Fixed income market update

October 2018

BMO Fixed Income

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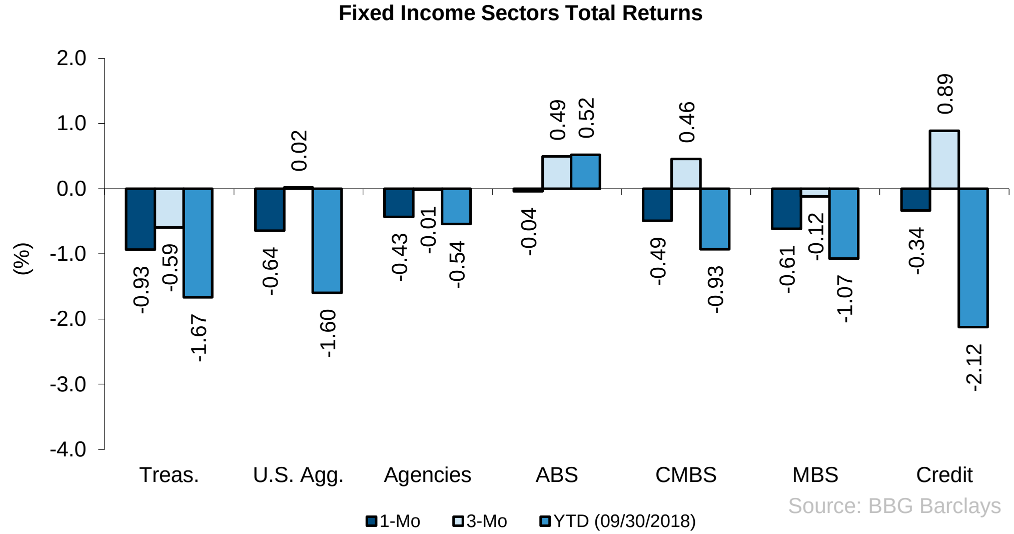
BMO Global Asset Management

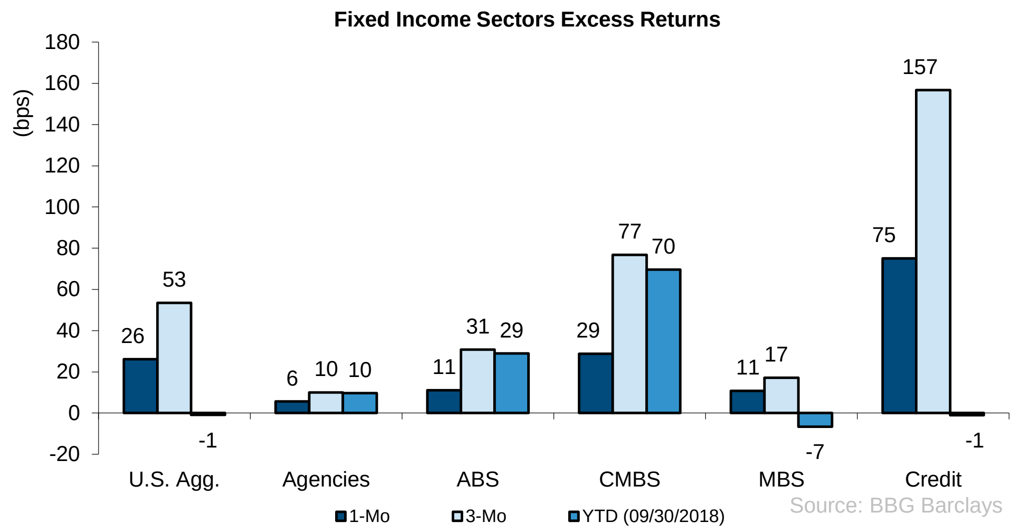
Fixed income market update

- For the quarter ended September 30, 2018, the Bloomberg Barclays U.S. Aggregate Bond Index returned 0.02%. Year to date, the index has returned -1.60%.

- U.S. Treasuries returned -0.59% during the quarter as the yield on the 10-year U.S. Treasury rose to 3.06% at the end of September from 2.86% at the end of June. For the quarter, long Treasuries (-2.88%) underperformed intermediate Treasuries (-0.12%.)

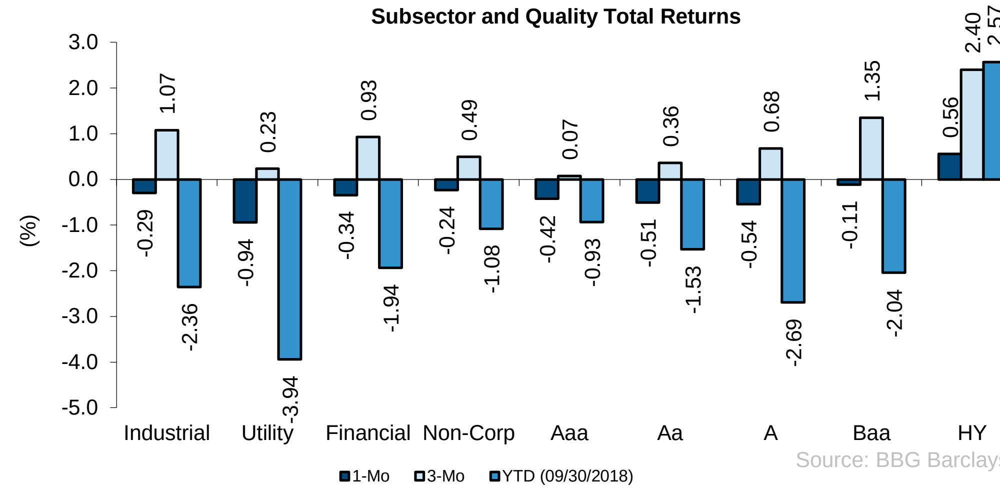
- Mortgage-backed securities (MBS) returned -0.12% during the quarter, outperforming duration-matched Treasuries by 17 basis points. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index remained unchanged during the quarter, ending the period at 28 basis points.

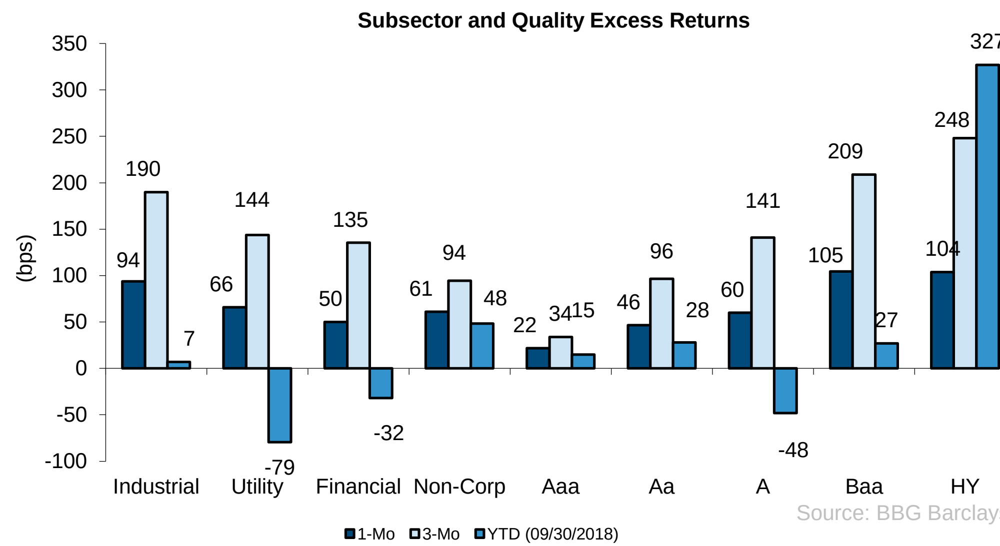




Fixed income market update (continued)

- Credit securities returned 0.89% for the quarter, outperforming Treasuries by 157 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 100 bps, 16 basis points tighter than at the end of June. For the quarter, long credit (+1.26%) outperformed intermediate credit (+0.73%) by 232 basis points on a duration-adjusted basis.
- For the quarter, on a duration-adjusted basis, industrials delivered 190 basis points of excess returns, outperforming utilities, financials and non-corporates by 46, 55 and 96 basis points, respectively.
- BBB rated securities delivered 209 basis points of excess return for the quarter, outperforming AAA, AA and A rated securities by 175, 113 and 68 basis points of excess return, respectively. High yield delivered 248 basis points of excess return for the quarter.

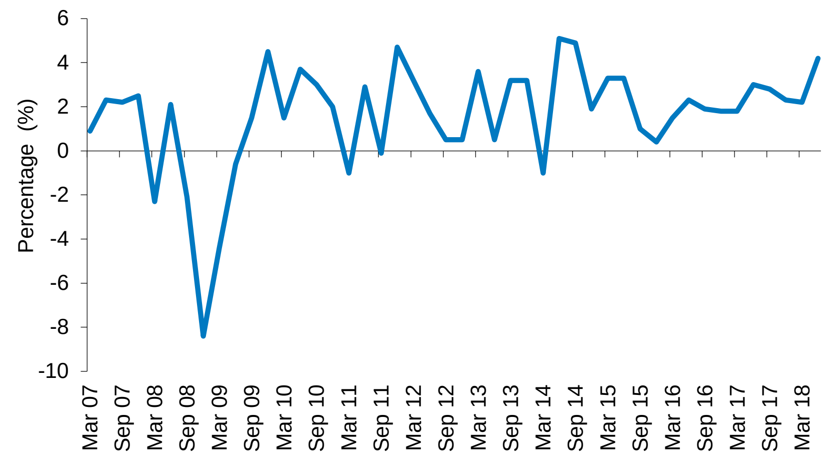




Economic update

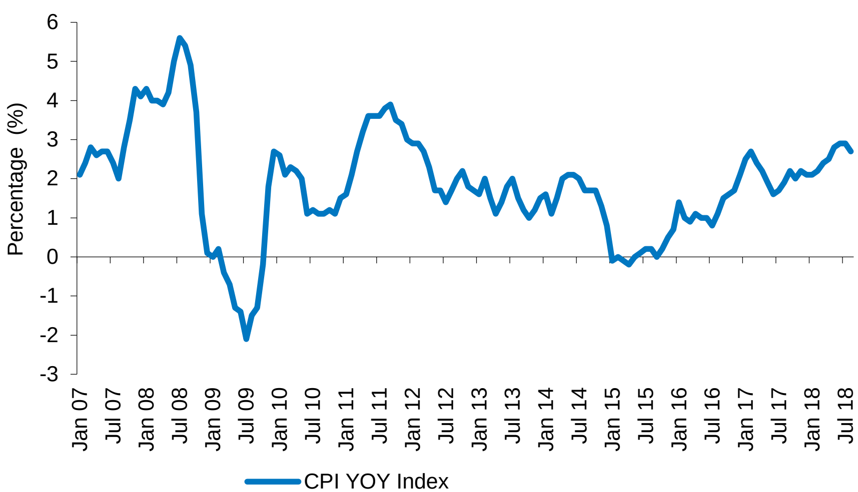
Second quarter U.S. gross domestic product (GDP) was unrevised from the prior estimate at a 4.2% annualized rate, bringing growth for the first half of 2018 to 3.2%. August durable goods orders rose sharply, up 4.2% versus a 2.0% expectation supporting expectations of strong third quarter growth. The consensus estimate for third quarter GDP growth is 3.0%.

Gross Domestic Product (GDP)



Source: Bureau of Economic Analysis

Consumer Price Index (YoY)

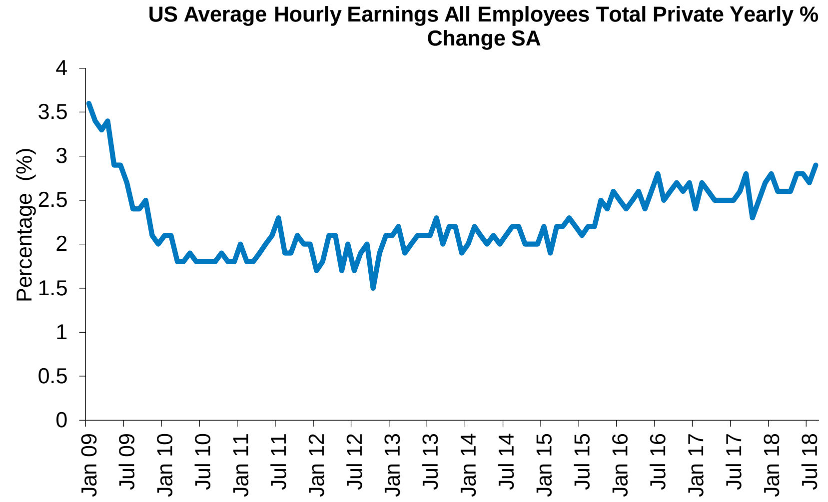


Source: Bureau of Labor Statistics

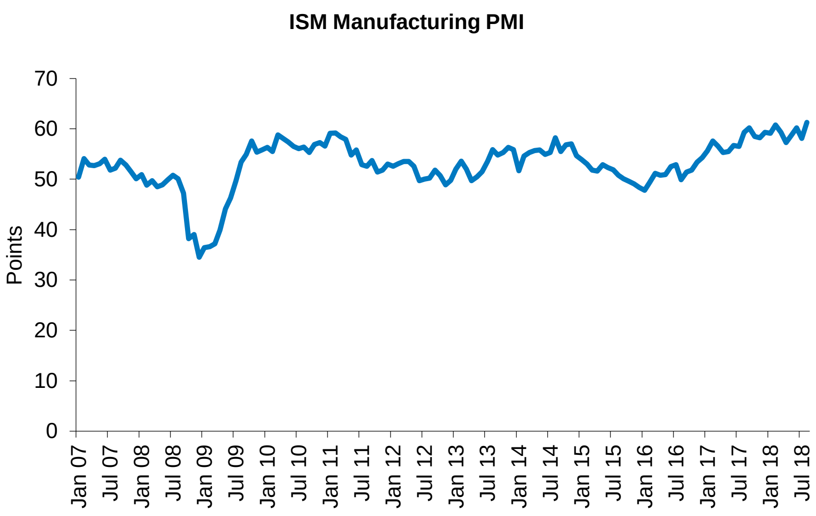
The Consumer Price Index (CPI) increased 0.2% in August, below the 0.3% consensus estimate. CPI rose 2.7% for the trailing year, this reading was 0.2% below last month's figure, which had been the largest in six years. Core CPI, which excludes the impact of energy and food, rose by 0.1% for the month and 2.2% for the trailing year, a 0.2% decline from the prior month. Core personal consumption expenditures (PCE), the Fed's preferred inflation gauge, rose 0.1% in August and 2.0% for the trailing year.

Economic update (continued)

August average hourly earning data showed wages rose 2.9% for the trailing year, the largest increase since 2009. August non-farm payrolls increased by 201,000, which was above market expectations of 191,000. However, revisions to the prior two months reduced payrolls by 50,000 jobs. The unemployment rate remained unchanged at 3.9% while the underemployment rate declined 0.1% to 7.4%. Labor force participation declined 0.2% to 62.7%.



Source: Bureau of Labor Statistics



Source: Institute for Supply Management

The Institute for Supply Management's ISM Manufacturing Index increased to a level 61.3 in August versus the consensus estimate of 57.6, with any level above 50 representing expansion. The strong reading represented the highest index level since 2004. Both the export and import gauges declined, partially due to trade tensions, but remained above 50 representing continued expansion. The September PMI figure, released October 1, showed a declined to 59.8.

Economic and market perspective

- Trade and protectionism concerns remained in focus as the United States and China continued to engage in a back and forth over tariff policy. During September, the U.S. announced and implemented a 10% tariff on $200 billion worth of imports from China. The tariff rate on those goods will increase to 25% at the end of the year barring additional negotiation. Combined with the previously announced tariffs on $50 billion of Chinese goods, the tariffs now cover approximately half of imports from China. China reciprocated by implementing tariffs ranging from 5 – 10% on an additional $60 billion worth of imports from the United States. This new round brings the total U.S. goods subject to Chinese tariffs to $110 billion. The Trump administration has threatened to expand tariffs to another $267 billion of imports, which would subject effectively all imports from China to tariffs.
- For most of the month there seemed to be limited progress including Canada in the new deal negotiated between the United States and Mexico to replace NAFTA. Over the final weekend of the September an agreement was reached to include Canada in what will be called the USMCA (U.S.-Mexico-Canada Agreement.) The deal appears to modify many existing provisions rather than replacing NAFTA entirely. The agreement did not end U.S. steel and aluminum tariffs on Canada.
- Italian bond yields rose sharply at the end of the month as the Italian government approved a 2019 budget deficit of 2.4%. This level is three times above what the prior government had set and is above the levels expected by the European Union (E.U.) prompting market concerns.
- In other international negotiations, Brexit tensions continue to linger as the March 2019 date for the British exit from the E.U. is now six months away. With no deal between Britain and the E.U. seemingly close to completion the approaching deadline has caused concerns of a 'no-deal exit' with potentially larger disruption to trade than a negotiated exit that includes trade agreements.
- After persistent economic challenges, the International Monetary Fund (IMF) gave Argentina its biggest loan package ever, increasing the package to $57 billion over three years to help stabilize the country. The loan includes strict conditions such as zero budgetary deficit in 2019 and limitations on central bank currency interventions.

Outlook and conclusions

- U.S. trade deficits widened almost $4 billion in August to nearly $76 billion as exports fell. In particular, a nearly 10% decline in exports of some agricultural products impacted the trade deficit. The decline is likely tied to tariffs, both in the current implementation and front-loading of orders prior to implementation.
- As expected, the Federal Open Market Committee increased the Federal Funds rate at their September 25-26th meeting. The 25 basis point increase is the eighth of the current cycle and brings the Fed Funds target range to 2.0% - 2.25%. Of note, the Committee removed language that referred to current monetary policy as "accommodative," however, Fed Chairman Jerome Powell downplayed the significance of the language change. He indicated that the Fed would remain focused on economic data, which remained strong, and the Fed wanted to avoid the implications that it could precisely know when policy ceased to be accommodative. Fed Funds futures are projecting over a 70% likelihood of a fourth rate hike this year at the December meeting. A Fed Governor generally viewed as 'dovish,' Lael Brainard, delivered what was viewed as a 'hawkish' speech in mid-September furthering a market view of the Fed continuing with additional rate hikes.
- In our view, fixed income performance in third quarter was a balancing act between the positive U.S. economic landscape and global economic and geopolitical events. For the quarter overall, rates moved higher and non-governmental spreads tightened as U.S. economic data won out, but periods such as August demonstrated the risk-off sentiment and volatility potential from international events even with positive U.S. data. This difference in data between regions parallels the divergence of monetary policy, which is well under way. We expect this divergence to continue near-term as the Fed continues its normalization process with additional rate hikes. While trade policy and global events suggest continued volatility, attractive yields and strong economic fundamentals continue to support U.S. fixed income.

Fixed income returns as of September 30, 2018

Index Returns as of September 30, 2018						
	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	-0.64	0.02	-1.60	0.26	0.53	-0.01
U.S. Treasury	-0.93	-0.59	-1.67	-	-	-
Intermediate	-0.52	-0.12	-0.81	-	-	-
Long	-2.96	-2.88	-5.79	-	-	-
TIPS	-1.05	-0.82	-0.84	-	-	-
Agencies	-0.43	-0.01	-0.54	0.06	0.10	0.10
U.S. MBS	-0.61	-0.12	-1.07	0.11	0.17	-0.07
U.S. Credit	-0.34	0.89	-2.12	0.75	1.57	-0.01
Intermediate	-0.24	0.73	-0.73	0.32	0.86	0.24
Long	-0.56	1.26	-5.20	1.73	3.18	-0.56
Industrial	-0.29	1.07	-2.36	0.94	1.90	0.07
Utility	-0.94	0.23	-3.94	0.66	1.44	-0.79
Financial	-0.34	0.93	-1.94	0.50	1.35	-0.32
Non-Corporate	-0.24	0.49	-1.08	0.61	0.94	0.48
Aaa	-0.42	0.07	-0.93	0.22	0.34	0.15
Aa	-0.51	0.36	-1.53	0.46	0.96	0.28
A	-0.54	0.68	-2.69	0.60	1.41	-0.48
Baa	-0.11	1.35	-2.04	1.05	2.09	0.27
High Yield	0.56	2.40	2.57	1.04	2.48	3.27
Floating Rate Notes	0.21	0.80	1.99	0.13	0.43	0.86

Source: Bloomberg Barclays

Disclosures

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

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