Monthly Market Review

Robust tailwinds created positive momentum for the economy and the equity markets as the new year began. The strengthening economy presents a good environment for fixed income investors, but also raises the risk of higher rates that could drag down returns on longer-duration investments.

Economic Highlights

- After months of build-up and speculation, Congress passed a controversial tax cut bill in late December. This new legislation, the first major tax reform since 1986, lowers the corporate tax rate to 21% from 35%, while also lowering individual tax rates. Early assessments suggest a positive economic reaction for the near-term.
- Final tallies for second and third quarter U.S. gross domestic product (GDP) were 3.1% and 3.2%, respectively. This is the first time since 2014 that the U.S. economy grew at more than 3% in back-to-back quarters. Economists raised projections for growth over the next year to the 2.5 - 3% level with consumer spending and private investment bolstering those estimates.
- At its December meeting, the Federal Open Market Committee (FOMC) raised the overnight fed funds target rate for the third time in 2017, to a new range of 1.25% to 1.5%. Despite two dissenting votes to keep rates unchanged in December, Federal Reserve (Fed) Governors and many investors anticipate another three hikes in 2018.
- Inflation, which has the potential to be the primary deterrent to future Fed rate hikes, remains well below the Fed's target of 2%. Core personal consumption expenditures (PCE), year-over-year, have posted sub-two percent levels for consecutive months since May 2012.
- The December jobs report showed the economy added 148,000 jobs—a disappointing result. Overall, 2017 averaged 171,000 jobs added per month, a bit below the 221,000 per year for the prior three years. Other key labor market indicators were unchanged including the low unemployment rate and the trend of modest wage growth.

Bond Markets

- The U.S. Treasury yield curve continued to flatten in December. The combination of Fed rate hikes buoying the front end of the curve and tepid inflation restraining long-term Treasury rates has resulted in the least slope in the yield curve since 2007. Ten-year Treasury yields were unchanged in December at 2.41%, while two-year yields rose 10 basis points (bps) to 1.89%. Over the quarter, the 10-year yield was up 7 bps while the two-year yield rose 40 bps.
- The increase in short- and intermediate-term Treasury yields depressed returns for the month, as market price erosion offset income for maturities of less than seven years. However, benchmark Treasury notes for 10- and 30-year constant maturities exponentially outpaced their shorter counterparts, posting one-month unannualized returns of 0.26% and 2.07%, respectively.
- Corporate bonds finished the year on a strong note, as credit spreads narrowed further, yet again reaching new post-recession lows.
- Despite the Fed's ongoing balance sheet reduction measures, federal agency mortgage-backed securities (MBS) provided positive excess returns relative to Treasuries in December.

Equity Markets

- Domestic and international stock markets finished the year on a strong note. The S&P 500 Index (S&P 500) returned 1.1% for the month, pushing the year-to-date performance up to 21.8%. The S&P 500 is 12-for-12 in terms of positive monthly total returns for the large-cap index for the first time ever, dating back to 1928.
- Sector performance within the S&P 500 was mostly strong with eight of the 11 sectors posting positive returns. Telecom was the best performing sector for a second consecutive month, with a 5.8% return. The Utilities sector finished as the worst performing sector, declining 6.1%.
- The U.S. Dollar Index declined for the second consecutive month, continuing a somewhat surprising weakening trend in 2017. As a result, most global equity markets produced significantly stronger dollar-denominated performance relative to their local currency returns for both December and the calendar year.

PFM Outlook

- As we pass the ten-year anniversary of the official start of the nation's most recent recession (December 2007), the domestic economic landscape continues to show signs of resilience, breadth and positive momentum.
- Agency yield spreads remain incredibly tight and we expect them to remain so. What value exists is largely confined to price concessions when new issues are first traded. On the other hand, the supranational sector offers additional income benefit relative to both Treasury and agency securities and we view this as an opportunity to increase allocations to the sector.
- Corporate spreads, albeit tight, still offer a risk-adjusted yield benefit relative to similar maturity government securities. We remain constructive on the sector, at least over the near term, as profits and balance sheets remain strong. The trajectory of corporate spread narrowing may slow in 2018, and we are cognizant of downside risks that may weigh on the sector later in the year.
- With the Fed scheduled to increase the pace of sales of its Treasuries and MBS holdings from $4 billion to $8 billion per month this quarter, we view the agency MBS sector as vulnerable to spread widening in 2018.
- Cash and money market yields are expected to rise in response to anticipated Fed moves. A good deal of this is already reflected in the yields available in Treasury bills and high-quality money market instruments with maturities of three- to six-months. Liquidity portfolios should continue to benefit from this.

U.S. Treasury Yields

Maturity	Dec 31, 2016	Nov 30, 2017	Dec 31, 2017	Monthly Change
3 Month	0.50%	1.26%	1.38%	0.12%
6 Month	0.61%	1.44%	1.53%	0.09%
2 Year	1.19%	1.78%	1.89%	0.11%
5 Year	1.93%	2.14%	2.21%	0.07%
10 Year	2.45%	2.41%	2.41%	0.00%
30 Year	3.07%	2.83%	2.74%	-0.09%

Yields by Sector and Maturity as of December 31, 2017

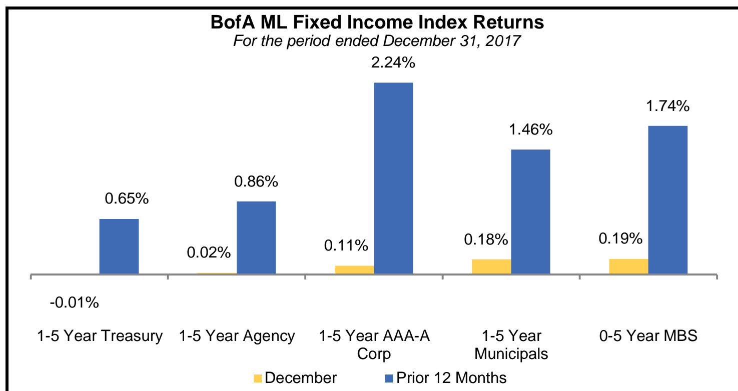
Maturity	U.S. Treasury	Federal Agency	Corporates-A Industrials	AAA Municipals
3 Month	1.38%	1.33%	1.80%	-
6 Month	1.53%	1.41%	1.86%	-
2 Year	1.89%	1.96%	2.20%	1.32%
5 Year	2.21%	2.27%	2.62%	1.58%
10 Year	2.41%	2.69%	3.18%	2.10%
30 Year	2.74%	3.02%	3.70%	2.76%

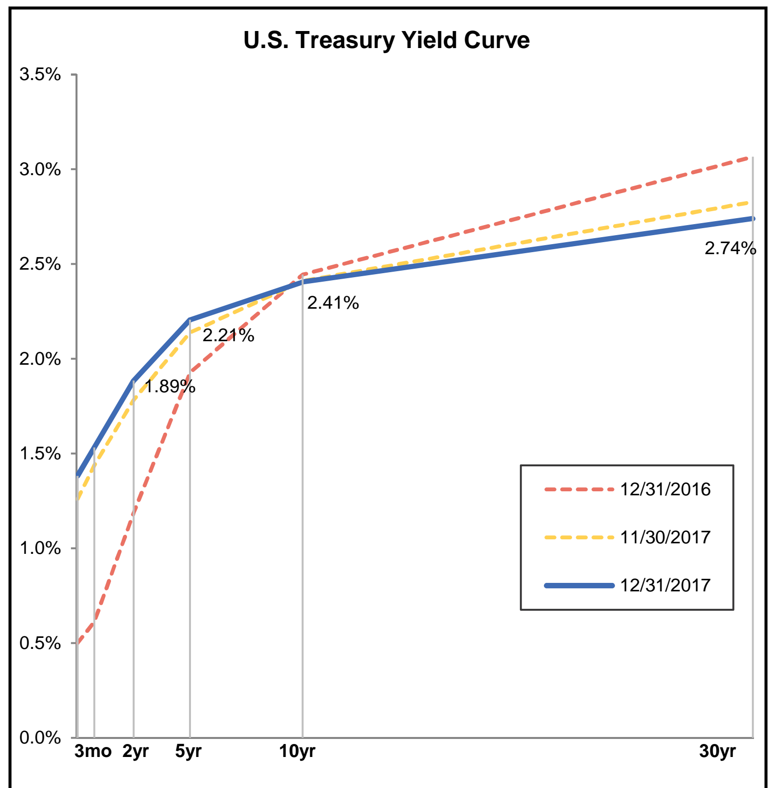
Spot Prices and Benchmark Rates

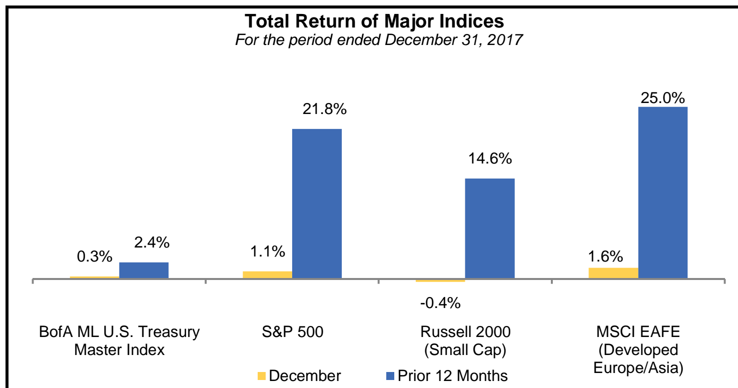
Index	Dec 31, 2016	Nov 30, 2017	Dec 31, 2017	Monthly Change
1 Month LIBOR	0.77%	1.37%	1.56%	0.19%
3 Month LIBOR	1.00%	1.49%	1.69%	0.20%
Effective Fed Funds Rate	0.55%	1.07%	1.33%	0.26%
Fed Funds Target Rate	0.75%	1.25%	1.50%	0.25%
Gold ($/oz)	$1,152	$1,273	$1,309	$36
Crude Oil ($/Barrel)	$53.72	$57.40	$60.42	$3.02
US Dollars per Euro	$1.05	$1.19	$1.20	$0.01

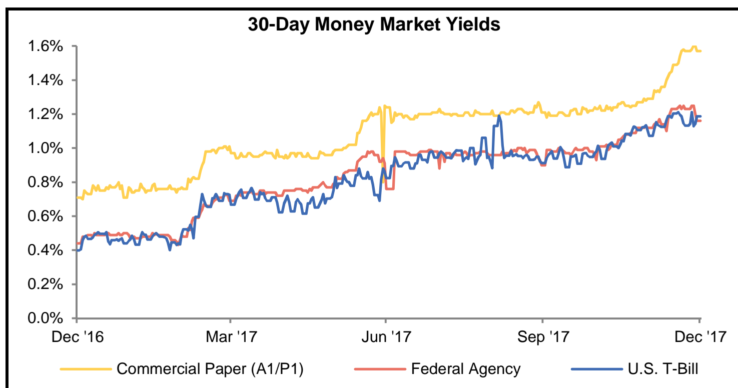
Economic Indicators

Indicator	Release Date	Period	Actual	Survey (Median)
Nonfarm Payrolls	5-Jan	Dec	148k	190k
CPI ExFood&Energy YoY	13-Dec	Nov	1.7%	1.8%
Retail Sales MoM	14-Dec	Nov	0.8%	0.3%
Consumer Confidence	8-Dec	Dec	96.8	99.0
GDP Annualized QoQ	21-Dec	3Q	3.2%	3.3%
New Home Sales	22-Dec	Nov	17.5%	-4.4%
FOMC Rate Dec. (Upper)	13-Dec	Dec	1.50%	1.50%









Source: Bloomberg. Data as of December 31, 2017 unless otherwise noted.

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