Fixed income market update

February 2019

BMO Fixed Income

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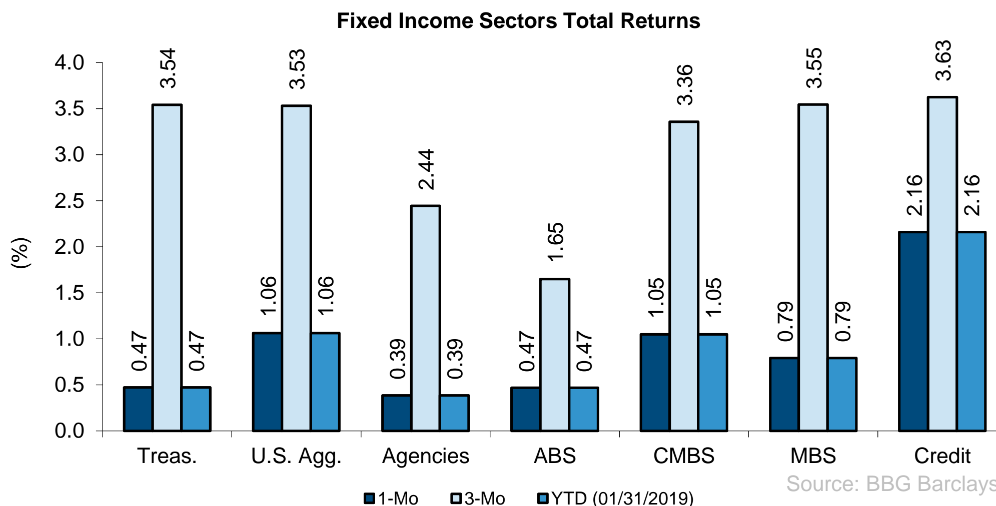
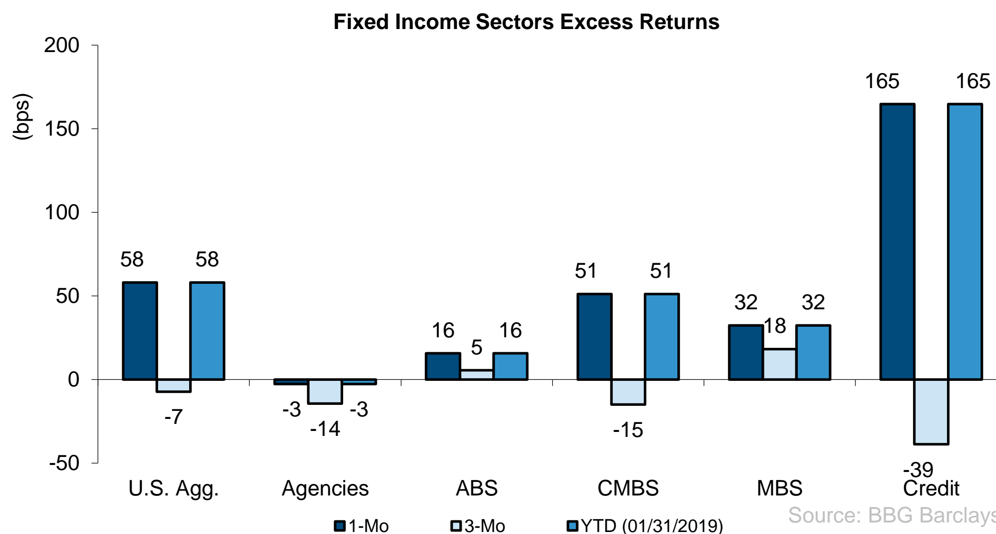
BMO Global Asset Management

Fixed income market update

- For the month ended January 31, 2019, the Bloomberg Barclays U.S. Aggregate Bond Index returned 1.06%.
- U.S. Treasuries returned 0.47% during the month as the yield on the 10-year U.S. Treasury declined to 2.63% at the end of January from 2.68% at the end of December. For the month, long Treasuries (+0.67%) outperformed intermediate Treasuries (+0.43%.)
- Mortgage-backed securities (MBS) returned 0.79% during the month outperforming Treasuries by 32 basis points on a duration-adjusted basis. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index tightened 3 basis point during the month, ending the period at 32 basis points.



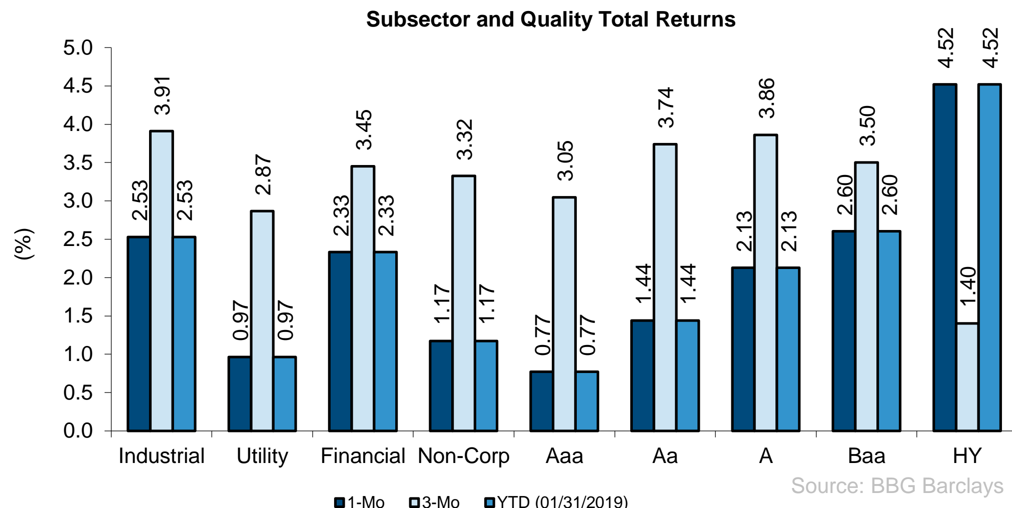


Fixed income market update (continued)

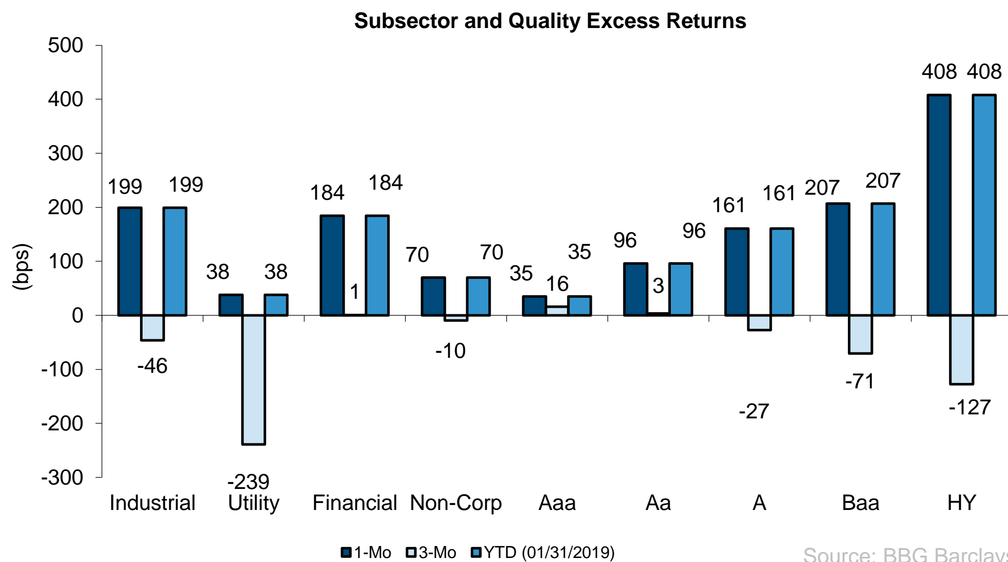
- Credit securities returned 2.16% for the month, outperforming Treasuries by 165 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 121 bps, 22 basis points tighter than at the end of December. For the month, long credit (+3.46%) outperformed intermediate credit (+1.60%) by 165 basis points on a duration-adjusted basis.

- For the month, on a duration-adjusted basis, industrials delivered 199 basis points of excess returns, outperforming financials, non-corporates and utilities by 15, 129 and 161 basis points, respectively.

- BBB rated securities delivered 207 basis points of excess return for the month, outperforming AAA, AA and A rated securities by 172, 111 and 46 basis points of excess return, respectively. High yield delivered 408 basis points of excess return for the month.



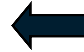
	Industrial	Utility	Financial	Non-Corp	Aaa	Aa	A	Baa	HY
1-Mo	2.53	0.97	2.33	1.17	0.77	1.44	2.13	2.60	4.52
3-Mo	3.91	2.87	3.45	3.32	3.05	3.74	3.86	3.50	1.40
YTD (01/31/2019)	2.53	0.97	2.33	1.17	0.77	1.44	2.13	2.60	4.52

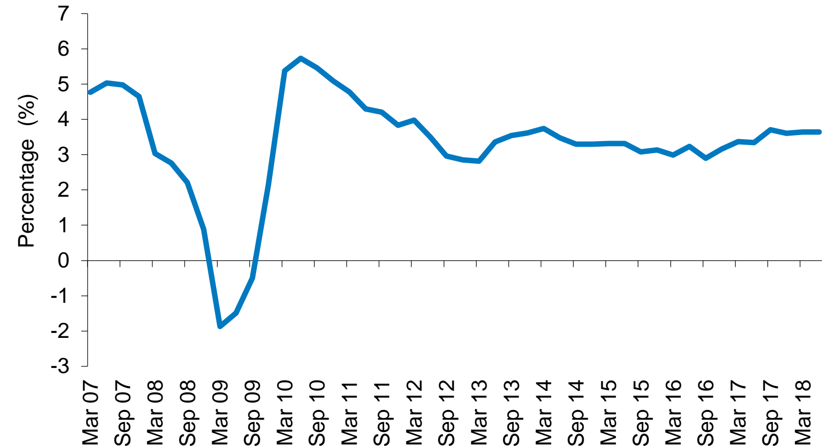


	Industrial	Utility	Financial	Non-Corp	Aaa	Aa	A	Baa	HY
1-Mo	199	38	184	70	35	96	161	207	408
3-Mo	-46	-239	1	-10	16	3	-27	-71	-127
YTD (01/31/2019)	199	38	184	70	35	96	161	207	408

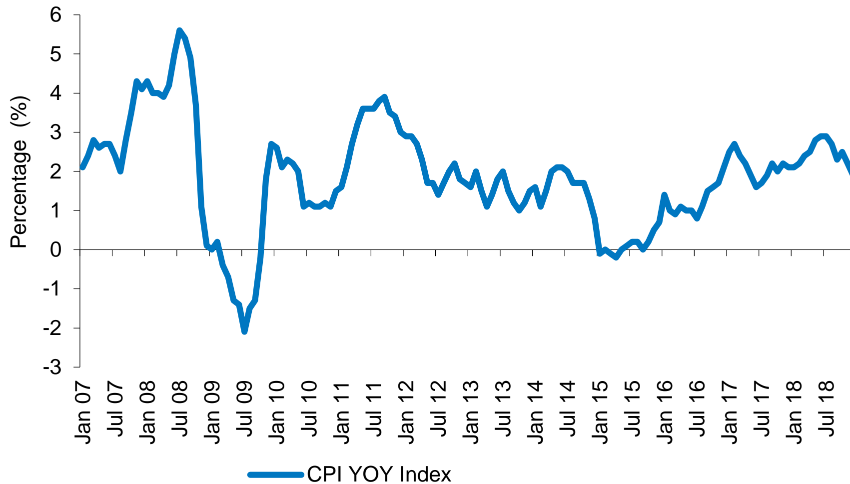
Economic update

The government shutdown has delayed the release of the first estimate of fourth quarter GDP. The International Monetary Fund (IMF) reduced their forecast for global GDP in 2019 to 3.5%. As of October, the projection had been for 3.7% growth, itself a reduction from the 3.9% expectation in July. Of note, growth projections for Europe and emerging markets were reduced, while the U.S. projection was unchanged at 2.5% in 2019. For 2020, the IMF projects U.S. growth of 1.8%.





Source: Internation Montery Fund

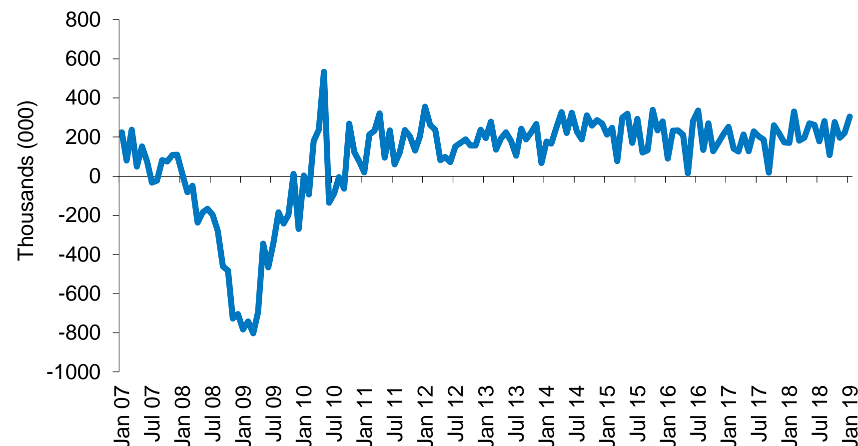


Source: Bureau of Labor Statistics

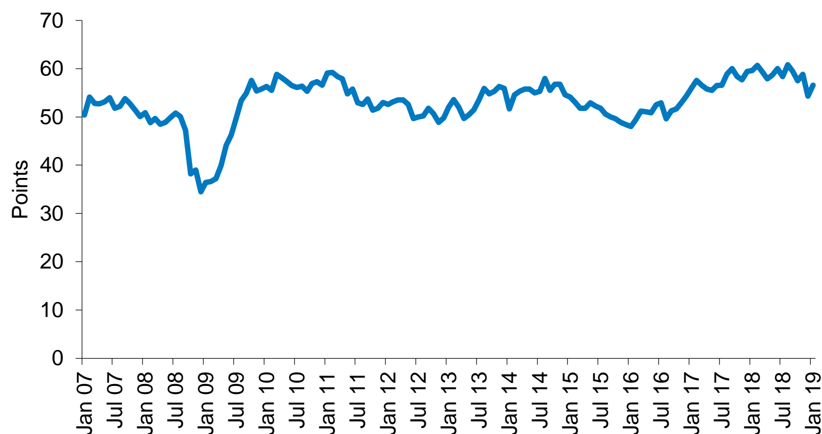
The Consumer Price Index (CPI) fell for the first time since March with a 0.1% decline in December. CPI rose 1.9% for the trailing year, declining from 2.2% in November and 2.5% in October. Core CPI, which excludes the impact of energy and food, rose by 0.2% for the month and 2.2% for the trailing year, the same as last month. Core PCE, the Fed's preferred inflation gauge, rose 1.9%. This was a 0.1% increase from last month and modestly below the Fed's 2% target.

Economic update (continued)

On February 1, non-farm payrolls were announced at 304,000 jobs created in January versus a 165,000 expectation, the second consecutive strong report (December was originally +312,000 prior to downward revisions.) Average hourly earning data showed wages also rose 3.2% for the trailing year, unchanged from December and matching October for the largest increase since 2009. The unemployment rate in the U.S. rose 0.1% to 4.0%; the labor participation rate was unchanged in January after rising 0.2% to 63.1% in December. The underemployment rate rose 0.5% to 8.1%.



Source: Bureau of Labor Statistics



Source: Institute for Supply Management

In the beginning of January, the ISM manufacturing Index declined to 54.3 (on a scale of 100, with anything above 50 signifying economic expansion) from 58.8 in November. While the overall figure suggests reasonable growth, the magnitude of decline was worrying to markets in tandem with perceptions of slowing growth. On February 1, ISM data was released showing a rebound in levels to 56.6

Economic and market perspective

- The partial U.S. government shutdown that began in December was finally resolved on a temporary basis in January after 35 days. It was the longest government shutdown in U.S. history, during which approximately 320,000 Federal workers were furloughed. This impact is expected to be felt in U.S. first quarter GDP by as much as 0.4% according to the Congressional Budget Office. The short-term fix provides funding through February 15, but did not address the major issues dividing President Trump and the Democratic held Congress, setting up the potential for a repeat.
- U.S. consumer confidence declined to 120.2 from 126.6 in December, a greater than expected decline, according to the Conference Board. This figure is the lowest in a year and a half, though recent figures have been at 18 year highs. Also in the report, the percentage of people expecting business conditions to soften was at the highest level since 2013, following the last major government shutdown. In terms of labor market expectations, the difference between participants saying jobs were plentiful as opposed to difficult to find remained near the highest levels in 18 years.
- Brexit drama continued with a resounding (but expected) defeat of Theresa May's Brexit plan in British parliament. The set timeline for Brexit is growing short absent a postponement, but parliament voted to force the prime minister to renegotiate the Brexit deal with the E.U. Renegotiation of the deal was quickly rejected by the E.U.
- For December, Chinese Producer Price Index (PPI) rose 0.9% for the trailing year versus the expectation of 1.6%. This was the latest in a series of disappointing economic data points coming from China, which has raised concerns about the impact to the global economy. Trade tensions with the U.S. persist, leading to another round of high level trade talks. Chinese President Xi Jinping indicated he would like to resolve the dispute by March 1. Criminal accusations against Huawei Technologies added to tensions in the month. In response to the continued trade tensions and softening data, the People's Bank of China cut reserve ratios by 1%, with speculation that more easing may be needed.
- Only a month after the European Central Bank (ECB) announced it would officially end its purchase of new assets in December 2018, ECB President Mario Draghi said that all policy tools would be available to support the European economy, including reinitiating a bond buying program. His comments reflected concerns around trade tensions, Brexit and slowing growth in Europe. For example, German industrial output fell 4.7% in November for the past year, the worst result since 2009 and European core CPI remained at 1%.

Outlook and conclusions

- After the Fed's comments in December around the rate hike were poorly received, Fed Chairman Powell made more dovish comments on January 10 to the Economic Club of Washington. These comments included restating the patience and data-dependency of the Fed and importantly more flexibility regarding the unwinding of the Fed's balance sheet. Perceptions around inflexibility of the Fed regarding the balance sheet unwind were blamed for the market's reaction after the prior Fed meeting.
- The Federal Open Market Committee met on January 29-30th and, as expected, announced no change in the Fed Funds Rate range of 2.25% - 2.50%. The Fed removed language referring to "further gradual increases" suggesting a slower approach to normalization and reinforced by their statement that "in light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes." The Fed also indicated they expect to maintain "an ample supply" of bank reserves, suggesting a higher terminal value for the balance sheet. As of January 31, Fed Fund Futures project a 0% probability of any rate hikes in 2019.
- In our view, the return of market liquidity at the outset of the year and the market realization of the overreaction in December were more impactful than recent economic and geopolitical events. On balance, economic data weakened during the month, prior to the strong data at the outset of February, though at least in the U.S. the data was coming off of a strong base such that current figures are still robust. Outside the U.S. the data is weaker; in both the U.S. and internationally, geopolitical and fiscal policy concerns remain. These concerns are likely to persist and with them volatility. On balance though, the recovery of risk assets leaves markets more fairly valued than a month ago, but we believe there is still room for markets to recover further. Broad bond yields remained above 3.1%, reflecting both modestly lower interest rates and tighter corporate and mortgage spreads. The opportunity set in non-governmental fixed income remains robust and overall yields for broad U.S. fixed income remain attractive.

Fixed income returns as of January 31, 2019

Index Returns as of January 31, 2019				
	Total Return (%)		Excess Return (%)	
	Month-to-Date	Year-to- Date	Month-to-Date	Year-to- Date
U.S. Aggregate	1.06	1.06	0.58	0.58
U.S. Treasury	0.47	0.47	-	-
Intermediate	0.43	0.43	-	-
Long	0.67	0.67	-	-
TIPS	1.35	1.35	-	-
Agencies	0.39	0.39	-0.03	-0.03
U.S. MBS	0.79	0.79	0.32	0.32
U.S. Credit	2.16	2.16	1.65	1.65
Intermediate	1.60	1.60	1.14	1.14
Long	3.46	3.46	2.79	2.79
Industrial	2.53	2.53	1.99	1.99
Utility	0.97	0.97	0.38	0.38
Financial	2.33	2.33	1.84	1.84
Non-Corporate	1.17	1.17	0.70	0.70
Aaa	0.77	0.77	0.35	0.35
Aa	1.44	1.44	0.96	0.96
A	2.13	2.13	1.61	1.61
Baa	2.60	2.60	2.07	2.07
High Yield	4.52	4.52	4.08	4.08
Floating Rate Notes	0.82	0.82	0.67	0.67

Source: Bloomberg Barclays

Disclosures

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

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