Monthly Market Update

November 2016

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"More budget cuts. To save paper and toner,
we won't be using vwls nymr. D y ndrstnd?"

Current Market Themes

- No movement from the Fed in November meeting
- Moderate U.S. economic conditions:
  - GDP growth picking up after weak first half of 2016
  - Labor market continues to strengthen
  - Inflation slowly picking up
- Treasury yields have been trending higher, but curve remains flat by historic standards
- Global central bank policies continue to be very accommodative
  - Policy rates in Europe and Japan are zero or negative
  - Large scale asset purchase programs continue, but tapering of these programs may be on the horizon
- Global headwinds have dissipated with improving economic situations in China and Europe.

FOMC Statement Highlights

November

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Highlights of FOMC Statement

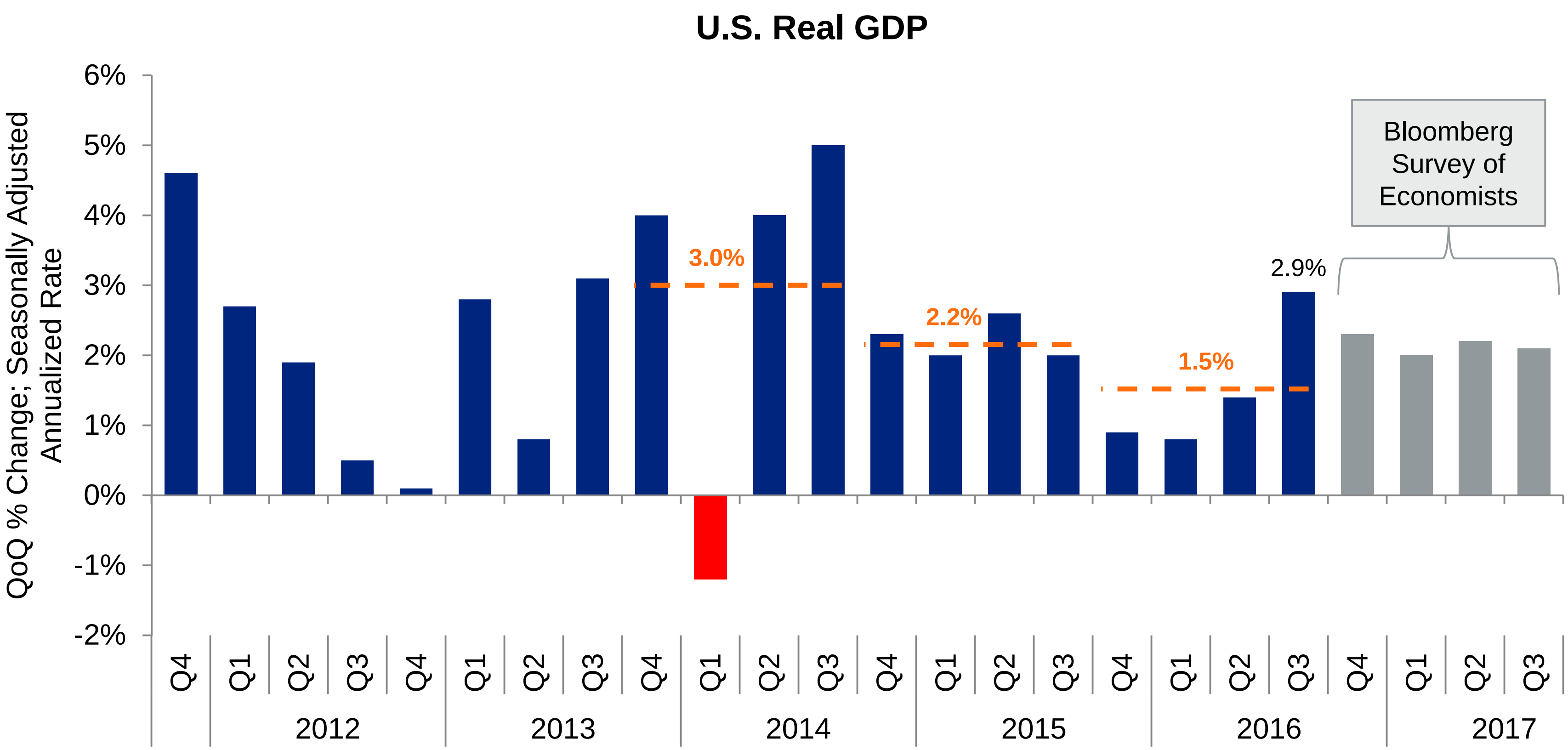
- **Labor market has continued to strengthen** and growth of **economic activity has picked up from the modest pace**
- **Job gains have been solid**
- **Inflation has increased somewhat since earlier this year**

- Against this backdrop, **the Committee decided to maintain the target range for the federal funds rate at 0.25 – 0.50%**.
- The Committee judges that **the case for an increase in the federal funds rate has continued to strengthen** but decided, for the time being, **to wait for some further evidence** of continued progress toward its objectives.

Source: Federal Reserve.

U.S. Economy Bounces Back in Third Quarter

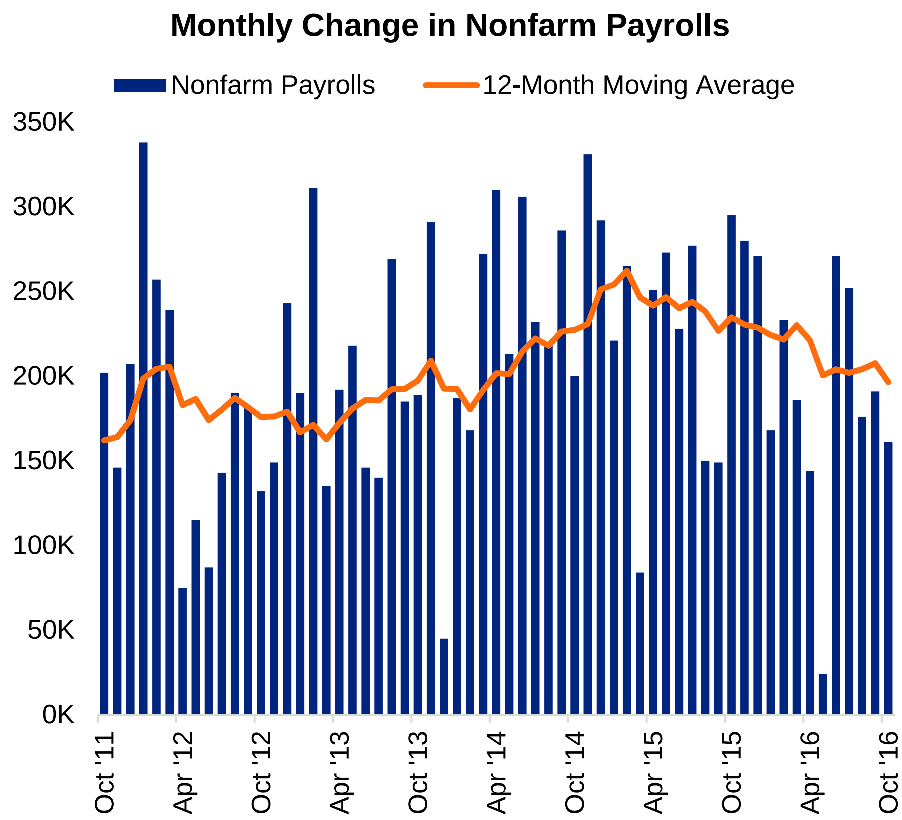
- U.S. GDP growth increased at an annual rate of 2.9% in the third quarter of 2016, the strongest reading in 2 years, according to the Bureau of Economic Analysis' initial estimate.
- Third quarter GDP reflected positive contributions from personal consumption, gross private investment, government spending, and net exports. Gross private investment has returned to positive territory, driven entirely by a large increase in private inventories, after three straight quarters of negative contributions to GDP.

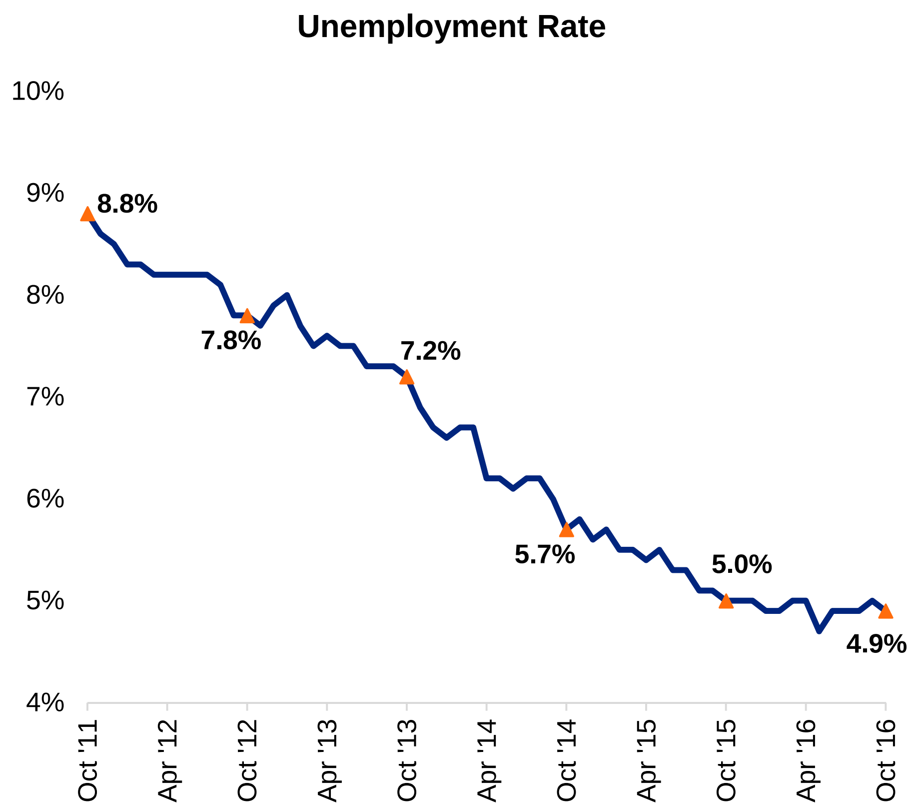


Source: Bureau of Economic Analysis; Bloomberg survey results as of 11/01/16.

Labor Market Strength Continues

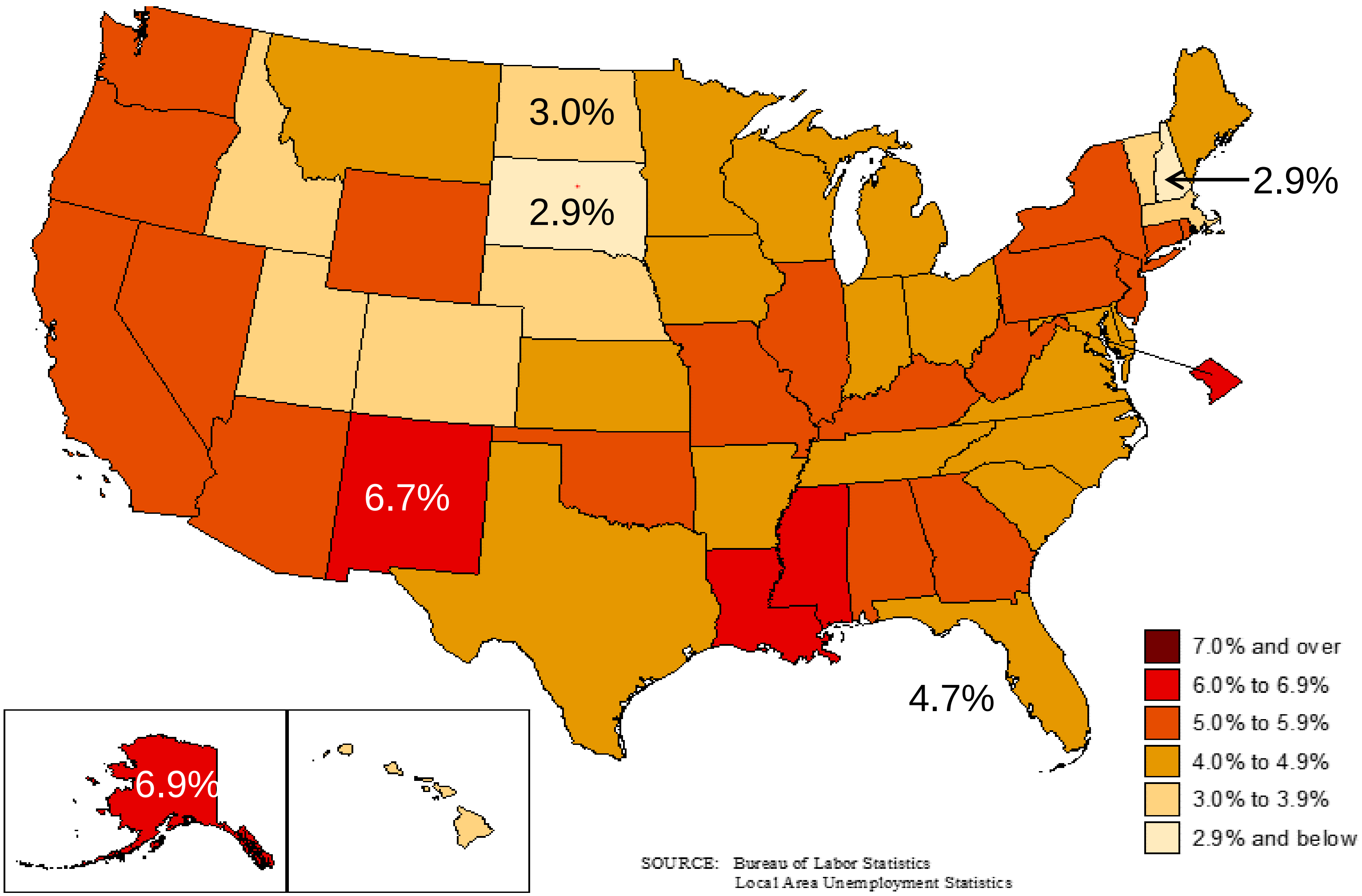
- The U.S. labor market added 161,000 jobs in October, short of the 173,000 expectations, while the prior month's were revised up by 35,000 additional jobs.
- The unemployment rate fell to 4.9%. More notably, the U6 unemployment rate, which includes part-time and discouraged workers for economic reasons, ticked down to 9.5%, the lowest since 2008.
- Average hourly earnings surprised markets with an increase of 2.8% year-over-year, the strongest growth rate since 2009.





Source: Bureau of Labor Statistics, as of 11/04/16.

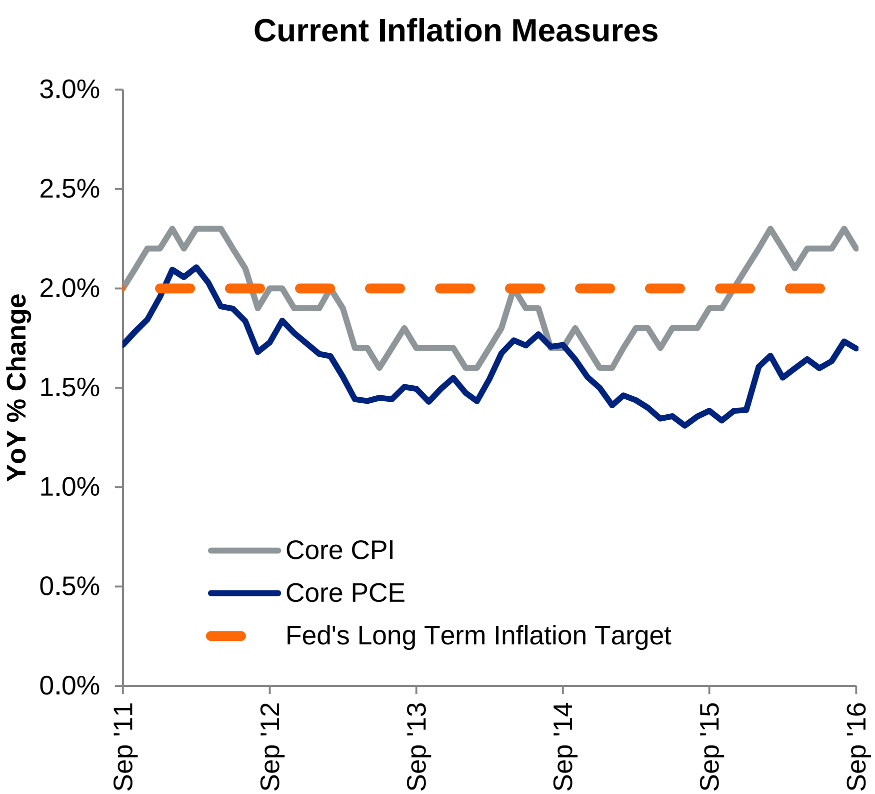
Unemployment Rates by State

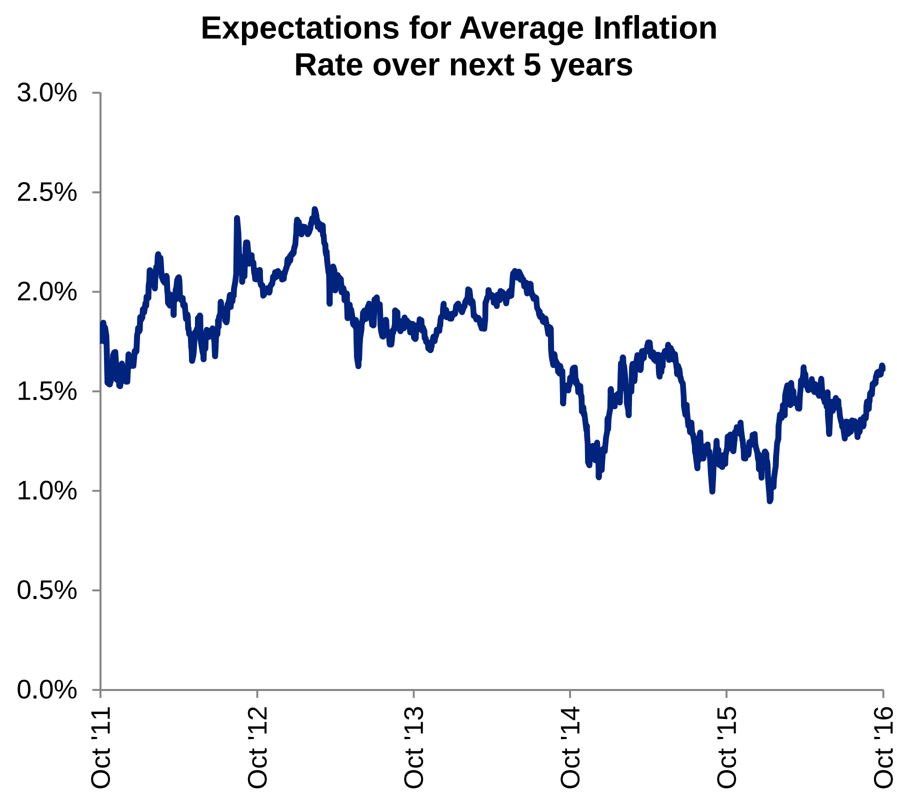


Source: Bureau of Labor Statistics, Local Area Unemployment Statistics, as of 09/30/16.

Inflation Rising Slowly

- The core personal consumption expenditures (PCE) price index, the Fed's preferred gauge of core inflation, stayed around 1.7% year-over-year through September, continuing to modestly undershoot the Fed's 2% target.
- However, investors are expecting inflation to pick up, with market expectations for inflation over the next five years recovering back to levels in mid 2015; the attitude of policy makers also seems to have shifted in the recent months, with several regional Fed presidents becoming increasingly cognizant of signs that inflation may accelerate with the tighter labor market.

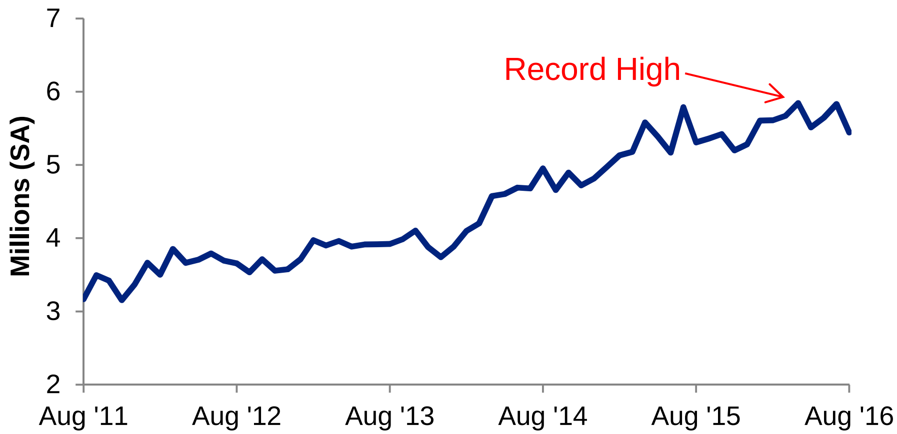




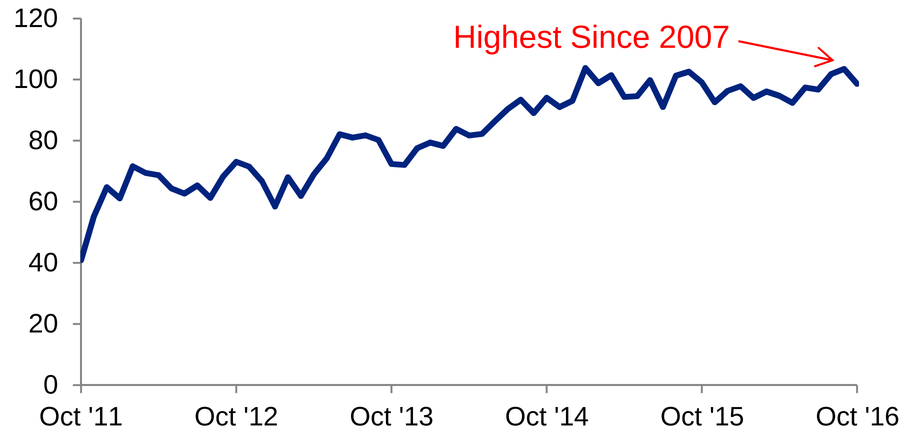
Source: Bloomberg as of 10/31/2016. Five year breakeven rate measures market expectations for inflation over next 5 years, as indicated by difference between yields on 5 year TIPS and 5 year treasury notes.

Economic Backdrop: Areas of Strength

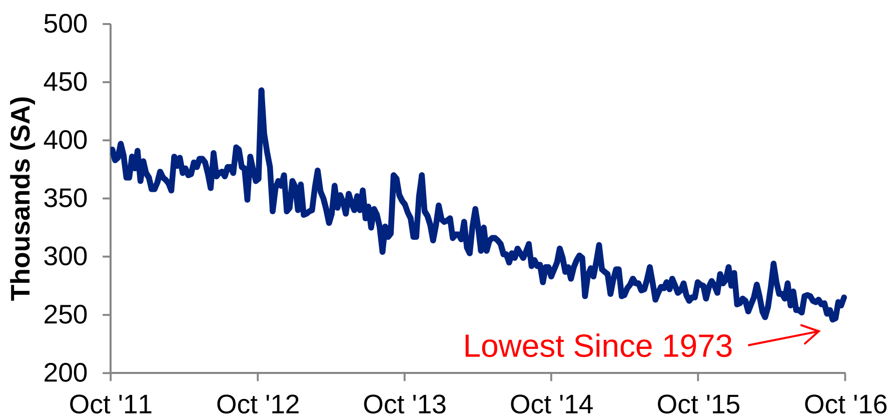
Total US Job Openings



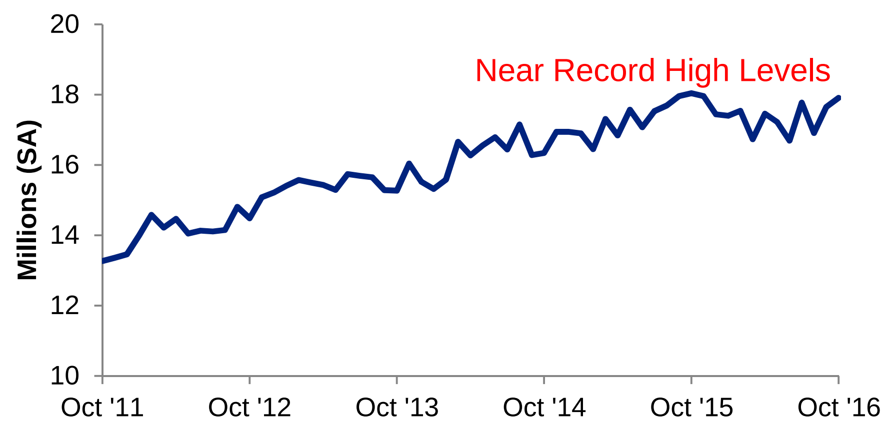
Consumer Confidence



Initial Jobless Claims

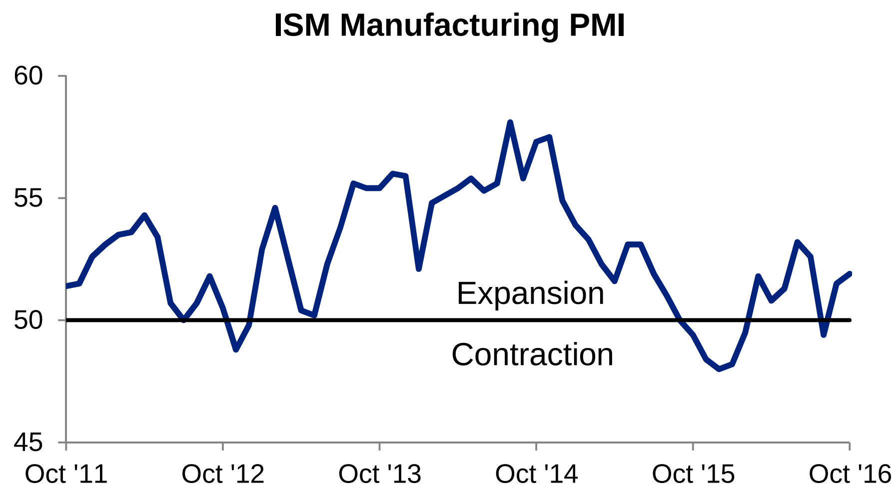


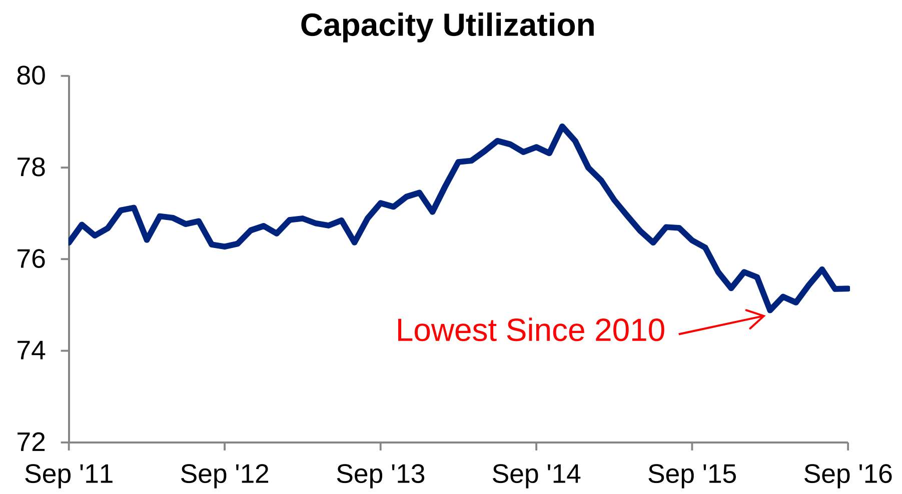
Total US Auto Sales

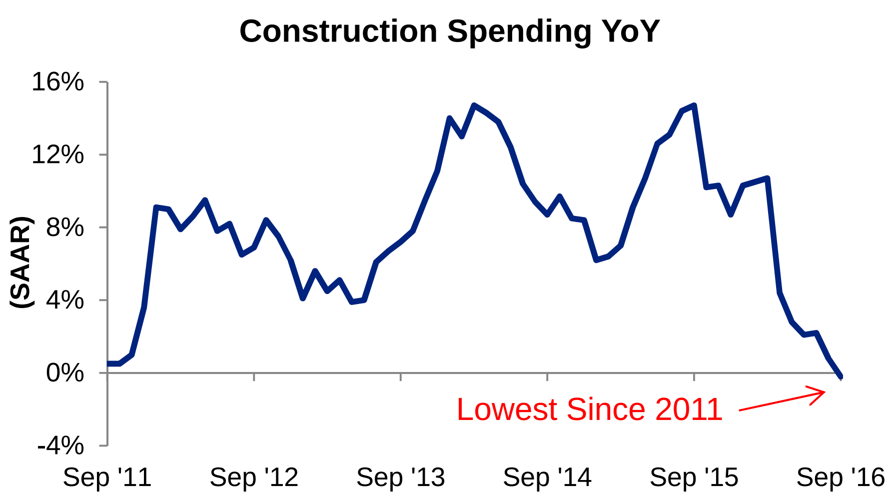


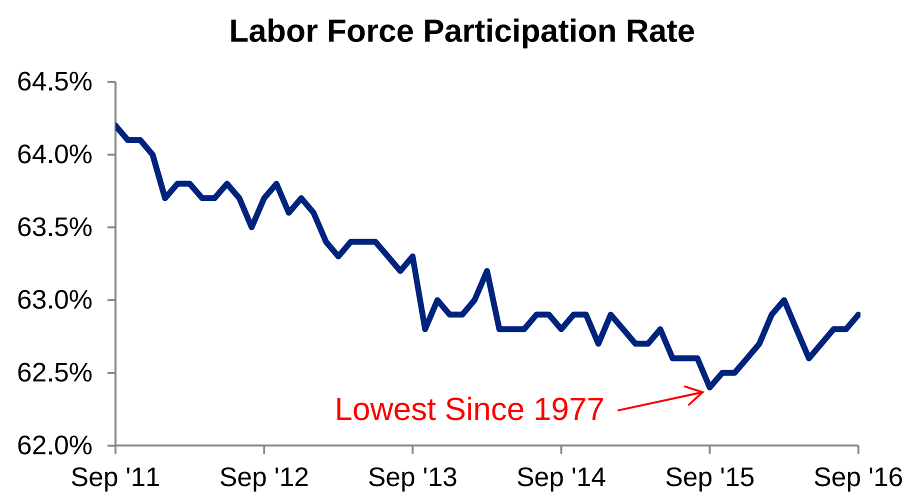
Source: Bloomberg. As of 10/31/16. SA is seasonally adjusted.

Economic Backdrop: Areas of Weakness







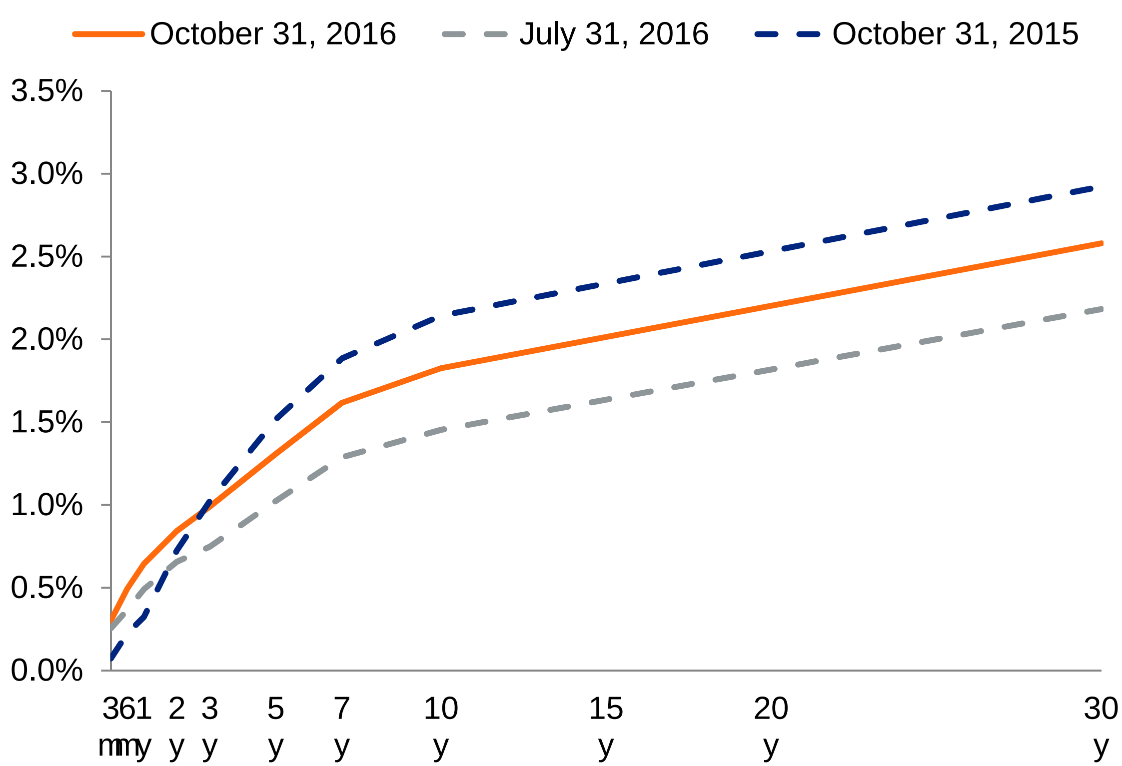


Source: Bloomberg. As of 10/31/16. SAAR is seasonally adjusted annualized rate.

Rates Rising, Treasury Curve Modestly Steeper

- Treasury rates have recovered from the Brexit decline, with the shorter end of the curve moving higher as market participants find a December rate hike increasingly more likely. The longer end rose more substantially over higher inflation expectations in the U.S. and rumors that the ECB may start reducing its quantitative easing program.
- As a result, the yield curve has steepened recently, although it remains flat compared to a year ago.

U.S. Treasury Yield Curve



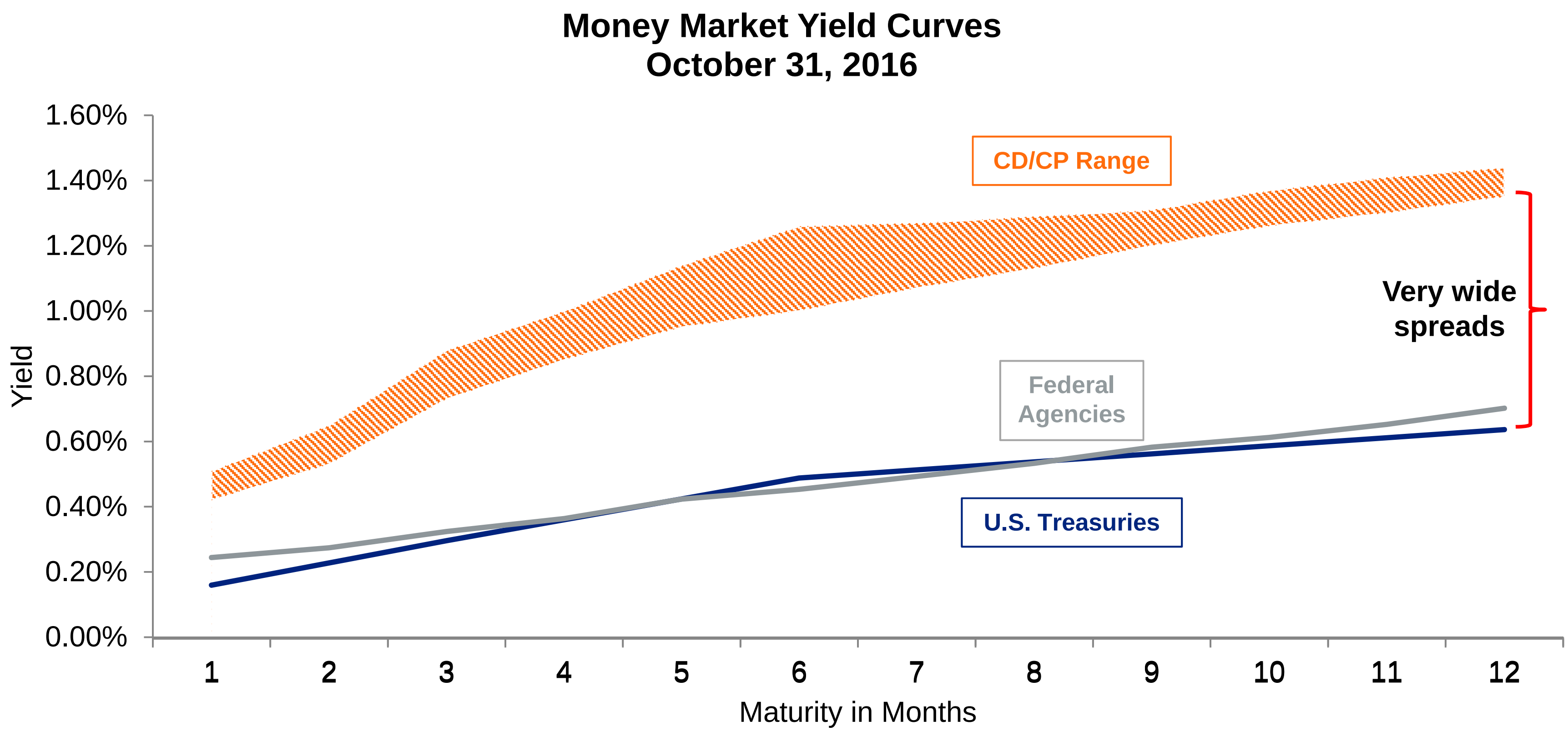
Yield Curve History

	10/31/16	07/31/16	10/31/15
1-Mo.	0.17	0.18	0.00
3-Mo.	0.30	0.26	0.07
6-Mo.	0.50	0.37	0.23
1-Yr.	0.64	0.49	0.32
2-Yr.	0.84	0.66	0.73
3-Yr.	0.99	0.75	1.03
5-Yr.	1.31	1.03	1.52
7-Yr.	1.62	1.29	1.89
10-Yr.	1.83	1.45	2.14
30-Yr.	2.58	2.18	2.92

Source: Bloomberg.

CP/CD Offer Wide Yield Spread over Treasuries

- Yields on commercial paper and negotiable bank CDs remain very attractive alternatives to Treasury Bills and short-term agencies. Money market reforms, which became effective on October 14, caused a significant shift in assets from prime funds (which typically purchase short credit instruments) to government-only funds. As a result, yield spreads widened sharply, especially in the 6-12 month area of the curve.

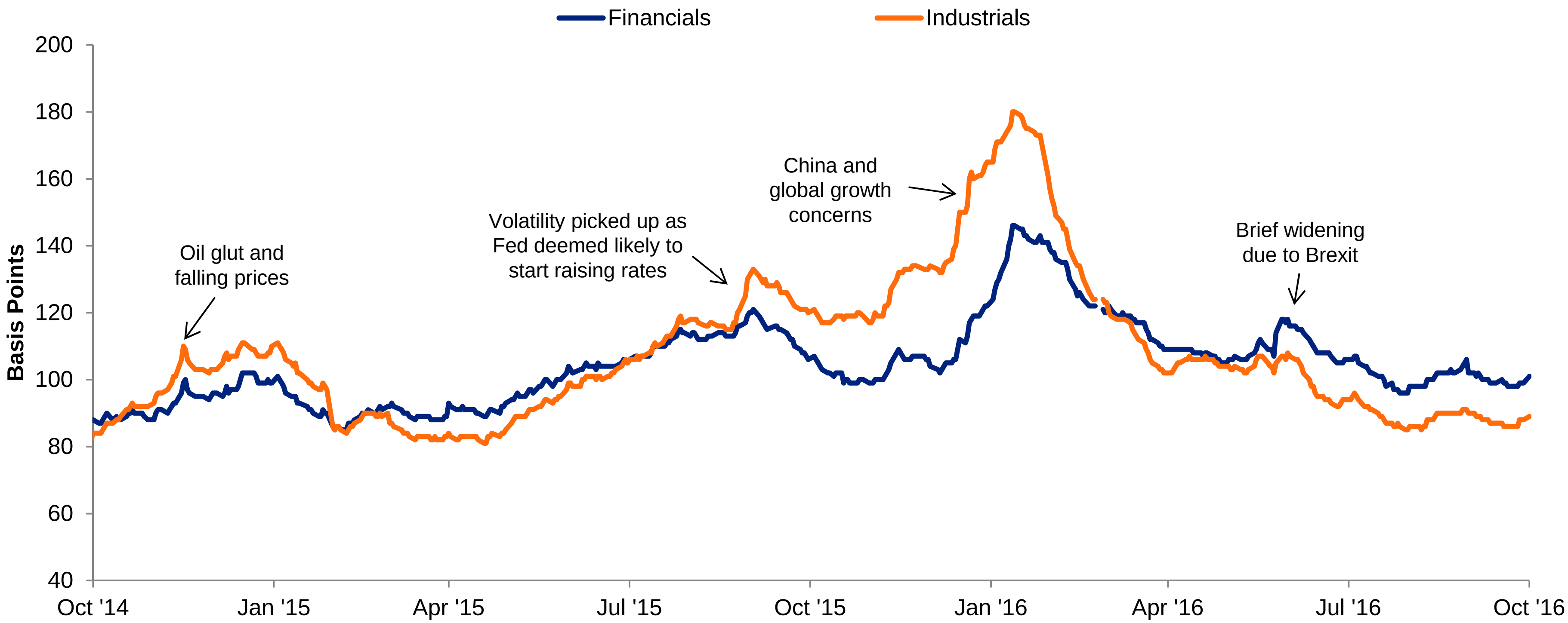


Source: Bloomberg, PFMAM. Information on CD/CP ranges are estimates based on independently compiled data. CP/CD rates vary by issuer, credit quality and structure.

Corporate Yield Spreads Remain Lower

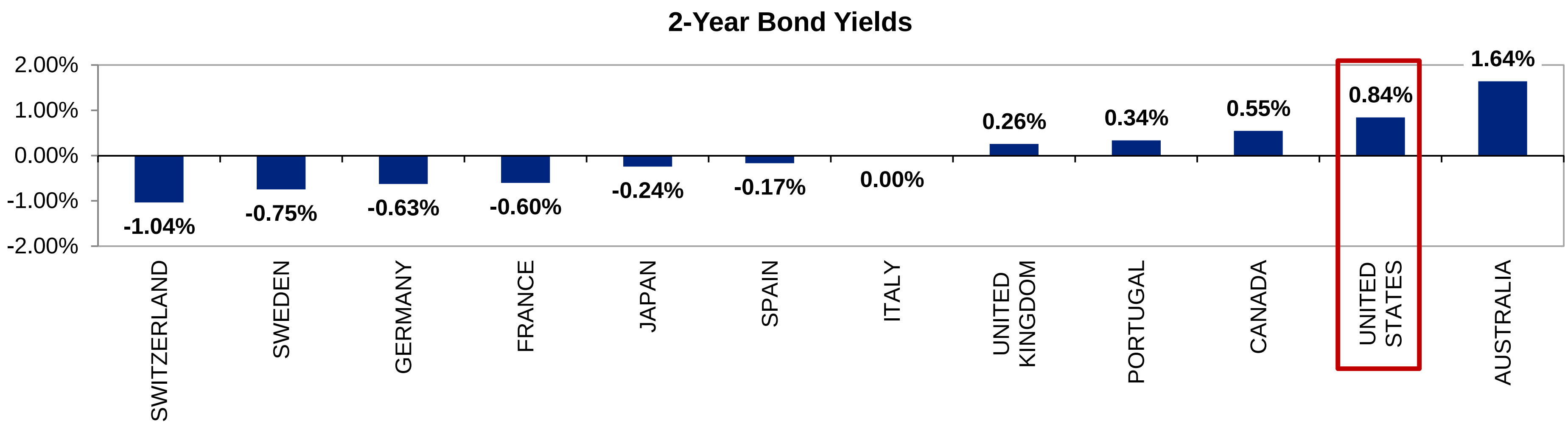
- Yield spreads on corporate securities have come down significantly since the beginning of the year as global headwinds have faded away. As a result, corporates have outperformed other fixed income sectors. Spread volatility could pick up again should central banks migrate away from accommodative policies.
- Credit profiles continue to be strong, but industrials are becoming more leveraged because of heavier debt issuance used to fund dividend payouts and stock buybacks; meanwhile profitability measures for financials remain pressured due to the low interest rate environment and higher capital requirements.

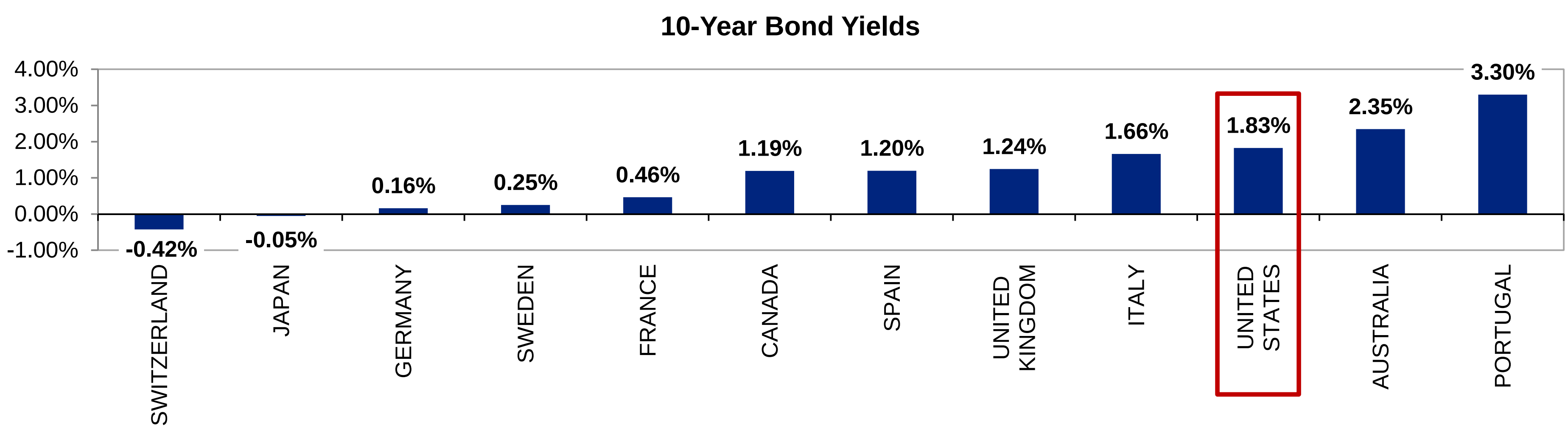
1-5 Year Investment Grade Corporate Yield Spreads



Source: Based on BofA Merrill Lynch 1-5 Year Corporate Indexes, as of 10/31/16. Yield spreads are based on option-adjusted spread (OAS).

Global Interest Rates Remain Very Low

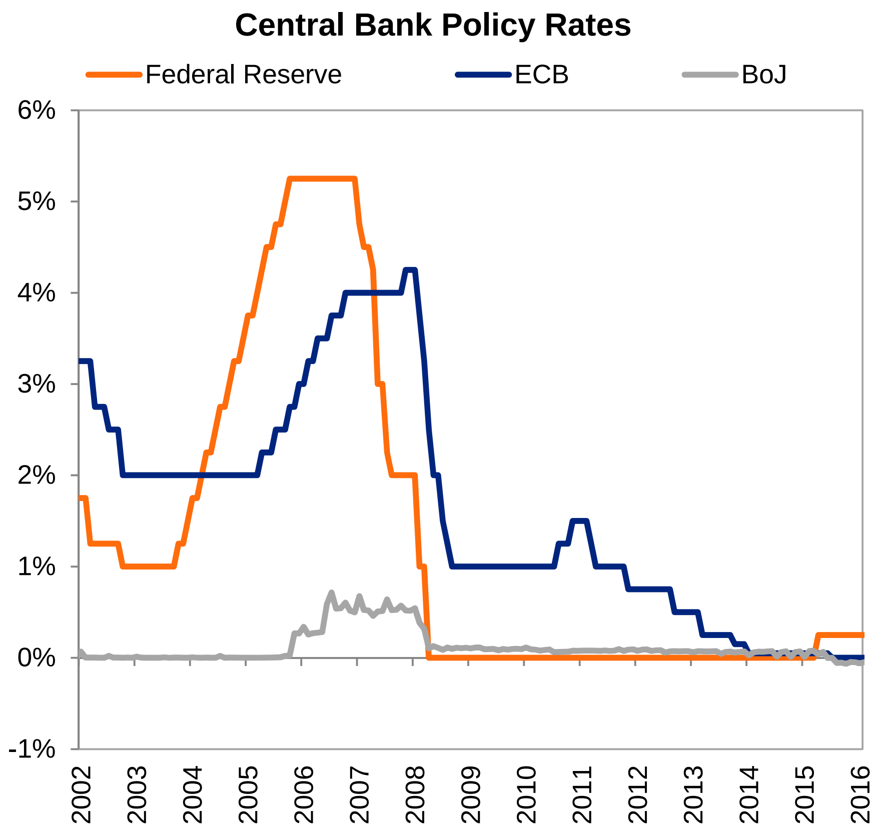


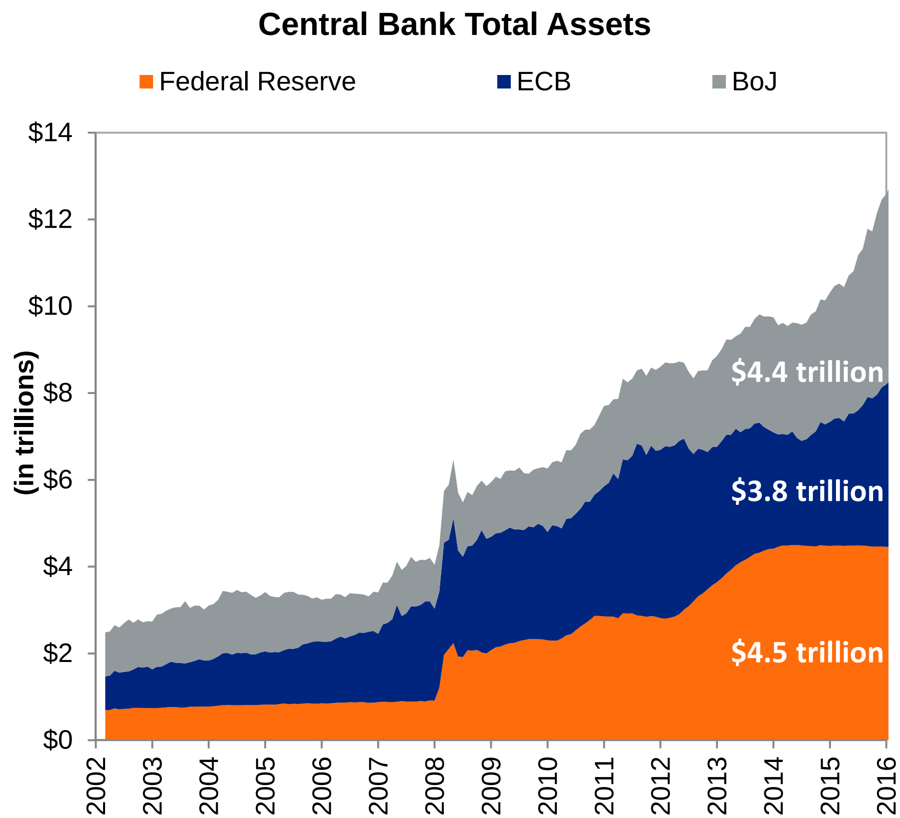


Source: Bloomberg. As of 10/31/16.

Global Central Banks' Unconventional Policies

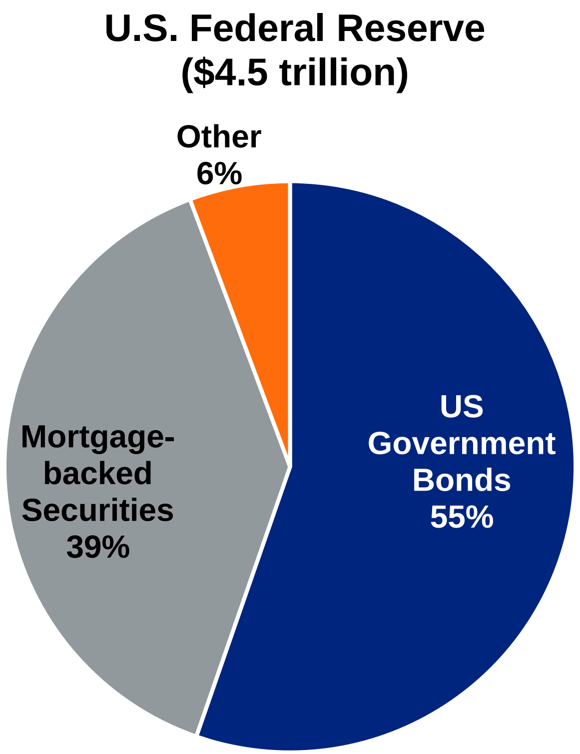
- Central banks around the world remain very accommodative. Although the Federal Reserve may raise rates again by the end of the year, further rate hikes are expected to be gradual and data dependent.
- Meanwhile, the European Central Bank (ECB) refinancing rate remains at zero while the Bank of Japan (BoJ) has a target rate of -0.1%. Both central banks continue to expand their asset buying program by increasing the size of their balance sheets to unprecedented levels and broadening the asset class mix.

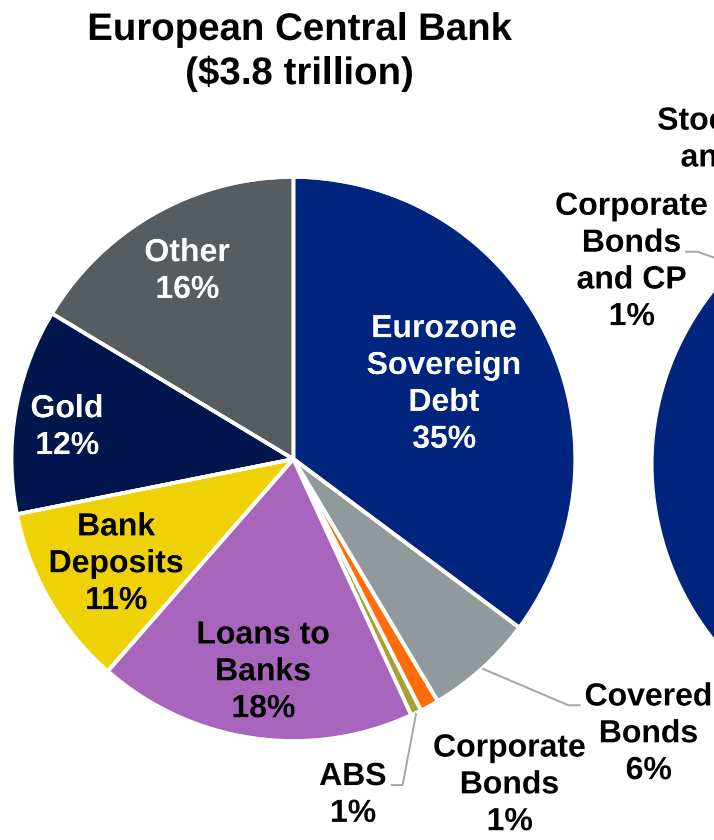


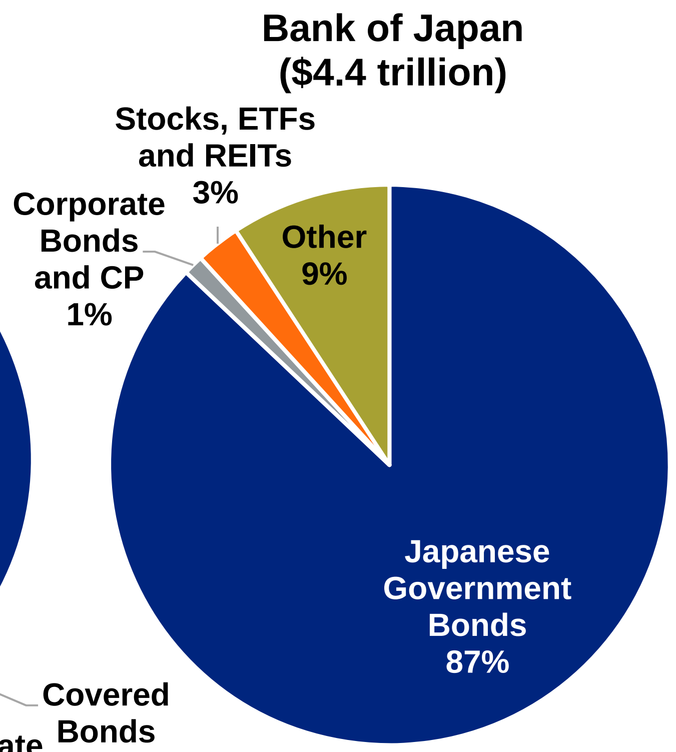


Source: Bloomberg. As of 10/31/16.

Global Central Banks' Holdings







Source: Federal Reserve as of 11/02/16, ECB as of 10/28/16 and BoJ as 10/31/16.

Sector Preferences – November 2016

Sector		PFMAM Investment Preference
MMF/LGIP		
Commercial Paper/CDs		
Treasury:	T-Bill	
	T-Note	
Agency:	<= 3 years	
	> 3 Years	
Corporates:	Financials	
	Industrials	
Municipal Bonds		
Asset-Backed		
Mortgage Backed		

Sector Considerations

CP/CDs
Over the past several weeks, CP/CD yields beyond three months have decreased approximately 10 basis points as Prime money market funds have begun to redeploy cash post 2a7 reform. Even at current levels and the FOMC in play for December, these short-term credit instruments continue to offer relative value vs. government securities.

Treasuries
Yields have moved generally higher post the Brexit-induced rally. 1-5 year maturities offer value near the upper end of recent trading ranges, but the yield curve remains relatively flat, as a result of an extended period of low inflation and a lower expected ceiling for interest rates from a gradual Fed.

Federal Agencies
Federal Agency spreads continued to tighten, as light supply, higher rates, and strong investor demand have kept a lid on spreads. This tighter move has erased most of the value found in the agency sector earlier in the year. As a result, rather than adding agencies, there may be opportunities to sell them and purchase US Treasuries of similar maturity at essentially the same yields. There may be value in new issues, if they come with a yield concession.

Corporates
We are growing increasingly cautious with the corporate sector. Spreads remain quite narrow heading into the fall, with the potential for volatility to pick up due to events like the U.S. election and an FOMC interest rate hike. Increased volatility may widen spreads and affect corporate returns in the short run.

Municipals
Taxable municipals offer fair value compared to other spread products but remain deal specific with limited availability of inventory.

ABS
Due to the tightening over the last month or so, ABS spreads versus Treasury securities are around fair value relative to historic levels. Going into year end, the new issue market is expected to be relatively quiet, but still offers the most attractive avenue to add exposure. Collateral performance remains within rating agency expectations.

MBS
Given the recent tightening on both an OAS and nominal basis, the MBS sector is now trading at the tighter end of its recent range. While seasonal supply is starting to slow, the sector will likely need the Treasury market to sell off in order to generate positive excess returns over the near term.

Source: PFMAM, as of 10/31/16. This material is for general information purposes only and is not intended to provide specific advice or a specific recommendation. Analysis is subject to changes in the market environment, and may vary based on the client's particular circumstances.

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