Fixed income market update

April 2019

BMO Fixed Income

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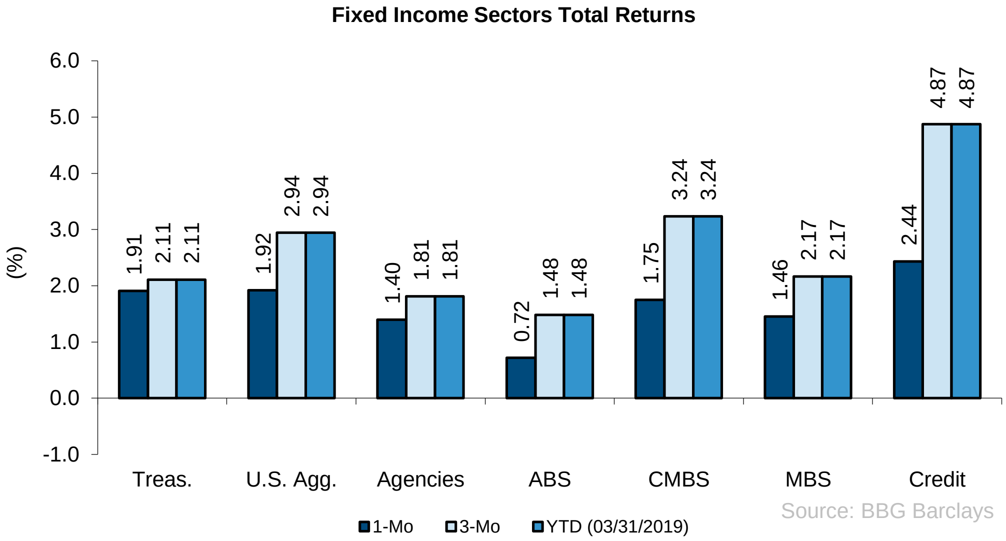
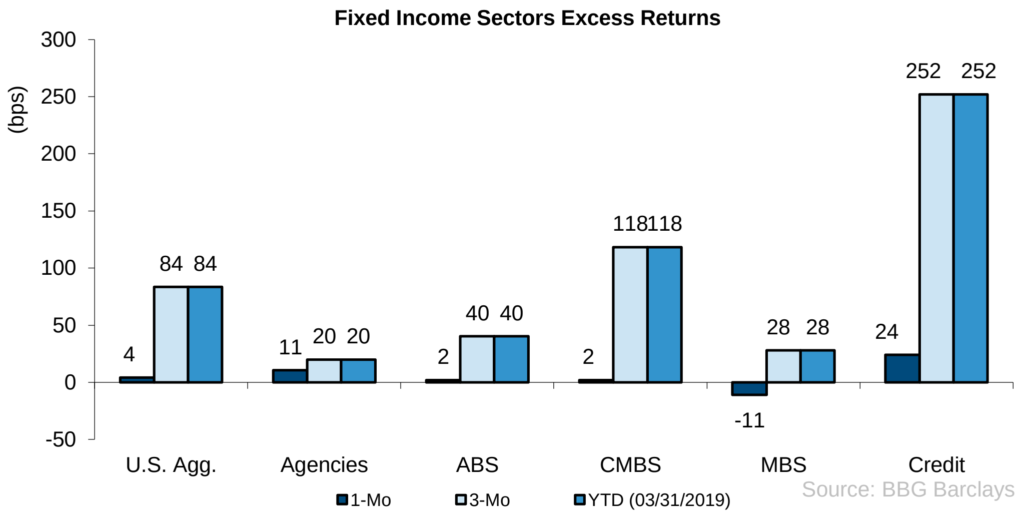
Fixed income market update

- For the quarter ended March 31, 2019, the Bloomberg Barclays U.S. Aggregate Bond Index returned 2.94%.

- U.S. Treasuries returned 2.11% during the quarter as the yield on the 10-year U.S. Treasury declined to 2.41% at the end of March from 2.68% at the end of December. For the quarter, long Treasuries (+4.67%) outperformed intermediate Treasuries (+1.59%.)

- Mortgage-backed securities (MBS) returned 2.17% during the quarter outperforming Treasuries by 28 basis points on a duration-adjusted basis. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index was unchanged during the quarter, ending the period at 35 basis points.



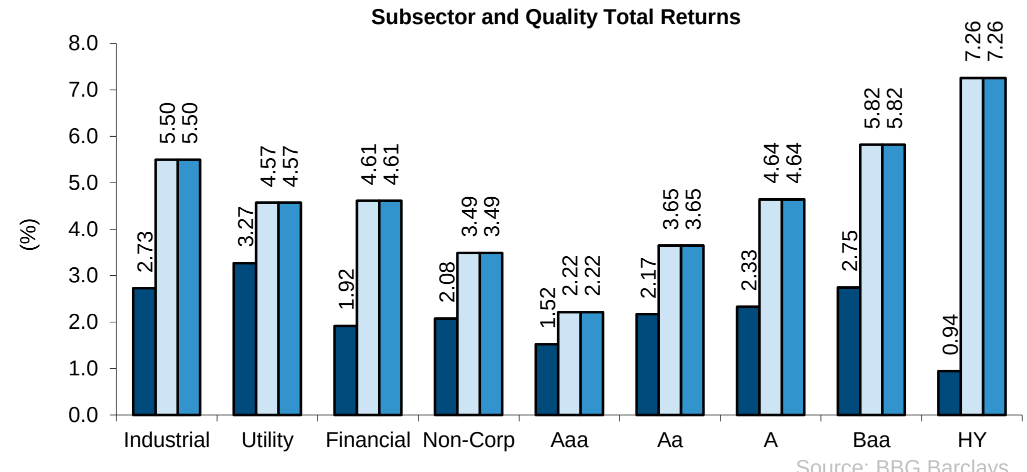


Fixed income market update (continued)

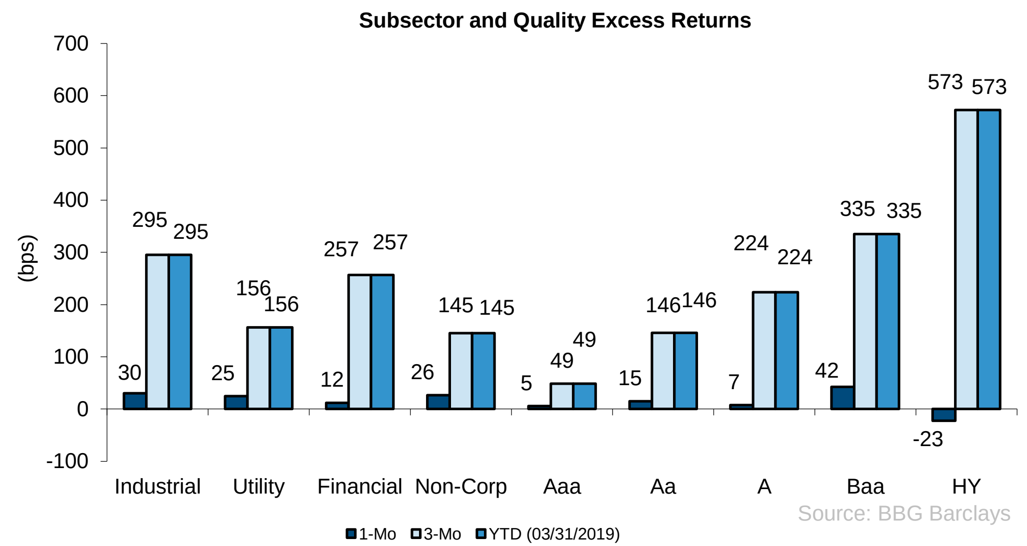
- Credit securities returned 4.87% for the quarter, outperforming Treasuries by 252 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 113 bps, 30 basis points tighter than at the end of December. For the quarter, long credit (+7.86%) outperformed intermediate credit (+3.55%) by 217 basis points on a duration-adjusted basis.

- For the quarter, on a duration-adjusted basis, industrials delivered 295 basis points of excess returns, outperforming financials, utilities and non-corporates by 38, 139 and 150 basis points, respectively.

- BBB rated securities delivered 335 basis points of excess return for the quarter, outperforming AAA, AA and A rated securities by 286, 189 and 111 basis points of excess return, respectively. High yield delivered 573 basis points of excess return for the quarter.



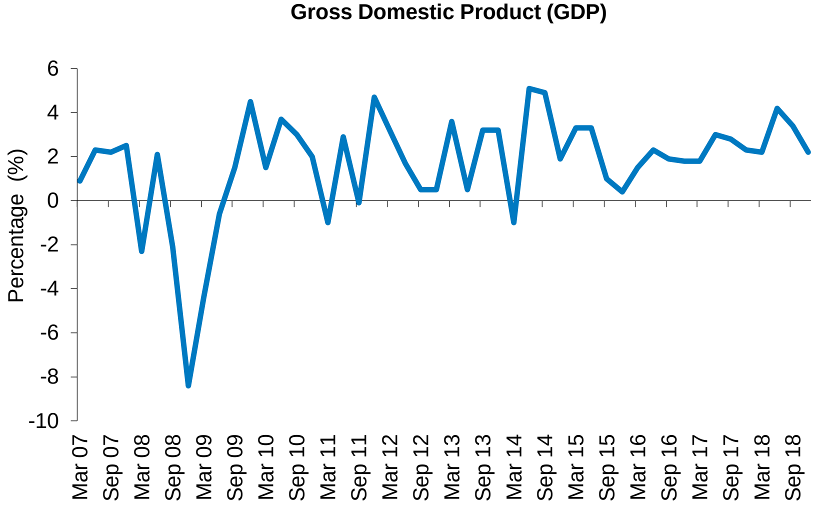
Source: BBG Barclays



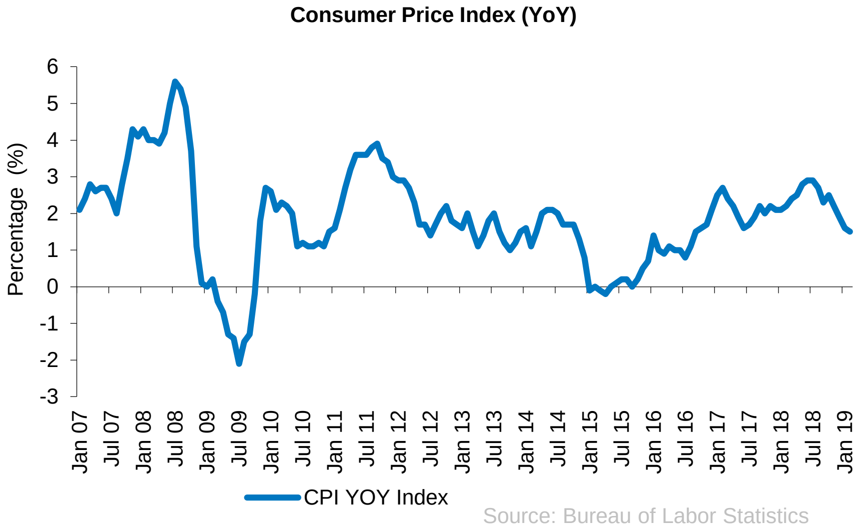
Source: BBG Barclays

Economic update

The final reading of fourth quarter GDP showed growth being revised down to 2.2%, as expected, from the prior estimate of 2.6%. The revision lowers GDP growth for the full year 2018 to just shy of a 3% increase at 2.9%. Consumer spending was revised down from 2.8% to 2.5% and business fixed investment was revised from 3.9% to 3.1%. Consensus for first quarter GDP growth is 1.5% and the estimate for the full year 2019 is 2.4%.



Source: Bureau of Economic Analysis



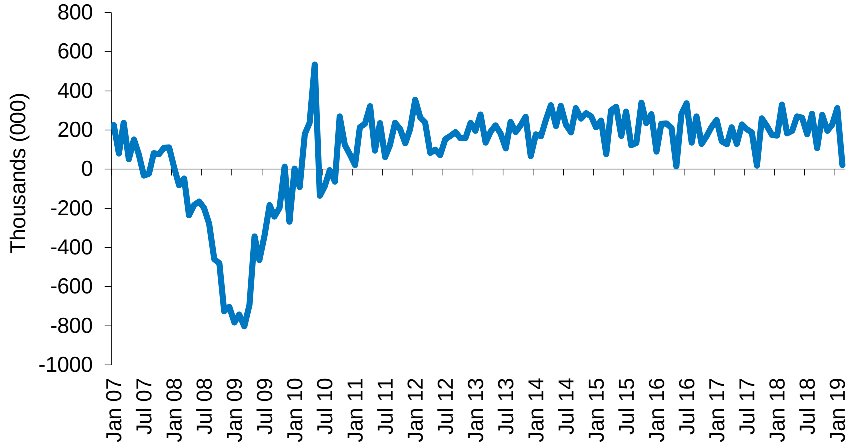
Source: Bureau of Labor Statistics

The Consumer Price Index (CPI) rose 0.2% in February after 3 months of no change. CPI rose 1.5% for the trailing year, declining from 1.6% in January; CPI had been a full point higher at 2.5% in October. Core CPI, which excludes the impact of energy and food, rose by 0.1% for the month and 2.1% for the trailing year, which was 0.1% lower than the prior month. Core PCE, the Fed's preferred inflation gauge, rose 1.8%. This was a 0.2% decrease from last month's figure which had been revised higher to 2%, the Fed's target.

Economic update (continued)

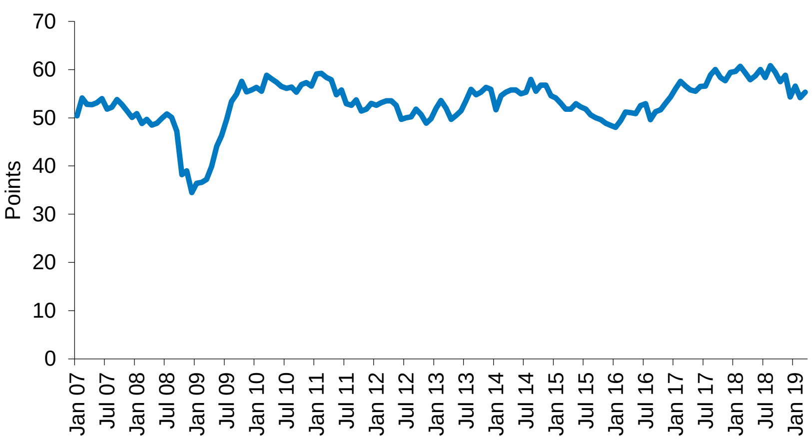
February non-farm payrolls increased by only 20,000 jobs, significantly below market expectations for 180,000 new jobs. Average hourly earning data showed wages rose above expectations at 3.4% for the trailing year, the fastest pace in the past decade. The unemployment rate in the U.S. declined 0.2% to 3.8% as the labor participation rate remained unchanged at 63.2%. The underemployment rate declined sharply to 7.3% from 8.1% in January.

Nonfarm Payrolls MOM (net)



Source: Bureau of Labor Statistics

ISM Manufacturing PMI



Source: Institute for Supply Management

ISM U.S. manufacturing PMI (Purchasing Managers Index) declined to 54.2 in February (on a scale of 100, with anything above 50 signifying economic expansion) from 56.6 in January. While the figures have declined from 2018 levels in the high 50s and low 60s, ISM levels still project for strong economic growth. On April 1, ISM manufacturing PMI for March was reported; ISM rose to 55.3, exceeding the expectation of 54.5.

Economic and market perspective

- The German manufacturing Purchasing Managers' Index (PMI) fell to 44.7, the third consecutive month below the 50 level, which divides growth from contraction. The overall PMI level fell to 51.5, above the 50 line, but the lowest level since June 2013. These figures triggered concerns of broadly slowing European economic growth.
- China lowered its growth target for 2019 to 6.0 - 6.5% after 2018 growth slowed to 6.6%, the lowest level of growth in 28 years. Chinese industrial output rose 5.3% for the January-February period (combined due to the New Year holiday), below expectations, and the slowest pace of increase since 2002. At the same time, unemployment rose from 4.9% to 5.3%. Subsequent to month end, Chinese manufacturing PMI rose to 50.5 for March from February's 49.2, breaking a 3 month streak of levels below 50. Negotiations between the United States and China on trade continue with trade representatives meeting in China the last week of March and in Washington the first week of April. China is looking for all tariffs to be lifted, U.S. officials have suggested some tariffs could remain in place; U.S. officials also indicated that progress had been made on the issue of intellectual property.
- The plans for Brexit remain unresolved as the already extended April 12 deadline rapidly approaches. British parliament voted on 8 non-binding proposals to gauge support for different solutions to Brexit, with none receiving a majority of support. Prime Minister May has suggested she could resign as an inducement for her plan passing, but to date this has been insufficient. The European Union has offered an extension of the deadline to exit until May 22 if a withdrawal agreement is ratified, but not beyond due to EU elections. Additional votes are scheduled in British Parliament and the situation is fluid.
- The European Central Bank (ECB) lowered its growth projections for the Euro area to 1.1% for the year from 1.7% in December. The ECB indicated earlier in March that it would delay its previous plans to begin raising rates after the summer based on weak data. In late March, Mario Draghi, ECB President, suggested that rates will "remain at their present levels at least through the end of 2019."

Outlook and conclusions

- The Federal Open Market Committee met on March 19-20th and surprised markets with their commentary following the meeting. While keeping the Fed Funds Rate in a range is 2.25% - 2.50% as expected, the Fed downgraded its expectations of additional rate hikes in 2019 from 2 to 0. Markets had been expecting the Fed to lower the projection from 2 to 1, affirming a more dovish outlook, but leaving the Fed room for flexibility. Similarly, the market had expected the Fed to announce an end to the balance sheet wind-down, but the Fed surprised by announcing the end would be in September not at the end of the year. This shift also implies a larger terminal balance of approximately $3.5 trillion for the balance sheet; the current balance sheet holdings are approximately $3.75 trillion. As expected, the Fed downgraded their view of economic growth to 2.1% from 2.3% and inflation to 1.8% from 1.9%. As of the end of March, Fed Funds futures project no chance of a rate hike and a 70% chance of one or more rate cuts by the end of the year.

- In our view, the Fed has a curious definition of “patience”. After suggesting and restating “patience” on policy, the Fed surprised markets with the impetuousness of their dovish shift. From our view, the Fed’s reaction was more change than was anticipated or needed and thus injected unnecessary uncertainty into markets. Recent economic data has become weaker than last year, however, this was largely anticipated and at least in the U.S. is yet to be a cause for significant concern; certainly credit and equity markets are not showing significant concerns and some data such as wage growth continues to strengthen. Internationally, however, the data is (and has been) more concerning. The ongoing Brexit saga, continuing trade negotiations and slowing global growth have again highlighted the United States as the relative “safe haven”. The combination of these factors and their impacts to global rates has had an impact on U.S. markets, bringing the 10 year Treasury to its lowest levels in over a year. At the same time, with non-governmental sectors rebounding from fourth quarter volatility and performing well to start the year, the effect has been stronger returns for U.S. fixed income in the first quarter of 2019 than most had anticipated.

Fixed income returns as of March 31, 2019

	Month-to-Date	Quarter-to- Date	Year-to- Date	Month-to-Date	Quarter-to- Date	Year-to- Date
U.S. Aggregate	1.92	2.94	2.94	0.04	0.84	0.84
U.S. Treasury	1.91	2.11	2.11	-	-	-
Intermediate	1.23	1.59	1.59	-	-	-
Long	5.26	4.67	4.67	-	-	-
TIPS	1.84	3.19	3.19	-	-	-
Agencies	1.40	1.81	1.81	0.11	0.20	0.20
U.S. MBS	1.46	2.17	2.17	-0.11	0.28	0.28
U.S. Credit	2.44	4.87	4.87	0.24	2.52	2.52
Intermediate	1.57	3.55	3.55	0.23	1.87	1.87
Long	4.33	7.86	7.86	0.26	4.04	4.04
Industrial	2.73	5.50	5.50	0.30	2.95	2.95
Utility	3.27	4.57	4.57	0.25	1.56	1.56
Financial	1.92	4.61	4.61	0.12	2.57	2.57
Non-Corporate	2.08	3.49	3.49	0.26	1.45	1.45
Aaa	1.52	2.22	2.22	0.05	0.49	0.49
Aa	2.17	3.65	3.65	0.15	1.46	1.46
A	2.33	4.64	4.64	0.07	2.24	2.24
Baa	2.75	5.82	5.82	0.42	3.35	3.35
High Yield	0.94	7.26	7.26	-0.23	5.73	5.73
Floating Rate Notes	0.37	1.62	1.62	0.07	1.01	1.01

Source: Bloomberg Barclays

Disclosures

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

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