Fixed income market update

March 2018

BMO Fixed Income

1001 Brickell Bay Dr.
Suite 2100
Miami, Florida 33131

bmogam.com/USFixedIncome

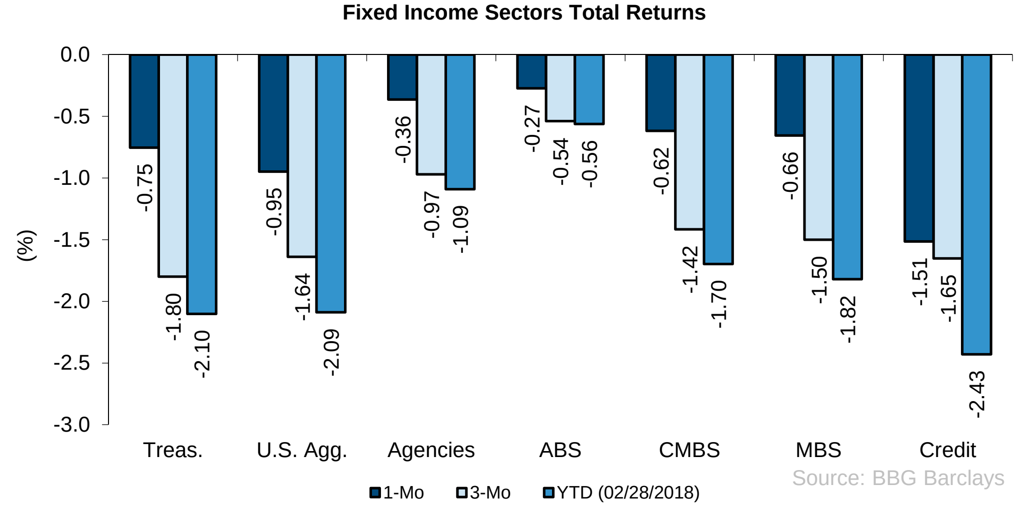
BMO Global Asset Management

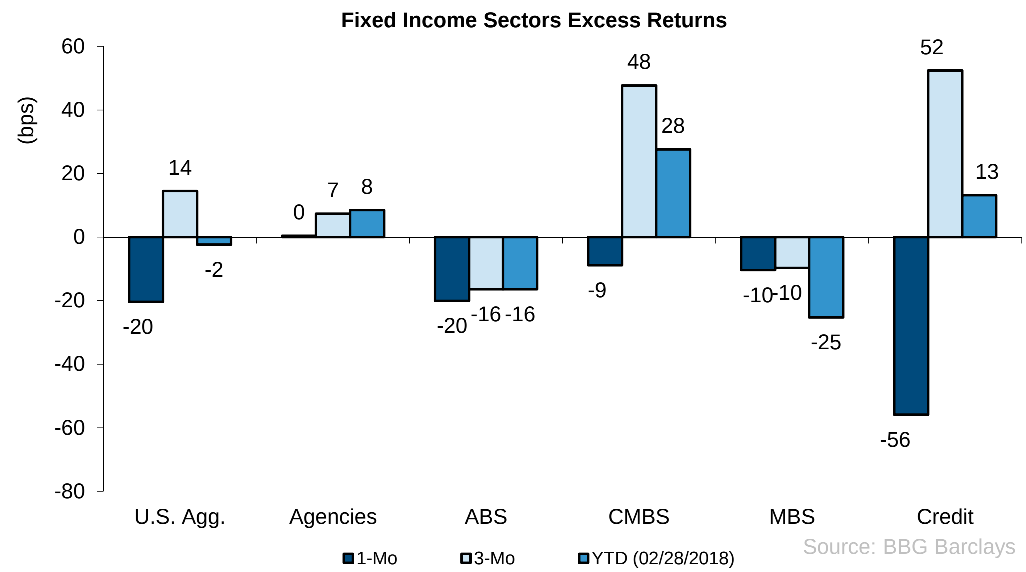
Fixed income market update

- For the month ended February 28, 2018, the Bloomberg Barclays U.S. Aggregate Bond Index returned -0.95%. Year to date, the index has returned -2.09%.

- U.S. Treasuries returned -0.75% during the month as the yield on the 10-year U.S. Treasury rose to 2.86% from 2.71% at the end of January. For the month, long Treasuries (-3.00%) underperformed intermediate Treasuries (-0.30%).

- Mortgage-backed securities (MBS) returned -0.66% during the month, underperforming duration-matched Treasuries by 10 basis points. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index widened by one basis point, ending the month at 26 basis points.



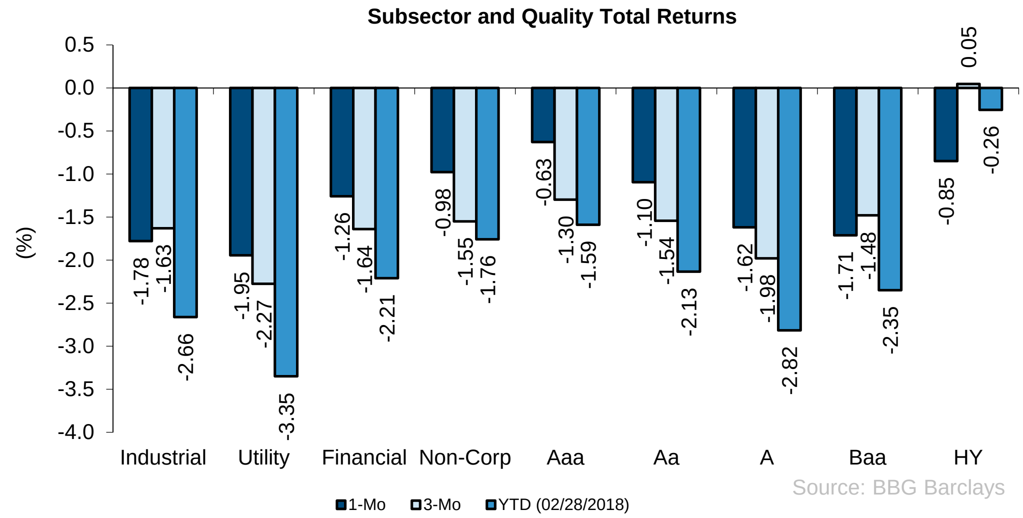


Fixed income market update (continued)

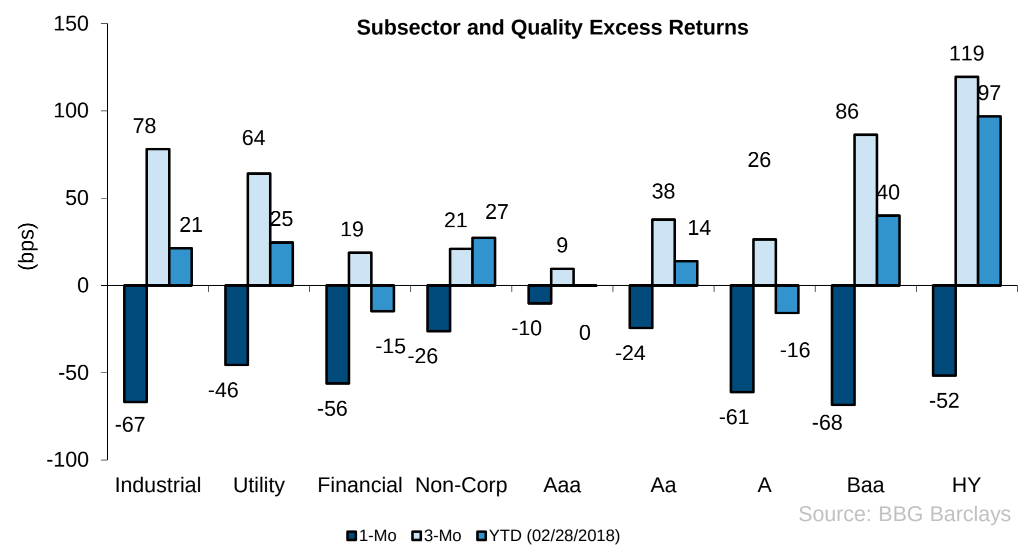
- Credit securities returned -1.51% for the month, underperforming Treasuries by 56 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 91 bps, 9 basis points wider than at the end of January. For the month, long credit (-3.31%) underperformed intermediate credit (-0.71%) by 67 basis points on a duration-adjusted basis.

- For the month, on a duration-adjusted basis, non-corporates delivered -26 basis points of excess returns, outperforming utilities, financials and industrials by 20, 30 and 41 basis points, respectively.

- AAA rated securities delivered -10 basis points of excess return for the month, outperforming AA, A and BBB rated securities by 14, 51 and 58 basis points of excess return, respectively. High yield delivered -52 basis points of excess return for the month.



Source: BBG Barclays

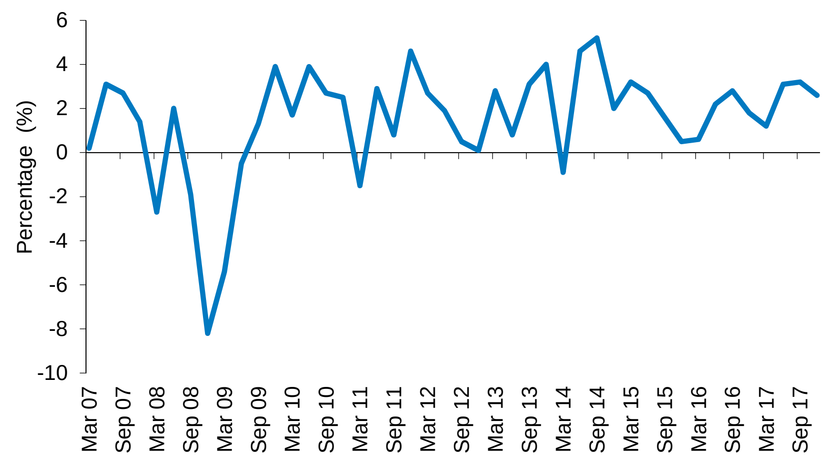


Source: BBG Barclays

Economic update

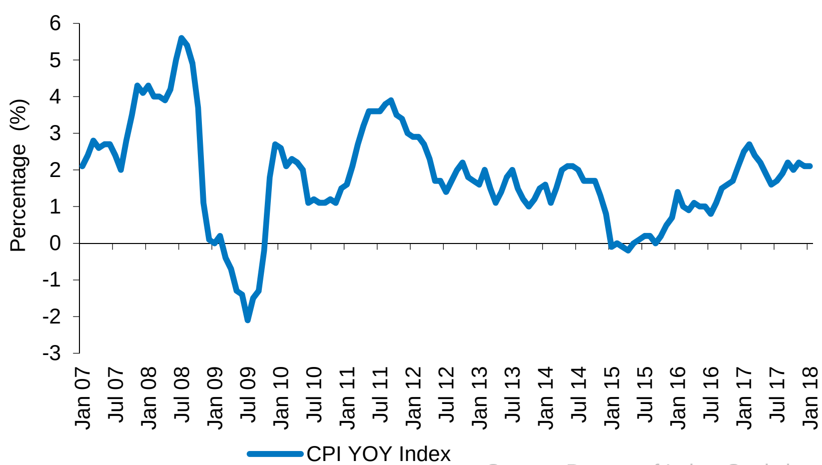
For the fourth quarter, U.S. gross domestic product (GDP) grew at 2.5%, in line with expectations, but 0.1% lower than the prior estimate. Consumer spending, which was unrevised, grew at a 3.8% rate, the highest since 2014. Business investment was revised higher and increased at a 11.8% pace, the highest since the third quarter of 2014. With imports growing 14%, the most since 2010, net imports reduced GDP by 1.1%. The Atlanta Fed's GDPNow estimates 2.6% growth for the first quarter of 2018, down meaningfully from its estimate of 4.2% at the end of January.

Gross Domestic Product (GDP)



Source: Bureau of Economic Analysis

Consumer Price Index (YoY)

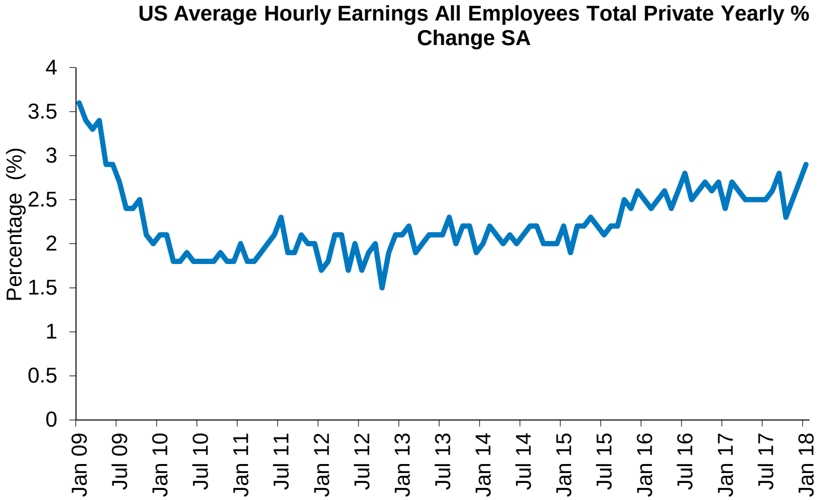


Source: Bureau of Labor Statistics

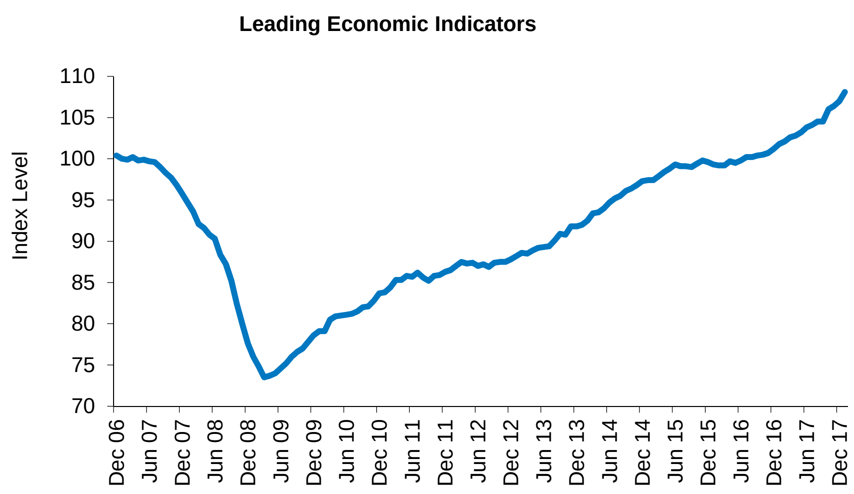
The Consumer Price Index (CPI) rose 0.5% in January and 2.1% for the past year. Core CPI, which excludes the impact of energy and food, rose by 0.3% for the month, the same as December. Core CPI rose 1.8% for the trailing year, the ninth consecutive period of a 1.7% or 1.8% increase. Core personal consumption expenditures (PCE), the Fed's preferred inflation gauge, rose 0.3% in January and 1.5% for the full year, in line with expectations.

Economic update (continued)

Wages rose 0.3% for the month and 2.9% for the trailing year, the highest level of wage growth since 2009. Additionally, data for prior month wages were revised higher from 2.5% to 2.7% for the trailing year. Real disposable income increased 0.6% in January, the biggest gain since 2012. Non-farm payroll data for January increased by 200,000 jobs in the month, above expectations. The unemployment rate remained at 4.1%, the lowest level since 2000. Labor force participation was unchanged at 62.7%, while the underemployment rate rose by 0.1% to 8.2%.



Source: Bureau of Labor Statistics



Source: The Conference Board

The Conference Board Leading Economic Index® (LEI) increased 1.0% in January to 108.1. The indicator, which aggregates ten key economic metrics, has increased 12 of the last 13 months and has now reached the highest level since the metric began in 1959. Also according to the Conference Board, consumer confidence hit its highest level since 2000 in February, with a reading of 130.8 after a reading of 124.3 in January. The difference between people finding jobs plentiful versus hard to find rose to 24.7%, the highest level since 2001.

Economic and market perspective

- After a record fifteen consecutive months of positive total returns, the S&P 500 declined 3.7% in February. This included an intra-month decline in excess of 10%, constituting the first equity market correction since a 13% decline at the end of 2015 and beginning of 2016. During the February correction, equity market volatility spiked to its highest level since mid-2015 and interest rate volatility rose to its highest level since the beginning of 2017. The correction was partially driven by higher inflation data, including wage data, and rising Treasury yields.
- The impacts of the U.S. tax reform passed in December continue to be felt. Changes in withholding for personal income taxes began mid-February, which should generally increase disposable income. In addition to the positive impacts on consumer confidence, the repatriation of cash has also begun. As a significant portion of these assets are held in short maturity government and corporate fixed income, there has been selling pressure on these assets as cash is repatriated to the U.S.
- The Bank of England (BOE) raised its GDP growth projections and U.K. wage growth data is improving, while inflation has been above target. During February, Mark Carney, Governor of the Bank of England, said that “in order to bring inflation back to target it is likely to be necessary to raise interest rates, to a limited degree, in a gradual process, but somewhat earlier and to a somewhat greater extent than we had thought in November.” The market has interpreted the statements as increased hawkishness from the BOE and an indication of two rate hikes this year, with one in May and the next in the November timeframe.
- While U.S. inflation data has increased and U.K. inflation is above target, European inflation remains persistently below target. Inflation fell for the third month in a row, with a 1.2% reading in February, the weakest in over a year. Nonetheless, the European Purchasing Managers’ Index rose to 58.8 in January from 58.1 in December, the highest level in over a decade and fourth quarter GDP growth was 0.6% (2.4% annualized.) German 10 year bunds closed the month at 0.66%, 4 basis points lower than at the end of January, but 23 basis points above the start of the year.

Outlook and conclusions

- Minutes from the Federal Open Market Committee's January 30-31 meeting were released in February. Notably, the minutes stated that "strengthening in the near-term economic outlook increased the likelihood that a gradual upward trajectory of the federal funds rate would be appropriate." The optimistic tone of the Fed members expressed in the minutes is widely assumed to have been strengthened since the end of January when the meeting was held, given the inflation and wage data released in the interim. The January meeting was the final one chaired by Janet Yellen, the March 20-21 meeting will be chaired by Jay Powell, whose term began on February 3. Markets are projecting a 100% likelihood of a hike in the Fed Funds rate at the upcoming meeting.
- In his much anticipated first testimony to Congress as Fed Chairman, Jay Powell focused on balancing the desire for inflation to meet Fed targets on a sustained basis with preventing an overheating economy. He acknowledged that both the broad economic outlook had improved and inflation prospects had increased since the December meeting, highlighting fiscal policy as one source of the stronger economic outlook. In responding to a question, Chairman Powell left open the possibility that the Fed could raise rates more than the three times projected in the December minutes, which surprised markets.
- In our view, the brief equity correction and the increase in U.S. ten year Treasury yields have been healthy for markets, even if producing short term discomfort. Long awaited wage growth and inflation have begun to appear, though there have been head fakes in this regard previously in the current cycle. As the markets sort out whether these represent isolated data points or emerging trends, an interesting interplay between equity and fixed income markets has been unfolding. Increasing rates prompted a sell-off in equities, which in turn prompted a flight to quality and decline in bond yields. After some back and forth, market participants were reminded of basic precepts of the game: equities can fall, even if they didn't for over a year, and rates can rise, even if they barely nudged last year. After a volatile month for markets, but with strong economic fundamentals, fixed income valuations appear more attractive with both higher rates and modestly wider spreads. Broad market fixed income yields, now in excess of 3%, are at their highest level in almost eight years, offering a new opportunity for investors.

Fixed income returns as of February 28, 2018

Index Returns as of February 28, 2018				
	Total Return (%)		Excess Return (%)	
	Month-to-Date	Year-to- Date	Month-to-Date	Year-to- Date
U.S. Aggregate	-0.95	-2.09	-0.20	-0.02
U.S. Treasury	-0.75	-2.10	-	-
Intermediate	-0.30	-1.27	-	-
Long	-3.00	-6.14	-	-
TIPS	-0.97	-1.82	-	-
Agencies	-0.36	-1.09	0.00	0.08
U.S. MBS	-0.66	-1.82	-0.10	-0.25
U.S. Credit	-1.51	-2.43	-0.56	0.13
Intermediate	-0.71	-1.48	-0.35	-0.07
Long	-3.31	-4.54	-1.02	0.56
Industrial	-1.78	-2.66	-0.67	0.21
Utility	-1.95	-3.35	-0.46	0.25
Financial	-1.26	-2.21	-0.56	-0.15
Non-Corporate	-0.98	-1.76	-0.26	0.27
Aaa	-0.63	-1.59	-0.10	0.00
Aa	-1.10	-2.13	-0.24	0.14
A	-1.62	-2.82	-0.61	-0.16
Baa	-1.71	-2.35	-0.68	0.40
High Yield	-0.85	-0.26	-0.52	0.97
Floating Rate Notes	0.10	0.41	0.00	0.19

Source: Bloomberg Barclays

Disclosures

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

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