

Fixed income market update

May 2019

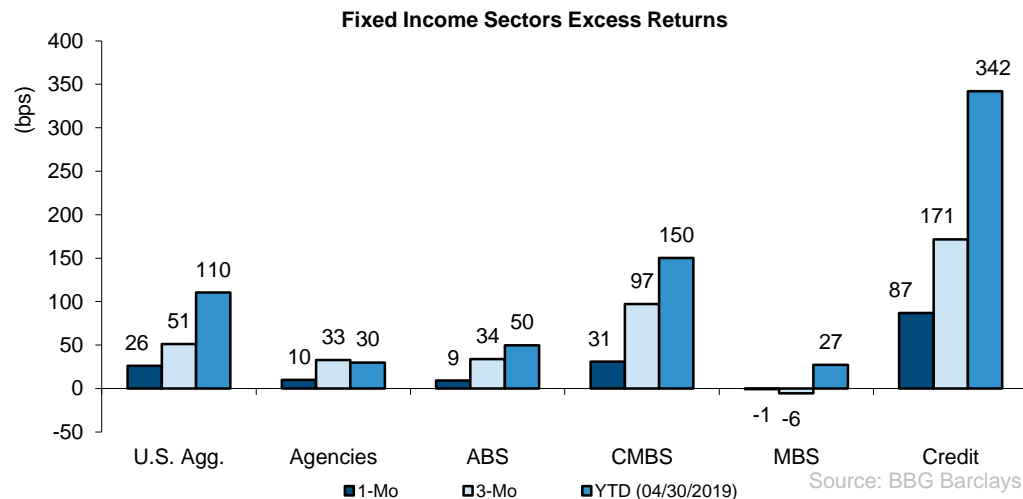
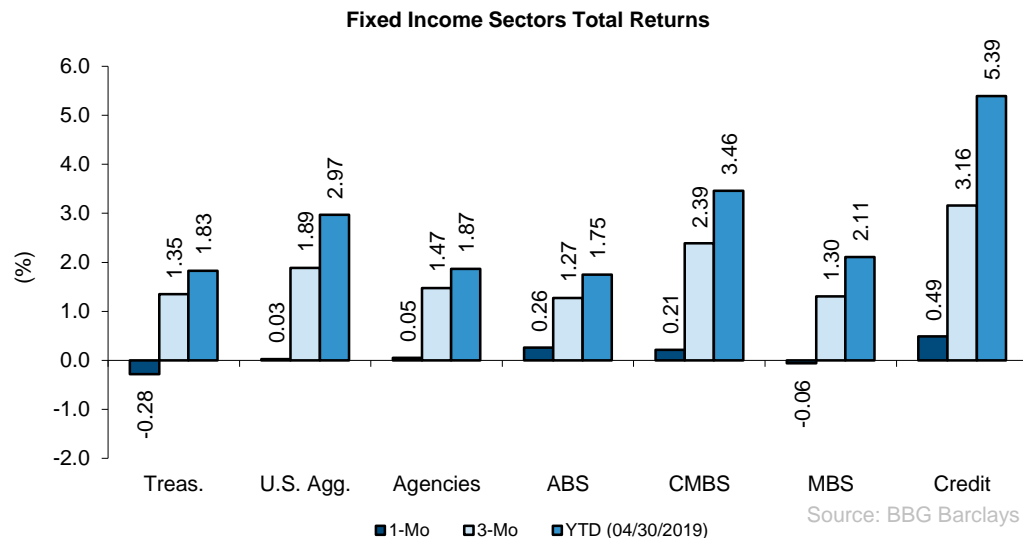
BMO Fixed Income

**1001 Brickell Bay Dr.
Suite 2100
Miami, Florida 33131**

bmogam.com/USFixedIncome

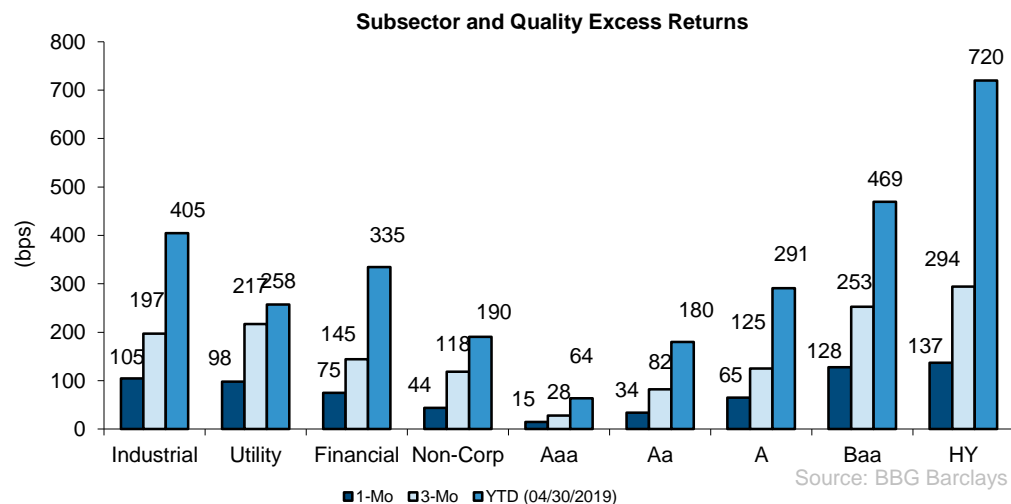
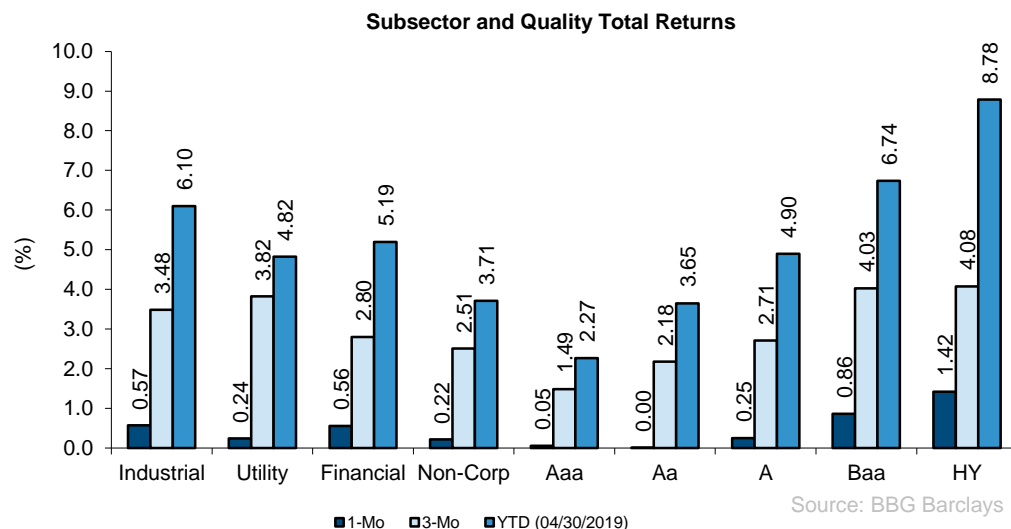
Fixed income market update

- For the month ended April 30, 2019, the Bloomberg Barclays U.S. Aggregate Bond Index returned 0.03%. Year to date, the index has returned 2.97%.
- U.S. Treasuries returned -0.28% during the month as the yield on the 10-year U.S. Treasury rose to 2.50% at the end of April from 2.41% at the end of March. For the month, intermediate Treasuries (+0.04%) outperformed long Treasuries (-1.79%).
- Mortgage-backed securities (MBS) returned -0.06% during the month underperforming Treasuries by 1 basis point on a duration-adjusted basis. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index widened 6 basis point during the month, ending the period at 41 basis points.



Fixed income market update (continued)

- Credit securities returned 0.49% for the month, outperforming Treasuries by 87 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 104 bps, 9 basis points tighter than at the end of March. For the month, long credit (0.61%) outperformed intermediate credit (0.44%) by 140 basis points on a duration-adjusted basis.
- For the month, on a duration-adjusted basis, industrials delivered 105 basis points of excess returns, outperforming utilities, financials and non-corporates by 7, 30 and 61 basis points, respectively.
- BBB rated securities delivered 128 basis points of excess return for the month, outperforming AAA, AA and A rated securities by 113, 94 and 63 basis points of excess return, respectively. High yield delivered 137 basis points of excess return for the month.

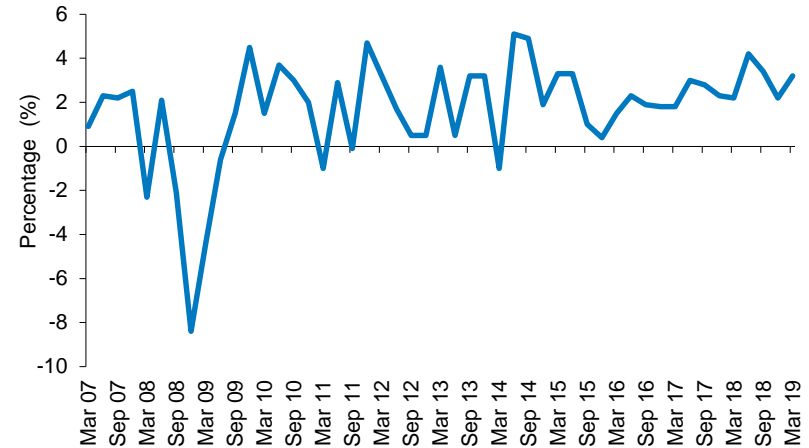


Economic update

For the first quarter, GDP grew 3.2%, well ahead of the 2.5% expectation. The reading was the best first quarter since 2015 despite concerns of negative impacts from the government shutdown. Net trade was additive (exports rose and imports declined), but inventory growth was also a significant contributor, which is viewed less favorably. Consumer spending only grew by 1.2%, though this exceeded estimates by 0.2%. Consensus for second quarter GDP growth is 2.5% and the estimate for the full year 2019 is 2.4%.



Gross Domestic Product (GDP)



Source: Bureau of Economic Analysis

Consumer Price Index (YoY)



Source: Bureau of Labor Statistics



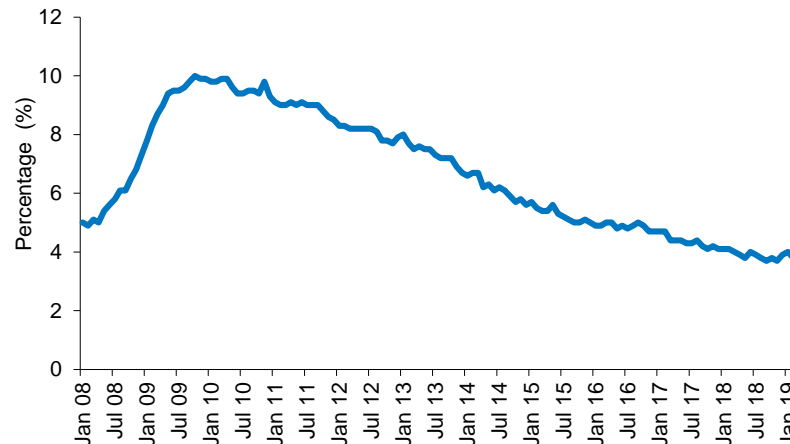
The Consumer Price Index (CPI) rose 0.4% in March, the largest monthly gain in over a year. CPI rose 1.9% for the trailing year, a rebound from the prior month's 1.5% increase, which had been the lowest in 3 years. Core CPI, which excludes the impact of energy and food, rose by 0.1% for the month and 2.0% for the trailing year. Core PCE, the Fed's preferred inflation gauge, was unchanged for the month and rose 1.6% for the trailing year, below the Fed's 2% target.

Economic update (continued)

March non-farm payrolls increased by 196,000 jobs, exceeding market expectations for 175,000 new jobs. Average hourly earning data showed wages rose 3.2% for the trailing year, below expectations and a decline from the 3.4% rate last month. The unemployment rate in the U.S. was unchanged at 3.8% as the labor participation rate declined 0.2% to 63.0%. The underemployment rate remained unchanged at 7.3%.



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



Source: Bureau of Labor Statistics

Oil (WTI CRUDE FUTURE)



Source: Bloomberg



Oil prices rose 5% in April to close above \$63 a barrel for the first time since October. Oil prices have increased almost 40% to start 2019, but still remain below June 2018's level of \$74 a barrel. During the month, the U.S. announced it would end waivers on Iran oil sanctions, which is expected to reduce available supply. At the same time, a general rebound in market sentiment and decreasing production from OPEC have supported prices moving higher.

Economic and market perspective

- The International Monetary Fund (IMF) lowered its global growth projections for 2019 to 3.3% from 3.5%, while noting it believed “the balance of risks remains skewed to the downside.” For 2020 though, the IMF projected an improvement of growth to 3.6%.
- Euro-area GDP grew more than expected in the first quarter at 0.4% and 1.2% for the trailing year. Unemployment in the Eurozone declined 0.1% to 7.7% in February. However, other data such as manufacturing PMI declined to 51.3 in April from 51.6 in March.
- Negotiations between the U.S. and China on trade have been ongoing with multiple delegations traveling between the two countries. U.S. Treasury Secretary Steven Mnuchin indicated he is looking for “substantial progress” in the next two rounds of dialogue; Mnuchin along with U.S. Trade Representative Robert Lighthizer are in Beijing the last week of April, which will be followed by Chinese Vice Premier Liu He’s visit to Washington the following week. Both sides have indicated that there has been progress on key issues such as intellectual property and forced technology transfers, but U.S. officials have expressed concern regarding enforcement mechanisms and timelines for removing tariffs.
- While negotiations with China on trade have attracted the most attention, trade issues persist between the U.S. and both the E.U. and Japan. In April, the European Union Member States authorized the European Commission to negotiate with the United States on trade matters. The directive proposes a “trade agreement strictly focused on industrial goods, excluding agricultural products”; President Trump has indicated he would like to see agricultural products included and threatened to impose tariffs on European auto manufacturers if agriculture is not included. President Trump plans to travel to Japan in May to meet Prime Minister Shinzo Abe to discuss trade among other topics.
- The deadline for Brexit was postponed until October 31, 2019 as it appeared no agreement would be reached by the already extended April deadline. The length of deferral was somewhat surprising as it allows the U.K. to remain in the European Union through May 23rd E.U. parliamentary elections, though Prime Minister May’s stated goal continues to be to exit the E.U. prior to the elections.

Outlook and conclusions

- The Federal Open Market Committee is currently meeting (April 30 – May 1) with markets pricing in effectively no chance of a rate hike or cut at this meeting. As of the end of April, Fed Funds futures project a 0% probability of a rate hike and approximately a 70% chance of a rate cut by the end of the year.
- Minutes from the March 19-20th meeting were released in April. The minutes stated that “a majority of participants expected that the evolution of the economic outlook and risks to the outlook would likely warrant leaving the target range unchanged for the remainder of the year.” However, the minutes also noted that “some participants indicated that if the economy evolved as they currently expected, with economic growth above its longer-run trend rate, they would likely judge it appropriate to raise the target range for the federal funds rate modestly later this year.”
- In our view, U.S. economic data has yet to demonstrate the magnitude of slowing that many had feared. For example, while the first quarter GDP report included some less positive data, the headline number surprised meaningfully to the upside. Similarly, unemployment and wage numbers remain strong, even if off from peak levels, and inflation remains in a reasonable range. Even European growth, at least short-term, surprised to the upside. This data, along with better than expected corporate earnings, has created a supportive landscape for non-governmental fixed income sectors. Credit markets have largely reflected this reality in the recent tightening of credit spreads, reaching spread levels last seen prior to fourth quarter volatility; in this context, the credit sector is likely fairly priced. By contrast, interest rates appear more focused on the Fed’s language regarding policy outlook than recent economic data; the result is that rates have moved somewhat higher than last month, but on balance we believe the asymmetry is to moderately higher rates.

Fixed income returns as of April 30, 2019

Index Returns as of April 30, 2019				
	Total Return (%)		Excess Return (%)	
	Month-to-Date	Year-to-Date	Month-to-Date	Year-to-Date
U.S. Aggregate	0.03	2.97	0.26	1.10
U.S. Treasury	-0.28	1.83	-	-
Intermediate	0.04	1.63	-	-
Long	-1.79	2.79	-	-
TIPS	0.33	3.54	-	-
Agencies	0.05	1.87	0.10	0.30
U.S. MBS	-0.06	2.11	-0.01	0.27
ABS	0.26	1.75	0.09	0.50
CMBS	0.21	3.46	0.31	1.50
U.S. Credit	0.49	5.39	0.87	3.42
Intermediate	0.44	4.00	0.42	2.31
Long	0.61	8.52	1.82	5.96
Industrial	0.57	6.10	1.05	4.05
Utility	0.24	4.82	0.98	2.58
Financial	0.56	5.19	0.75	3.35
Non-Corporate	0.22	3.71	0.44	1.90
Aaa	0.05	2.27	0.15	0.64
Aa	0.00	3.65	0.34	1.80
A	0.25	4.90	0.65	2.91
Baa	0.86	6.74	1.28	4.69
High Yield	1.42	8.78	1.37	7.20
Floating Rate Notes	0.44	2.07	0.24	1.26

Source: Bloomberg Barclays

Disclosures

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

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