Fixed income market update

August 2018

BMO Fixed Income

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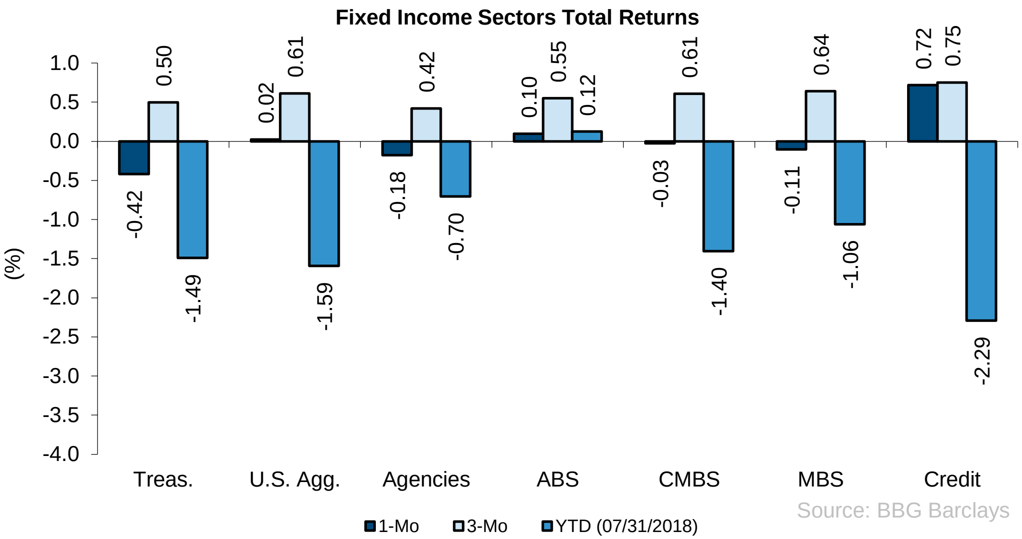
Fixed income market update

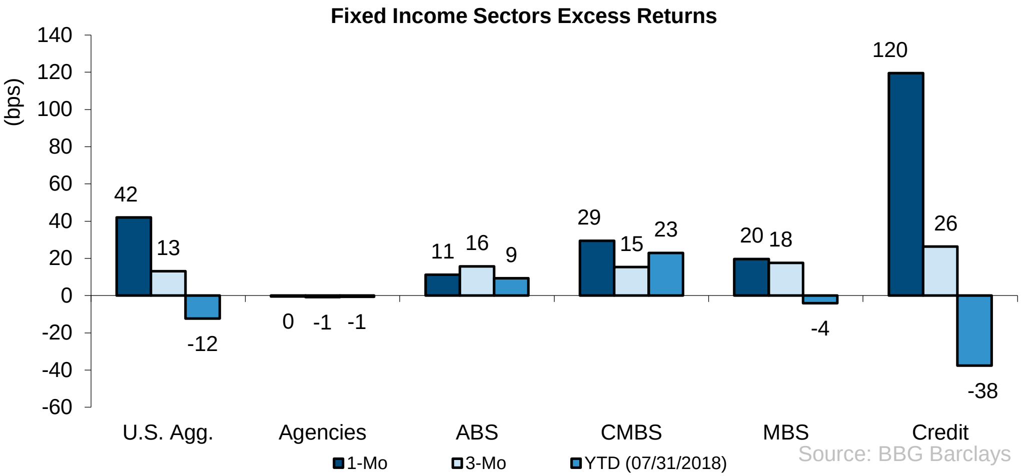
- For the month ended July 31, 2018, the Bloomberg Barclays U.S. Aggregate Bond Index returned 0.02%. Year to date, the index has returned -1.59%.

- U.S. Treasuries returned -0.42% during the month as the yield on the 10-year U.S. Treasury rose to 2.96% at the end of July from 2.86% at the end of June. For the month, long Treasuries (-1.47%) underperformed intermediate Treasuries (-0.20%.)

- Mortgage-backed securities (MBS) returned -0.11% during the month, outperforming duration-matched Treasuries by 20 basis points. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index tightened one basis point during the month, ending the period at 27 basis points.



Source: BBG Barclays



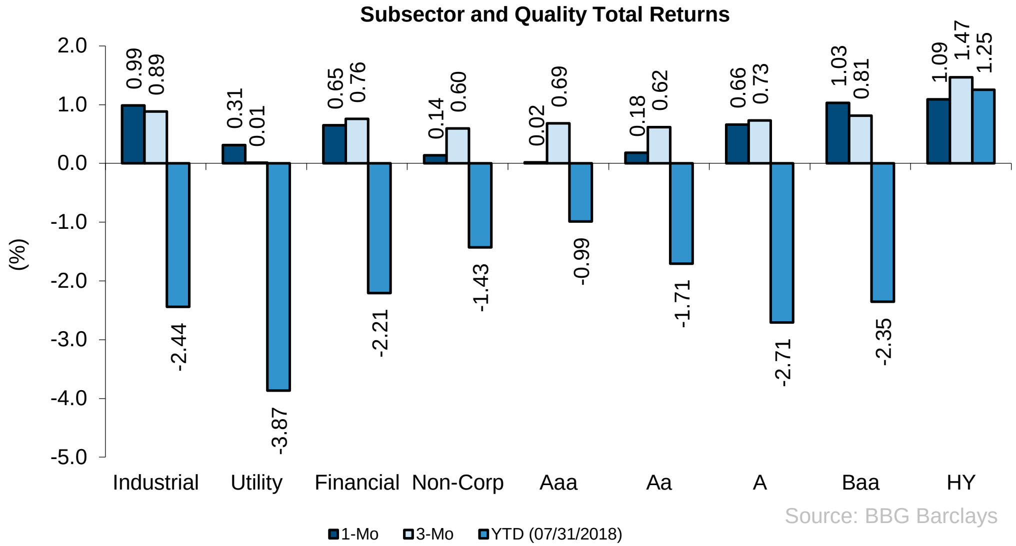
Source: BBG Barclays

Fixed income market update (continued)

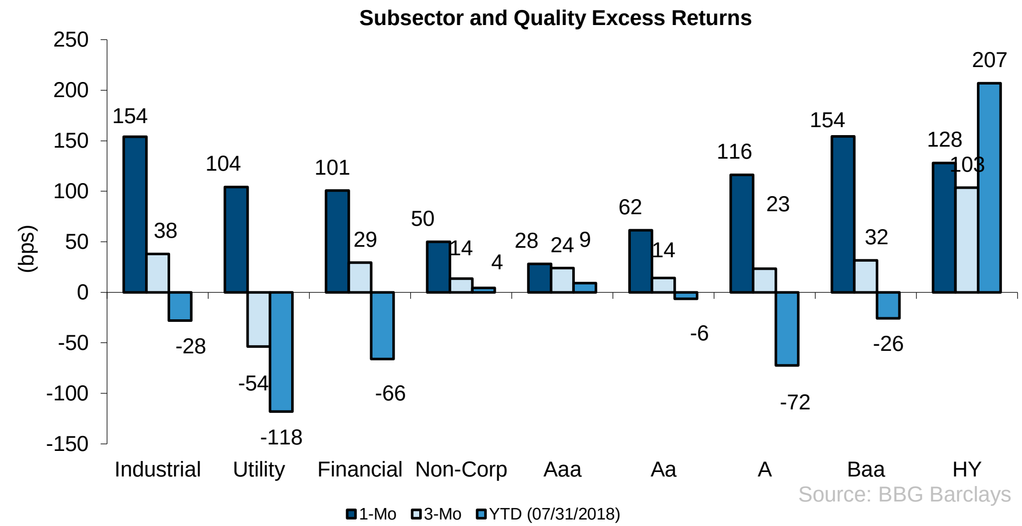
- Credit securities returned 0.72% for the month, outperforming Treasuries by 120 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 103 bps, 13 basis points tighter than at the end of June. For the month, long credit (+1.50%) outperformed intermediate credit (+0.37%) by 198 basis points on a duration-adjusted basis.

- For the month, on a duration-adjusted basis, industrials delivered 154 basis points of excess returns, outperforming utilities, financial and non-corporates by 50, 53 and 104 basis points, respectively.

- BBB rated securities delivered 154 basis points of excess return for the month, outperforming AAA, AA and A rated securities by 126, 92 and 38 basis points of excess return, respectively. High yield delivered 128 basis points of excess return for the month.



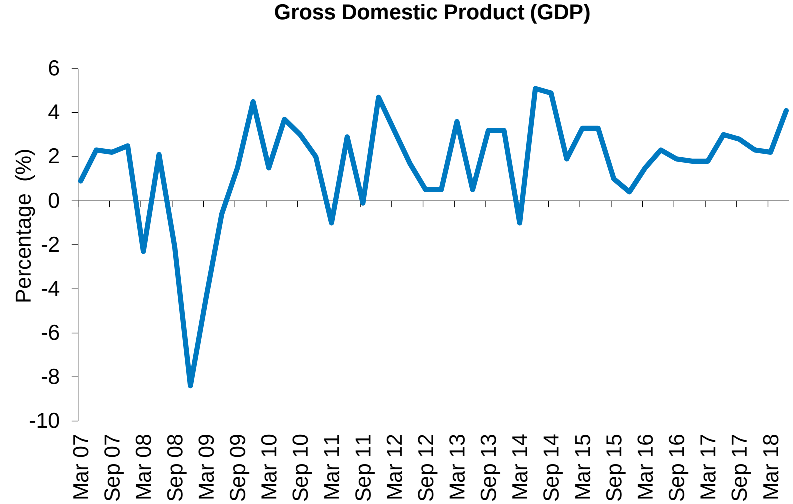
Source: BBG Barclays



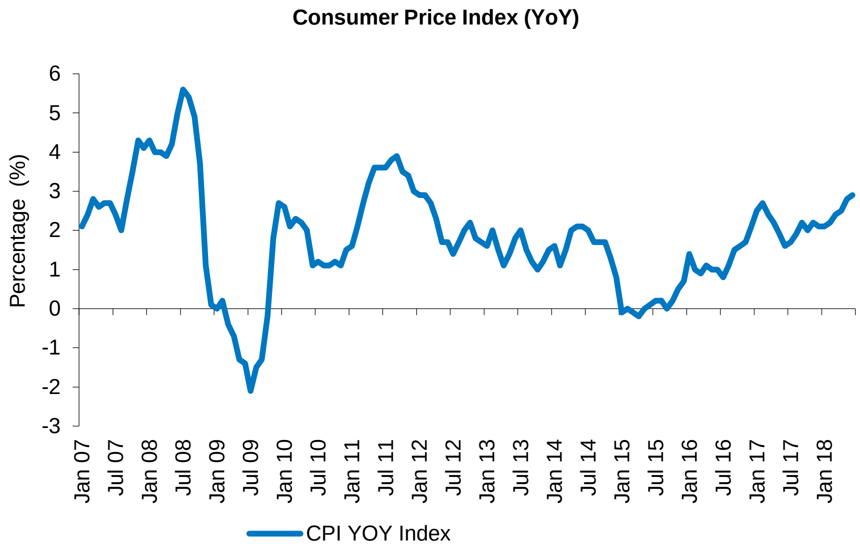
Source: BBG Barclays

Economic update

For the second quarter of 2018, U.S. gross domestic product (GDP) grew at a 4.1% annualized rate, the fastest pace in nearly four years. First quarter GDP was also revised 0.2% higher to 2.2%. With this growth, U.S. GDP exceeded $20 trillion for the first time. Consumer spending rose 4.0%, rebounding from the 0.5% rate last quarter, and business investment increased 7.3%. Net exports contributed 1%, the largest figure since 2013, while declines in inventories subtracted 1%, the most in four years.



Source: Bureau of Economic Analysis

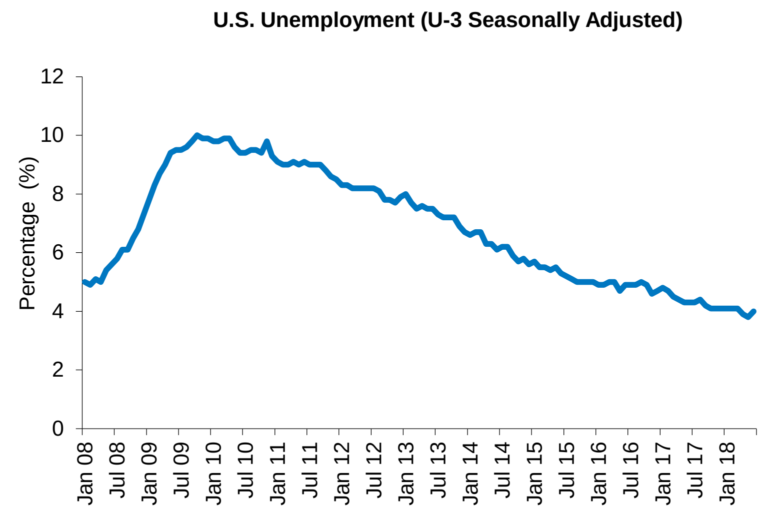


Source: Bureau of Labor Statistics

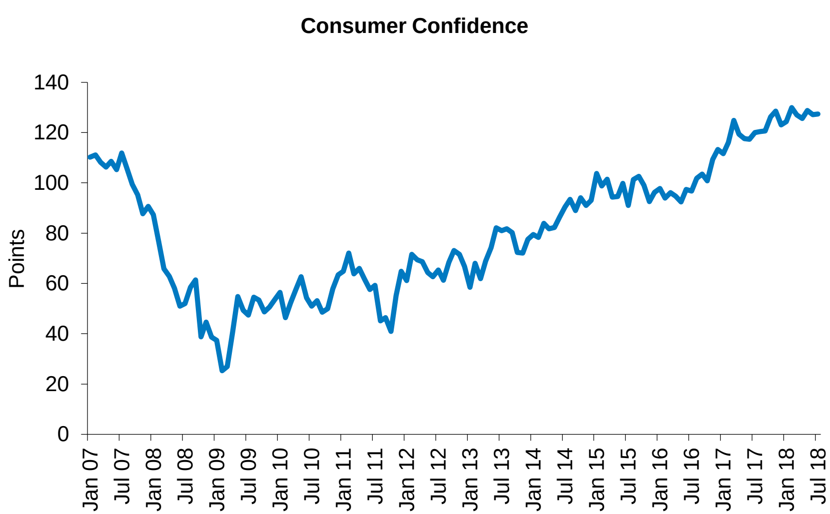
The Consumer Price Index (CPI) increased 0.1% in June and rose 2.9% for the trailing year, the largest yearly increase since the beginning of 2012. Core CPI, which excludes the impact of energy and food, rose by 0.2% for the month and 2.3% for the trailing year. Core personal consumption expenditures (PCE), the Fed's preferred inflation gauge, rose 0.1% in June and 1.9% for the trailing year.

Economic update (continued)

June non-farm payrolls increased by 213,000, mildly surpassing market expectations. Revisions to the prior two months added 37,000 jobs. The unemployment rate unexpectedly rose 0.2% to 4.0%, in part due to the 0.2% increase in labor force participation to 62.9%. Similarly, the underemployment rate rose 0.2% to 7.8%. Wages rose 0.2% for the month and 2.7% for the trailing year, modestly below expectation for a 2.8% increase.



Source: Bureau of Labor Statistics



Source: Conference Board

Consumer confidence rose more than expected in July according to the Conference Board. After a disappointing June report, the July level came close to the 18 year high set earlier in the year. While the present conditions index rose to 165.9 from 161.7, the expectations index declined to 101.7 from 104. Also released in July, the Conference Board's Leading Economic Index rose 0.5% for June after no change in May.

Economic and market perspective

- Tariffs and fears of protectionism remained in the headlines. Fears of a trade war with the European Union receded somewhat as President Trump and European Commission President Jean-Claude Juncker reached an agreement to forestall additional tariffs from going into effect. The European Union agreed to import more U.S. soybeans and liquid natural gas in exchange for the U.S. agreeing not to implement auto tariffs. The recently imposed U.S. tariffs on aluminum and steel remain in place subject to further negotiation.
- At the same time, 25% tariffs on $34 billion of Chinese goods went into effect in early July. The Trump administration announced further 10% tariffs on an additional $200 billion of Chinese goods to go into effect in two months, with threats that the amount could increase to $500 billion. After a break in negotiations, the U.S. and China appeared to be resuming trade talks at the end of the month. The People's Bank of China (PBOC) engaged in multiple actions to ease policy, partly in response to stresses from the trade dispute with the United States. In July, the PBOC unexpectedly injected over 500 billion yuan ($70 B+) into the Chinese economy with loans to financial institutions via its Medium-term Lending Facility loans and cut reserve requirements for the third time this year.
- The Bank of Japan's end of July meeting was widely anticipated on speculation of the first policy change since 2016. Japanese inflation data has remained persistently below target, with the last three months at only 0.2%. The BOJ left both interest rates and its quantitative easing program unchanged, but indicated it would loosen its yield curve control policy, allowing rates to rise more naturally on the margin. The Bank of England (BOE) is expected to increase interest rates on August 2nd. If this increase does occur, it would mark the second hike since shortly after the Brexit vote, when the BOE cut rates to 0.25%. The European Central Bank (ECB) met in July and, in line with expectations, made no changes to policy. However, the ECB did reaffirm the expectation of reducing and ultimately stopping monthly purchases this year. The ECB stated that they expect rates to "remain at their present levels at least through the summer of 2019."

Outlook and conclusions

- Minutes from the June 12-13 meeting of the Federal Open Market Committee were released in early July. In the minutes, the Committee expressed that the economy is “expanding at a solid rate” and the labor market is strengthening, but also that trade policy uncertainty could have a negative impact on the economy. While noting concerns that allowing inflation to run above trend could be damaging, which would suggest further rate hikes to stem inflation, some Committee members also raised concerns about the flattening of the yield curve. The market is not projecting a hike for the July 31/August 1 meeting, but projecting approximately a 90% chance of an additional hike at the September 25-26 meeting and a greater than 50% chance for a second additional hike before the year is over.

- The U.S. Treasury Department raised its estimates for third quarter borrowing by $50 billion to $329 billion. With this projected increase, the Treasury expects to borrow $769 in the second half, the largest six month borrowing since the second half of 2008 when the Treasury borrowed $1.1 trillion. The Treasury is now projecting $1.33 trillion of borrowing for the full year.

- Conclusions: During July, robust US economic data combined with increased comfort in tariff policy noise led to lower volatility and retracement of interest rates to higher levels. This environment was broadly supportive of risk assets, including non-governmental fixed income. Our outlook for these sectors based on fundamentals remains positive, but we do not expect volatility to remain at bay. While continued normalization of US monetary policy is broadly expected, we expect the pace of normalization within divergent global monetary policy and the unwinding of unconventional tools will prove significant to U.S. fixed income market developments. Additionally, with markets projecting two additional rate hikes in the U.S., the flattening of the yield curve will remain in focus for both the Fed and market participants. For now, as the economic backdrop remains strong, but policy uncertainty continues, both caution and optimism are warranted for fixed income investors.

Fixed income returns as of July 31, 2018

Index Returns as of July 31, 2018				
	Total Return (%)		Excess Return (%)	
	Month-to-Date	Year-to- Date	Month-to-Date	Year-to- Date
U.S. Aggregate	0.02	-1.59	0.42	-0.12
U.S. Treasury	-0.42	-1.49	-	-
Intermediate	-0.20	-0.89	-	-
Long	-1.47	-4.42	-	-
TIPS	-0.48	-0.51	-	-
Agencies	-0.18	-0.70	0.00	-0.01
U.S. MBS	-0.11	-1.06	0.20	-0.04
U.S. Credit	0.72	-2.29	1.20	-0.38
Intermediate	0.37	-1.08	0.59	-0.02
Long	1.50	-4.98	2.57	-1.16
Industrial	0.99	-2.44	1.54	-0.28
Utility	0.31	-3.87	1.04	-1.18
Financial	0.65	-2.21	1.01	-0.66
Non-Corporate	0.14	-1.43	0.50	0.04
Aaa	0.02	-0.99	0.28	0.09
Aa	0.18	-1.71	0.62	-0.06
A	0.66	-2.71	1.16	-0.72
Baa	1.03	-2.35	1.54	-0.26
High Yield	1.09	1.25	1.28	2.07
Floating Rate Notes	0.32	1.50	0.24	0.66

Source: Bloomberg Barclays

Disclosures

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

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