

Fixed income market update

November 2018

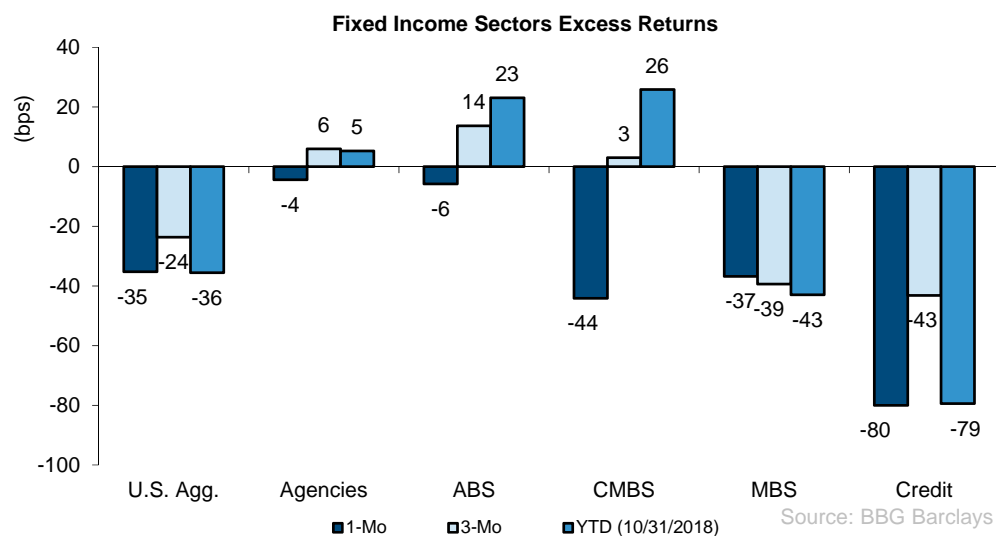
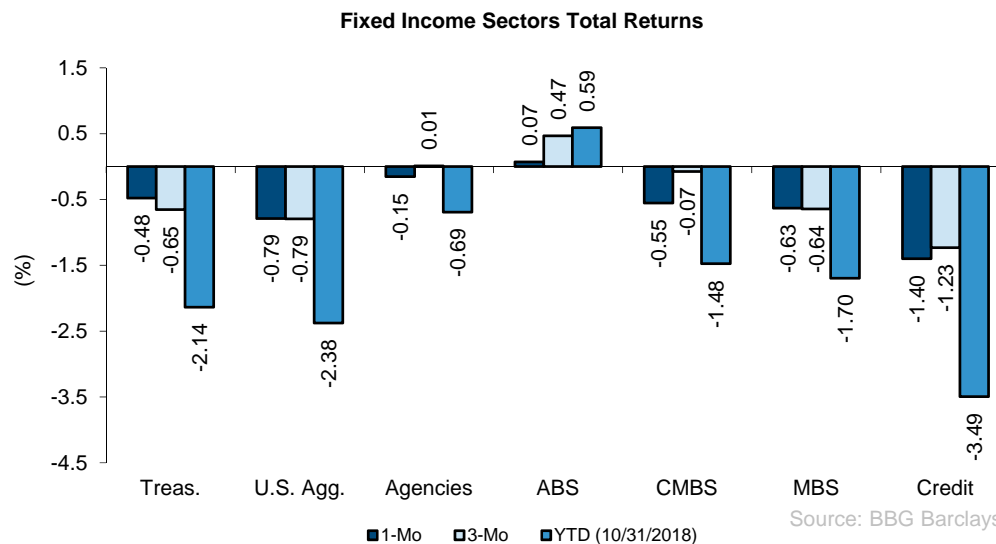
BMO Fixed Income

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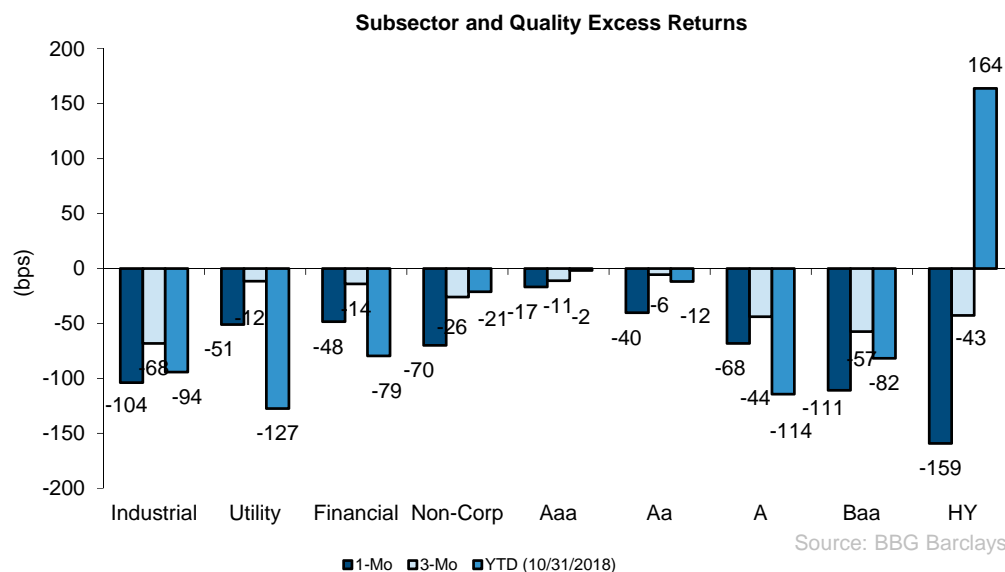
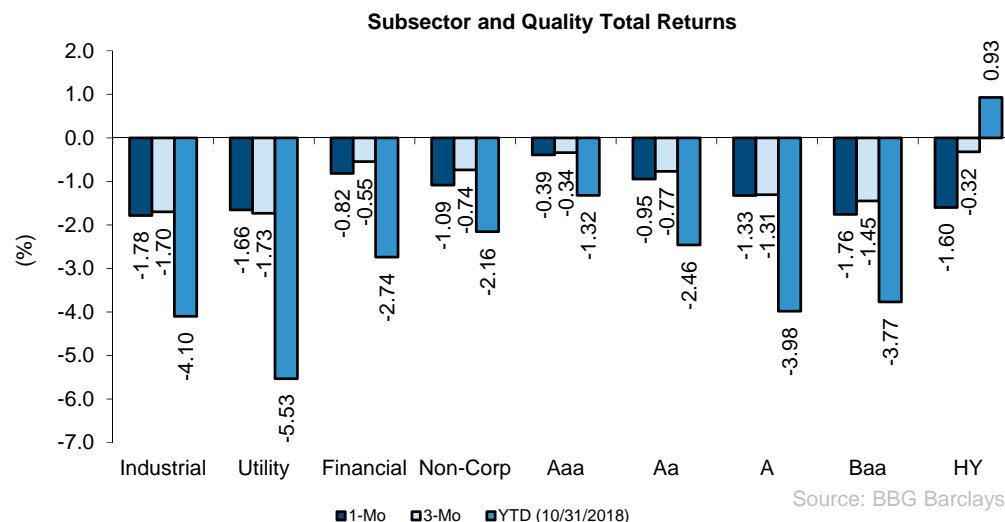
Fixed income market update

- For the month ended October 31, 2018, the Bloomberg Barclays U.S. Aggregate Bond Index returned -0.79%. Year to date, the index has returned -2.38%.
- U.S. Treasuries returned -0.48% during the month as the yield on the 10-year U.S. Treasury rose to 3.14% at the end of October from 3.06% at the end of September. For the month, long Treasuries (-3.05%) underperformed intermediate Treasuries (+0.04%).
- Mortgage-backed securities (MBS) returned -0.63% during the month, underperforming duration-matched Treasuries by 37 basis points. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index widened 6 basis points during the month, ending the period at 34 basis points.



Fixed income market update (continued)

- Credit securities returned -1.40% for the month, underperforming Treasuries by 80 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 112 bps, 12 basis points wider than at the end of September. For the month, long credit (-3.61%) underperformed intermediate credit (-0.42%) by 130 basis points on a duration-adjusted basis.
- For the month, on a duration-adjusted basis, financials delivered -48 basis points of excess returns, outperforming utilities, non-corporates and industrials by 3, 22 and 56 basis points, respectively.
- AAA rated securities delivered -17 basis points of excess return for the month, outperforming AA, A and BBB rated securities by 23, 51 and 94 basis points of excess return, respectively. High yield delivered -159 basis points of excess return for the month.

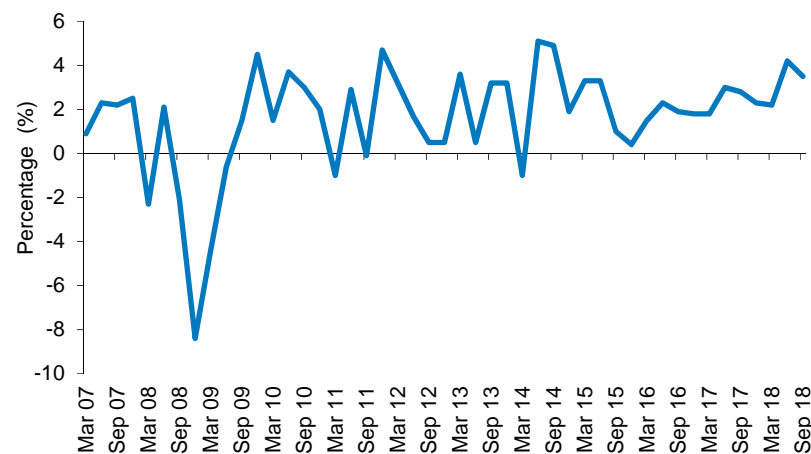


Economic update

The first estimate of third quarter U.S. gross domestic product (GDP) was released showing a better than expected 3.5% annualized growth rate. Consensus had been for growth in the low 3% range. Consumer spending, the largest component of GDP, grew by 4% in the quarter, the largest increase since the fourth quarter of 2014. However, business investment dropped 7.9%, the largest quarterly decline in two years.



Gross Domestic Product (GDP)



Source: Bureau of Economic Analysis

Consumer Price Index (YoY)



The Consumer Price Index (CPI) increased 0.1% in September, below the 0.2% consensus estimate. CPI rose 2.3% for the trailing year, this reading was 0.4% below last month's figure and 0.6% below the recent peak in July. Core CPI, which excludes the impact of energy and food, rose by 0.1% for the month and 2.2% for the trailing year, the same as last month. Core personal consumption expenditures (PCE), the Fed's preferred inflation gauge, rose 2.0% for the trailing year, in line with the Fed's target.

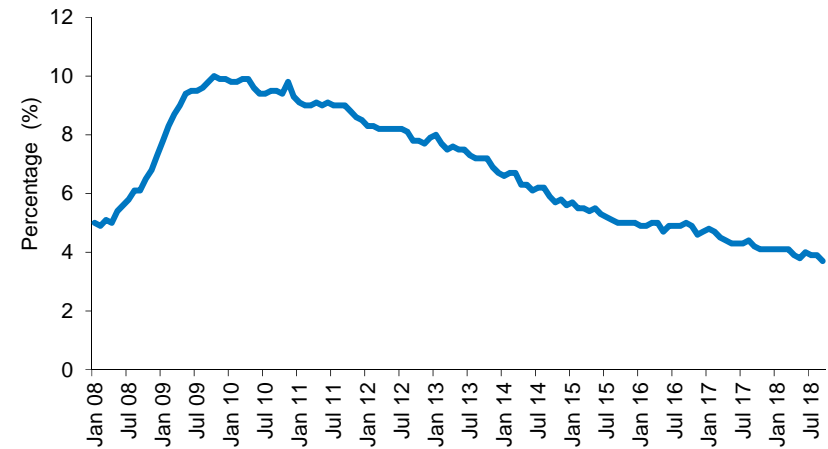
Source: Bureau of Labor Statistics

Economic update (continued)

The unemployment rate in the U.S. declined 0.2% to 3.7% in September, the lowest unemployment rate since 1969. September non-farm payrolls increased by 134,000, which was below market expectations of 180,000. However, revisions to the prior two months increased payrolls by 87,000 jobs. Average hourly earning data in September showed wages rose 2.8% for the trailing year, a 0.1% decrease from last month, which was the largest increase since 2009. The underemployment rate rose 0.1% to 7.5% and labor force participation was unchanged at 62.7%.

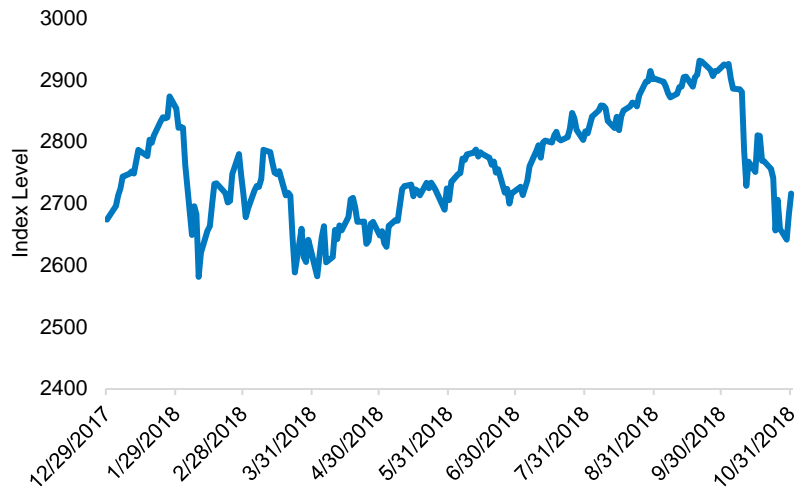


U.S. Unemployment (U-3 Seasonally Adjusted)



Source: Bureau of Labor Statistics

S&P 500



The S&P 500 experienced a correction during October, declining over 10% during the month, before recovering to close down almost 7%. After over two years without a correction, U.S. stocks experienced their second correction of 2018. Despite robust economic data, a number of factors, including rising interest rates and continued trade tensions contributed to the decline. Technology stocks in particular experienced a significant drawdown in the month.

Economic and market perspective

- Oil prices declined over 10% in October closing at \$65 a barrel. Earlier in the month, oil prices had increased above \$76 based on strong economic data and tensions in the Middle East regarding the killing of Saudi journalist Jamal Khashoggi. However, a general decline in market sentiment and concerns global demand could wane as a result of trade tensions between the U.S and China contributed to the decline during October. Also weighing on prices were increased supply of oil from Saudi Arabia, Russia and Libya, which offset decreased supply from Venezuela and Iran.
- European Union (E.U.) stresses with Italy continued in the month as the E.U. rejected a member state's budget for the first time. Based on the proposed budget, Italy's 2019 budget deficit was higher than levels considered acceptable by the E.U. The Italian government indicated to date that it will not change its plans for the budget for 2019.
- For the third quarter European GDP rose only 0.2%. The European growth figures were below expectations and the lowest levels of growth in over four years. At the same time, Eurostat's preliminary inflation report showed Euro region countries experiencing 2.1% inflation. This marked the fifth consecutive month of Euro inflation above the European Central Bank's (ECB) target of just below 2%. Core inflation rose 1.3%, a modest increase from the prior reading of 1.1%. Europe's unemployment rate was 8.1% as of September. The disappointing growth figures could weigh on the ECB's decisions regarding asset purchases and future rate hikes.
- In Brazil, Jair Bolsonaro won election as the country's next president. In terms of economic policy, he ran on a platform of privatization of government entities and deregulation of the economy, particularly as it pertains to the country's natural resources. His election is viewed as a change of direction for South America's largest economy. He was considered the more market friendly of the candidates and markets have welcomed his election.

Outlook and conclusions

- Minutes from the Federal Open Market Committee's September 25-26th meeting were released in mid-October. The Fed had raised the Fed Funds rate by 25 basis points to 2.0% - 2.25% at that meeting. The minutes noted the Committee's view that "further gradual increases in the target range for the federal Funds Rate would most likely be consistent with a sustained economic expansion, strong labor market conditions." President Trump has criticized the Fed's decision to raise rates, but to date this does not appear to have impacted the Fed's path going forward. Fed Funds futures are projecting over a 70% likelihood of a fourth rate hike this year at the December meeting.
- The employment cost index (ECI), another measure of wages, rose 0.8% in the third quarter above market expectations. For the trailing 12 months, ECI rose 2.8%, the same as last quarter matching the highest level in 10 years. Private sector wages rose 3.1% for the trailing year, the first time above 3% since 2008.
- US midterm elections will be held on November 6th. Consensus expectations are for Republicans to maintain control of the Senate and for Democrats to gain control of the House of Representatives. Potential policy implications include a second round of tax reform and funding for an infrastructure package depending on the outcome of congressional elections.
- In our view, markets in October exhibited the same interplay between rates and risk assets they have for much of the year. The pattern which has developed is one where strong economic data in the U.S. prompts interest rates to test new upper bounds, before the combination of pressure from higher rates and geopolitical uncertainties pulls rates down from their peaks. Nonetheless, rates settled at their highest month-end level of the year and with them, yields on broad fixed income benchmarks closed above 3.5% for the first time since 2009. This interplay has led to volatility and wider spreads despite the continued solid fundamentals. The combination of those solid fundamentals and higher yields reinforces our view of the attractiveness of fixed income, but with a watchful eye to continued volatility.

Fixed income returns as of October 31, 2018

Index Returns as of October 31, 2018				
	Total Return (%)		Excess Return (%)	
	Month-to-Date	Year-to-Date	Month-to-Date	Year-to-Date
U.S. Aggregate	-0.79	-2.38	-0.35	-0.36
U.S. Treasury	-0.48	-2.14	-	-
Intermediate	0.04	-0.78	-	-
Long	-3.05	-8.66	-	-
TIPS	-1.43	-2.27	-	-
Agencies	-0.15	-0.69	-0.04	0.05
U.S. MBS	-0.63	-1.70	-0.37	-0.43
U.S. Credit	-1.40	-3.49	-0.80	-0.79
Intermediate	-0.42	-1.14	-0.40	-0.15
Long	-3.61	-8.62	-1.70	-2.16
Industrial	-1.78	-4.10	-1.04	-0.94
Utility	-1.66	-5.53	-0.51	-1.27
Financial	-0.82	-2.74	-0.48	-0.79
Non-Corporate	-1.09	-2.16	-0.70	-0.21
Aaa	-0.39	-1.32	-0.17	-0.02
Aa	-0.95	-2.46	-0.40	-0.12
A	-1.33	-3.98	-0.68	-1.14
Baa	-1.76	-3.77	-1.11	-0.82
High Yield	-1.60	0.93	-1.59	1.64
Floating Rate Notes	0.10	2.09	-0.06	0.80

Source: Bloomberg Barclays

Disclosures

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

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