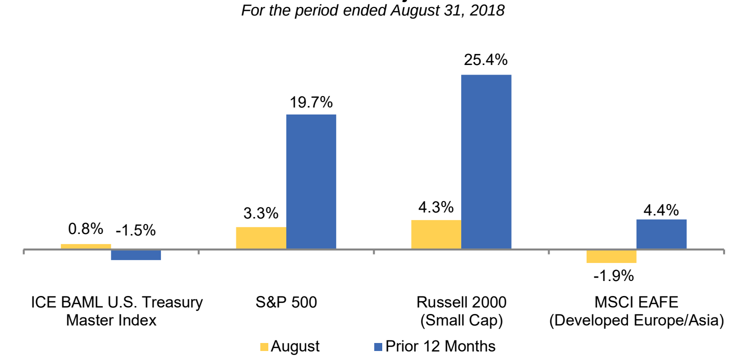
Economic Indicators

Indicator	Release Date	Period	Actual	Survey (Median)
Nonfarm Payrolls	7-Sep	Aug	201k	190k
CPI ExFood&Energy YoY	10-Aug	Jul	2.4%	2.3%
Retail Sales MoM	15-Aug	Jul	0.5%	0.1%
Consumer Confidence	28-Aug	Aug	133.4	126.6
GDP Annualized QoQ	29-Aug	2Q	4.2%	4.0%
New Home Sales MoM	23-Aug	Jul	-1.7%	2.2%
FOMC Rate Dec. (Upper)	1-Aug	Aug	2.00%	2.00%

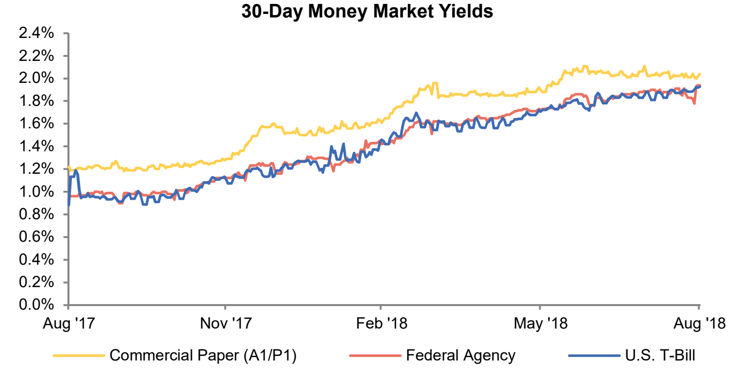
ICE BAML Fixed Income Index Returns
For the period ended August 31, 2018



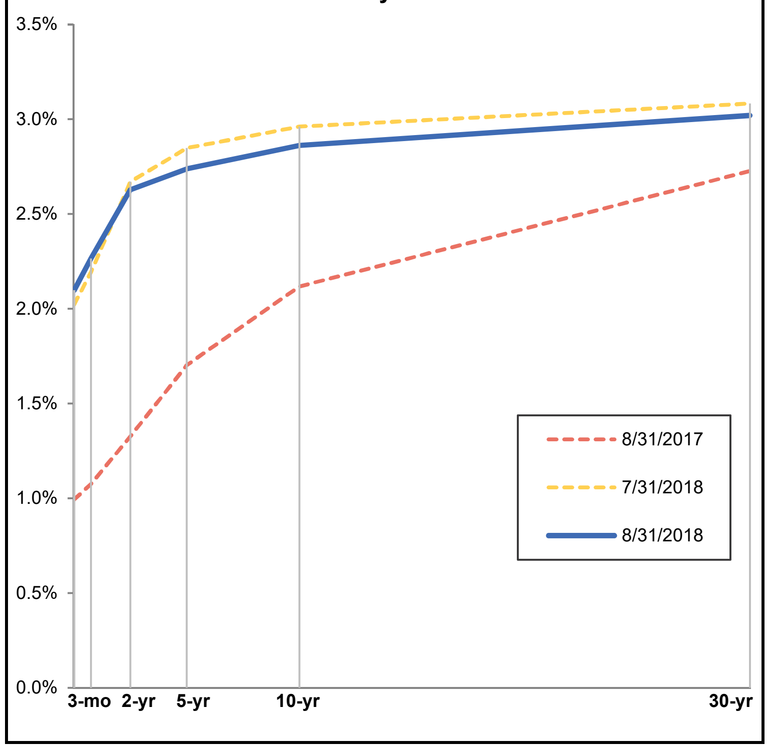
Total Return of Major Indices
For the period ended August 31, 2018



30-Day Money Market Yields



U.S. Treasury Yield Curve



Source: Bloomberg. Data as of August 31, 2018, unless otherwise noted.