Fixed income market update

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BMO Fixed Income

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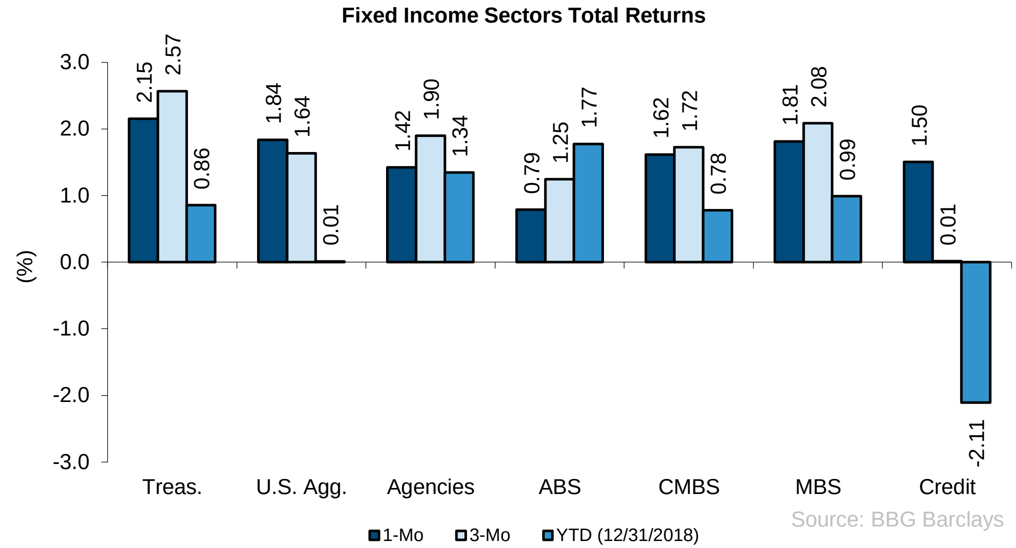
BMO Global Asset Management

Fixed income market update

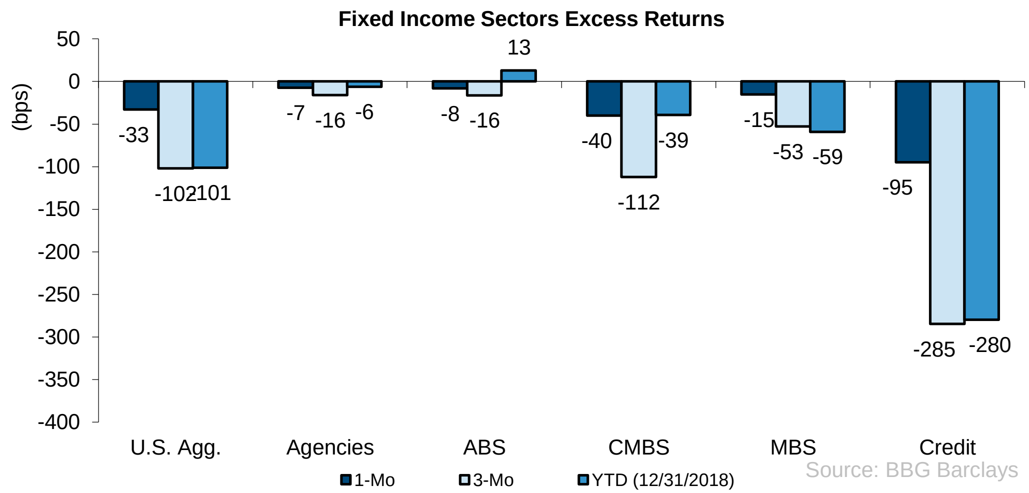
- For the quarter ended December 31, 2018, the Bloomberg Barclays U.S. Aggregate Bond Index returned 1.64%. For the year, the index returned 0.01%.

- U.S. Treasuries returned 2.57% during the quarter as the yield on the 10-year U.S. Treasury declined to 2.68% at the end of December from 3.06% at the end of September. For the quarter, long Treasuries (+4.19%) outperformed intermediate Treasuries (+2.24%.)

- Mortgage-backed securities (MBS) returned 2.08% during the quarter underperforming Treasuries by 53 basis points on a duration-adjusted basis. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index widened 7 basis point during the quarter, ending the period at 35 basis points.



Source: BBG Barclays



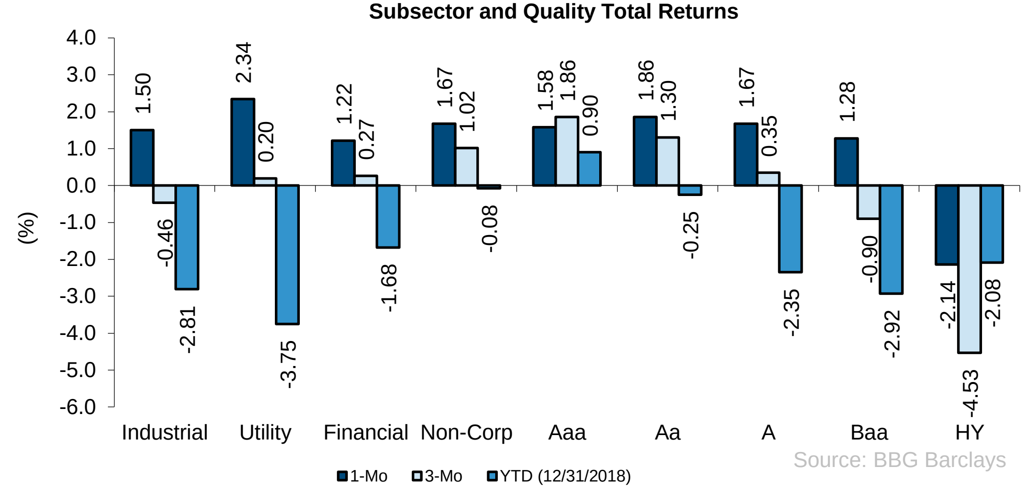
Source: BBG Barclays

Fixed income market update (continued)

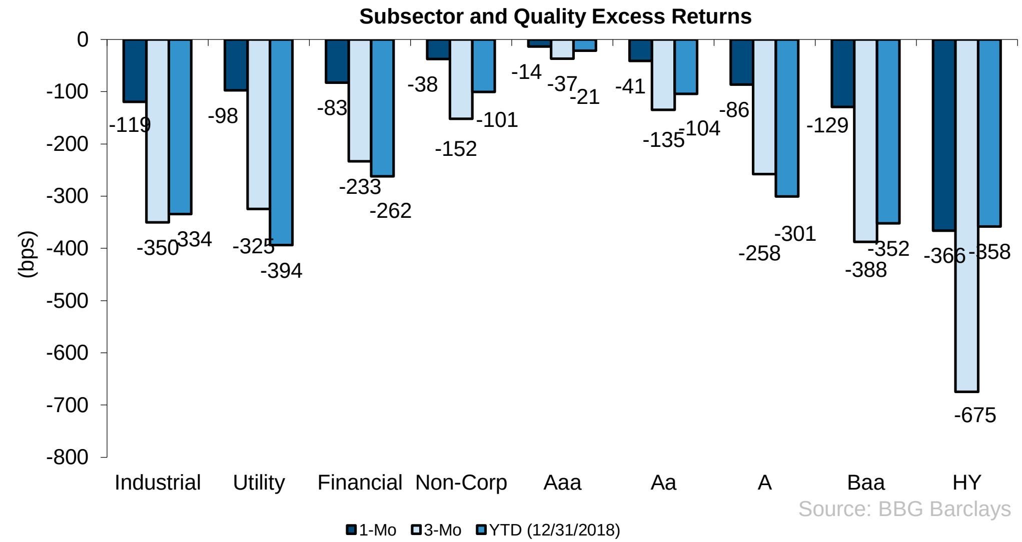
- Credit securities returned 0.01% for the quarter, underperforming Treasuries by 285 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 143 bps, 43 basis points wider than at the end of September. For the quarter, long credit (-1.64%) underperformed intermediate credit (+0.75%) by 421 basis points on a duration-adjusted basis.

- For the quarter, on a duration-adjusted basis, non-corporates delivered -152 basis points of excess returns, outperforming financials, utilities and industrials by 81, 173 and 198 basis points, respectively.

- AAA rated securities delivered -37 basis points of excess return for the quarter, outperforming AA, A and BBB rated securities by 98, 221 and 351 basis points of excess return, respectively. High yield delivered -675 basis points of excess return for the quarter.



Source: BBG Barclays

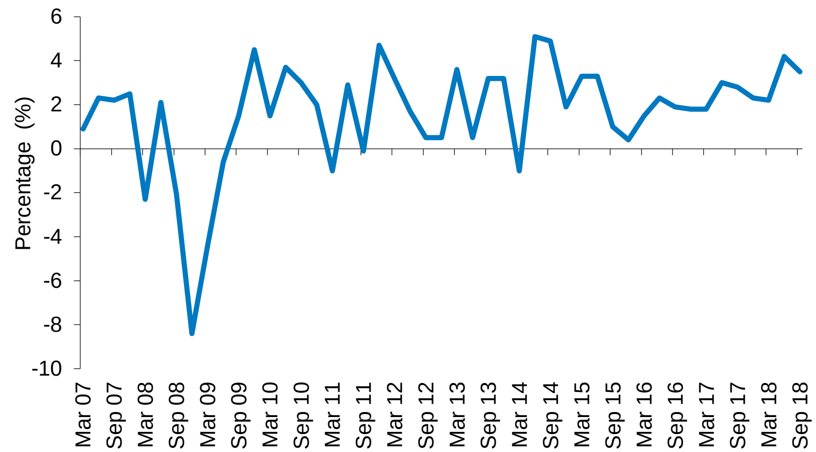


Source: BBG Barclays

Economic update

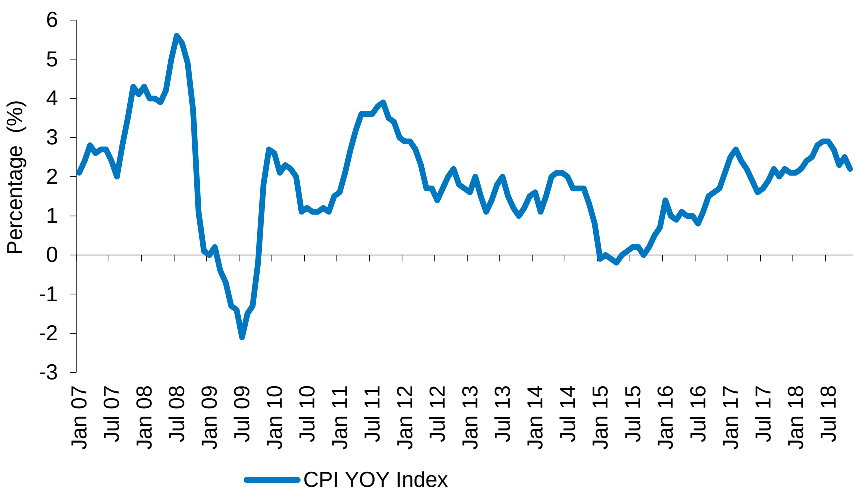
Third quarter U.S. gross domestic product (GDP) was revised 0.1% lower to an 3.4% annualized growth rate. Consumer spending, the largest component of GDP, grew by 3.5%, revised down from 3.6% in the prior estimate. Exports declined and imports increased versus the prior estimate, reducing GDP, while inventories increased, adding 2.3 percentage points to GDP. After-tax corporate profits were revised higher to 3.5% growth from 3.3% in the prior estimate and business investment matched the prior estimate at 2.5% growth. Consensus for fourth quarter growth is 2.9%.

Gross Domestic Product (GDP)



Source: Bureau of Economic Analysis

Consumer Price Index (YoY)

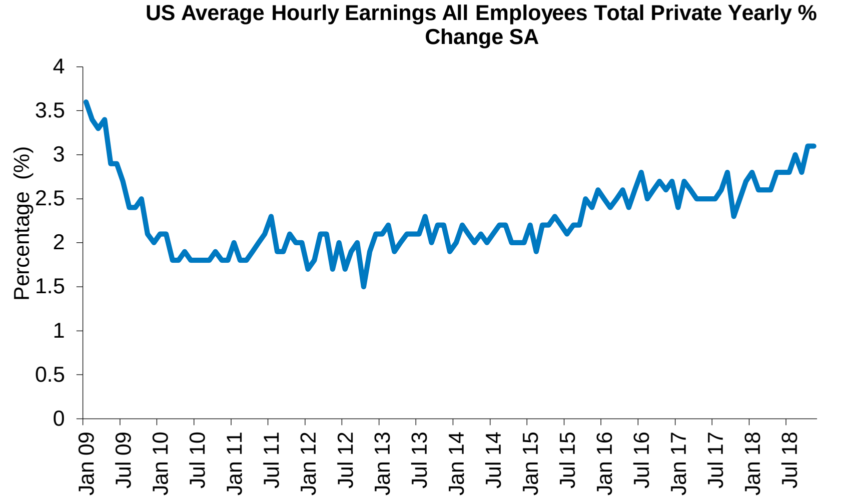


Source: Bureau of Labor Statistics

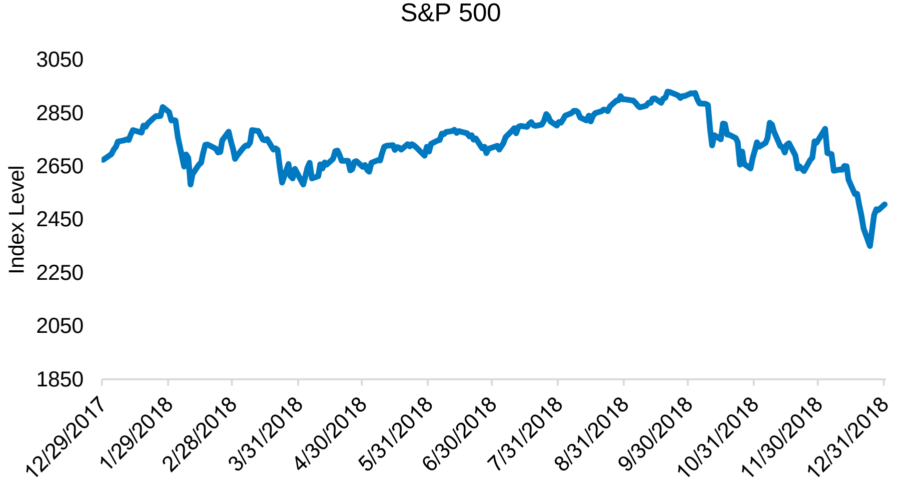
The Consumer Price Index (CPI) was unchanged for November, in line with consensus estimates. CPI rose 2.2% for the trailing year, declining from 2.5% in October and below the 2.9% recent peak in July. Core CPI, which excludes the impact of energy and food, rose by 0.2% for the month and 2.2% for the trailing year, 0.1% higher than last month. Core PCE, the Fed's preferred inflation gauge, rose 1.8%. This was a 0.1% decline from last month and below the Fed's 2% target.

Economic update (continued)

November non-farm payrolls increased by 155,000, below market expectations for 190,000 new jobs. The average monthly jobs gain for the first 11 months has been 206,000, above last year's 182,000. Average hourly earning data showed wages rose 3.1% for the trailing year, matching last month for the largest increase since 2009. The unemployment rate in the U.S. remained at 3.7%, the lowest unemployment rate since 1969 and labor participation rate was unchanged at 62.9%. The underemployment rate rose from 7.4% to 7.6%.



Source: Bureau of Labor Statistics



Source: S&P

The U.S. stock market experienced its first bear market (a decline of more than 20% from its peak) in a decade before stocks showed some recovery into year end. During December, the S&P 500 had its worst month since 2009, declining over 8%. This contributed to a 14% decline for the fourth quarter. For the year, the S&P declined 6%, its worst year since 2008 when the S&P fell 38%.

Economic and market perspective

- The decline in U.S. stocks reflected fading risk sentiment broadly. While magnified by fundamental factors, oil captured the same trend, falling to $45 a barrel from $51 at the end of November and $73 at the start of the quarter. Declining energy prices, which impacted November's inflation readings, are likely to continue impacting headline inflation in the coming months.
- The arrest of Huawei Technologies Co. Chief Financial Officer Meng Wanzhou contributed to market fears in the month. Huawei is a significant Chinese company and the arrest raised concerns that trade relations between the U.S. and China were worsening rather than improving after the temporary arrangement reached at the G20 in late November. Against the backdrop of trade tensions, economic data in China continued to weaken. Chinese retail sales in November grew at the slowest pace since 2003 and failed to meet expectations. The Chinese government has indicated it will increase 'countercyclical' measures, including fiscal and monetary policy to support their economy.
- Adding to tensions, the U.S. government partially shut down on December 23 as Congress and President Trump did not agree on terms to pass the next budget. The House (under Republican control at the time) passed a budget in line with the President's request for funds to build a border wall; however, Senate Democrats have indicated they would not support this version of the budget. Though the shutdown is only partial and already the third government shutdown of 2018, given the entrenched positions on funding for the border wall, there is concern this shutdown could last longer than previous ones.
- As expected, at its early December meeting, the European Central Bank (ECB) announced it would officially end its purchase of new assets at the end of December 2018. The ECB will continue to reinvest the principal of maturing assets, which will maintain its roughly €4.7 trillion in assets, at least until it begins raising interest rates. The ECB balance sheet is equivalent to approximately 40% of Eurozone GDP, approximately double the Fed's balance sheet size relative to the U.S. economy. At the same time as ending active buying, Draghi indicated that while risk were roughly balanced, "the balance of risk is moving to the downside owing to the persistence of uncertainties related to geopolitical factors, the threat of protectionism, vulnerabilities in emerging markets and financial market volatility." Political uncertainty has increased in Europe with the 'yellow vests movement' and riots in France and the lack of progress on Brexit.

Outlook and conclusions

- The Federal Open Market Committee met on December 18-19th and announced a 25 basis point increase in the Fed Funds Rate, in line with expectations. The rate hike was the fourth hike of the year and ninth of the current cycle. The new range for the Fed Funds Rate to a range is 2.25% - 2.50%. The Fed referred to strong economic fundamentals, lowered inflation expectations for the upcoming year, but decreased their expectation of rate hikes in 2019 to two from three. The Fed's 'dot plot', which shares the anonymous expectations of individual Fed members, revealed a lower median level for long term neutral rates at 2.8% versus 3.0% in the last dot plot. However, Chairman Powell seemed to downplay the chances of slowing or altering the pace of the wind-down of the balance sheet and did affirm that additional rate hikes could be warranted. Despite the adjustments, the market was expecting more dovish language than the Fed delivered.

- Subsequent to the meeting, rumors emerged that President Trump intended to fire Chairman Powell. The president has frequently criticized the Fed Chair, who he had nominated just over a year ago. The rumor and recent market volatility prompted Treasury Secretary Mnuchin to call the heads of the six largest U.S. banks to assess the state of the financial system. Mnuchin also denied President Trump would fire the Fed Chairman, including questioning his legal ability to do so.

- In our view, the fading of risk sentiment was already disproportionate to economic fundamentals coming into December before market fear accelerated in the month. U.S. economic data has remained robust though consensus expectations are for slowing, but positive growth. Factors that in a vacuum might have been interpreted more neutrally, such as the Fed's language surrounding the rate hike, have been viewed more negatively given the number of factors causing market concerns. With an already shaky equity market, trade tensions, political concerns overseas, deteriorating international growth, and a partial U.S. government shutdown, each marginal factors has increasingly impacted investor behavior. Recent market volatility and positive fixed income returns during the month demonstrate the defensiveness of the fixed income, while widening spreads have enhanced total return opportunities within the asset class. As markets sort through numerous geopolitical, monetary policy and fundamental economic developments, the likelihood of additional volatility remains elevated and further deterioration of risk sentiment is possible before markets calm. Nonetheless, the opportunity set in non-governmental fixed income is robust and overall yields for broad U.S. fixed income at 3.3% are at the highest levels to begin a year in almost a decade.

Fixed income returns as of December 31, 2018

Index Returns as of December 31, 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	1.84	1.64	0.01	-0.33	-1.02	-1.01
U.S. Treasury	2.15	2.57	0.86	-	-	-
Intermediate	1.50	2.24	1.41	-	-	-
Long	5.47	4.19	-1.84	-	-	-
TIPS	0.55	-0.42	-1.26	-	-	-
Agencies	1.42	1.90	1.34	-0.07	-0.16	-0.06
U.S. MBS	1.81	2.08	0.99	-0.15	-0.53	-0.59
U.S. Credit	1.50	0.01	-2.11	-0.95	-2.85	-2.80
Intermediate	1.10	0.75	0.01	-0.49	-1.57	-1.30
Long	2.45	-1.64	-6.76	-2.00	-5.78	-6.06
Industrial	1.50	-0.46	-2.81	-1.19	-3.50	-3.34
Utility	2.34	0.20	-3.75	-0.98	-3.25	-3.94
Financial	1.22	0.27	-1.68	-0.83	-2.33	-2.62
Non-Corporate	1.67	1.02	-0.08	-0.38	-1.52	-1.01
Aaa	1.58	1.86	0.90	-0.14	-0.37	-0.21
Aa	1.86	1.30	-0.25	-0.41	-1.35	-1.04
A	1.67	0.35	-2.35	-0.86	-2.58	-3.01
Baa	1.28	-0.90	-2.92	-1.29	-3.88	-3.52
High Yield	-2.14	-4.53	-2.08	-3.66	-6.75	-3.58
Floating Rate Notes	-0.24	-0.35	1.63	-0.57	-1.05	-0.20

Source: Bloomberg Barclays

Disclosures

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

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