Fixed income market update

December 2018

BMO Fixed Income

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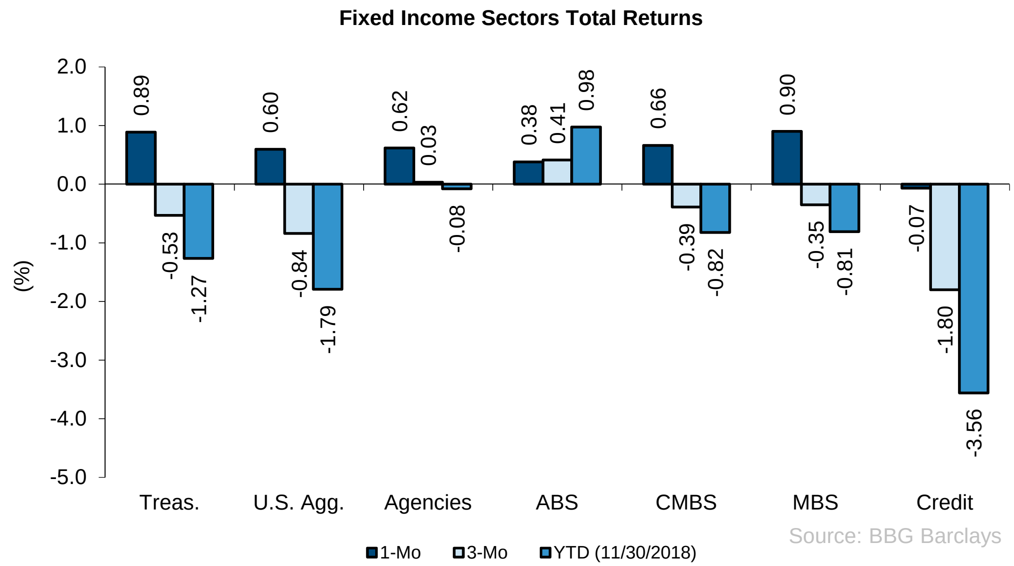
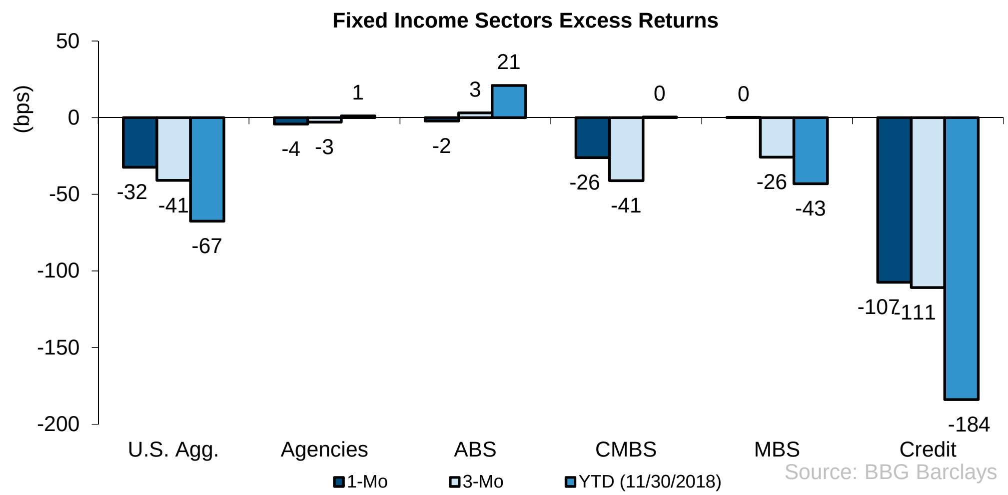
BMO Global Asset Management

Fixed income market update

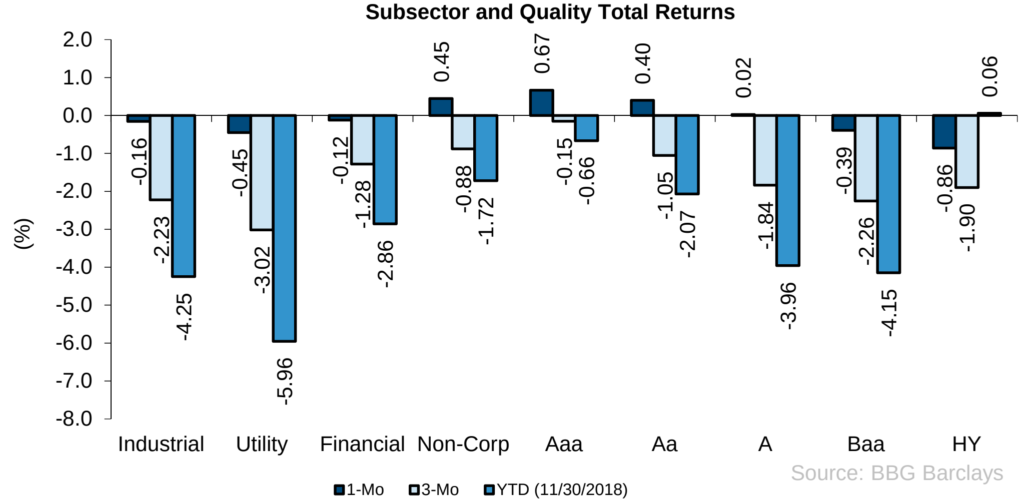
- For the month ended November 30, 2018, the Bloomberg Barclays U.S. Aggregate Bond Index returned 0.60%. Year to date, the index has returned -1.79%.
- U.S. Treasuries returned 0.89% during the month as the yield on the 10-year U.S. Treasury declined to 2.99% at the end of November from 3.14% at the end of October. For the month, long Treasuries (+1.89%) outperformed intermediate Treasuries (+0.69%.)
- Mortgage-backed securities (MBS) returned 0.90% during the month in line with duration-matched Treasuries. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index widened 1 basis point during the month, ending the period at 35 basis points.



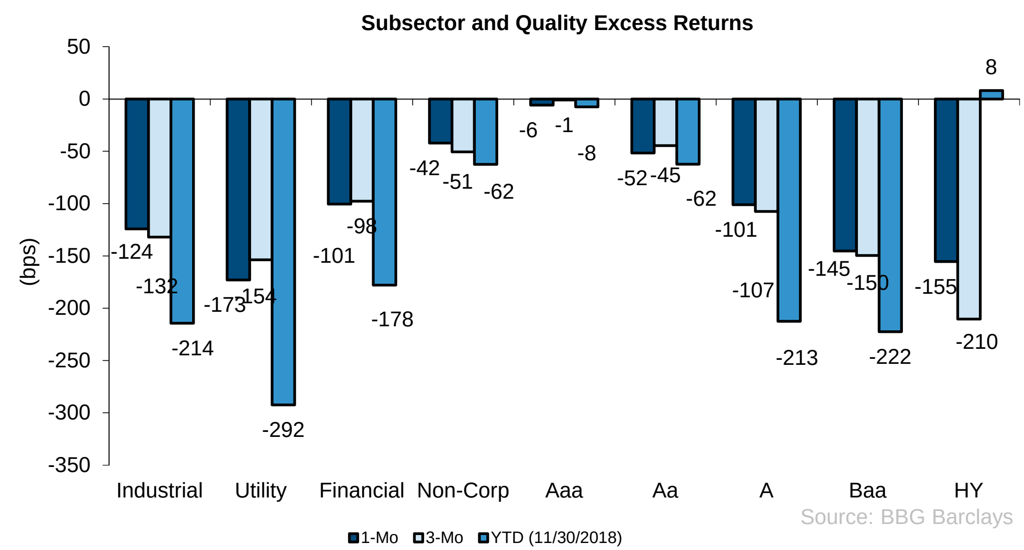


Fixed income market update (continued)

- Credit securities returned -0.07% for the month, underperforming Treasuries by 107 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 129 bps, 17 basis points wider than at the end of October. For the month, long credit (-0.40%) underperformed intermediate credit (+0.08%) by 138 basis points on a duration-adjusted basis.
- For the month, on a duration-adjusted basis, non-corporates delivered -42 basis points of excess returns, outperforming financials, industrials and utilities by 59, 82 and 131 basis points, respectively.
- AAA rated securities delivered -6 basis points of excess return for the month, outperforming AA, A and BBB rated securities by 46, 95 and 139 basis points of excess return, respectively. High yield delivered -155 basis points of excess return for the month.



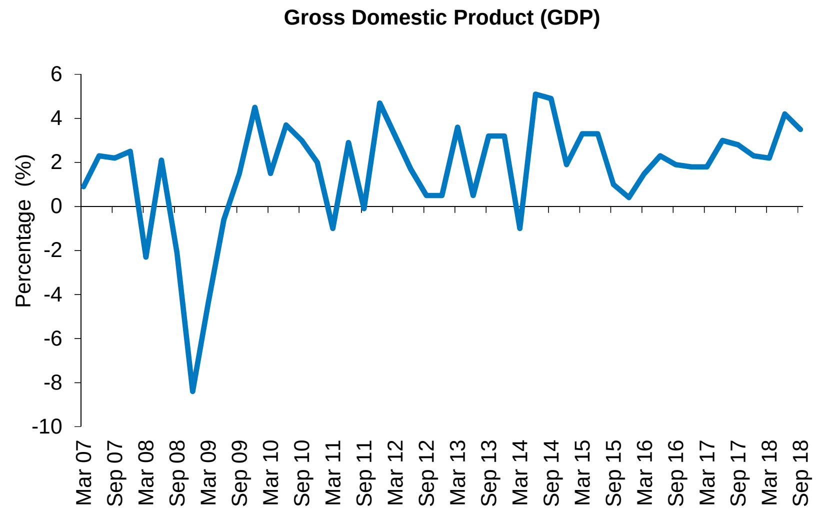
Source: BBG Barclays



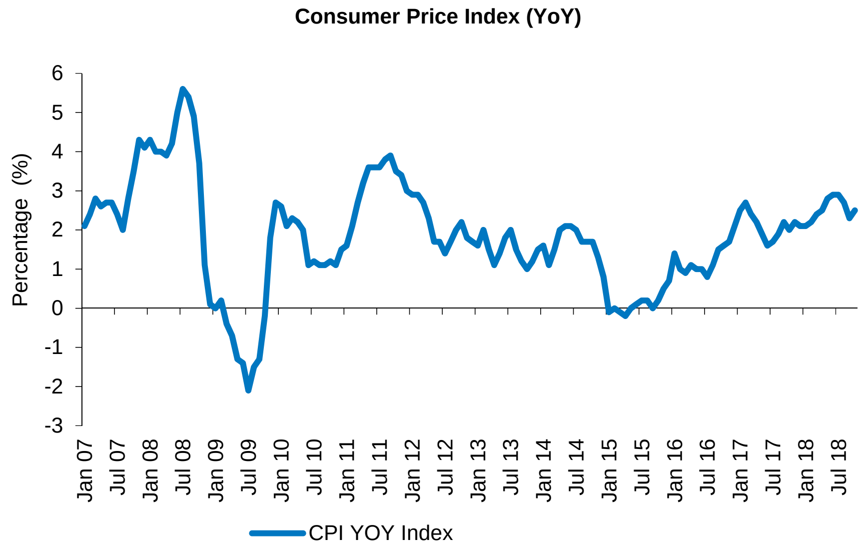
Source: BBG Barclays

Economic update

Third quarter U.S. gross domestic product (GDP) was unrevised at a 3.5% annualized growth rate. Consumer spending, the largest component of GDP, grew by 3.6%, revised down from 4% in the prior estimate. Imports were revised higher such that the trade gap reduced GDP by 1.9%, the highest level since 1985. Inventories increased, adding 2.3% to GDP, above the 2.1% prior estimate. Business investment rose 3.5%, an upward revision from the 0.4% figure in the prior estimate. Consensus for fourth quarter growth is 2.5%.



Source: Bureau of Economic Analysis

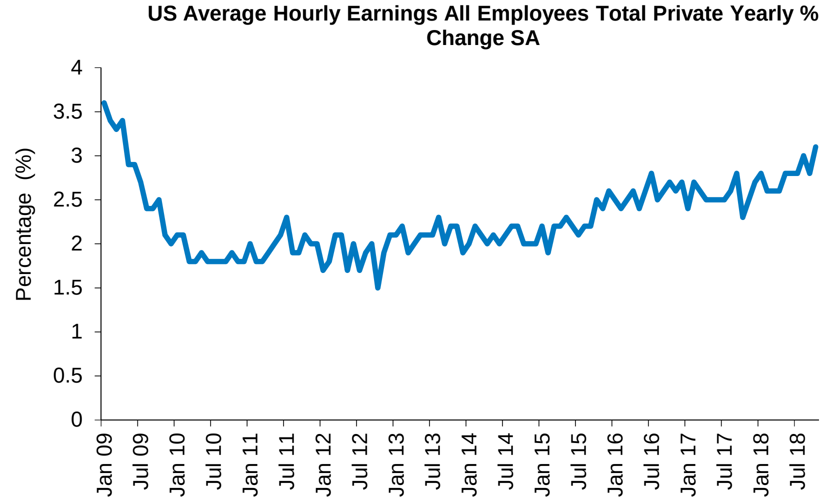


Source: Bureau of Labor Statistics

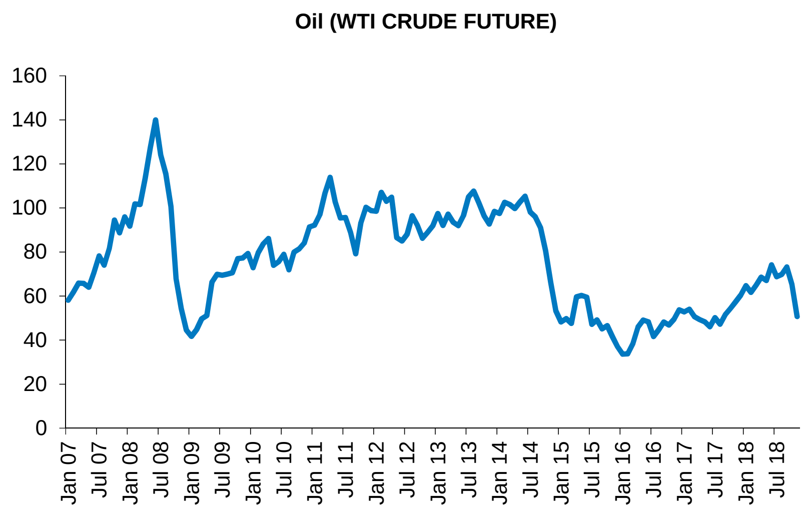
The Consumer Price Index (CPI) increased 0.3% in October, in line with consensus estimate. CPI rose 2.5% for the trailing year, increasing from the past two months, but below the 2.9% recent peak in July. Core CPI, which excludes the impact of energy and food, rose by 0.1% for the month and 2.1% for the trailing year. Core PCE, the Fed's preferred gauge, rose 1.8%. That is the lowest level since February and below the Fed's target. Declining energy prices are likely to impact headline inflation in the coming months.

Economic update (continued)

Average hourly earning data for October showed wages rose 3.1% for the trailing year, the largest increase since 2009. October non-farm payrolls increased by 250,000, well ahead of market expectations for 190,000 new jobs. The unemployment rate in the U.S. remained at 3.7%, the lowest unemployment rate since 1969, despite a 0.2% increase in the labor participation rate. The underemployment rate declined 0.1% to 7.4%.



Source: Bureau of Labor Statistics



Source: Bloomberg

Oil prices declined over 20% in November, falling from $65 a barrel to just over $50. This decline has exceeded 30% over the past two months from above $73 at the end of September. The decline in oil reflected declining risk sentiment more broadly as well as other market themes such as concerns over slowing global growth, trade policy tension and the strong dollar. Further, unexpected exemptions for Iranian exports boosted supply. OPEC is set to meet this week with expectations for a cut in production to help support the price of oil.

Economic and market perspective

- After months of increasing rounds of tariffs between the U.S. and China, the meeting at the G-20 between President Trump and President Xi was highly anticipated. The meeting, which occurred over the final weekend of the month (and after markets closed for the month) appears to have resulted in a temporary break in the escalation of tariffs. As part of the 90 day deal the U.S. agreed to, the U.S. will pause the introduction of further tariffs and increases in rates on existing tariffs in exchange for China agreeing to make significant purchases of U.S. goods.

- In addition to concerns around trade tensions, weakening economic data globally contributed to the risk off sentiment in November. Chinese third quarter GDP growth slowed to its lowest level since 2009 at 6.5% and official PMI measures showed manufacturing slowing to no growth with a PMI reading of 50.0 (50 being the divider between growth and contraction on the PMI scale.) Similarly, in addition to last month's weak GDP growth figures in Europe (+0.2%), this month's European PMI figures fell short of expectations at 52.4, the lowest levels in four years.

- Brexit remained in the news as Prime Minister Theresa May's proposal to exit the European Union, which appeared to be supported by international parties, elicited strong pushback within the U.K. This pushback included the resignations of multiple ministers; it is currently expected that her proposal will not pass parliament.

- European Union (E.U.) tensions with Italy over budget deficits continued in the month after it had appeared more progress had been made. A second E.U. committee agreed that the proposed Italian budget would not comply with E.U. budgetary rules, allowing the E.U. to formally begin a process of disciplinary procedures against Italy. Those procedures are not expected to begin until January and any agreements in the interim could avoid that process. The process could result in financial sanctions.

Outlook and conclusions

- The Federal Open Market Committee met on November 7-8th and announced no change in policy, in line with expectations. Minutes of the meeting were subsequently released later in the month. The minutes included a reference to raising rates again "fairly soon", which is widely understood to be the December meeting. Fed Funds futures are projecting over a 75% likelihood of a fourth rate hike this year at the December meeting.
- In the last week of the month, both Fed Chair Jerome Powell and Fed Vice Chair Richard Clarida suggested the current Fed Funds rate was "just below" neutral. This language walks back Chair Powell's comment last month that the Fed Funds rate was a "long way" from neutral.
- Consensus was largely met in the U.S. midterm elections held on November 6th. Republicans maintained control of the Senate (picking up 2 seats) and Democrats gained control of the House of Representatives (picking up approximately 40 seats.) The results would seem to limit the potential for a second round of tax reform and shifts focus to areas where bipartisan agreement could be reached. Near term, election induced jitters have faded as no extreme results materialized, but longer term, Democrats assuming control of House committees could increase oversight and investigations into the Trump administration, which could increase volatility from political headlines.
- In our view, fading risk sentiment, while not without basis, has been disproportionate to economic fundamentals. In the U.S. in particular, though there are concerns that the Fed will push too far or economic data will materially deteriorate, neither fear has yet materialized. Overseas, the story is different where growth does appear to be slowing. The global sentiment shift has been most acutely seen in oil, but has also pushed credit spreads to two year wides and MBS spreads to four year wides, while pulling the 10 year Treasury back to around the 3% level. Interestingly, on balance, these changes have left yields on broad benchmarks relatively unchanged since last month and near 10 year highs. These levels of yield remain attractive with an increased opportunity set in the non-governmental sectors, but the prospects of further volatility remain as markets sort through numerous geopolitical, monetary policy and fundamental economic developments.

Fixed income returns as of November 30, 2018

Index Returns as of November 30, 2018				
	Total Return (%)		**Excess Return (%)**	
	Month-to-Date	**Year-to- Date**	**Month-to-Date**	**Year-to- Date**
U.S. Aggregate	0.60	-1.79	-0.32	-0.67
U.S. Treasury	0.89	-1.27	-	-
Intermediate	0.69	-0.09	-	-
Long	1.89	-6.93	-	-
TIPS	0.48	-1.80	-	-
Agencies	0.62	-0.08	-0.04	0.01
U.S. MBS	0.90	-0.81	0.00	-0.43
U.S. Credit	-0.07	-3.56	-1.07	-1.84
Intermediate	0.08	-1.07	-0.66	-0.80
Long	-0.40	-8.99	-2.04	-4.06
Industrial	-0.16	-4.25	-1.24	-2.14
Utility	-0.45	-5.96	-1.73	-2.92
Financial	-0.12	-2.86	-1.01	-1.78
Non-Corporate	0.45	-1.72	-0.42	-0.62
Aaa	0.67	-0.66	-0.06	-0.08
Aa	0.40	-2.07	-0.52	-0.62
A	0.02	-3.96	-1.01	-2.13
Baa	-0.39	-4.15	-1.45	-2.22
High Yield	-0.86	0.06	-1.55	0.08
Floating Rate Notes	-0.21	1.88	-0.41	0.38

Source: Bloomberg Barclays

Disclosures

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

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