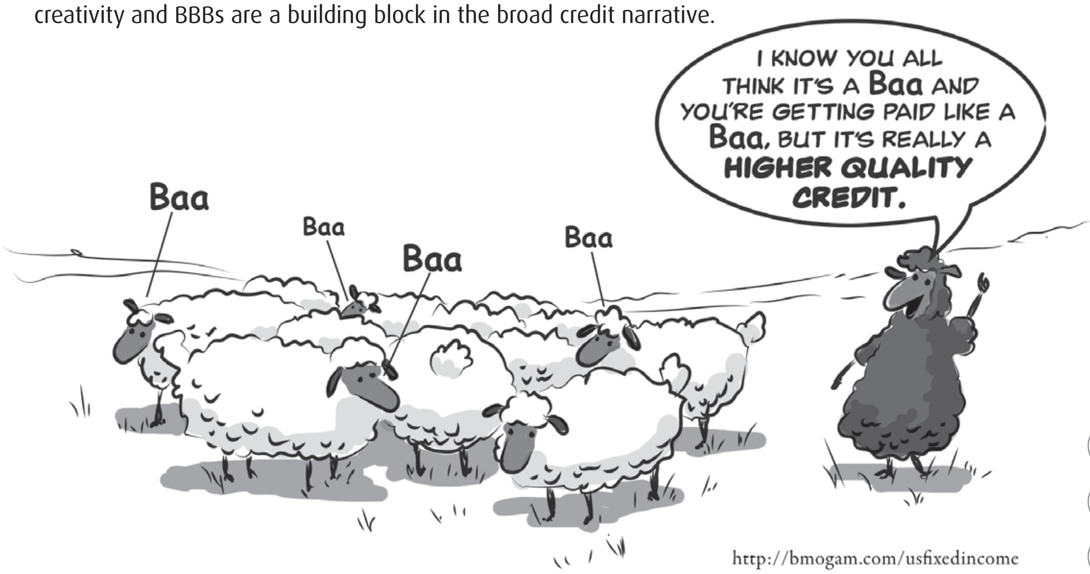
Fixed Income Insights

BBB bonds: More Fortnite or Minecraft?

From popular discussion, the increase in BBB bonds has been framed as akin to the popular video game Fortnite—effectively a battle for survival against the odds. This trend toward BBB ratings in the corporate debt universe has come into recent focus particularly as fears around the end of the current economic cycle have become more pronounced.

We do not dismiss concerns surrounding BBBs, but seek to add context to the conversation. Further, while much of the discussion has focused on one rating segment, we observe a broader trend to lower ratings in the investment grade world. While people generally equate lower ratings with declining credit fundamentals, a reasonable general proposition, we have observed that more is at play in the recent period.

From our perspective, this has been a long evolving story, not a sudden concern, and one which touches on multiple storylines rather than a solitary narrative of deteriorating credit. We view BBBs more in a Minecraft framework than Fortnite. The corporate debt space is a dynamic landscape for creativity and BBBs are a building block in the broad credit narrative.



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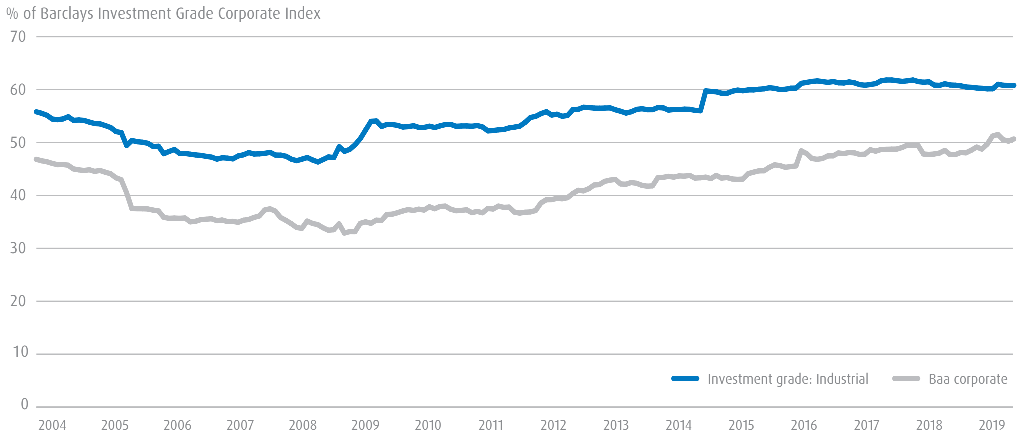
Changing skins or changing characters?

One important aspect of corporate debt evolution in the past decade has been the relative increase of industrials versus financials and utilities in the Barclays Investment Grade Corporate Index. Prior to the crisis, industrials were less than 50% of the corporate benchmark and at one point as low as 46% of the index. Today, industrials' share of the corporate market is above 60%. This increase has tightly, though not precisely, tracked the increase in BBB securities in the corporate index due to the lower average ratings of industrials versus financials.

Is quality of issuers declining or are more industrials issuing?



Source: Bloomberg Barclays

While the increase in BBBs has garnered concern, it is important to note, this has essentially been the goal of global monetary policy. Emerging from 2008, global central banks and certainly the Federal Reserve promoted lower interests with the goal of fostering real economic growth versus financial leverage. The result has been what one might expect: increased issuance from industrial issuers relative to other sectors.

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Since the inception of data for the industrials sector within the Bloomberg Barclays Investment Grade Corporate Index, average quality for the sector has only varied within a range of a single notch, from A2/A3 to A3/Baa1. The sector has had the lower A3/Baa1 83% of the time (based on monthly data), the same average rating it has today. This is not to disregard that the share of BBBs within individual corporate sectors has increased, but that the increase in BBBs for the overall corporate sector has largely been driven by the shifts between sectors.

How to build a stable bank

From 2005 to 2008, the average rating of the financial sector was Aa3/A1. Since that time, the average rating has fallen two notches to an A2/A3 rating. Though one might expect this would represent a deterioration of fundamentals and thus an increase in systemic risk given the sector, we believe the opposite to be the case.

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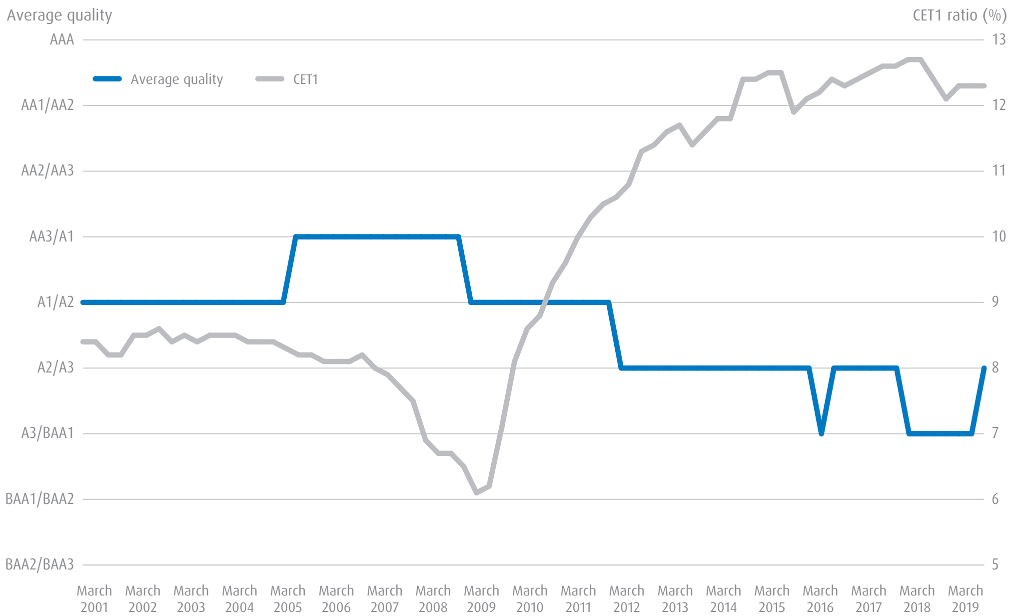
For example, an analysis of Common Equity Tier 1 (CET1), a measure of bank solvency that gauges a bank's capital strength, demonstrates the relative strength of today's financial sector balance sheets. This risk-weighted metric shows the financial sector as not only healthier than prior to 2008, but also than any point in nearly two decades. Other metrics, such as asset quality, reflect similar balance sheet health with the most recent data showing 0.5% loans and leases removed from the books and charged against loss reserves versus a historical average rate of 1%. Similarly, financial corporations have continued to grow profits to record levels post-crisis even against a backdrop of increased macroprudential regulation that has specifically targeted reducing systemic risk emanating from the sector.

Financial sector average ratings vs. capital ratios over time



Source: Bloomberg Barclays, Federal Reserve Bank of New York

Thus, it is that much of the decline in ratings is a change in the expected level of government support, particularly at the bank holding company level where debt is most often issued; we note that deposit ratings (the ratings on the group's most senior obligations) are more aligned with pre-crisis levels. Given the fundamental strength of the sector described above, we contend the optics of lower aggregate ratings should not be a primary concern. Further, the increased issuance at the individual bank level is actually constructive as it built a necessary (and required) capital base. This is to say, there is effectively a positive impact from issuance, rather than negative association (i.e. leverage) one would find in other sectors.

The combination of these factors reinforces to us that ratings alone cannot be used to judge the evolving nature of credit quality that investors encounter. A holistic assessment of credit is needed, which entails an understanding of the individual sectors as well as an appreciation for the history of the markets to grasp today's rating environment in context.

> It appears that much of the decline in ratings is structural, namely the expected level of government support, which we would contend is not the primary concern in today's environment.

The referee 'skin'

Inherent in the concern around BBB rated bonds is a belief in the impartiality of rating agencies. We make no secret of our healthy skepticism of the ratings assigned by agencies, not relying on them for the evaluation of an issuer's credit quality. While our empirical observation is that many share our wariness of the agencies in evaluating an individual bond, this position seems to shift when discussing the market writ large.

Continued

The assignment of ratings is done with an understanding that economic cycles turn and conditions can become less favorable. As S&P states in their rating methodology: "Companies viewed as having strong fundamentals (i.e., those enjoying investment-grade ratings) are unlikely to see significant rating changes because of factors deemed to be cyclical, unless the cycle is either substantially different from that expected, or the company's performance is somehow exceptional relative to that expected."

This is not to suggest a recession would not prompt downgrades—economic stress can certainly impact companies differentially and the credit quality of some companies could materially deteriorate. However, it is clear that ratings agencies did not assign half of the U.S. corporate universe a BBB rating knowing that the first downturn we experience would create an avalanche of downgrades to high yield.

BBB downgrades: A battle royale?

In our view, part of the fear surrounding a wave of downgrades is recency bias—expectations that future recessions or economic downturns would be as destructive as 2008. Given a variety of metrics we have discussed in prior pieces, including both strong consumer health and reasonable corporate health as well as our view of lower systemic risk in the financial sector, our view is that the next turn in the business cycle will lead to a recession, but not a financial crisis. While certainly not a pleasant or desirable outcome, a more normal recession would be unlikely to cause the magnitude of damage that occurred in 2008.

Given a variety of metrics we have discussed in prior pieces, including both strong consumer health and reasonable corporate health as well as our view of lower systemic risk in the financial sector, our view is that the next turn in the business cycle will lead to a recession, but not a financial crisis.

Interestingly, even in the stress period of the financial crisis, a "wave" of BBB downgrades did not occur. In 2008 and 2009, for example, approximately 5% and 6%, respectively, of BBBs were downgraded to high yield. Over time, the annual downgrade rate for BBB to below investment grade is about 4.4% per year (Moody's data for 1970-2018). Thus the 2008 and 2009 figures represent increased downgrades, but not a deluge. What was notable, however, was the lack of upgrades in those periods. By contrast to the approximately 4.5% a year of BBBs that have been upgraded historically, in 2008 and 2009 those figures were 2.3% and 1%, respectively.

In 2018, the downgrade rate for BBBs was approximately, 1.3%; this suggests that downgrades could triple from the 2018 level and rather than represent a "wave" would simply mean a return to normalcy. Ratings migration is part of the normal course of business, not reserved for economic downturns, but the recent period has been a relatively benign one for credit issuers, which has in some ways distorted expectations for investors.

Who will survive?

Default rates have been low, for example in 2018 the default rate was only 1.1% across all credit (investment grade and high yield). Thus even absent a clear catalyst, defaults are more likely to rise than fall over the coming period. Moody's projects defaults across all corporates to rise to 1.5% in 2019, slightly below the 1.6% annual average since 1983.

2008 was, unsurprisingly, the worst single year for BBB losses (defaults less recoveries on those defaults). In that year, BBB bonds experienced a 68 basis point loss versus no loss for AAA bonds; at the same time, the average additional spread (as measured by OAS) for BBB versus AAA over the past 10 years has been 121 basis points. This is to say, if one were to indiscriminately hold BBB bonds and AAA bonds at their average yields to maturity, even in the worse stress year in recent memory, BBBs would have been the right call; this does not account for market impacts during that time when BBBs significantly underperformed. However, from a structural perspective, the yields offered by the BBBs outweighed the losses even in a terrible stress situation. Other factors, such as volatility, liquidity and uncertainty are included in the BBB premium, which can become apparent when examining market value impacts during periods of stress.

Continued

Thus, we do not dismiss concerns about increasing defaults or increased potential for downgrades, but our conclusion is not to avoid 50% of the market either. Indeed, higher quality bonds are not immune from downgrade or default risk, though they typically offer less spread cushion in the event of negative outcomes. For example, A rated bonds offered 60 basis points more on average than AAA bonds over the past 10 years and experienced a 27 basis point loss in 2008.

Conclusions — More Minecraft than Fortnite

On the scale of battle for survival to building a world, we place the BBB discussion closer to the Minecraft version. The decline in corporate ratings and the increased share of the corporate universe taken up by BBBs is due to a variety of factors. In some cases, lower credit quality metrics are indeed the culprit, but not exclusively; structural shifts have been significant over time.

From a pure credit perspective, we find it interesting that amidst the concern about BBBs, there is broader acceptance of other forms of credit, including bank loans and private debt, which are generally considered riskier than BBB corporates. While part of the appeal of these sectors is that they offer higher yields than higher quality counterparts, the same can be said, to a lesser degree, of BBB bonds. From a demand side though, we acknowledge the magnitude of the BBB universe is more than double the high yield universe, so theoretical mass downgrades create difficulty in finding buyers. Our view is that mass downgrades are unlikely to materialize, but were they to occur, it is not the newest entrants (i.e., downgrades), but the smallest constituents that are most likely at risk of losing sponsorship.

We do not dismiss the concerns building around BBBs, rather we seek to place them into a context and framework where we can understand how we arrived at today's level of BBB bonds. We believe that the recent period has been particularly benign for credit and that it is entirely reasonable for downgrades and defaults to increase from today's low levels. We do not agree with the Fortnite view of BBBs…but we aren't entirely sad about the prevalence of this view either. If investors systematically fear a quality segment, it can create opportunities for those willing to take a deeper look — especially at the security level.

We believe that the recent period has been particularly benign for credit and that it is entirely reasonable for downgrades and defaults to increase from today's low levels.

Fund updates: First quarter of 2019

BMO TCH Core Plus Bond Fund: The fund outperformed for the period. Liquidity returned to the market after the severe period of illiquidity in the fourth quarter, allowing securities, which had repriced on limited volume in the fourth quarter, to return closer to fundamental value; in particular, securities in the energy, pharmaceuticals and financials sectors contributed to performance, while selection with the food & beverage sector detracted from performance on idiosyncratic developments. The Fund had an overweight to credit (+252 basis points of excess return), which benefitted returns as credit spreads tightened meaningfully on risk sentiment and market liquidity. Overweight positioning in lower quality investment grade (BBB +335 basis points of excess return) and allocations to high yield (+558 basis points of excess returns) had particularly positive impacts on the portfolio. With the Fund having below benchmark duration, yield curve management was a negative contributor during the quarter as rates declined 27 basis points on the 10-year U.S. Treasury (from 2.68% at the end of December to 2.41% at the end of March).

BMO TCH Corporate Income Fund: The fund outperformed for the period. Liquidity returned to the market after the severe period of illiquidity in the fourth quarter, allowing securities, which had repriced on limited volume in the fourth quarter, to return closer to fundamental value; in particular, securities in the energy and technology sectors contributed to performance, while selection with the food & beverage sector detracted from performance on idiosyncratic developments. The Fund had an overweight to corporate credit (+273 basis points of excess return versus +145 basis points for non-corporate credit), which benefitted returns as spreads tightened meaningfully on improved risk sentiment and market liquidity. Overweight positioning in lower quality investment grade (BBB +335 basis points of excess return) and allocations to high yield (+558 basis points of excess returns) had particularly positive impacts on the portfolio. By sector, the overweight to industrials (+290 basis points of excess return) and underweight to utilities (+156 basis points of excess return) added further to relative performance. With the Fund having below benchmark duration, yield curve management was a negative contributor during the quarter as rates declined 27 basis points on the 10-year U.S. Treasury (from 2.68% at the end of December to 2.41% at the end of March).

BMO Strategic Income Fund: The fund outperformed for the period. Sector and quality selection was the largest contributor to performance during the quarter as risk appetite returned to the market and liquidity improved. In this environment, non-governmental assets significantly outperformed Treasuries. Allocations to high yield (+573 basis points of excess returns) had particularly positive impacts on the portfolio, though returns by quality segment were relatively undifferentiated within high yield. Emerging market debt (+316 basis points of excess return) performed well for the period. Allocations to commercial mortgage backed securities (CMBS), in particular subordinated tranches, experienced solid performance, and non-agency residential mortgage backed securities (RMBS) continued to enhance portfolio income with their significant yield advantage relative to agency equivalents. The Fund had an overweight to investment grade credit (+252 basis points of excess return), which benefitted returns as credit spreads tightened meaningfully and overweight positioning in lower quality investment grade (BBB +335 basis points of excess return) was beneficial. Security selection was a positive contributor in the quarter. In particular, corporate issuers within the energy, technology and basic industries sectors added to relative performance, while selection within the food & beverage, retail and services sectors diminished relative performance. Though not a primary consideration for the Fund, yield curve management detracted from portfolio performance.

BMO High Yield Bond Fund: The Fund outperformed in the period. Security selection was the largest positive contributor to performance in the quarter. Liquidity returned to the market after the severe period of illiquidity in the fourth quarter, allowing securities which had repriced on limited volume in the fourth quarter to return closer to fundamental value; in particular, selection was favorable in the energy, home builders and technology sectors contributed to performance, while selection within the food & beverage sector detracted from performance on idiosyncratic developments. Sector effects were additive with the overweight to the energy sector benefitting from a rebound in energy pricing and home builders and related sectors supported by the move lower in interest rates. Quality selection had a limited impact on portfolio performance given the relatively limited dispersion of performance by quality segment. The portfolio had modestly below benchmark duration, which detracted on the margin from relative performance given the move lower in U.S. interest rates in the quarter.

	Share class[1]	Inception date	Ticker	1-mo	Q1	YTD	1-yr	3-yr	5-yr	10-yr	Since inception	Gross	Net
				Returns as of March 31, 2019 (%)								Expenses (%)[2]	
BMO TCH Core Plus Bond Fund	A NAV[3]	05/27/14	BATCX	1.78	3.88	3.88	3.53	3.48	2.91	5.30	5.33	0.59	0.59
BMO TCH Core Plus Bond Fund	A OFFER[3]			-1.76	0.22	0.22	-0.12	2.26	2.19	4.93	4.97		
BMO TCH Core Plus Bond Fund	Y	12/22/08	MCYBX	1.78	3.88	3.88	3.53	3.48	2.91	5.30	5.33	0.59	0.59
BMO TCH Core Plus Bond Fund	I	12/22/08	MCBIX	1.80	4.04	4.04	3.78	3.74	3.17	5.56	5.58	0.34	0.34
Bloomberg Barclays U.S. Aggregate Bond Index				1.92	2.94	2.94	4.48	2.03	2.74	3.76			
BMO TCH Corporate Income Fund	A NAV[3]	05/27/14	BATIX	2.12	5.07	5.07	3.66	5.56	3.91	7.24	7.24	0.63	0.59
BMO TCH Corporate Income Fund	A OFFER[3]			-1.46	1.38	1.38	0.02	4.32	3.17	6.86	6.87		
BMO TCH Corporate Income Fund	Y	12/22/08	MCIYX	2.12	5.06	5.06	3.65	5.56	3.90	7.24	7.24	0.63	0.59
BMO TCH Corporate Income Fund	I	12/22/08	MCIIX	2.13	5.19	5.19	3.82	5.70	4.04	7.41	7.42	0.45	0.45
Bloomberg Barclays U.S. Credit Index				2.44	4.87	4.87	4.89	3.48	3.60	6.21			
BMO Strategic Income Fund[4]	A NAV[3]	05/27/14	BMTAX	1.05	5.65	5.65	3.91	3.11	3.31	4.21	4.82	0.92	0.80
BMO Strategic Income Fund[4]	A OFFER[3]			-2.49	1.94	1.94	0.23	1.89	2.59	3.85	4.67		
BMO Strategic Income Fund[4]	Y	12/13/92	MRGIX	1.05	5.65	5.65	3.92	3.11	3.31	4.21	4.82	0.91	0.80
BMO Strategic Income Fund[4]	I	05/31/07	MGIIX	1.07	5.84	5.84	4.17	3.41	3.57	4.47	4.93	0.67	0.55
Bloomberg Barclays U.S. Aggregate Bond Index				1.92	2.94	2.94	4.48	2.03	2.74	3.76			
BMO High Yield Bond Fund[5]	A NAV[3]	05/27/14	BMHAX	0.78	7.54	7.54	4.88	5.89	3.13	—	4.75	2.01	0.91
BMO High Yield Bond Fund[5]	A OFFER[3]			-2.72	3.72	3.72	1.17	4.64	2.40	—	4.24		
BMO High Yield Bond Fund[5]	I	12/29/11	MHBNX	0.80	7.61	7.61	5.13	6.11	3.38	—	4.99	1.76	0.66
ICE BofA Merrill Lynch U.S. High Yield Master II Constrained Index				0.96	7.38	7.38	5.92	8.68	4.70	—	—		

Performance data quoted represents past performance and past performance is not a guarantee of future results. Investment returns and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Mutual fund performance changes over time and current performance may be lower or higher than what is stated. To receive the most recent month-end performance, call 1-800-236-3863. Returns quoted are pre-tax. Investor should consider his or her current and anticipated investment horizon and income tax bracket when making an investment decision as the illustration above does not reflect these factors. For more information about performance, please contact your investment professional. Total returns for periods of less than one year are cumulative.

1 Performance data quoted prior to the inception of the Class A shares is the performance of the Fund's Investor Class (Class Y). Class A Offer reflects a sales load charged at the time of initial investment.

2 Expenses for Class A shares are based on estimated amounts for the current fiscal year. Net expense ratio reflects contractual fee waivers and/or expense reimbursements made by BMO Asset Management Corp., the investment adviser (Adviser), as applicable. The Adviser may not terminate these fee waivers and/or expense reimbursements prior to December 31, 2019 without the consent of the Fund's Board of Directors, unless the investment advisory agreement is terminated. Without these contractual waivers, the Funds' returns would have been lower. Please see the prospectus for more information.

3 The maximum sales charge (load) imposed on purchases (as a percentage of offering price) is 3.50% for Class A shares. The Class NAV performance does not reflect the deduction of the sales load or fee, and if reflected, the load or fee would reduce the performance quoted.

4 Effective May 8, 2017, the BMO Mortgage Income Fund changed its name to the BMO Strategic Income Fund. Effective June 29, 2017, the BMO TCH Intermediate Income Fund merged with the BMO Strategic Income Fund.

5 Effective March 7, 2017, the BMO Monegy High Yield Bond Fund has changed its name to the BMO High Yield Bond Fund.

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The Bloomberg Barclays US Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

ICE BofA Merrill Lynch U.S. High Yield Master II Constrained Index tracks the performance of US dollar denominated below investment grade rated corporate debt publically issued in the US domestic market.

Investments cannot be made in an index.

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