Monthly Market Review

October 2016

Economic Highlights

- Economic data released in October generally met or exceeded expectations, indicating a continuing rebound in growth from the slow pace in the first half of the year.
- In the first estimate of third quarter growth, the U.S. economy expanded at an annual rate of 2.9%, making it the strongest quarter since the third quarter of 2014. Business investment contributed to growth for the first time in a year, and inventories grew for the first quarter since the start of 2015. However, third-quarter consumer spending fell from the second quarter's pace.
- October saw the 73rd consecutive month of job growth, with the U.S. labor market adding 161,000 jobs — fewer than the median estimate of 173,000. The unemployment rate fell back to 4.9%. In a positive sign, job openings remained near record highs, and initial unemployment claims fell to their lowest level since 1973.
- As economic data indicated a stronger pace of expansion, and inflation indicators moved toward the coveted 2% level, expectations rose for a Federal Reserve (Fed) interest rate hike.

Bond Markets

- Global bond yields spiked in October due to concern that the Fed and other global central banks would begin to gradually reduce stimulus measures currently in place. The jump in rates produced the worst month of bond market losses in more than two years.
- Treasury yields rose across all maturities in October, with longer maturities leading the way and the yield curve steepening. The 2-year Treasury yield climbed 8 basis points (bps) to 0.84% while the yield on the 10-year Treasury rose 23 bps to 1.83%. All Treasury benchmarks posted negative returns due to the rise in yields.
- Federal agency yield spreads narrowed during the month, nearing their tightest levels of the year. As a result, agency investments outperformed Treasury investments, although like Treasuries, most one-month returns were negative.
- Investment-grade corporate yield spreads remained within a tight range in October, near their lows of the year. Corporate bonds modestly outperformed comparable-maturity Treasuries for the month, adding to the sector's excess returns this year.
- Asset-backed securities (ABS) and mortgage-backed securities (MBS) also outperformed comparable-maturity Treasuries as spreads compressed to near their tightest levels of the year.
- Yields on money market securities with maturities of three months and longer narrowed slightly from near their widest levels of the year as issuers and investors adjusted to money market reform, which became effective October 14.

Equity Markets

- Broad domestic equity indexes posted their largest monthly declines since the sell-off that started the year. The S&P 500 Index dropped 1.9%, while the tech-heavy Nasdaq slumped 2.3% and the Dow Jones Industrial Average fell 0.9%.
- In U.S. dollar terms, most major global equity markets declined as the U.S. dollar strengthened more than 3% during the month against a basket of foreign currencies. In Europe, equities posted their biggest declines since Britain's "Brexit" vote to leave the European Union, as the Euro Stoxx 600 Index fell 3.5%. In Asia, Chinese and Japanese equity markets posted strong gains.

PFMAM Outlook

- The U.S. economy is expected to continue to show improved growth relative to the first half of the year, led by consumer spending, job gains and housing.
- Most market participants now expect a 0.25% increase in the federal funds rate at the Fed's December meeting. Outside the U.S., global central banks continue to administer accommodative monetary policy, keeping rates low and implementing large-scale purchase programs. Meanwhile, some sovereign bond rates rose in October on the expectation that the European Central Bank may taper its accommodation over the next year.
- The U.S. presidential election continues to be the biggest uncertainty facing the markets in the near term. In the last week of October, nervousness about the outcome caused stocks to sell off and bonds to rally. The uncertainty is expected to persist after Election Day.
- Portfolios have been positioned with durations close to benchmarks in an effort to protect them from unpredictable rate moves. We recommend a somewhat more defensive posture as we approach a potential December rate hike.
- As investment-grade corporate yield spreads have tightened further, the incremental return potential for the corporate bond sector has declined. Despite tighter spreads and robust issuance, market demand has been strong. We are maintaining current allocations to credit sectors, while being more selective on new purchases.
- Money market reform has created exceptional opportunities in shorter-term credit instruments, such as commercial paper and negotiable bank certificates of deposit (CDs). In some cases, short-term credit securities offer higher yields than longer-term Treasuries and agencies. Since mid-October, some of the exceptional value has diminished as institutional funds and markets have adjusted to the new world of prime funds with floating net asset values. Still, opportunities remain, and short-maturity credit sectors continue to offer value.

U.S. Treasury Yields

Maturity	Oct 31, 2015	Sep 30, 2016	Oct 31, 2016	Monthly Change
3 Month	0.07%	0.28%	0.30%	0.02%
6 Month	0.23%	0.43%	0.50%	0.07%
2 Year	0.73%	0.76%	0.84%	0.08%
5 Year	1.52%	1.15%	1.31%	0.16%
10 Year	2.14%	1.60%	1.83%	0.23%
30 Year	2.92%	2.32%	2.58%	0.26%

Yields by Sector and Maturity as of October 31, 2016

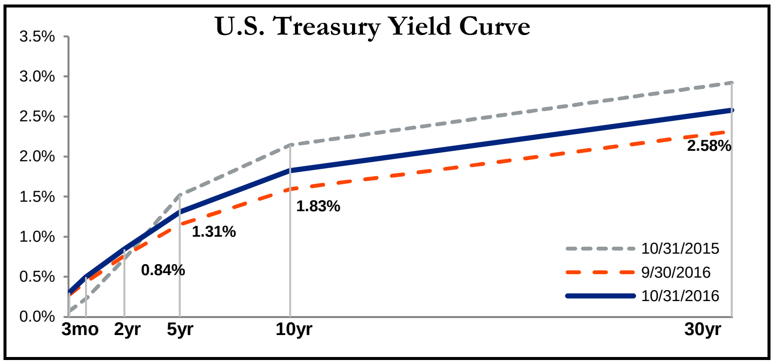
Maturity	U.S. Treasury	Federal Agency	Corporates-A Industrials	Municipals
3 Month	0.30%	0.34%	0.93%	-
6 Month	0.50%	0.45%	0.98%	-
2 Year	0.84%	0.92%	1.34%	0.88%
5 Year	1.31%	1.45%	1.97%	1.26%
10 Year	1.83%	2.15%	2.75%	2.01%
30 Year	2.58%	2.81%	3.83%	4.04%

Spot Prices and Benchmark Rates

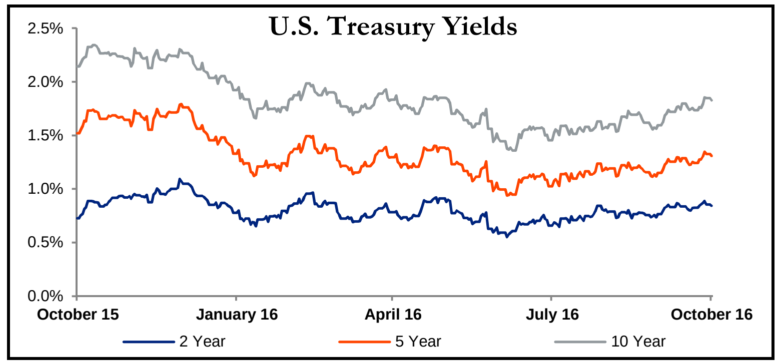
Maturity	Oct 31, 2015	Sep 30, 2016	Oct 31, 2016	Monthly Change
1 Month LIBOR	0.19%	0.53%	0.53%	0.00%
3 Month LIBOR	0.33%	0.85%	0.88%	0.03%
Effective Fed Funds Rate	0.07%	0.29%	0.31%	0.02%
Fed Funds Target Rate	0.25%	0.50%	0.50%	0.00%
Gold ($/oz)	$1,141	$1,313	$1,273	-$40
Crude Oil ($/Barrel)	$46.59	$48.24	$46.86	-$1.38
U.S. Dollars per euro	$1.10	$1.12	$1.10	-$0.02

October's Economic Indicators

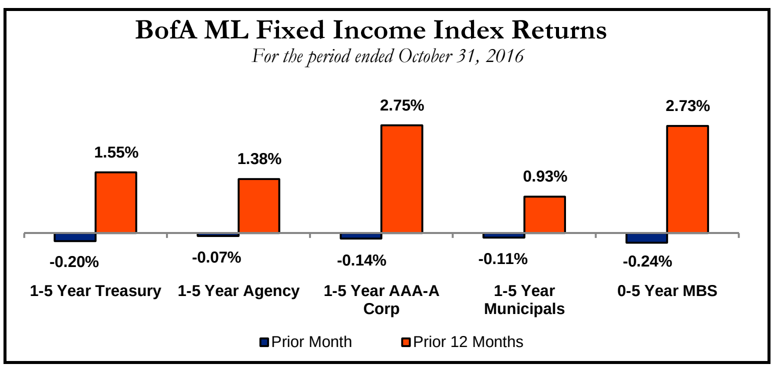
Indicator Name	Release Date	Period	Actual	Survey (Median)
Change in Nonfarm Payrolls	Oct 07	Sep	156k	172k
Retail Sales MoM	Oct 14	Sep	0.60%	0.60%
CPI Ex Food & Energy YoY	Oct 18	Sep	2.20%	2.30%
Existing Home Sales	Oct 20	Sep	5.47m	5.35m
Consumer Confidence	Oct 25	Oct	98.6	101.5
New Home Sales	Oct 26	Sep	593k	600k
GDP Annualized QoQ	Oct 28	3Q (First)	2.90%	2.60%



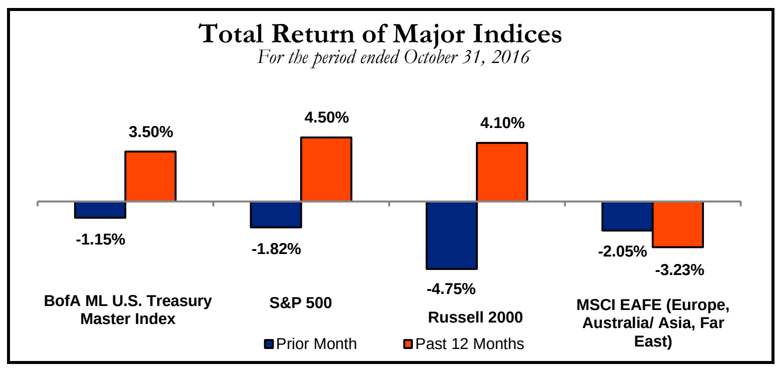
Treasury yields rose in October, led by longer-term maturities, steepening the yield curve the most this year as the 10-year outpaced the 2-year by 0.15%.



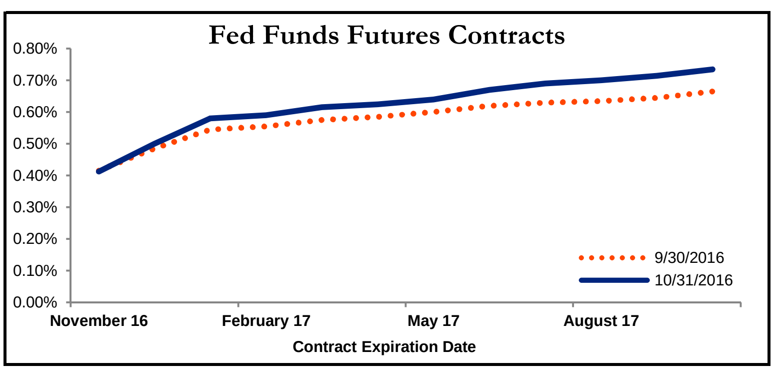
Treasury yields remained significantly lower for the year amid a flatter yield curve as longer-term maturity yields led declines.



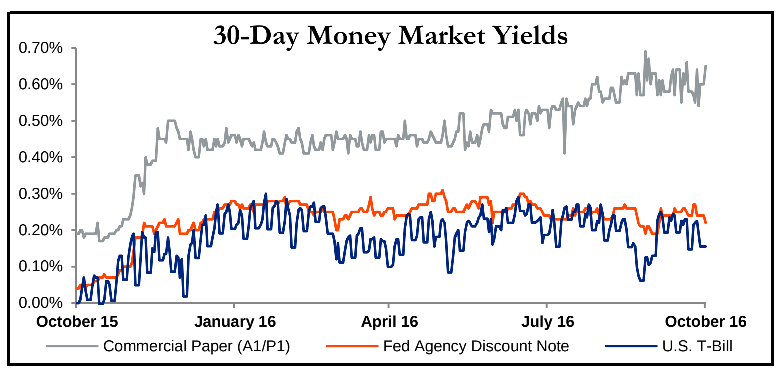
Fixed income indexes posted declines, led by long-term indexes, as yields rose and the yield curve steepened.



Domestic and international equity indexes declined in October, underperforming fixed-income indexes for the second month in a row.



Rate hike expectations increased in October as the probability of a hike at the Fed's December meeting rose to its highest level of the year.



Spreads continued to widen between commercial paper and government securities, such as Treasuries and agencies, as money market reform took effect in October.

Source: Bloomberg. Data as of October 31, 2016 unless otherwise noted.

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