Fixed income market update

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BMO Fixed Income

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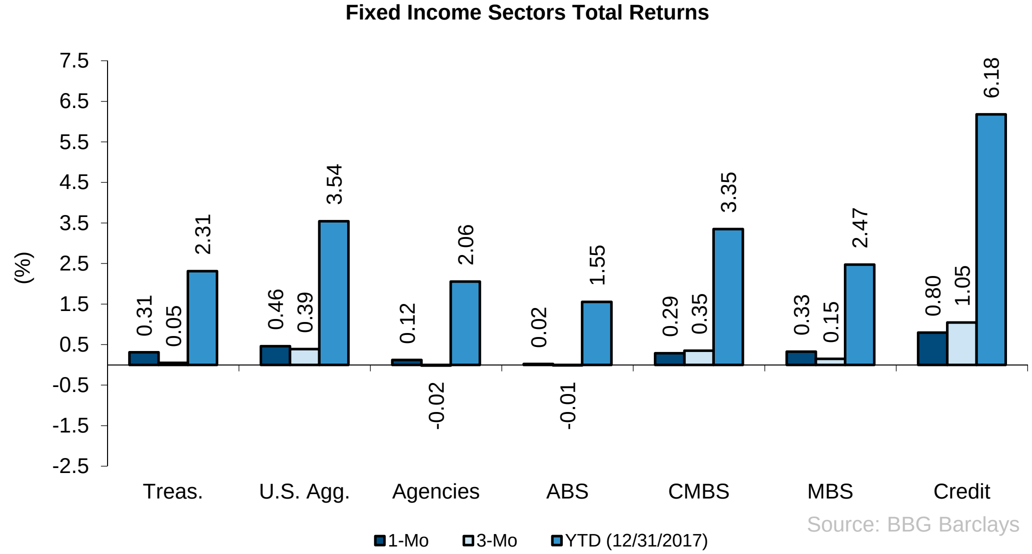
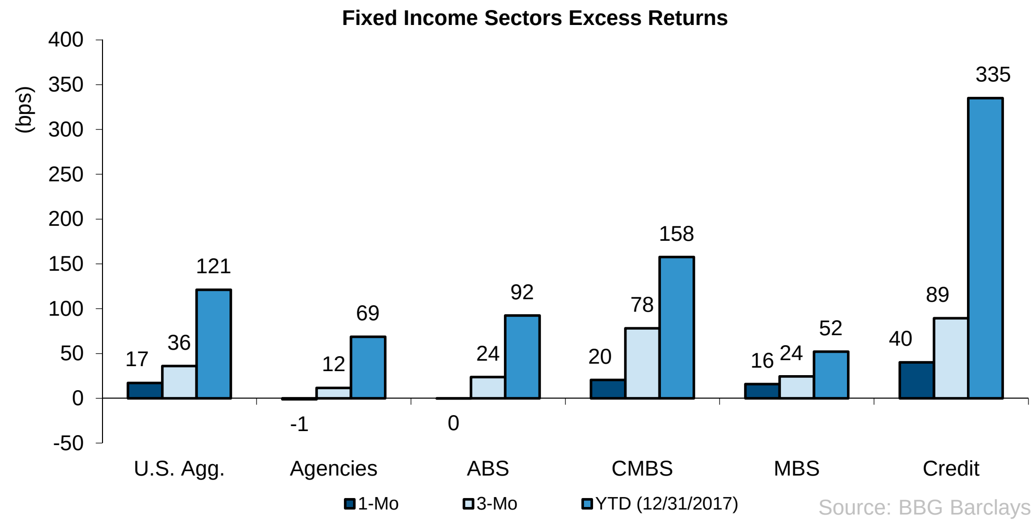
Fixed income market update

- For the quarter ended December 31, 2017, the Bloomberg Barclays U.S. Aggregate Bond Index returned 0.39%. For the year, the index returned 3.54%.

- U.S. Treasuries returned 0.05% during the quarter as the yield on the 10-year U.S. Treasury rose to 2.41% from 2.33% at the end of September. For the quarter, long Treasuries (+2.37%) outperformed intermediate Treasuries (-0.41%) as the yield curve flattened.

- Mortgage-backed securities (MBS) returned 0.15% during the quarter, outperforming duration-matched Treasuries by 24 basis points. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index widened 3 basis points to end the quarter at 25 basis points.



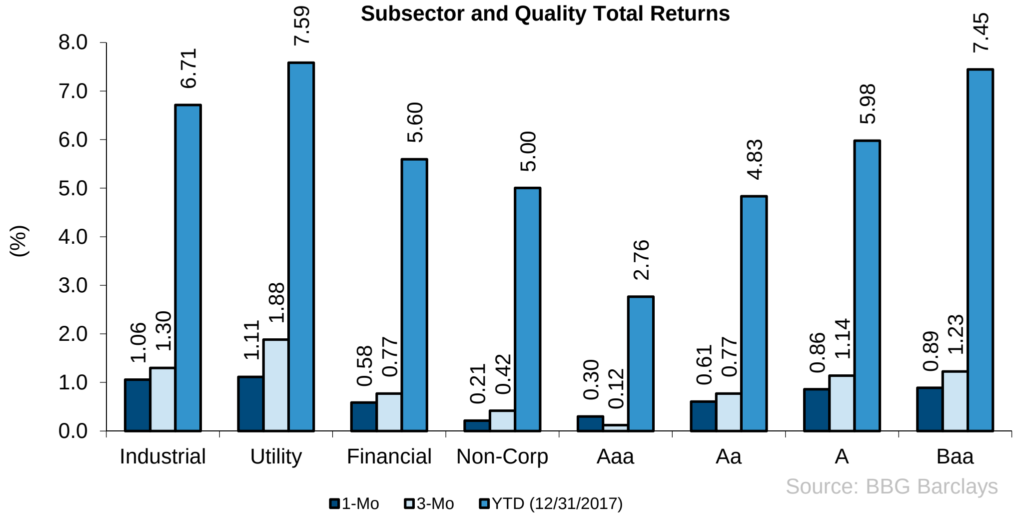


Fixed income market update (continued)

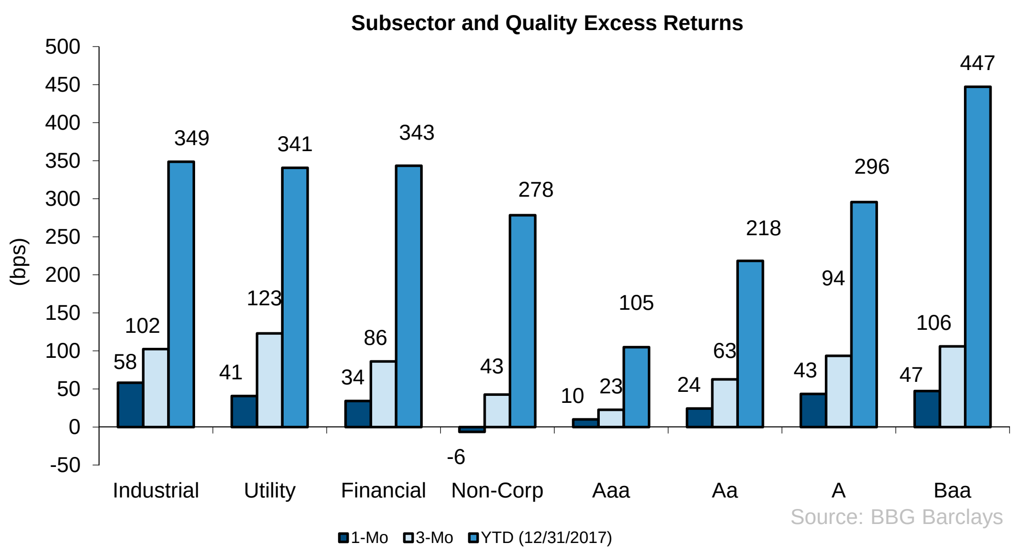
- Credit securities returned 1.05% for the quarter, outperforming Treasuries by 89 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 89 bps, 7 basis points tighter than at the end of September. For the quarter, long credit (+3.18%) outperformed intermediate credit (+0.11%) by 129 basis points on a duration-adjusted basis.

- For the quarter, on a duration-adjusted basis, utilities delivered 123 basis points of excess returns, outperforming industrials, financials and non-corporates by 21, 37 and 80 basis points, respectively.

- BBB rated securities delivered 106 basis points of excess return for the quarter, outperforming AAA, AA and A rated securities by 83, 43 and 12 basis points of excess return, respectively. High yield delivered 72 basis points of excess return for the quarter.



Source: BBG Barclays

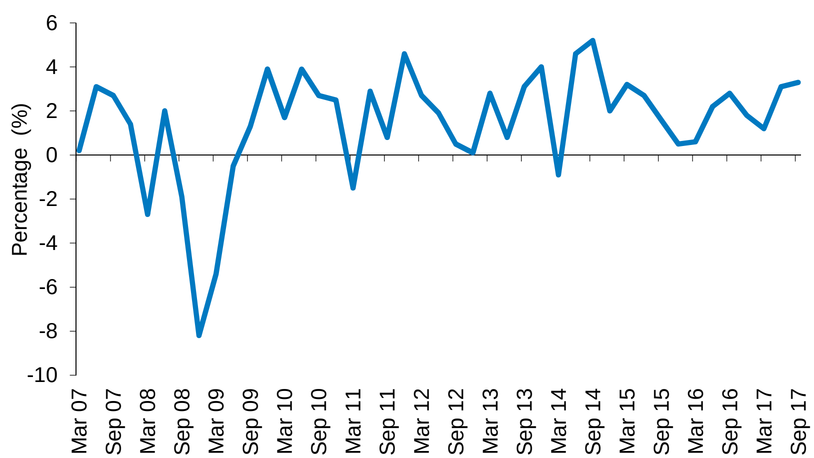


Source: BBG Barclays

Economic update

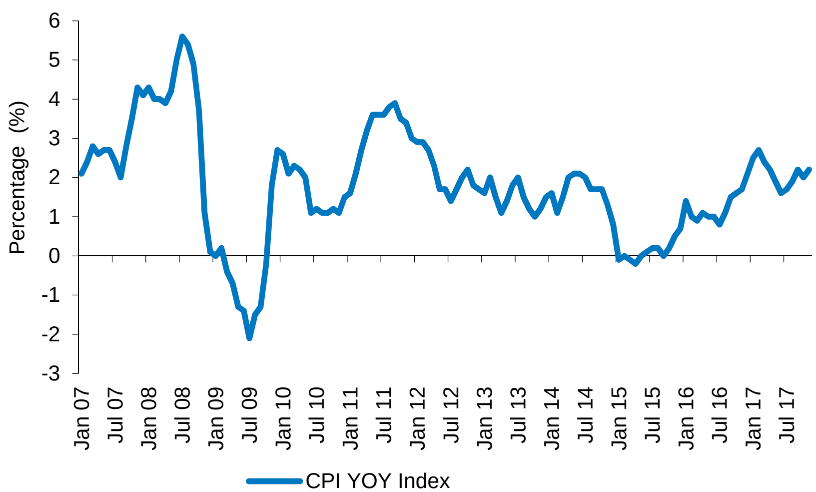
In the final reading of third quarter, U.S. gross domestic product (GDP) was revised 0.1% lower to a 3.2% annualized rate. Consumer spending (+2.2%) moderated from the prior reading, but business investment (+10.8%) was revised higher and rose at the fastest rate in thee years. The Atlanta Fed's GDPNow estimates 2.8% growth for the fourth quarter, a 0.1% increase from the projection at the end of November. The New York Fed Staff Nowcast has a more optimistic 3.9% growth projection for the fourth quarter.

Gross Domestic Product (GDP)



Source: Bureau of Economic Analysis

Consumer Price Index (YoY)

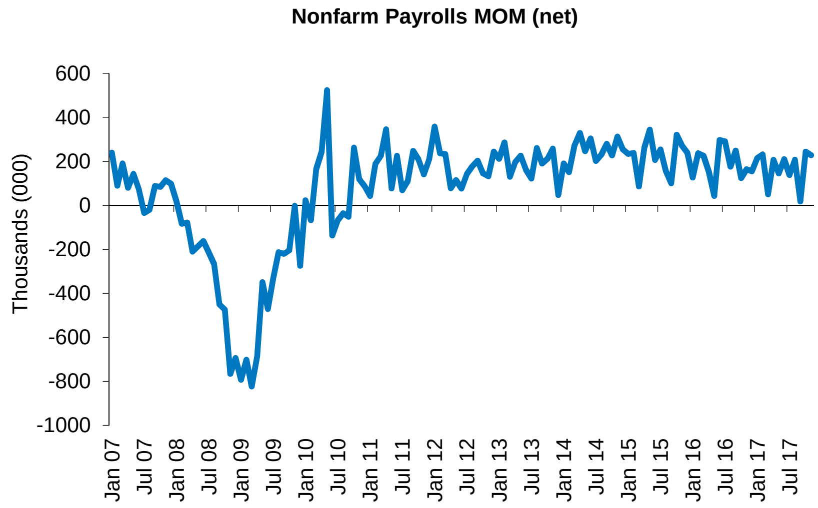


Source: Bureau of Labor Statistics

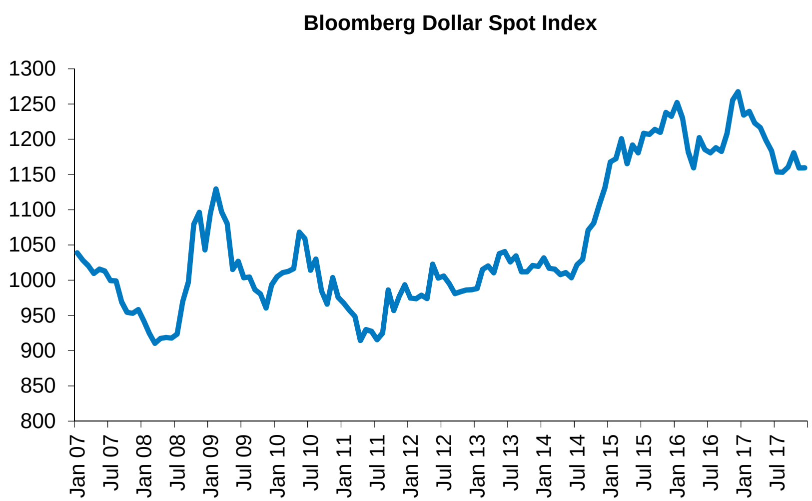
The Consumer Price Index (CPI) rose 0.4% in November and 2.2% for the past year, largely due to the recent increase in energy prices. The energy index rose 9.4% for the trailing twelve months. Core CPI, which excludes the impact of energy and food, rose by 0.1% for the month and 1.7% for the trailing year. Core personal consumption expenditures (PCE), the Fed's preferred inflation gauge, rose 0.1% in November and 1.5% for the trailing year.

Economic update (continued)

Non-farm payroll data for November showed a gain of 228,000 jobs in the month, above expectations. For 2017, job gains averaged 174,000 a month, below the 187,000 average of 2016. The unemployment rate remained at 4.1%, the lowest level since 2000, and 0.6% lower versus the end of 2016. Wages rose 0.2% for the month and 2.5% for the trailing year, both below expectations. Labor force participation was unchanged at 62.7%, while the underemployment rate rose by 0.1% to 8.0%.



Source: Bureau of Labor Statistics



Source: Bloomberg

Despite tightening monetary policy and improving economic growth, in 2017 the U.S. dollar fell for the first time since 2012. After strengthening at the end of 2016 and hitting a 14 year high at the outset of 2017, the dollar dropped 8.5% for the year. This decline was the largest for the dollar in a decade. Of particular note was the decline versus the Euro, which had almost gone to parity at $1.03 in January, but closed the year at $1.20 as the European economy began to improve.

Economic and market perspective

- The long anticipated and debated tax reform legislation was passed on December 20th. The plan has been described as the largest set of changes to the U.S. tax code in over 30 years and includes significant changes to the corporate as well as personal tax regimes. The bill will reduce corporate tax rates from 35% to 21%, speed up deductibility of business investment and shift the U.S. from a citizenship-based system to modified territorial system. Personal marginal tax rates will be reduced across all income brackets with a variety of changes in deductions as well as changes to inheritance tax, generation skipping tax and alternative minimum taxes. Other long time Republican priorities were included in the bill, including the repeal of the "individual mandate" in Obamacare and opening the Arctic National Wildlife Refuge for oil exploration. The bill is expected to add $1.5 trillion to the deficit over 10 years.

- Forecasts of the impact of the bill vary, with more aggressive analyses showing a 3-5% gain in GDP growth over 10 years and others showing almost no gain after the first few years. For next year, most projections are showing a 0.3 – 0.5% increase in GDP growth due to the implementation of the tax plan. Prior to passage of the tax plan, the National Federation of Independent Business survey showed small-business optimism hitting its highest level since 1986 and a record number (+24%) of small businesses anticipating hiring new personnel (net of those anticipating reducing their workforces).

- Twice in December, Congress passed stopgap measures to avoid a government shutdown. The continuing resolutions fund government operations through mid-January. The White House also indicated that President Trump will release the principals of his long discussed infrastructure plan in January prior to the State of the Union address at the end of the month. Early indications are that the plan will call for a minimum of $200 billion in direct Federal spending to be paired with $800 billion of state, local and private spending with a focus on rebuilding transportation infrastructure.

Outlook and conclusions

- As expected, the Federal Open Market Committee raised the Fed Funds rate range by 25 basis points to 1.25 – 1.50% when it met on December 12-13. For the year, the Fed raised rates three times for a total of a 75 basis points of increases. These hikes were in line with the Fed's projections at the end of 2016, the first year in this cycle when Fed projections materialized. The Fed also confirmed that it will allow the balance sheet to shrink by up to $20 billion a month of maturing assets beginning in January, in line with the announced plan to unwind the balance sheet. Fed projections call for the Fed Funds rate to end 2018 at 2.1%, 60 basis points above the current upper bound. For the end of 2019 and the long-run Fed Funds rate, the Fed projects rates of 2.7% and 2.8% respectively.

- Oil prices continued to rebound in December, crossing the $60 a barrel market and ending the month at the highest level since 2014. Oil rose 12% for the year on improving global growth, declining demand/supply imbalance and agreements between OPEC (Organization of the Petroleum Exporting Countries) and non-OPEC countries to reduce output.

- In our view, the recent modest increase in rates is healthy and appropriate given the improving U.S. economic data and the final passage of tax reform. As we had suggested for the year, rates remained range-bound with the 10 year Treasury closing 2017 within three basis points of where it ended 2016. With long rates effectively unchanged, but the Fed able to push through three rates hikes, the yield curve flattened meaningfully. This flattening was in line with our long held expectations about Fed actions, which came to fruition in 2017. With growth expectations remaining robust and the corporate landscape improving with the new tax laws, credit remains appealing though markets have priced in the positive backdrop, bringing spreads to their tightest levels in a decade. Inflation, both broad measures and wages, remains the outlier given otherwise more bullish data. With the awareness of the current levels of rates and spreads, we expect the current environment and policy changes will create winners and losers, adding to our focus on uncovering idiosyncratic security selection opportunities.

Fixed income returns as of December 31, 2017

Index Returns as of December 31, 2017						
	Total Return (%)			**Excess Return (%)**		
	Month-to-Date	**Quarter-to- Date**	**Year-to- Date**	**Month-to-Date**	**Quarter-to- Date**	**Year-to- Date**
U.S. Aggregate	0.46	0.39	3.54	0.17	0.36	1.21
U.S. Treasury	0.31	0.05	2.31	-	-	-
Intermediate	0.03	-0.41	1.14	-	-	-
Long	1.72	2.37	8.53	-	-	-
TIPS	0.92	1.26	3.01	-	-	-
Agencies	0.12	-0.02	2.06	-0.01	0.12	0.69
U.S. MBS	0.33	0.15	2.47	0.16	0.24	0.52
U.S. Credit	0.80	1.05	6.18	0.40	0.89	3.35
Intermediate	0.25	0.11	3.67	0.20	0.50	2.36
Long	2.03	3.18	12.21	0.86	1.79	5.78
Industrial	1.06	1.30	6.71	0.58	1.02	3.49
Utility	1.11	1.88	7.59	0.41	1.23	3.41
Financial	0.58	0.77	5.60	0.34	0.86	3.43
Non-Corporate	0.21	0.42	5.00	-0.06	0.43	2.78
Aaa	0.30	0.12	2.76	0.10	0.23	1.05
Aa	0.61	0.77	4.83	0.24	0.63	2.18
A	0.86	1.14	5.98	0.43	0.94	2.96
Baa	0.89	1.23	7.45	0.47	1.06	4.47
High Yield	0.30	0.47	7.50	0.23	0.72	6.10
Floating Rate Notes	0.15	0.55	2.31	0.06	0.29	1.49

Source: Bloomberg Barclays

Disclosures

All investments involve risk, including the possible loss of principal.

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