Fixed income market update

June 2019

BMO Fixed Income

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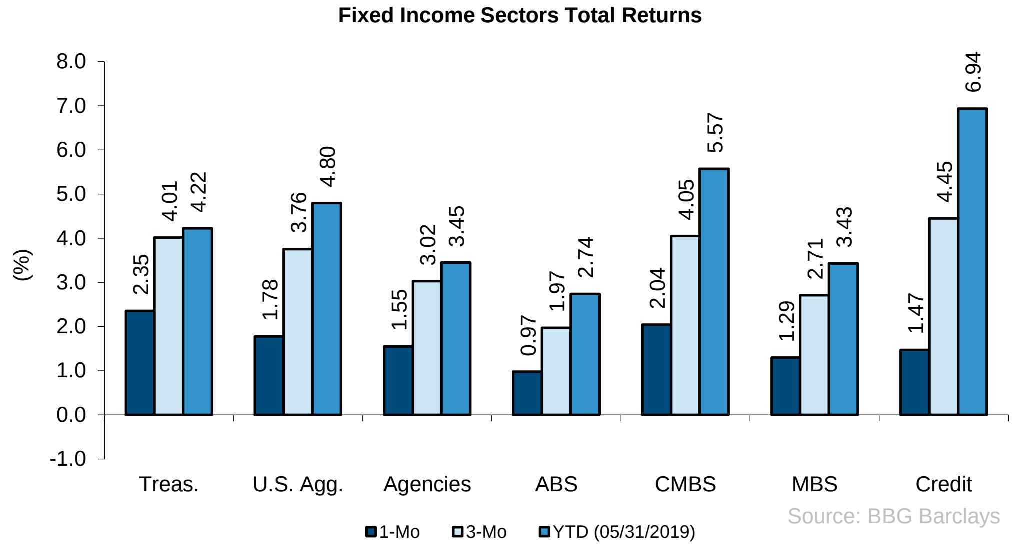
BMO Global Asset Management

Fixed income market update

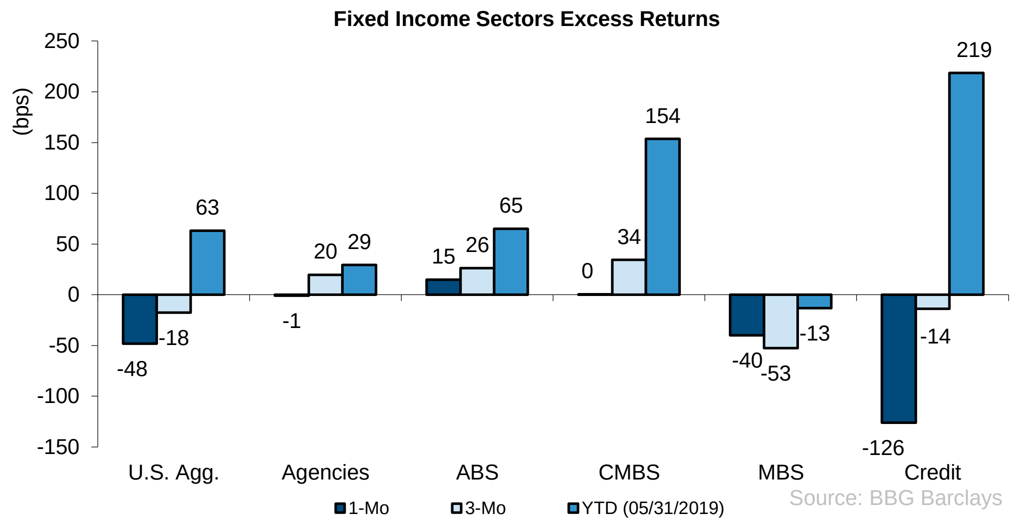
- For the month ended May 31, 2019, the Bloomberg Barclays U.S. Aggregate Bond Index returned 1.78%. Year to date, the index has returned 4.80%.

- U.S. Treasuries returned 2.35% during the month as the yield on the 10-year U.S. Treasury declined to 2.12% at the end of May from 2.50% at the end of April. For the month, long Treasuries (+6.54%) outperformed intermediate Treasuries (+1.48%.)

- Mortgage-backed securities (MBS) returned 1.29% during the month underperforming Treasuries by 40 basis point on a duration-adjusted basis. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index widened 3 basis point during the month, ending the period at 44 basis points.



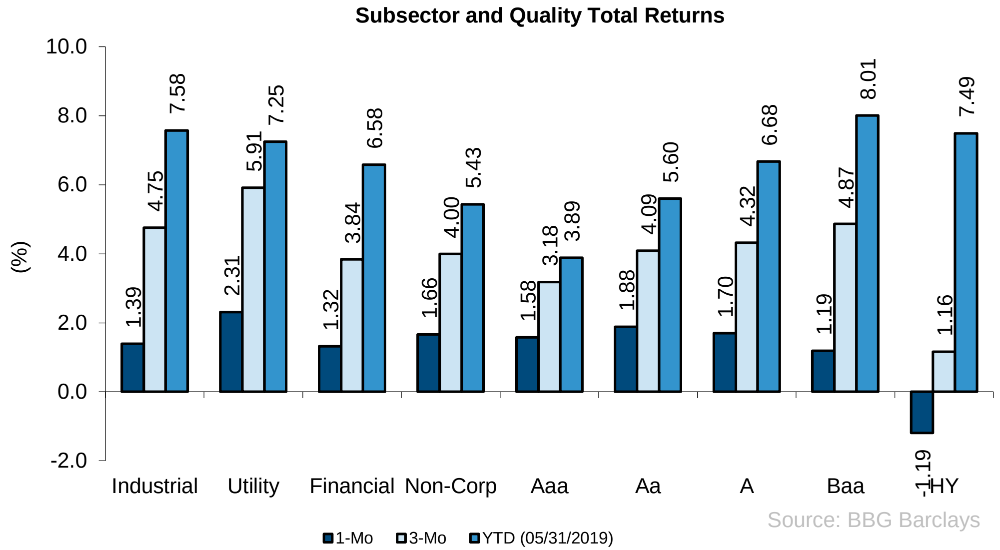
Source: BBG Barclays



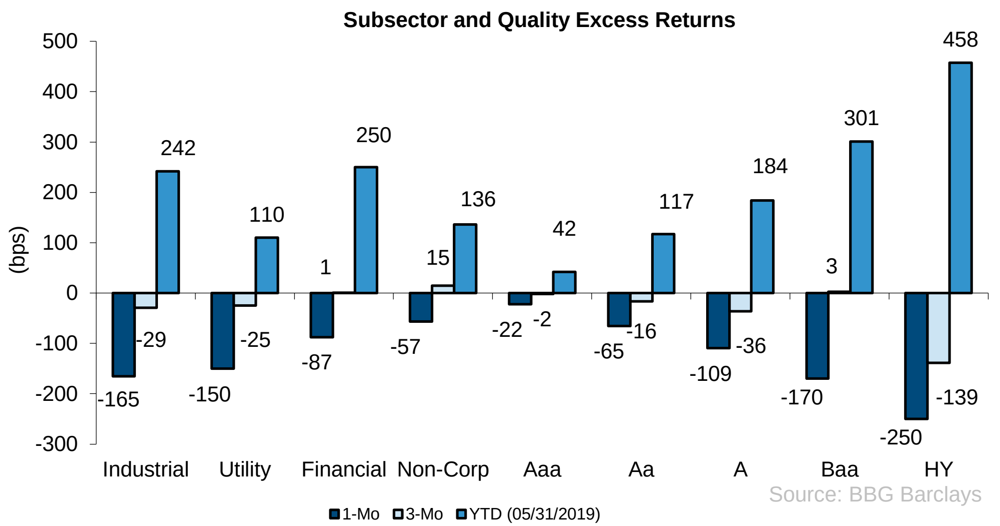
Source: BBG Barclays

Fixed income market update (continued)

- Credit securities returned 1.47% for the month, underperforming Treasuries by 126 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 120 bps, 16 basis points wider than at the end of April. For the month, long credit (+2.38%) underperformed intermediate credit (+1.05%) by 227 basis points on a duration-adjusted basis.
- For the month, on a duration-adjusted basis, non-corporates delivered -57 basis points of excess returns, outperforming financials, utilities and industrials by 30, 93 and 108 basis points, respectively.
- AAA rated securities delivered -22 basis points of excess return for the month, outperforming AA, A and BBB rated securities by 43, 87 and 148 basis points of excess return, respectively. High yield delivered -250 basis points of excess return for the month.



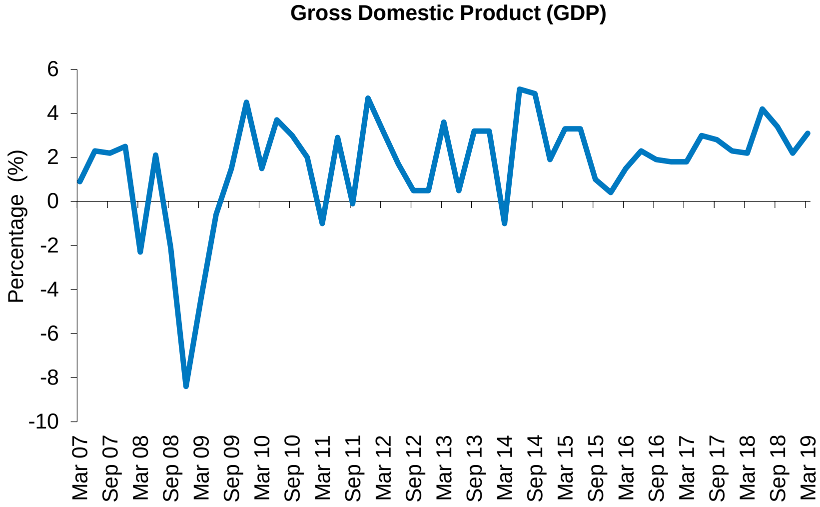
Source: BBG Barclays



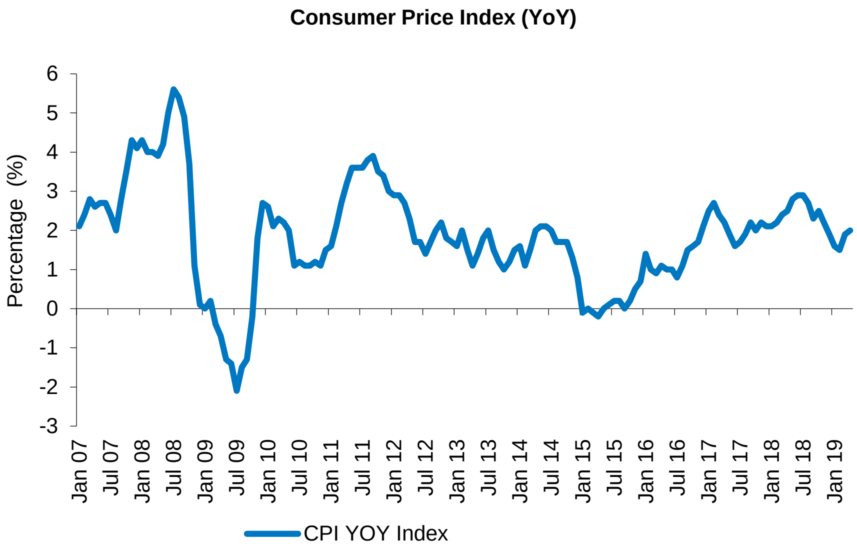
Source: BBG Barclays

Economic update

First quarter GDP growth was revised down 0.1% to 3.1%, better than the 3.0% expectation. Though somewhat reduced since the first reading, net trade remained additive (exports rose 4.8% and imports declined 2.5%). Inventory growth declined since the last reading, but was still a significant contributor. Consumer spending increased 0.1% to 1.3% since the first GDP estimate, a decline from 2.5% in the fourth quarter. Consensus for second quarter GDP growth is 2.6% and the consensus expectation for the full year 2019 has increased 0.2% to 2.6%.



Source: Bureau of Economic Analysis



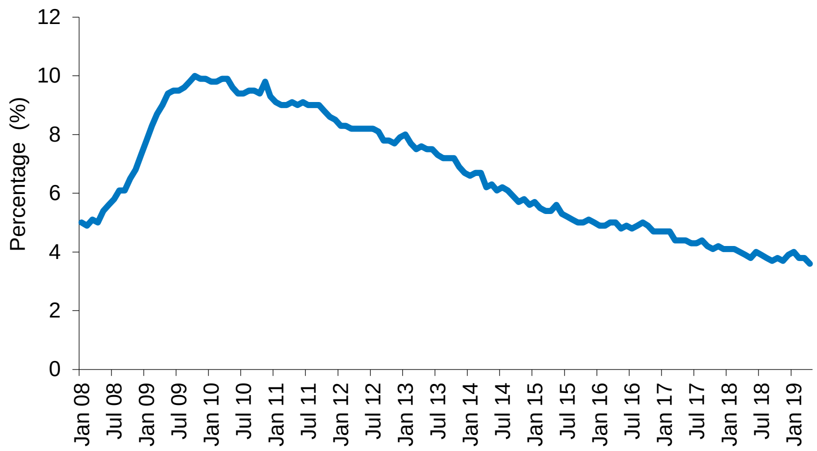
Source: Bureau of Labor Statistics

The Consumer Price Index (CPI) rose 0.3% in April, a slight decline from March. CPI rose 2.0% for the trailing year, a slight increase from last month. Core CPI, which excludes the impact of energy and food, rose by 0.1% for the month and 2.1% for the trailing year. Core PCE, the Fed's preferred inflation gauge, rose 0.2% for the month and rose 1.6% for the trailing year, below the Fed's 2% target, but a 0.1% increase from March.

Economic update (continued)

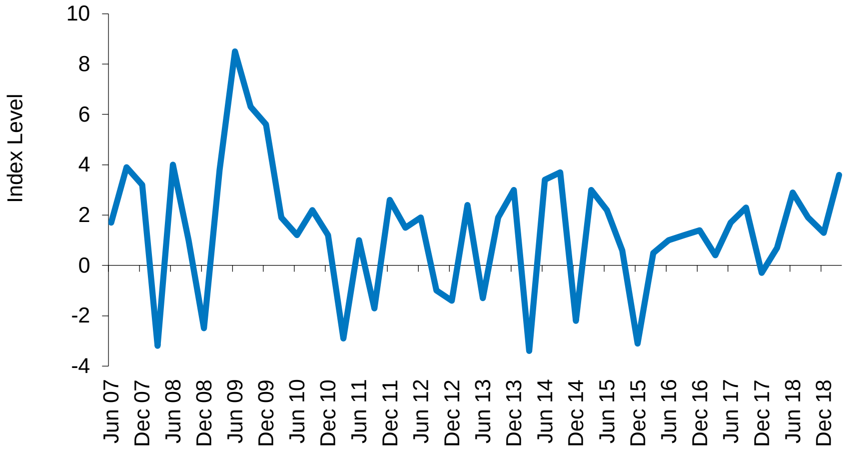
April non-farm payrolls increased by 263,000 jobs, exceeding market expectations for 190,000 new jobs. The unemployment rate in the U.S. declined 0.2% to 3.6%, the lowest level since 1969. The labor participation rate declined 0.2% to 62.8% and the underemployment rate remained unchanged at 7.3%. Average hourly earning data showed wages rose 0.2% for the month and 3.2% for the trailing year, slightly below the 3.3% expectation.

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



Source: Bureau of Labor Statistics

US Output Per Hour Nonfarm Business Sector QoQ SA



Source: Bureau of Labor Statistics

Labor productivity increased 3.6% in the first quarter as output rose 4.1% and hours worked increased 0.5%; this was the largest quarterly increase in 5 years. For the trailing year, productivity increased 2.4%, the best rate since 2010; productivity growth has averaged just 1.3% since 2007. Unit labor costs rose only 0.1% for the trailing year, the lowest increase since 2013.

Economic and market perspective

- The market sentiment decline in May was largely driven by the ongoing trade dispute between the U.S. and China. After expectations of a near term resolution had buoyed markets in April, these hopes faded in May. On May 10, the U.S. announced an increase in tariffs from 10% to 25% on a suite of Chinese imports worth approximately $200 billion. In response, China announced a series of tariffs ranging from 5% to 25% on U.S. goods worth approximately $60 billion. No further trade talks have been scheduled since the last round ended May 10 without resolution.
- Due to the trade tensions, China has reportedly stopped purchasing U.S. soybeans; the Chinese agreement to purchase soybeans had been considered a conciliatory measure during the trade dispute. Concerns around Chinese technology firm Huawei building 5G infrastructure for U.S. allies, which the U.S. fears could allow for digital spying, have added to tensions. Further, China introduced a potential restriction on exports to the U.S. of rare earth metals as a point of leverage in the trade dispute. China accounted for over 70% of the global production in 2018; rare earth metals are broadly used in industrial production from cell phones and technology to oil refining and electric car motors.
- Chinese Purchasing Managers' Index (PMI) declined more than expected in May, falling from a level of 50.1 (above the level of 50 which demarcates the difference between expansion and contraction) to 49.4 reflecting a decrease in manufacturing.
- At the end of May, President Trump announced a 5% tariff on all imports from Mexico to begin June 10th. The tariffs are to be imposed to pressure Mexico to restrict cross-border migration. The tariffs are structured to increase 5% a month until reaching 25% in October. Mexico has stated its objections to the tariffs and has indicated it may impose retaliatory tariffs. U.S. trade with Mexico totaled $670 billion in 2018; approximately $370 billion of imports and $300 billion of exports. The announcement of tariffs on Mexico has raised concerns that the trade deal to replace NAFTA could be in jeopardy.
- Oil prices fell 16% in May, from $63 to approximately $53 a barrel, the largest monthly decline since November. The decline in oil prices reflected the negative impact to sentiment from trade tensions as well as continued fears of slowing global growth.

Outlook and conclusions

- The Federal Open Market Committee met April 30 – May 1 with markets pricing in effectively no chance of a rate hike or cut at the meeting. No change was made in the Fed Funds rate as expected, but the Fed made a more subtle tweak by lowering the interest on excess reserves (IOER) it pays banks for deposits held at the Fed. Chairman Powell referred to the change as a "small technical adjustment," indicating that it had "no implications" for policy.
- Minutes from that meeting were released later in May. The minutes reiterated the Fed's expectations for "patient" monetary policy and that this stance could be in place for "some time." In referring to the reduction in IOER, the Fed indicated that if further reductions were warranted they would consider lowering the overnight reverse repo rate first.
- At the end of May, Fed Vice Chairman Richard Clarida indicated that current policy was appropriate, but that if either inflation remains persistently below target or "global economic and financial developments present a material downside risk" the Fed would reassess policy. As of the end of May, Fed Funds futures project a 0% probability of a rate hike and approximately of a 90% chance a rate cut by the end of the year.
- At the end of May, the Fed Funds rate (range of 2.25% - 2.50%) exceeded interest rates on the 10 year Treasury. Recent market volatility and fears of slowing global growth have led to a marked decline in long rates in the U.S. during the month.
- In our view, market sentiment, which had been too sanguine about progress on trade talks last month, has now become too despondent about potential outcomes. In particular, we view interest rates in the U.S. as having overreacted to fears as opposed to responding to fundamentals, which remain more robust. This suggests to us that rates are more likely to rise than fall from their current levels. We believe the relationship between short rates and longer ones is worth monitoring, but not dispositive regarding future economic or market outcomes. Credit spreads, which had been pricing in the strength of U.S. economic data but less potential for volatility, have now widened to more attractive levels though still tighter than at year end. Spread levels better reflect the combination of economic data and potential for additional volatility, while offering some yield pick-up in what has quickly become a low interest rate environment.

Fixed income returns as of May 31, 2019

Index Returns as of May 31, 2019				
	Total Return (%)		Excess Return (%)	
	Month-to-Date	Year-to- Date	Month-to-Date	Year-to- Date
U.S. Aggregate	1.78	4.80	-0.48	0.63
U.S. Treasury	2.35	4.22	-	-
Intermediate	1.48	3.13	-	-
Long	6.54	9.52	-	-
TIPS	1.65	5.25	-	-
Agencies	1.55	3.45	-0.01	0.29
U.S. MBS	1.29	3.43	-0.40	-0.13
ABS	0.97	2.74	0.15	0.65
CMBS	2.04	5.57	0.00	1.54
U.S. Credit	1.47	6.94	-1.26	2.19
Intermediate	1.05	5.09	-0.54	1.78
Long	2.38	11.11	-2.81	3.22
Industrial	1.39	7.58	-1.65	2.42
Utility	2.31	7.25	-1.50	1.10
Financial	1.32	6.58	-0.87	2.50
Non-Corporate	1.66	5.43	-0.57	1.36
Aaa	1.58	3.89	-0.22	0.42
Aa	1.88	5.60	-0.65	1.17
A	1.70	6.68	-1.09	1.84
Baa	1.19	8.01	-1.70	3.01
High Yield	-1.19	7.49	-2.50	4.58
Floating Rate Notes	0.21	2.29	-0.12	1.14

Source: Bloomberg Barclays

Disclosures

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

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