Monthly Market Review

Fixed Income | February 2022

pfm asset management

"Federal Reserve hawks take flight."

Economic Highlights

► COVID-19, inflation and Russian aggression topped the headlines in January. Still, the strong pivot by the Federal Reserve (Fed) to reduce monetary accommodation and set the stage for a series of rate hikes drove the markets.

► With the Fed already committed to tapering its bond purchases at an accelerated pace, the Federal Open Market Committee (FOMC) indicated with unusual clarity that it "expects it will soon be appropriate to raise the target range for the federal funds rate." That set off a wave of speculation about when and how much the Fed would move, and turbo-charged the rising rate trend that had already been in place throughout the fourth quarter. By month-end, the market had priced in 4-5 quarter-point rate hikes for the year.

► COVID-19 cases declined sharply, falling from a seven-day moving average peak of about 800,000 to around 500,000 by month-end, and headed lower. Hospitalizations also fell, with the typical lag. Sadly, deaths continued to rise to near the peak levels of the pandemic. But, with each variant and new wave of infections, the impact on the economy seems to be less impactful.

► Looking backward, U.S. real gross domestic product (GDP) beat expectations, growing at 6.9% in the fourth quarter and 5.7% for calendar year 2021 – the strongest annual growth rate since 1984. Activity in the fourth quarter was boosted by inventory rebuilding, accounting for 4.9% of the overall growth rate. Whether that is a good sign of businesses increasing production to meet consumer demand, or a bad sign of business miscalculation as demand shifts from goods to services will play out over the next few quarters.

► Employment gains were strong again as the U.S. economy added 467,000 jobs to start the year, far exceeding expectations. The unemployment rate ticked slightly higher to 4.0% from 3.9%, largely due to a bump in the labor force participation rate to 62.2% from 61.9%. Wages rose sharply, as average hourly earnings were up 5.7% year-over-year amid near historic job openings.

► Consumer inflation reached 7.5% in January, the hottest pace since 1982, as pandemic-related supply and demand imbalances persist. Everything from fuel oil, gasoline, and new and used cars to food, shelter and clothing showed outsized price increases.

Bond Markets

► U.S. Treasury yields continued to march higher, resulting in an upward shift in the yield curve. In January, the yield on the benchmark 2-year Treasury note jumped 45 basis points (bps) to 1.18%, while the yield on the benchmark 10-year Treasury increased 27 bps to 1.78%.

► In January, Treasury indices generated some of their worst monthly returns over the past decade as yields ascended to post-pandemic highs. For example, the ICE BofA 1-, 5-, and 10-year U.S. Treasury indices returned -0.26%, -1.57%, and -2.39%, respectively.

Equity Markets

► Reacting to rising rates, high input costs, and slowing earnings expectations, equity markets sold off in January, suffering their worst monthly performance since the onset of the pandemic (March 2020). The S&P 500 fell 5.2%, the Dow Jones Industrial Average fell 3.2%, while the tech-heavy Nasdaq tumbled 9.0%, its worst January since 2008.

► International equity markets generally fared better, as the MSCI ACWI ex-U.S. Index of global developed and emerging markets fell only 3.7%. The U.S. Dollar Index (DXY) strengthened marginally in the first month of the year, masking intra-month volatility.

PFMAM Strategy Recap

► The Fed has laid the groundwork for monetary policy tightening, and the countdown to a March rate lift-off sparked higher rates and increased volatility. Given the expectation for a further rise in Treasury yields over at least the near-term, unless something material changes, we plan to maintain our defensive duration posture. As they say, "Don't fight the Fed."

► Investment-grade (IG) corporates were not immune from market skittishness, as yield spreads widened to 12-month highs. Following several months of maintaining historically low allocations to the sector, we cautiously view the recent bump in spreads as an opportunity to increase holdings at more attractive levels. Issuer diligence and selectivity remain paramount.

► Taxable municipals and AAA-rated asset-backed securities (ABS) generated excess returns over Treasuries, but suffered negative returns for the month nonetheless. ABS quality remains strong and stable, but spreads now look less attractive than corporates.

► Federal agency spreads remain essentially zero and offer little value outside of an occasional new issue.

► The mortgage-backed securities (MBS) sector is suffering from a triple-whammy of historically tight spreads, extending durations as rates rise, and Fed tapering of MBS purchases. We maintain our defensive bias, especially avoiding lower coupon issues.

► Yields on money market instruments like commercial paper and bank CDs have begun to surge, pricing in expected Fed rate hikes. Compared to overnight rates of 0.05%, 6-month commercial paper at 0.50%-0.60% and 1-year CDs nearing 1% offer excellent incremental yield.

U.S. Treasury Yields

Duration	Jan 31, 2021	Dec 31, 2021	Jan 31, 2022	Monthly Change
3-Month	0.05%	0.04%	0.19%	0.15%
6-Month	0.07%	0.19%	0.46%	0.27%
2-Year	0.11%	0.73%	1.18%	0.45%
5-Year	0.42%	1.26%	1.61%	0.35%
10-Year	1.07%	1.51%	1.78%	0.27%
30-Year	1.83%	1.90%	2.11%	0.21%

Yields by Sector and Maturity

Maturity	U.S. Treasury	Federal Agency	Corporates-A Industrials	AAA Municipals
3-Month	0.19%	0.18%	0.77%	--
6-Month	0.46%	0.36%	0.84%	--
2-Year	1.18%	1.20%	1.35%	0.82%
5-Year	1.61%	1.64%	2.05%	1.18%
10-Year	1.78%	1.96%	2.63%	1.78%
30-Year	2.11%	2.44%	3.21%	2.31%

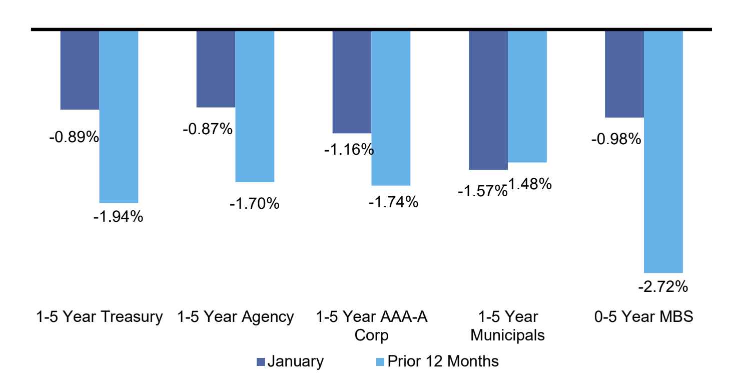
Spot Prices and Benchmark Rates

Index	Jan 31, 2021	Dec 31, 2021	Jan 31, 2022	Monthly Change
1-Month LIBOR	0.12%	0.10%	0.11%	0.01%
3-Month LIBOR	0.20%	0.21%	0.31%	0.10%
Effective Fed Funds Rate	0.07%	0.07%	0.08%	0.01%
Fed Funds Target Rate	0.25%	0.25%	0.25%	0.00%
Gold ($/oz)	$1,847	$1,829	$1,795	-$34
Crude Oil ($/Barrel)	$52.20	$75.21	$88.15	$12.94
U.S. Dollars per Euro	$1.21	$1.14	$1.12	-$0.02

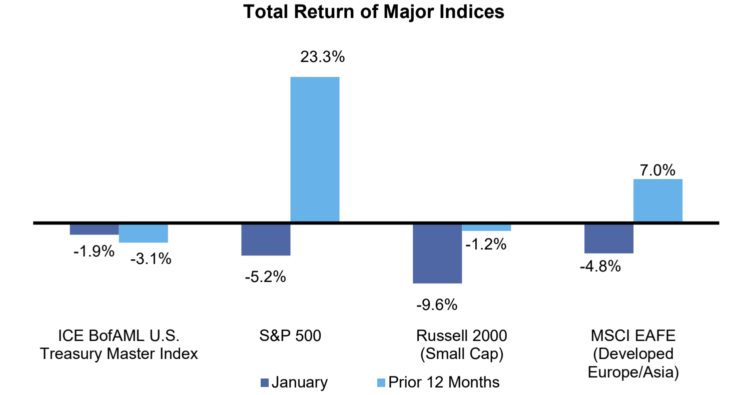
Key Economic Indicators

Indicator	Release Date	Period	Actual	Survey (Median)
Retail Sales Advance MoM	14-Jan	Dec	-1.9%	-0.1%
Consumer Confidence	25-Jan	Jan	113.8	111.2
GDP Annualized QoQ	27-Jan	4Q A	6.9%	5.5%
PCE Core Deflator YoY	28-Jan	Dec	4.9%	4.8%
ISM Manufacturing	1-Feb	Jan	57.6	57.5
Change in Non-Farm Payrolls	4-Feb	Jan	467k	125k
Unemployment Rate	4-Feb	Jan	4.0%	3.9%

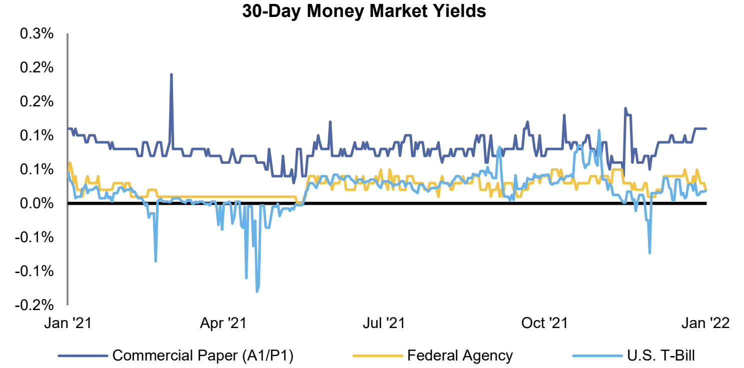
ICE BofAML Fixed Income Index Returns



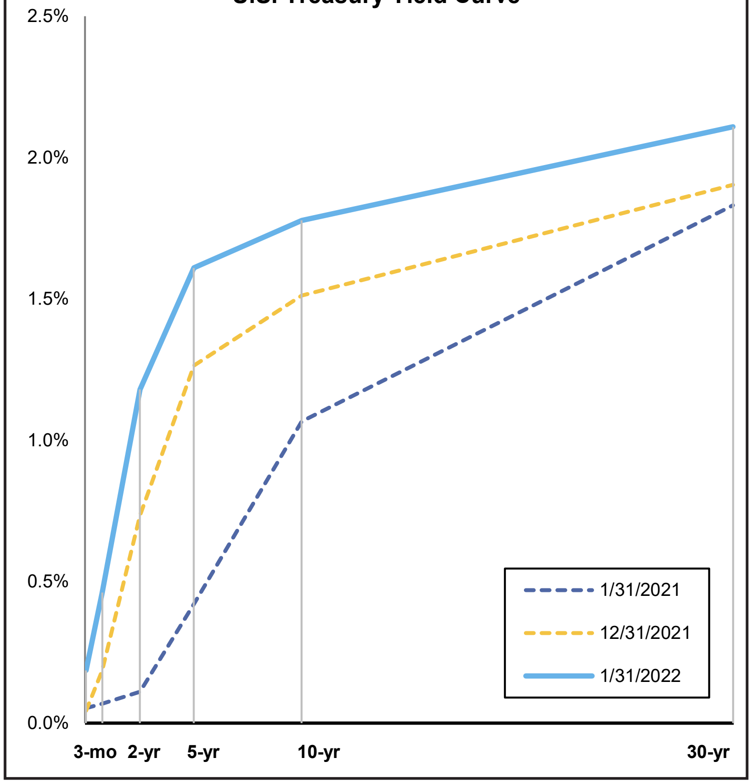
Total Return of Major Indices



30-Day Money Market Yields



U.S. Treasury Yield Curve



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