



# *Economic and Interest Rate Update*

**December 5, 2018**

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# Agenda

## **ECONOMIC REVIEW**

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Where are we today and how have capital markets reacted?

## **KEY TRENDS**

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What are we watching

## **MARKETS**

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What does this mean for Public Fund investors in New Mexico?



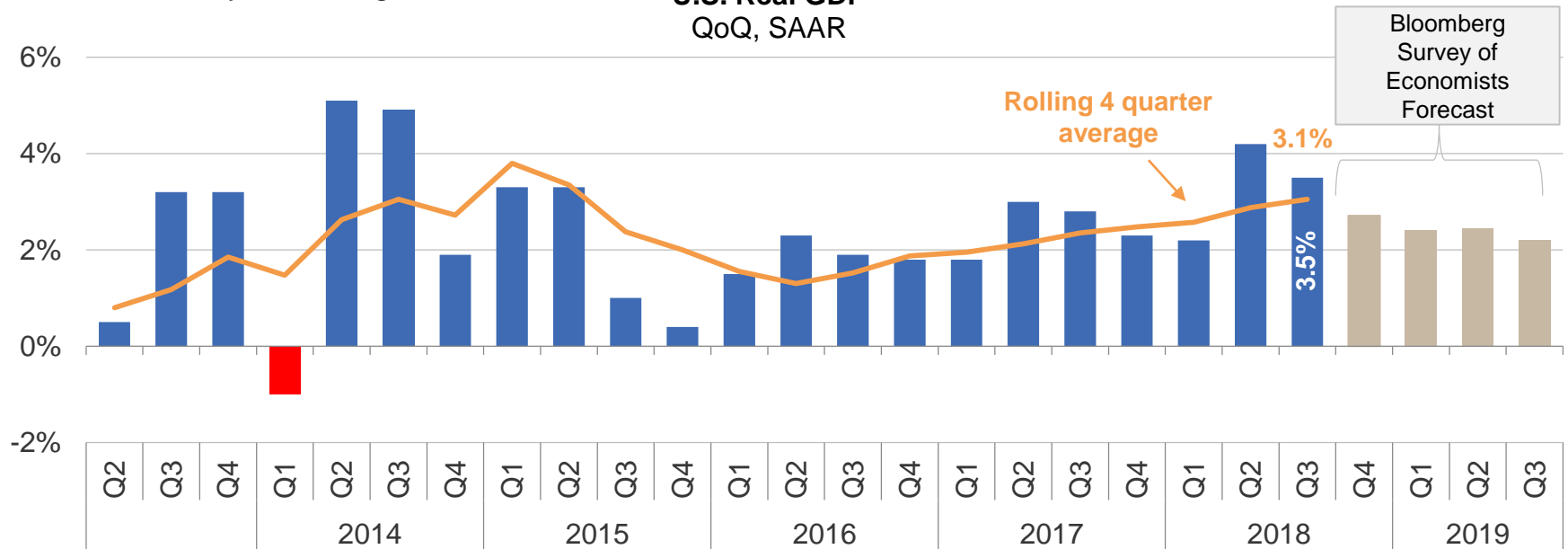
**Where are we today and  
how have capital markets reacted?**



## Strong Economic Growth in the Third Quarter

- U.S. economic activity expanded at a solid pace in Q3.
  - The gross domestic product (GDP) grew at a 3.5% annual rate, making Q2 and Q3 the best back-to-back quarters since 2014.
  - Consumer spending and inventories, provided their largest contributions since 2014 and 2015, respectively. Government spending rose by the most since 2016, providing a boost from fiscal stimulus and defense spending.
  - The drag from trade was the largest in 33 years. Housing posted its third consecutive drag on GDP growth. Non-residential business investment rose by the weakest clip in nearly two years, suggesting the boost from corporate tax cuts may be wearing off.

**U.S. Real GDP**  
QoQ, SAAR



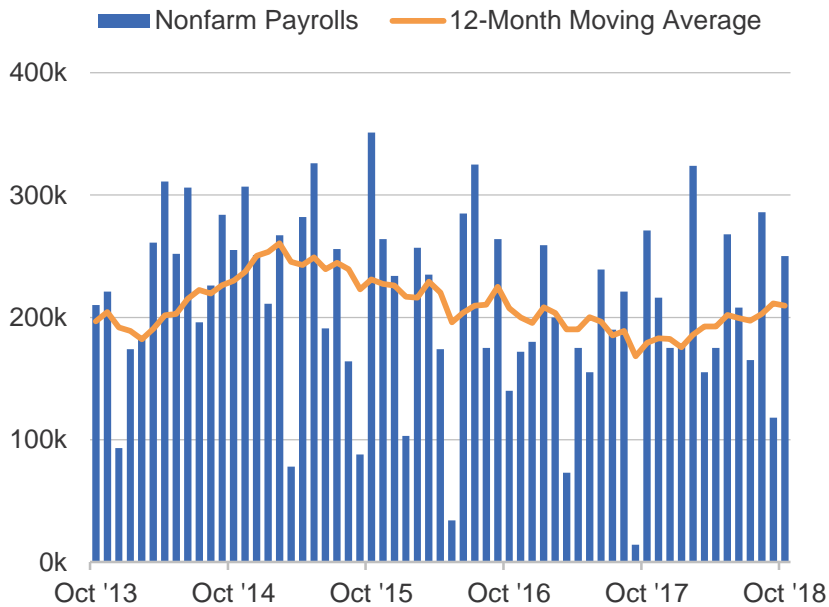
Source: Bloomberg, as of Q3 2018, first growth estimate. SAAR is seasonally adjusted annualized rate. Orange denotes rolling four-quarter averages.



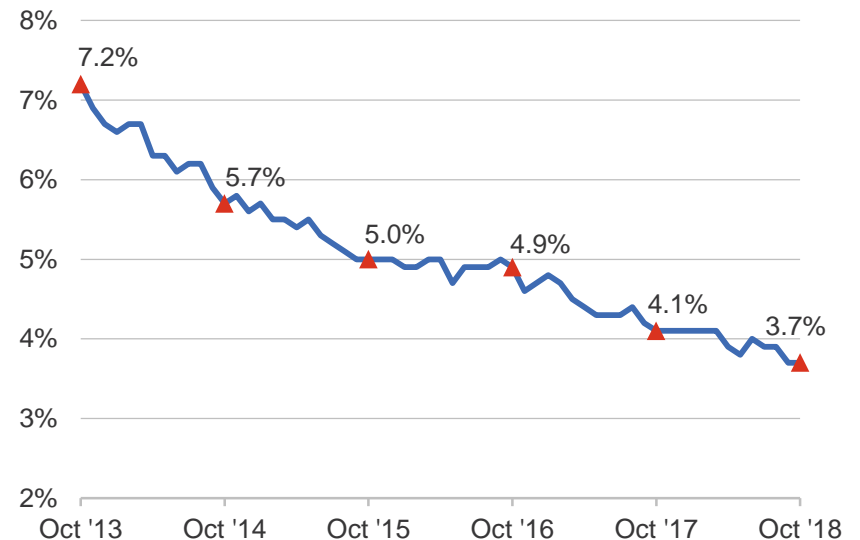
## Strong Labor Market Spurs Modest Uptick in Wages

- The U.S. economy added 250k jobs in October, which beat expectations.
- Job gains have averaged 213k per month so far this year.
  - The unemployment rate remained stable at 3.7% in October, the lowest level since 1969.
  - Average hourly earnings – a key measure of wage growth – accelerated from 2.8% in September to a new cycle high of 3.1% in October.

### Monthly Change in Nonfarm Payrolls



### Unemployment Rate

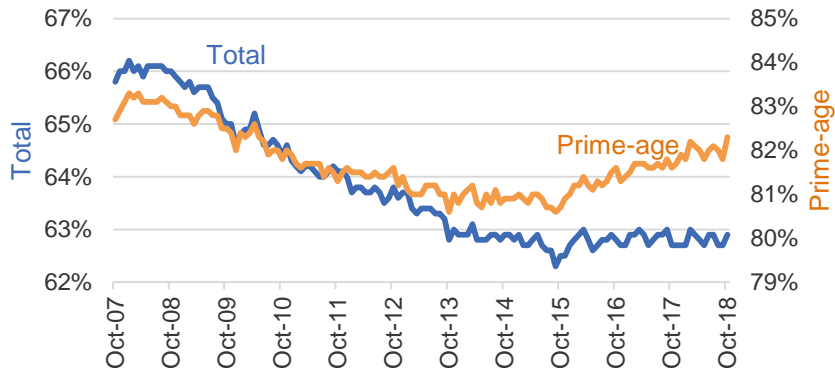


Source: Bloomberg, as of October 2018.

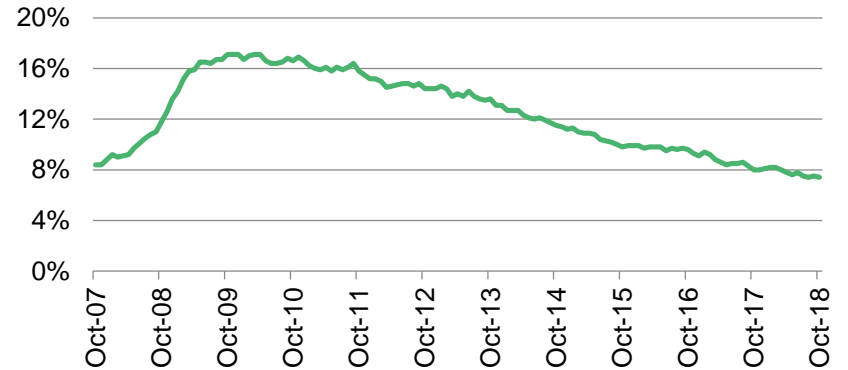


# Employment Indicators

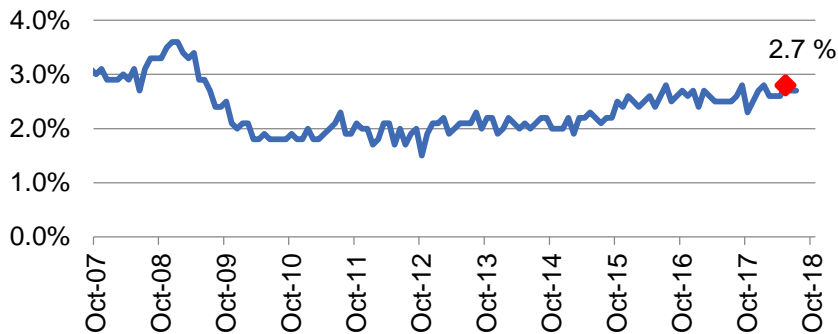
### Labor Force Participation Rate



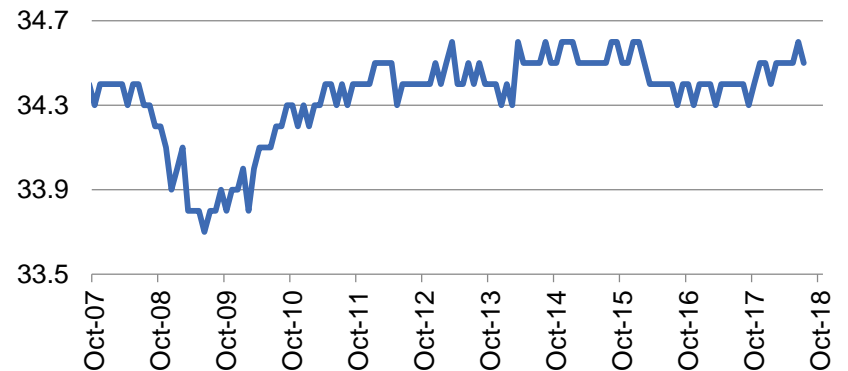
### U-6 Underemployment Rate



### Average Hourly Earnings (YoY %)



### Total Private Sector Average Weekly Hours



Source: Bloomberg, most recent data as of July 2018. BLS defines "prime-age" as individuals ranging from 25 – 54 years of age.

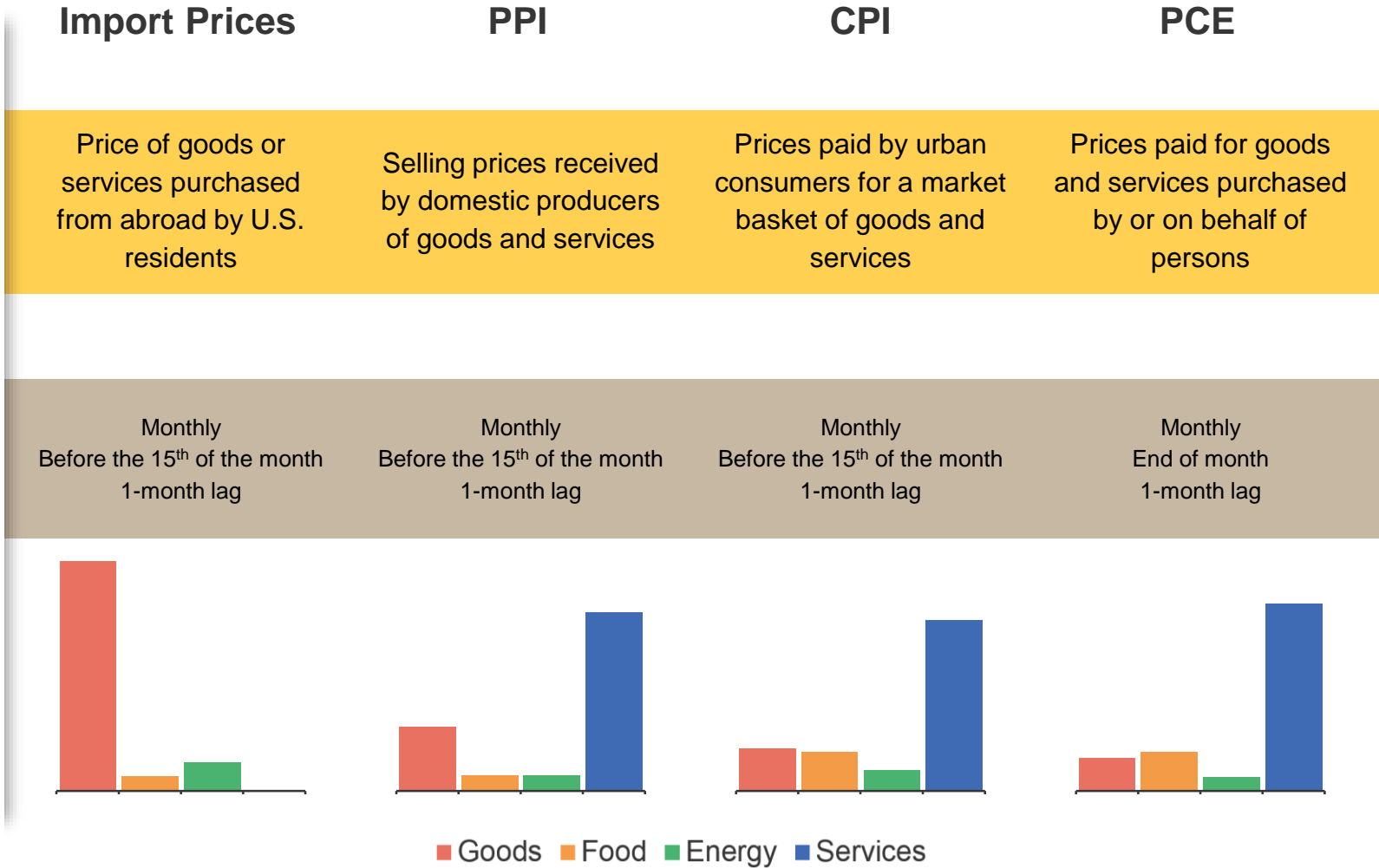


# Differences Between Inflation Indicators

  
*measures*

  
*release*

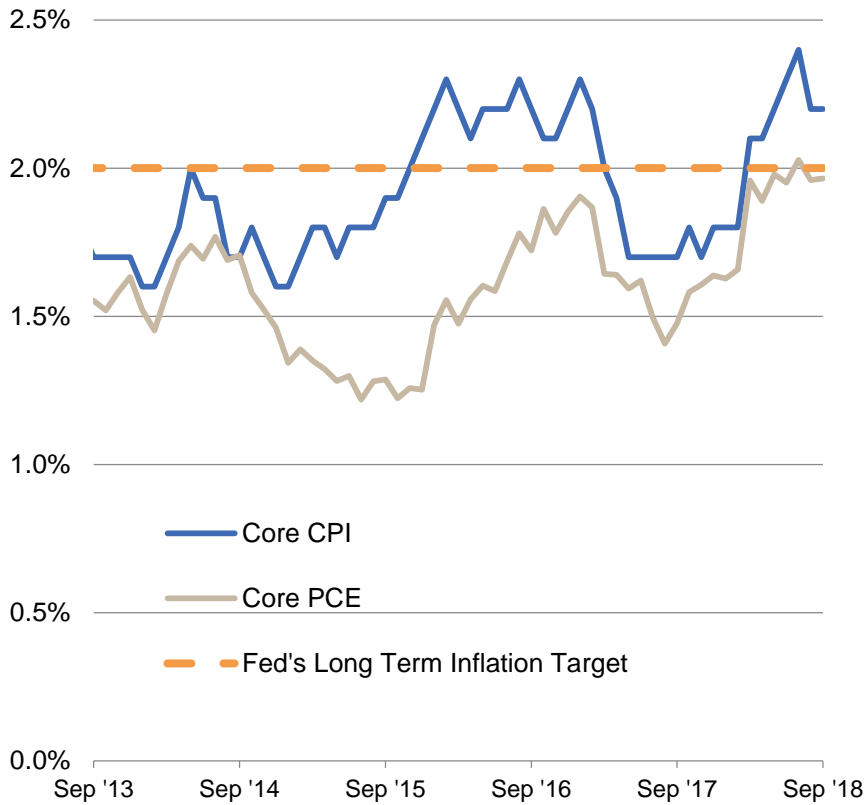
  
*composition*





# Inflation Closer to Fed's 2% Target

### Inflation Measures (YoY)



### Expectations for Average Inflation Rate over Next 5 Years



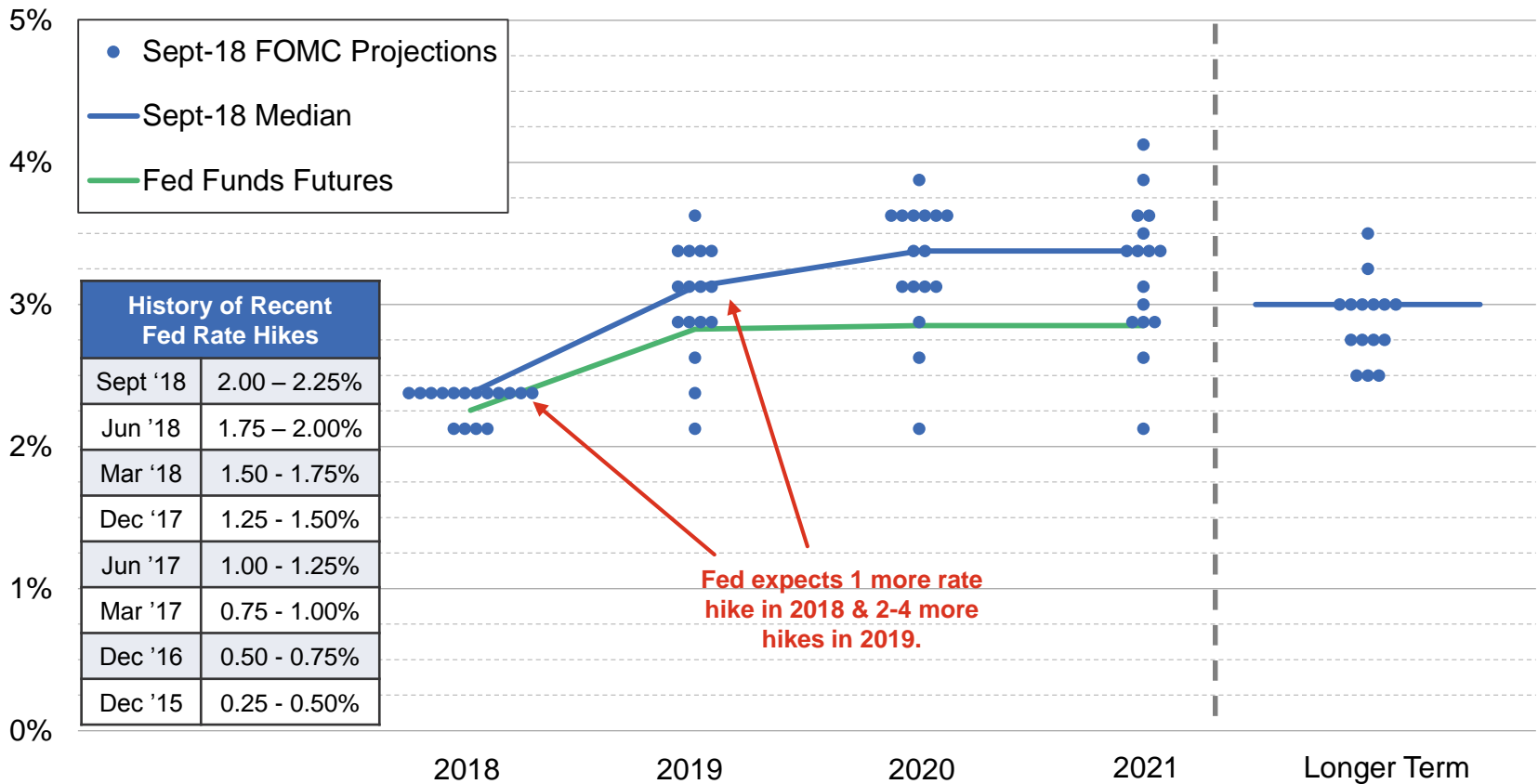
Source: Bloomberg, latest data available as of October 31, 2018. Inflation expectations based on yield difference between 5-year Treasury note and 5-year Treasury Inflation Protected Securities (TIPS).





# FOMC's September "Dot Plot" Projects More Rate Hikes

## Fed Participants' Assessments of 'Appropriate' Monetary Policy



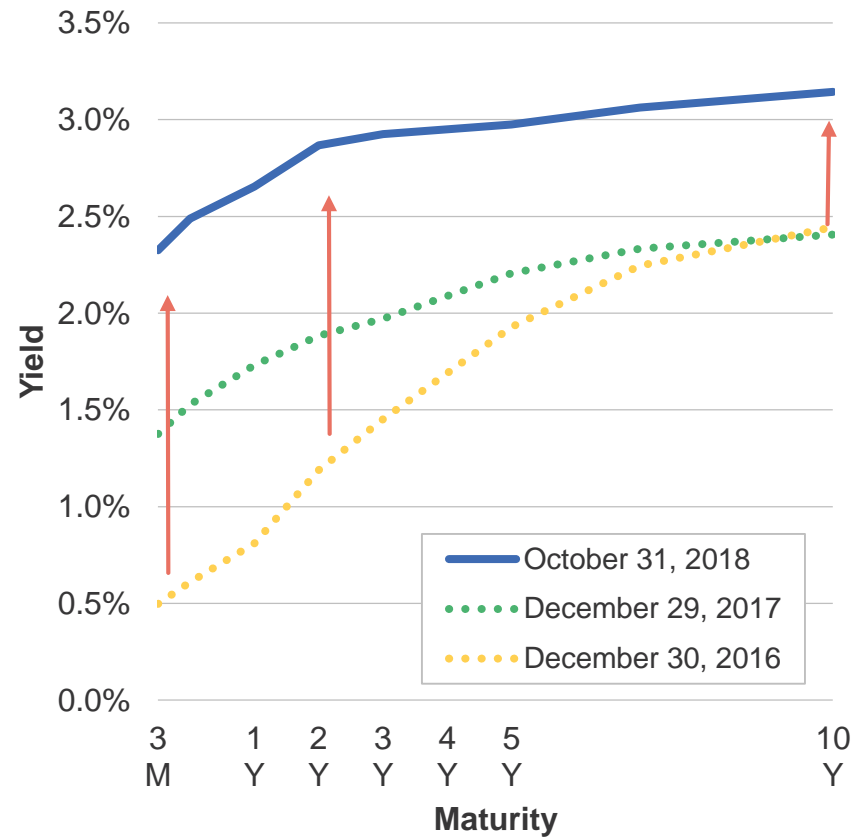
Source: Federal Reserve and Bloomberg. Individual dots represent each Fed members' judgement of the midpoint of the appropriate target range for the federal funds rate at each year-end. Fed funds futures as of 9/26/18.



## U.S. Yield Curve Has Flattened

Tenor	Current 10/31/18	Year-End 12/29/2017	Year-End 12/30/16
3 month	2.33%	1.38%	0.50%
6 month	2.49%	1.53%	0.61%
1 year	2.65%	1.73%	0.81%
2 year	2.87%	1.88%	1.19%
3 year	2.92%	1.97%	1.45%
5 year	2.97%	2.21%	1.93%
10 year	3.14%	2.41%	2.44%

### U.S. Treasury Yield Curve



Source: Bloomberg, as of 10/31/18.

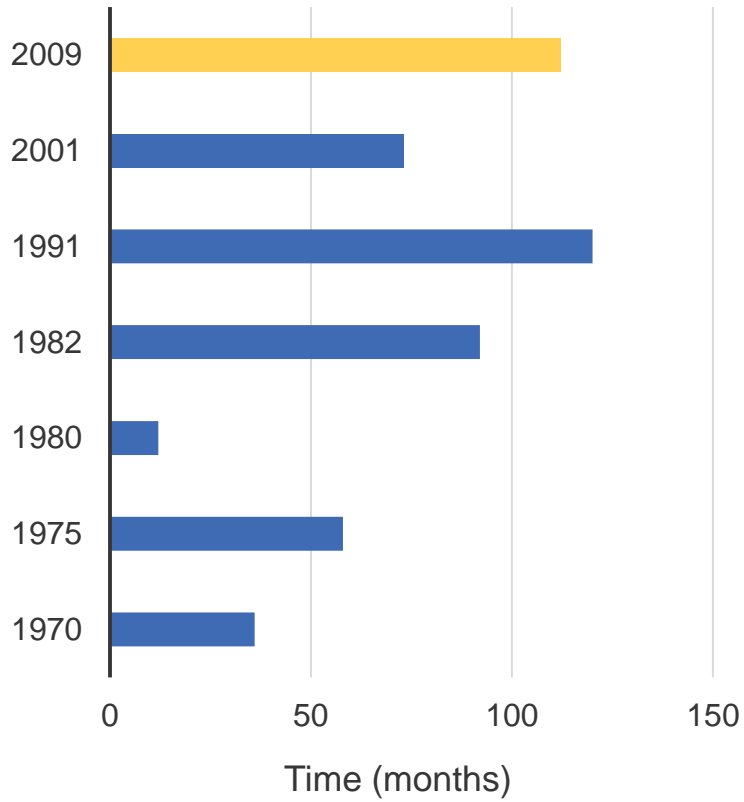


**What are we watching?**

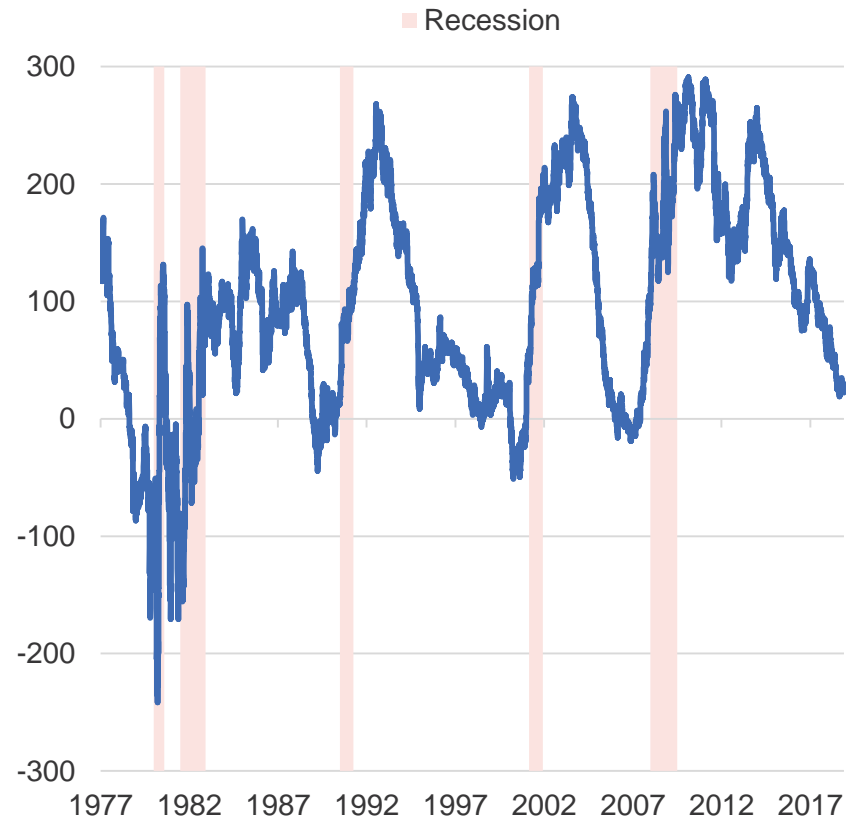


# Business Cycle Risk

### Duration of U.S. Expansion Periods



### 10-Year vs. 2-year Treasury Yield Spread



Left source: The National Bureau of Economic Research, as of October 2018.

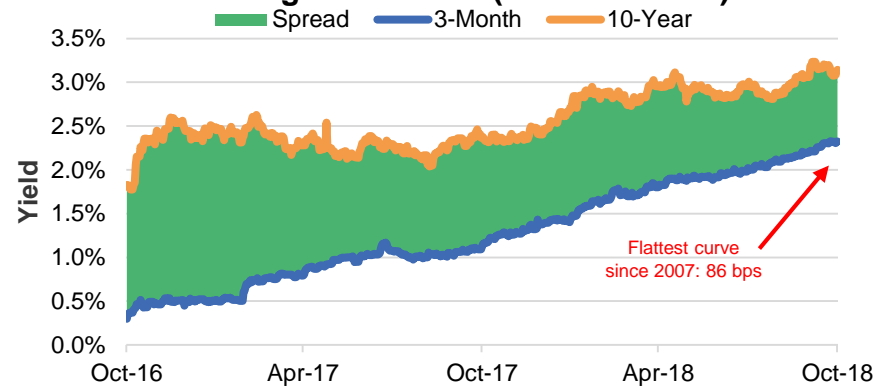


# What We're Watching...

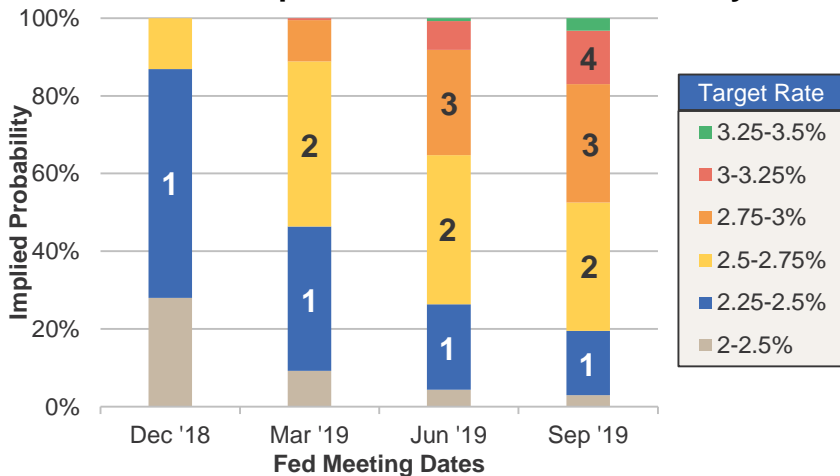
### 1-5 Year Corporate Spreads



### Flattening Yield Curve (10-Yr vs. 3-Mo)



### Market Implied Fed Rate Hike Probability



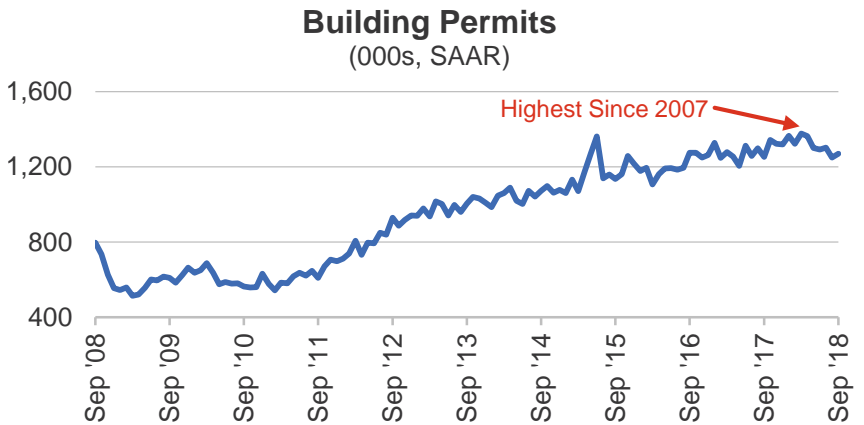
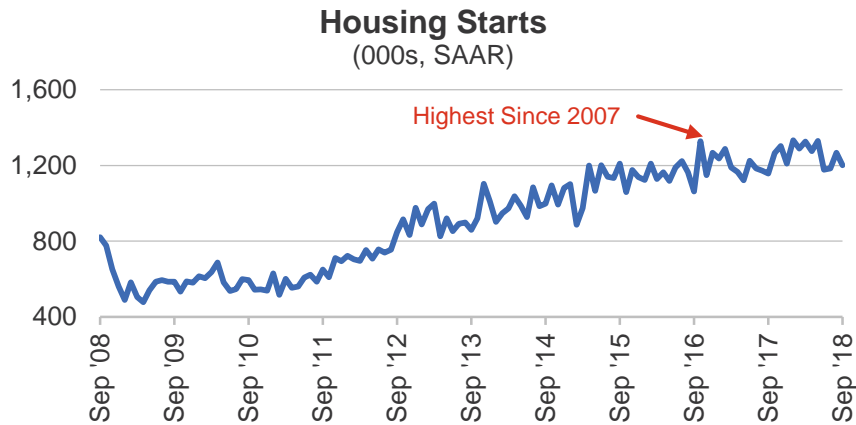
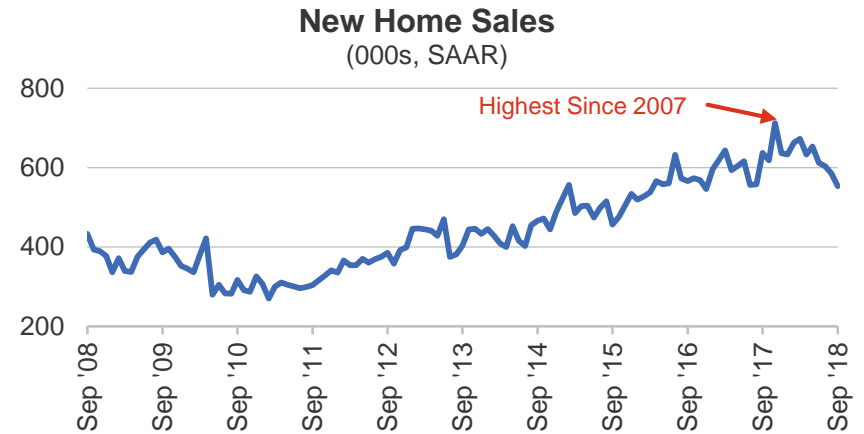
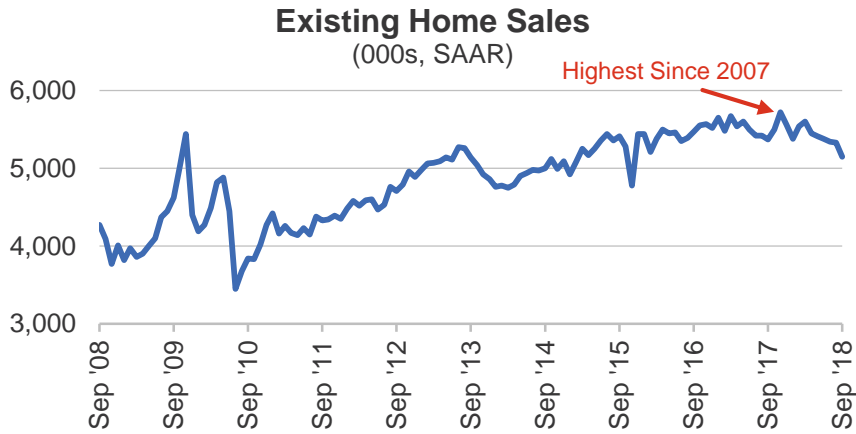
### Economic Indicators are Strong

Metrics At or Near Multi-Year Bests	
U.S. GDP (2018Q3)	Unemployment Rate
Consumer Confidence	Job Openings
Consumer Sentiment	Avg. Hourly Earnings
U.S. Manufacturing	Inflation (Core PCE)

Source: Bloomberg, yield spreads from ICE BofAML Indices, as of 10/31/18. Implied Fed Rate Hike Probability, as of 10/31/2018.



# Housing Market Momentum Continues to Slow



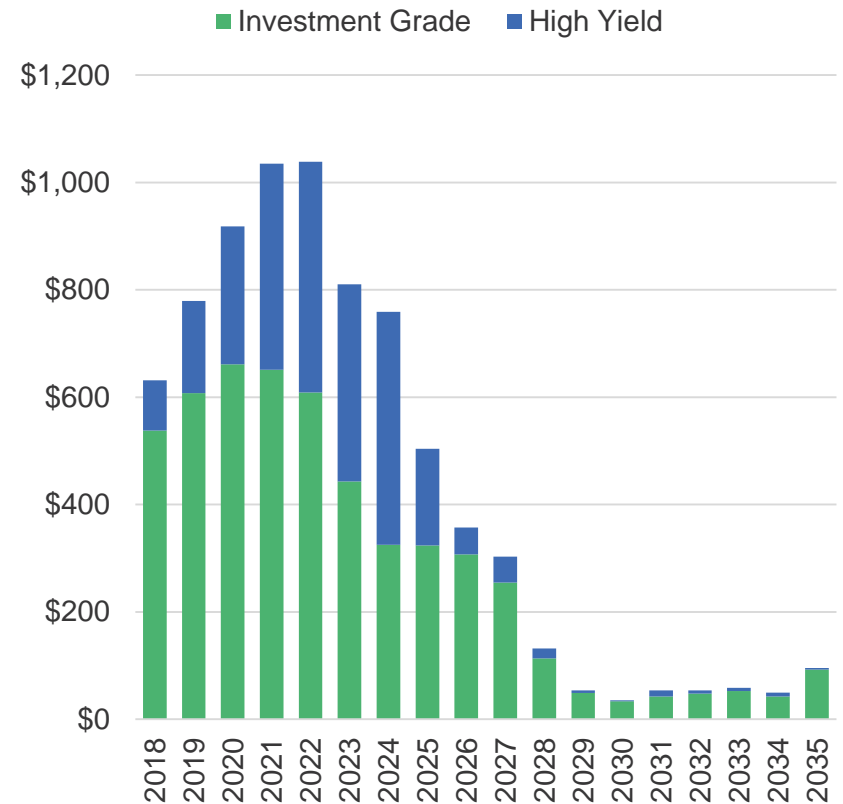
Source: Bloomberg, most recent data as of September 2018. SAAR is the seasonally adjusted annualized rate.



## U.S. Corporations Face Large Refinancing Needs

- About two thirds of all outstanding corporate debt is coming due in the next five years.
- U.S. companies may need to refinance \$4 trillion in debt maturing by 2022.
- Since rates are rising, firms will need to pay higher interest costs, using up cash that could have been allocated to investment or growth.
- However, firms may need to issue less debt if tax reform leaves them with more cash on hand.
- Significant refinancing supply could pressure yield spreads wider, but the impact is likely to be gradual.

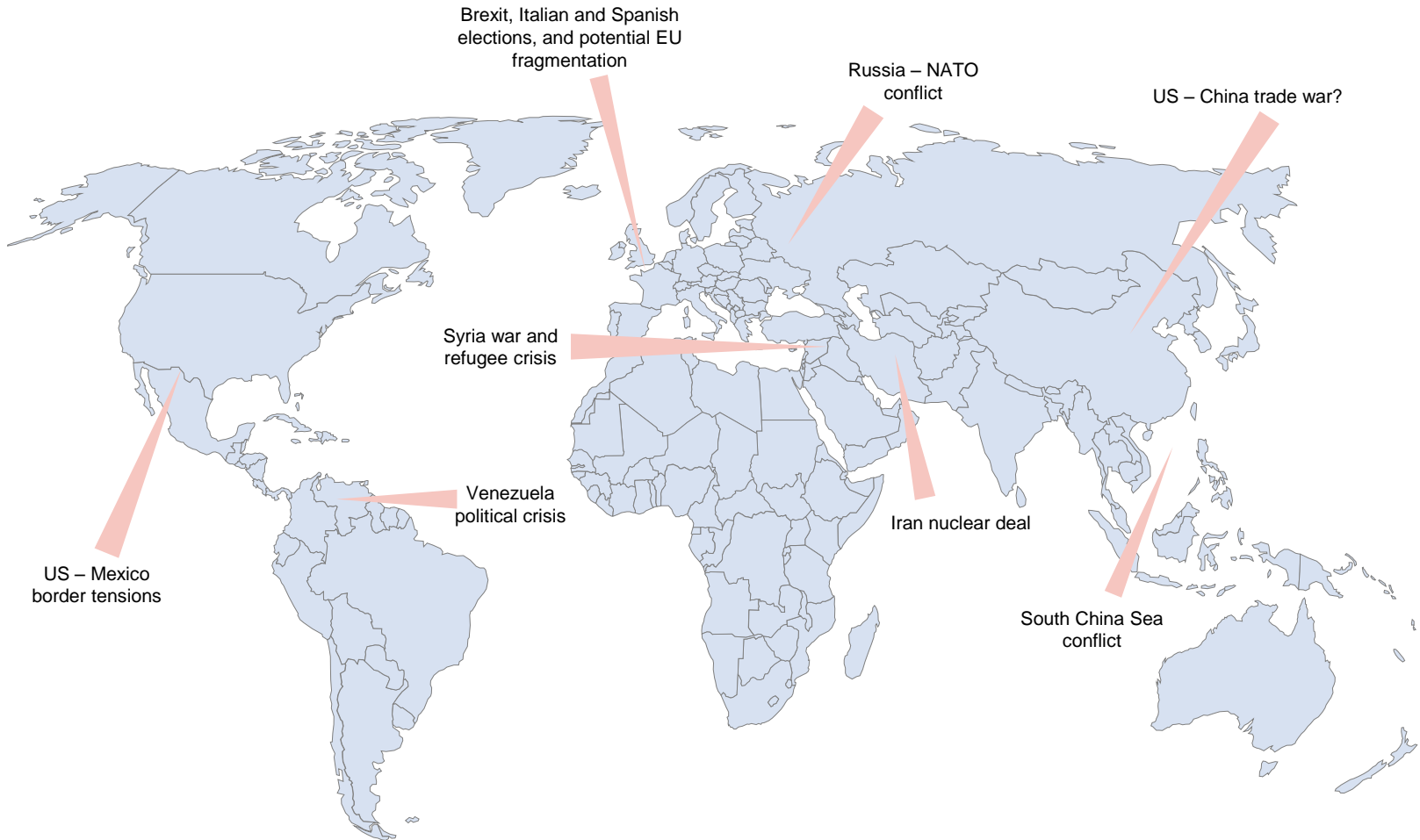
### Maturing Corporate Debt



Source: S&P CapitalIQ, Bloomberg, as of 05/11/2018.



# Geopolitical Risks Around the Globe







**What does this mean for Public Fund  
investors in New Mexico?**



## Yield History of 10-Year U.S. Treasury

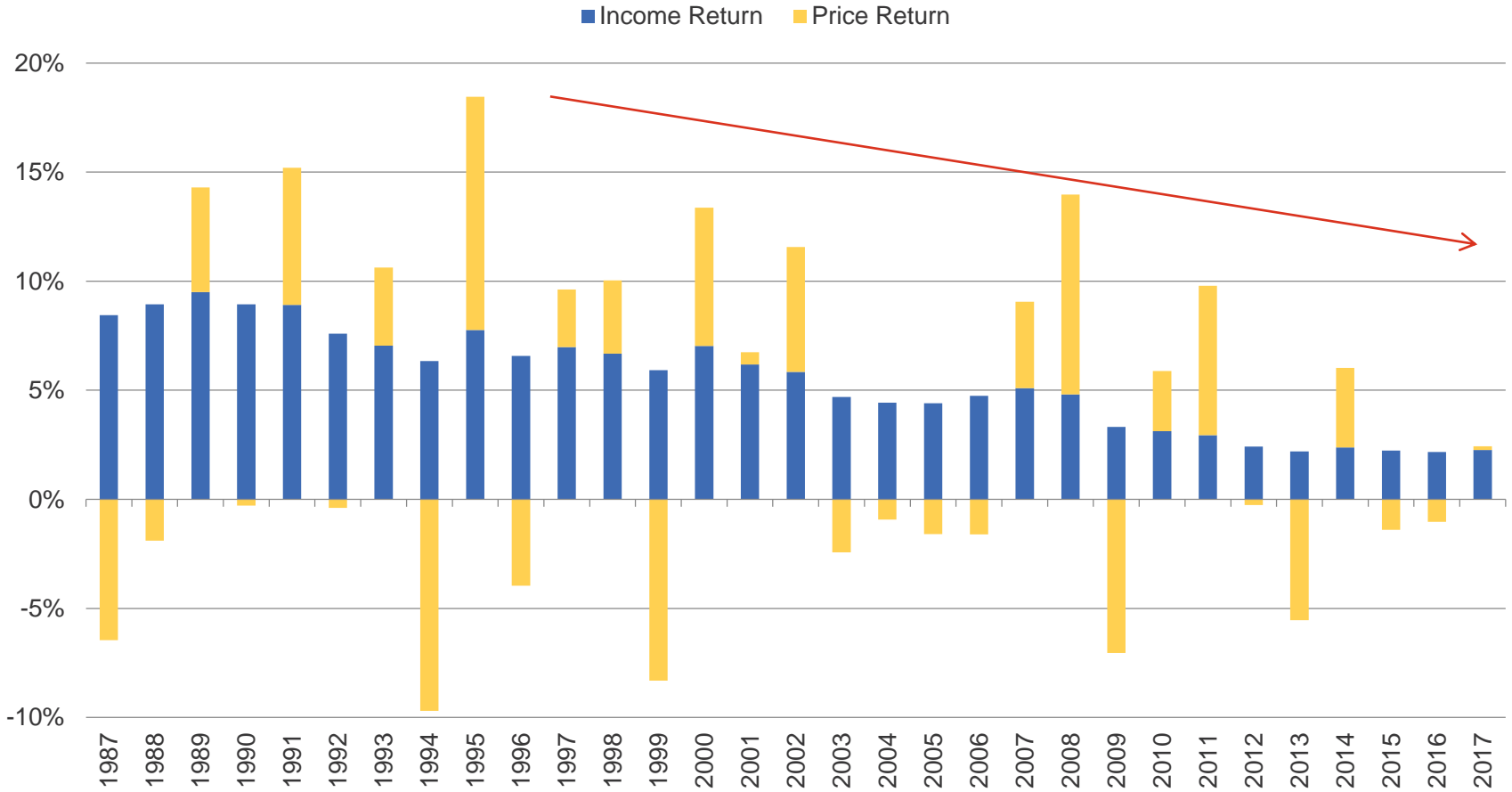


Source: Bloomberg, as of 7/31/2018.



# Lower Yields = Less Income & Smaller Buffer

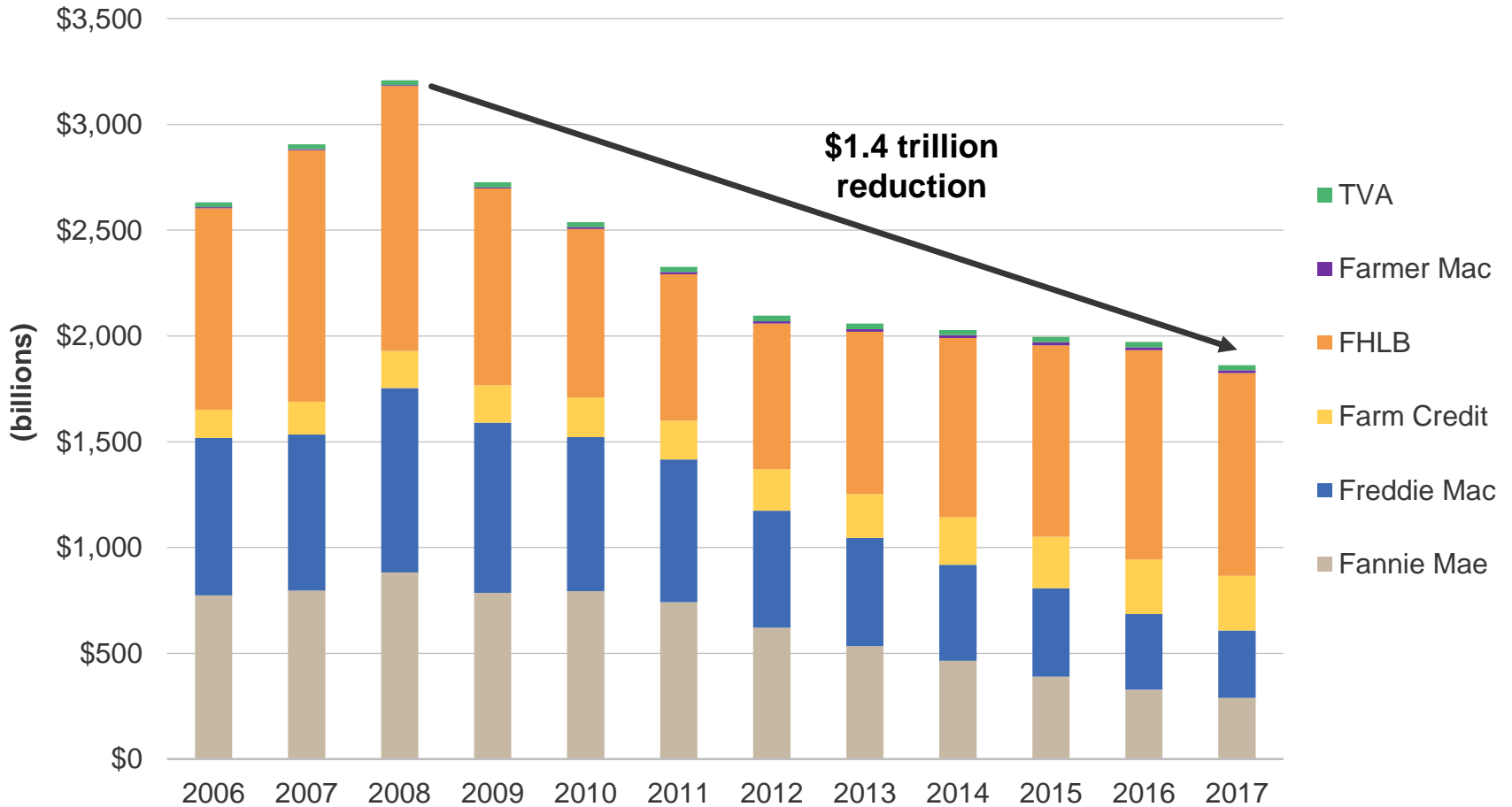
## Total Return Components of BofA Merrill Lynch U.S. Treasury Index



Source: Bloomberg, BofA Merrill Lynch Indices as of 12/31/17.



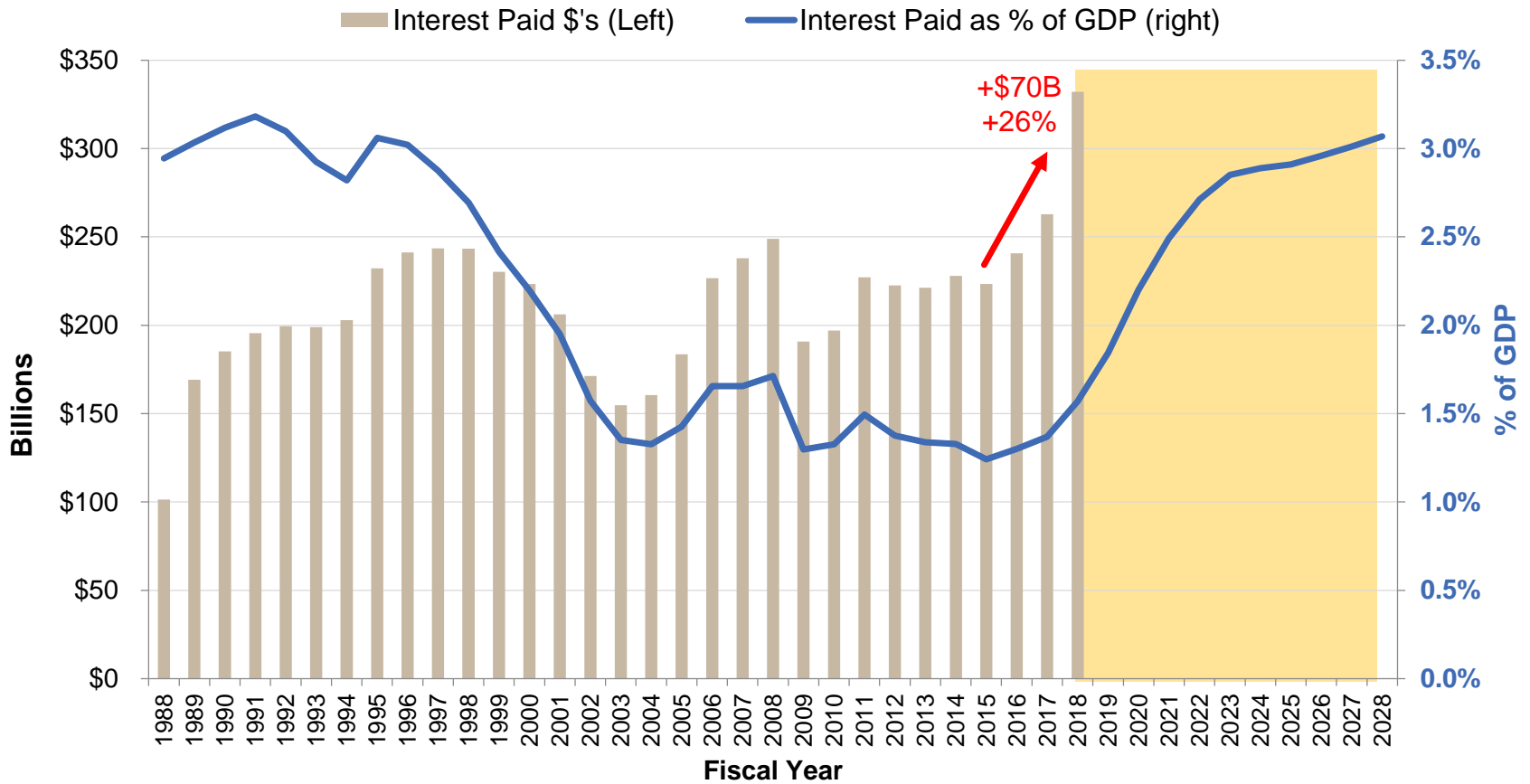
## Agency Debt Outstanding Continues to Shrink



Source: SIFMA, as of December 2017.



## U.S. Treasury Debt Service Surged in 2018



Source: CBO, Bloomberg.



## Yield Environment as of October 31, 2018

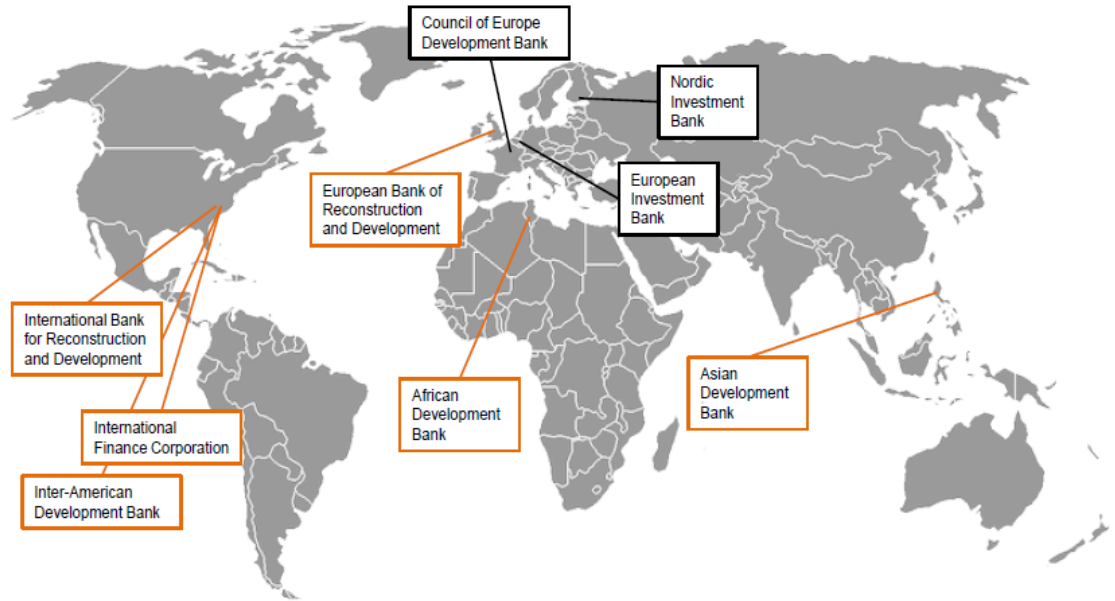
Maturity	Treasury	Federal Agency	AA Corporate	A Corporate	Corporate BBB
3-Month	2.33%	2.28%	2.63%	2.77%	2.98%
6-Month	2.49%	2.38%	2.71%	2.85%	3.08%
1-Year	2.65%	2.63%	2.87%	3.02%	3.27%
2-Year	2.87%	2.90%	3.17%	3.32%	3.60%
3-Year	2.92%	2.97%	3.30%	3.48%	3.81%
5-Year	2.97%	3.12%	3.52%	3.67%	4.10%
10-Year	3.14%	3.51%	3.96%	4.14%	4.72%

Source: Bloomberg BVAL yield curves for Treasury and Corporate. TradeWeb for Federal Agency yields. 3 and 6 month corporate yields from commercial paper; A-1+ for AA and A-1 for A. Yields are for indicative purposes only; actual yields may vary by issue.



# Supranationals

- Multilateral organization of governments for which the United States is a participant, shareholder, and/or voting member
- International financial institutions generally established by agreements among nations with member nations contributing capital and participating in management
- Tend to have excellent credit quality due to multi-national ownership and commitment, long and successful operating histories, and significant capital from a diverse capital base



Sources: World Bank, Standard & Poor's, BofA Merrill Lynch



Source: World Bank.



## AAA Supranationals with U.S. as Largest Shareholder

SUPRANATIONAL	% U.S. SHAREHOLDING	U.S. SHAREHOLDER POSITION	LOCATION OF HEADQUARTERS	YEAR ESTABLISHED
International Bank for Reconstruction and Development (World Bank)	16%	1 <sup>st</sup>	Washington, DC, USA	1944
International Finance Corporation (IFC)	24%	1 <sup>st</sup>	Washington, DC, USA	1956
Inter-American Development Bank (IDB)	30%	1 <sup>st</sup>	Washington, DC, USA	1959
Asian Development Bank (ADB)	16%	1 <sup>st</sup> (co-largest with Japan)	Manila, Philippines	1966

Source: World Bank.

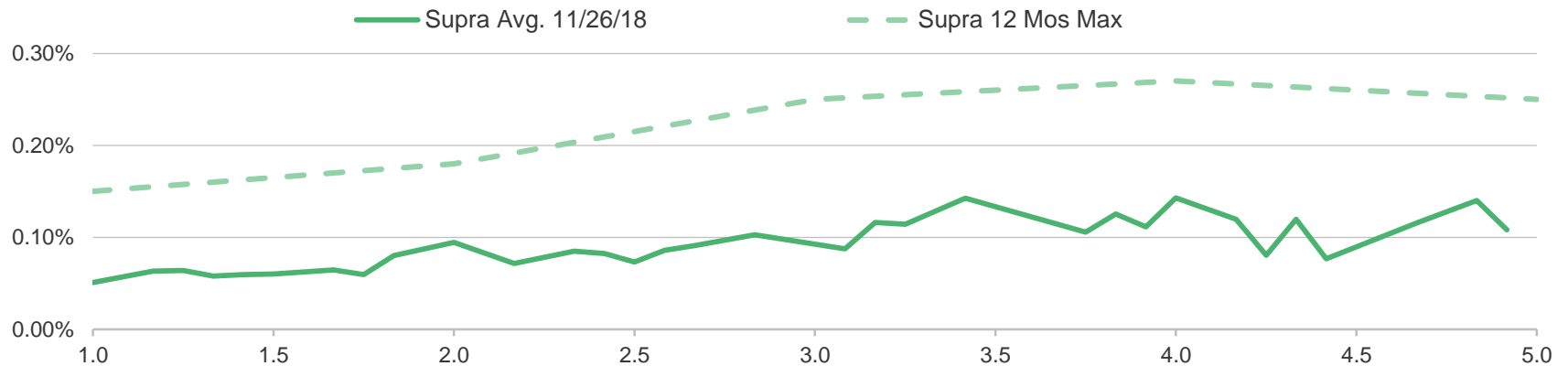




## Potential Yield Benefit from Supranationals

- Carry more yield spread and offer an attractive alternative in the high-quality government agency space
- Seasonal issuers – tend to issue heavily in Q4 and Q1, which may create trading opportunities

### SUPRA G SPREAD



			Period Ended 10/31/2018					
October 31, 2018	Effective Duration	Yield	YTD	1 Month	3 Month	1 Year	3 Years	5 Years
U.S. Treasury	1.85	2.86%	0.44%	0.15%	0.35%	0.25%	0.47%	0.57%
Agency	1.82	2.91%	0.65%	0.12%	0.40%	0.49%	0.65%	0.73%
<b>Supranationals</b>	1.96	2.99%	0.57%	0.12%	0.39%	0.38%	0.69%	0.73%

Source: Bloomberg, MarketAxess, BofA Merrill Lynch Indices, PFMAM Trading Desk. As of July 31, 2018 unless otherwise noted. G Spread is the difference in yield compared to a Treasury note of comparable maturity. Please refer to the accompanying Important Disclosures.



## 10-Year Quarterly Return Correlations

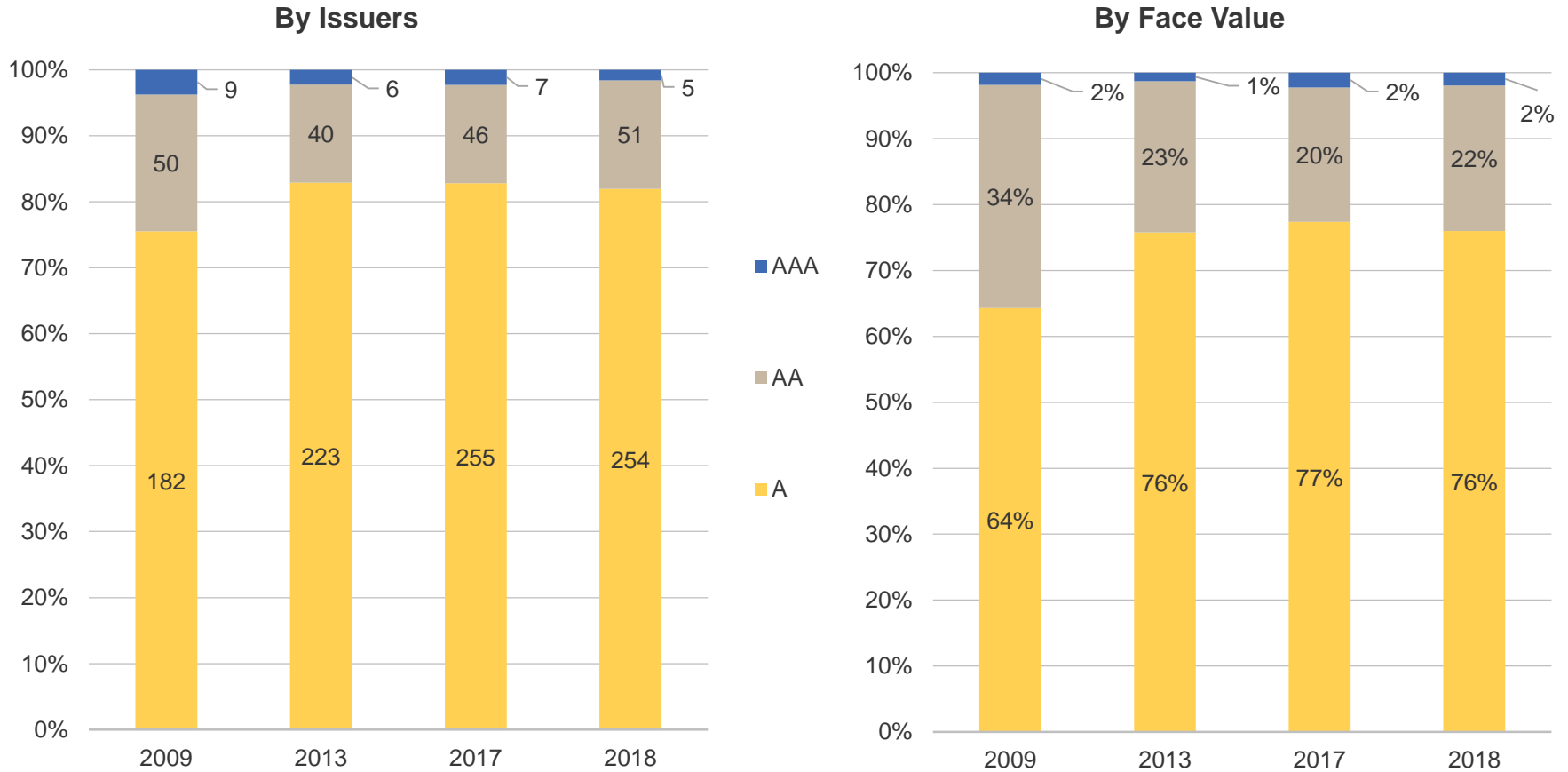
	U.S. Treasury	Agency	Non-callable Agency	Callable Agency	Corp A-AAA	Corp AAA	Corp AA	Corp A
U.S. Treasury	1.00							
Agency	0.91	1.00						
Non-callable Agency	0.92	1.00	1.00					
Callable Agency	0.75	0.91	0.87	1.00				
Corp A-AAA	0.25	0.55	0.55	0.53	1.00			
Corp AAA	0.57	0.77	0.78	0.67	0.89	1.00		
Corp AA	0.34	0.61	0.61	0.57	0.99	0.93	1.00	
Corp A	0.20	0.52	0.52	0.51	1.00	0.87	0.97	1.00

Source: BofA Merrill Lynch 1-5 Year Indices, as of 10/31/2018.



# Corporate Ratings Landscape Continues to Evolve

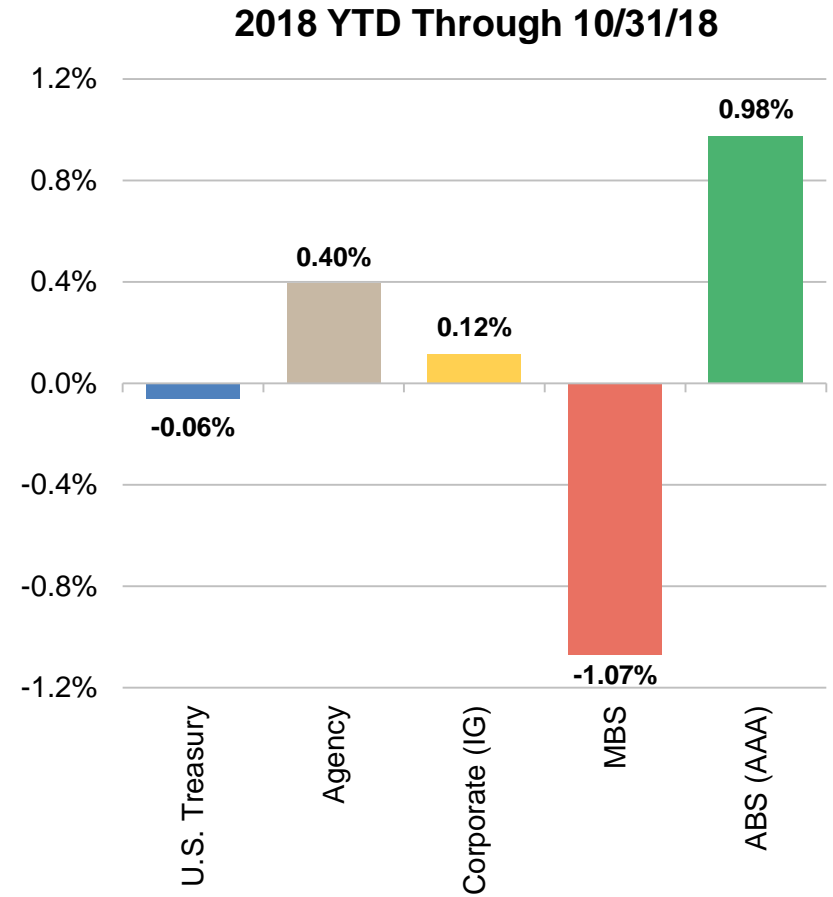
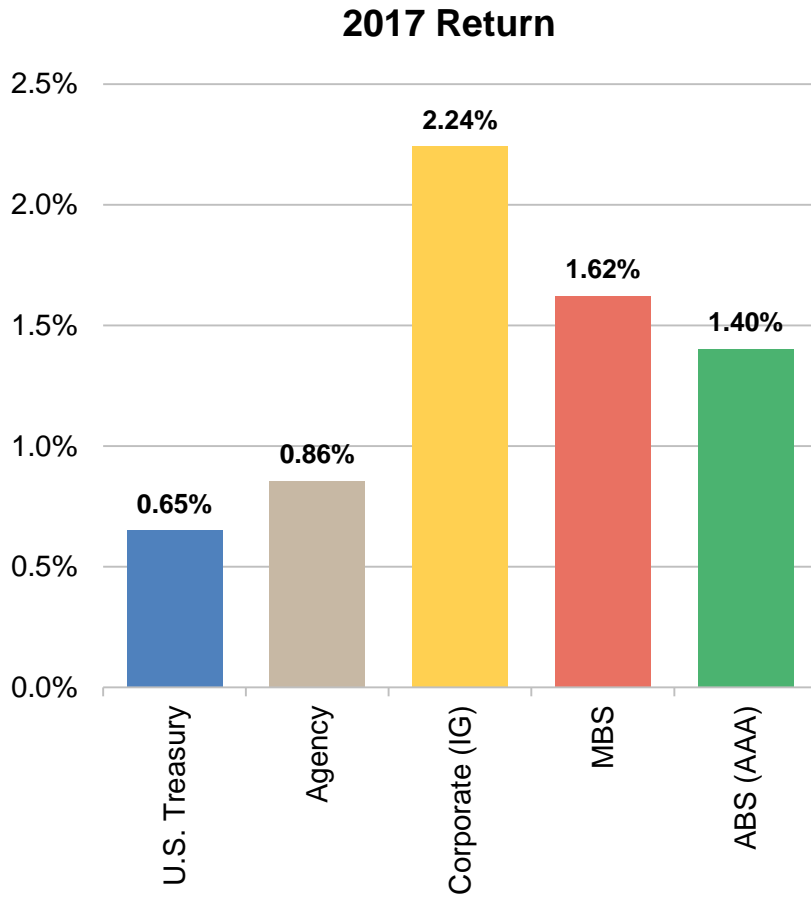
## Composition of Merrill Lynch 1-5 Year AAA-A Corporate Index



Source: BofA Merrill Lynch Indices composite ratings.



## Fixed Income Sector Returns (1-5 Year Indices)



Source: ICE BofAML Indices. MBS and ABS indices are 0-5 year, based on weighted average life. As of 10/31/18.



## Fixed-Income Index Returns

October 31, 2018	Effective Duration	Yield	YTD	1 Month	3 Month	1 Year	3 Years	5 Years
<b>1-3 Year Indices</b>								
<b>U.S. Treasury</b>	1.78	2.82%	0.44%	0.15%	0.35%	0.25%	0.47%	0.57%
<b>Agency</b>	1.67	2.84%	0.65%	0.12%	0.40%	0.49%	0.65%	0.73%
<b>Corp A-AAA</b>	1.84	3.32%	0.76%	0.04%	0.51%	0.65%	1.35%	1.33%
<b>MBS (0 to 3 Years)</b>	4.63	3.62%	(1.15%)	(0.75%)	(1.12%)	(1.14%)	0.29%	0.85%
<b>Municipals</b>	1.75	2.13%	0.86%	(0.01%)	(0.27%)	0.37%	0.65%	0.76%
<b>1-5 Year Indices</b>								
<b>U.S. Treasury</b>	2.55	2.86%	(0.07%)	0.13%	0.27%	(0.36%)	0.41%	0.70%
<b>Agency</b>	2.03	2.88%	0.39%	0.11%	0.38%	0.18%	0.65%	0.88%
<b>Corp A-AAA</b>	2.60	3.47%	0.11%	(0.05%)	0.39%	(0.07%)	1.42%	1.61%
<b>MBS (0 to 5 Years)</b>	3.63	3.43%	(1.07%)	(0.36%)	(0.13%)	(1.12%)	0.59%	1.45%
<b>Municipals</b>	2.44	2.24%	0.59%	(0.10%)	(0.44%)	(0.04%)	0.68%	0.95%
<b>Master Indices (Maturities 1 Year and Greater)</b>								
<b>U.S. Treasury</b>	6.06	2.99%	(2.27%)	(0.53%)	(0.73%)	(2.05%)	0.22%	1.30%
<b>Agency</b>	3.86	3.03%	(0.69%)	(0.13%)	0.03%	(0.71%)	0.80%	1.45%
<b>Corp A-AAA</b>	6.75	3.94%	(3.43%)	(1.12%)	(0.96%)	(2.77%)	1.93%	2.70%
<b>MBS (0 to 30 Years)</b>	5.26	3.72%	(1.69%)	(0.67%)	(0.69%)	(1.53%)	0.73%	1.72%
<b>Municipals</b>	6.82	2.92%	(1.23%)	(0.72%)	(1.20%)	(0.67%)	1.94%	3.40%

Source: BofA Merrill Lynch Indices. Returns greater than one year are annualized.

# Questions?



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