Fixed income market update

January 2021

BMO Fixed Income

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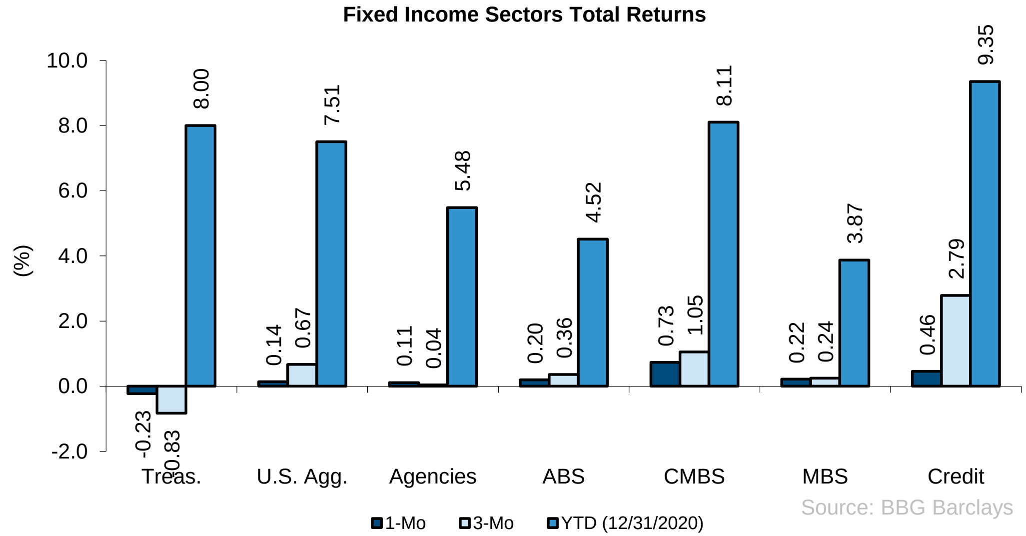
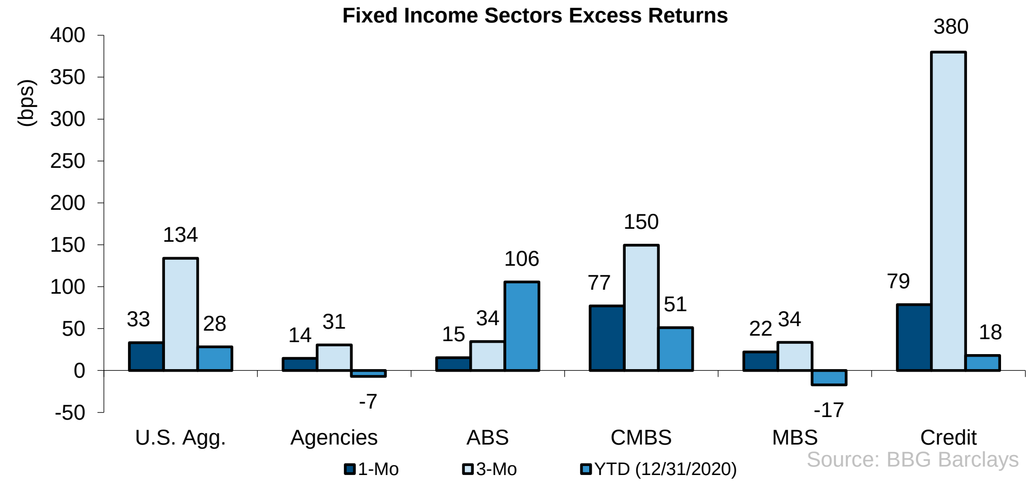
BMO Global Asset Management

Fixed income market update

- For the quarter ended December 31, 2020, the Bloomberg Barclays U.S. Aggregate Bond Index returned 0.67%. For the year, the index returned 7.51%.
- U.S. Treasuries returned -0.83% during the quarter as the yield on the 10-year U.S. Treasury rose to 0.91% at the end of December from 0.68% at the end of September; the 10-year began 2020 at 1.92%. For the quarter, long Treasuries (-3.00%) underperformed intermediate Treasuries (-0.23%.)
- Mortgage-backed securities (MBS) returned 0.24% during the quarter, outperforming Treasuries by 34 basis point on a duration-adjusted basis. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index tightened 22 basis points during the quarter, ending the period at 39 basis points.



Source: BBG Barclays



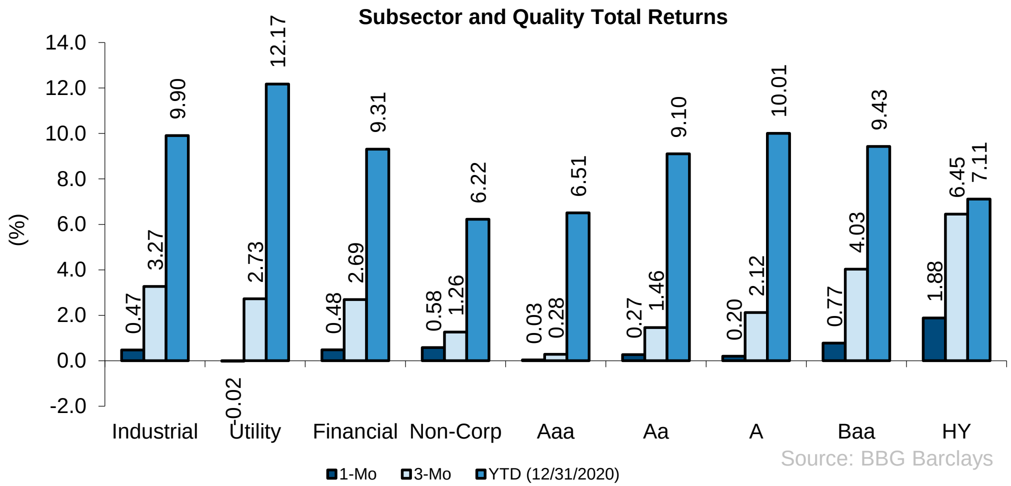
Source: BBG Barclays

Fixed income market update (continued)

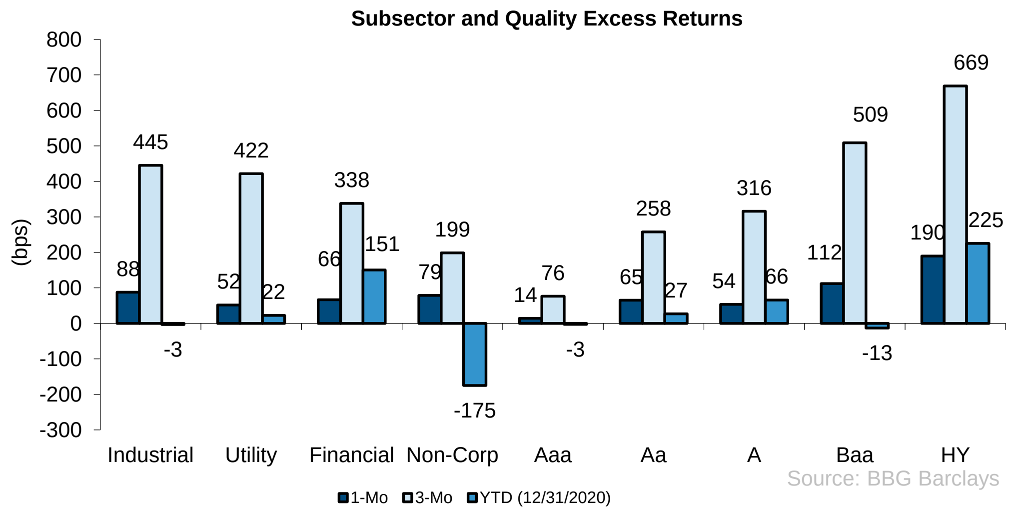
- Credit securities returned 2.79% for the quarter, outperforming Treasuries by 380 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 92 bps, 36 basis points tighter than at the end of September.

- For the quarter, industrials delivered 445 basis points of excess return on a duration-adjusted basis, outperforming utilities, financials and non-corporates by 23, 107 and 246 basis points, respectively.

- BBB rated securities were the best performing investment grade quality segment during the quarter, delivering 509 basis points of excess return and outperforming AAA, AA and A rated securities by 433, 251 and 193 basis points of excess return, respectively. High yield delivered 669 basis points of excess return for the quarter.



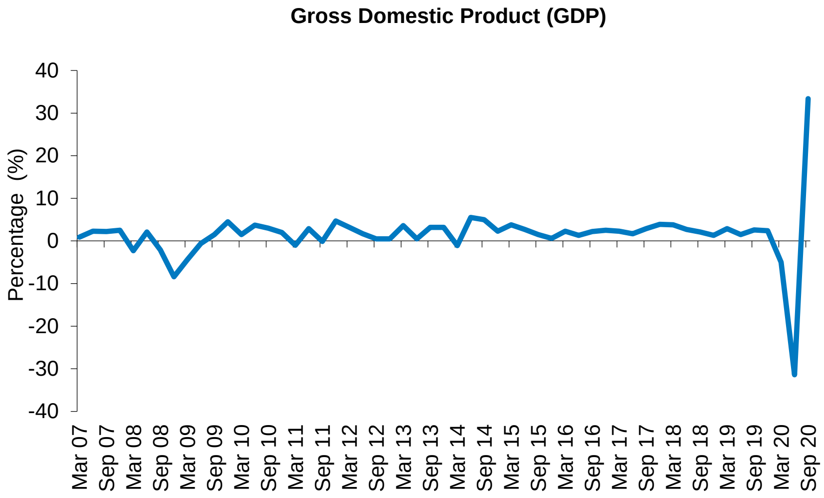
Source: BBG Barclays



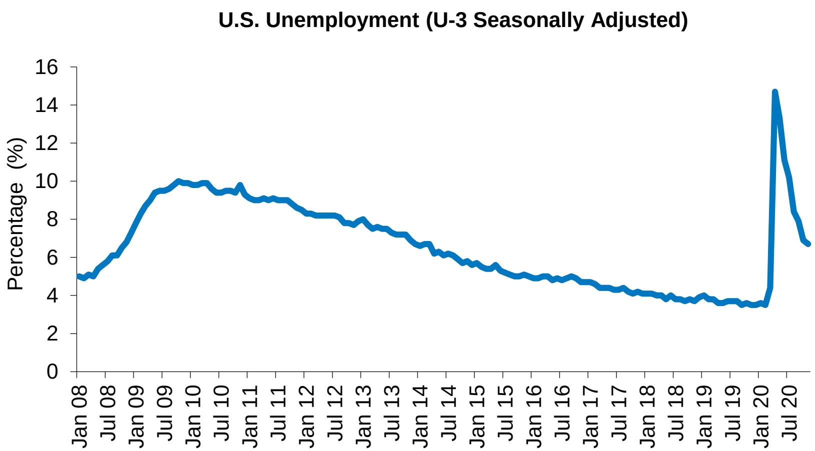
Source: BBG Barclays

Economic update

GDP growth set records for both the worst and best quarters of growth in history in 2020. In the second quarter, GDP declined -31.4% and in the third quarter it rebounded 33.4%. First quarter GDP shrank at a -5.0% rate, while consensus estimates for the fourth quarter are for growth of 4.6%. Consensus estimates are for overall GDP to have shrunk by 3.5% in 2020, with expectations for a sharp rebound of 3.9% in 2021. Inflation, as measured by CPI, remains subdued in the range of 1.2% with consensus expectations for inflation to rise to 2.0% for 2021.



Source: Bureau of Economic Analysis

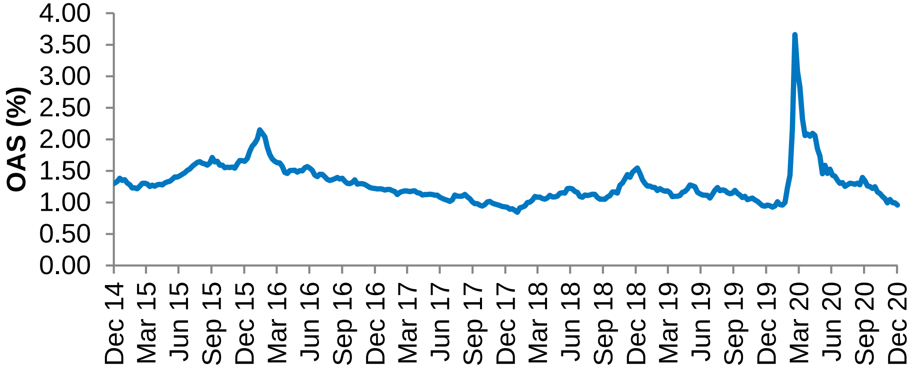


Source: Bureau of Labor Statistics

The U.S. unemployment rate declined for the seventh consecutive month to a rate of 6.7%, less than half the rate when unemployment peaked in April at 14.7% The rate declined 0.2% from last month's level of 6.9%, in line with expectations. Underemployment fell from 12.1% to 12.0% after peaking in April at 22.8%. Labor force participation declined by 0.2% to 61.5%. Wages grew 0.3% in November, better than expectations of 0.1%, and 4.4% for the trailing year.

Market update

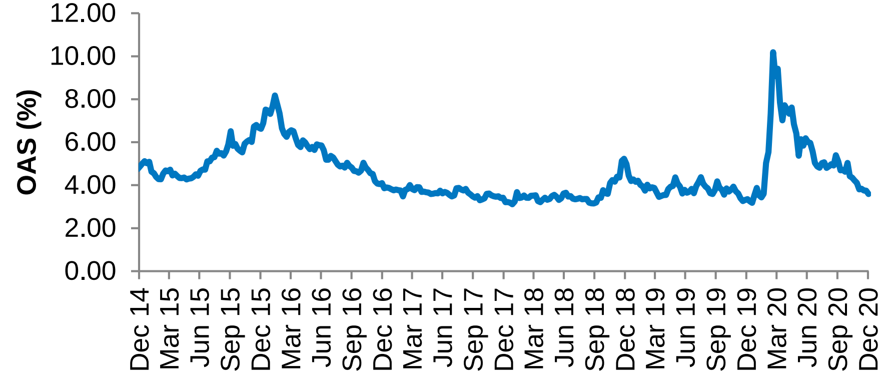
U.S. Investment Grade Corporate Spreads (weekly)



Source: Bloomberg Barclays

After widening to 366 bps in March, IG corporate spreads tightened all the way back to 96 basis points, only 3 bps wider than where they began 2020.

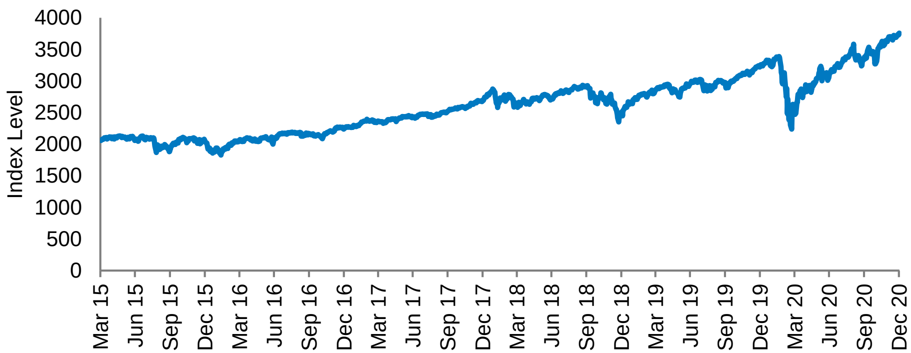
U.S. High Yield Corporate Spreads (weekly)



Source: Bloomberg Barclays

HY spreads remain 24 bps wide to the start of the year, despite a significant recovery; income drove strong excess returns in 2020.

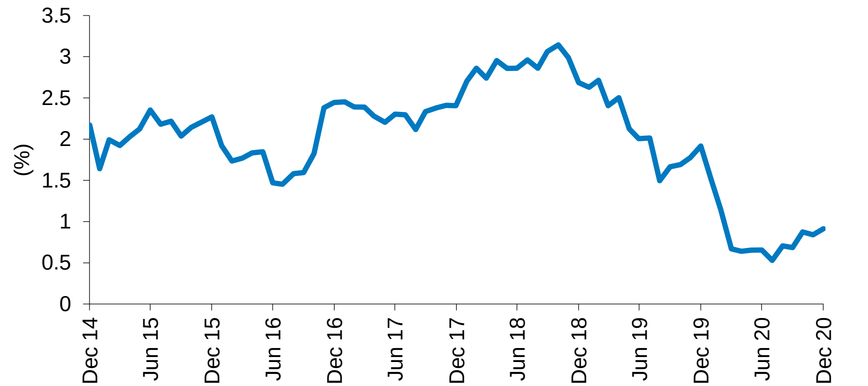
S&P 500



Source: Standard & Poor's

U.S. equities rose over 18% for 2020 after having been down more than 30% in March.

U.S. 10 Year Treasury Yields



Source: Bloomberg

10-year yields fell over 100 basis points in 2020, from 1.92% to 0.91%. Rates declined as low as 0.53% at the end of July.

News & nuggets

Virus & Vaccine:

- A new coronavirus strain first observed in the United Kingdom, which is believed to be significantly more contagious, has spread across borders and been observed in the U.S. in several states. The new strain is a stark reminder that despite approvals for vaccines and the beginning of mass vaccinations, there is still much ground to cover before the world moves on from the global pandemic and its economic effects.
- Even apart from the new strain, coronavirus cases continue to remain high; for example, the number of hospitalizations in Texas set records for five consecutive days in December. During 2020 approximately 350,000 Americans died from the virus.

Politics & Fiscal Policy:

- After the expected ‘blue wave’ failed to materialize in the 2020 U.S. elections, the expectations for fiscal stimulus moderated in both scale and timing. After delay, a compromise stimulus package of $900 billion, titled the ‘Coronavirus Response and Relief Supplemental Appropriations Act’, was passed. President Trump threatened not to sign the law based on the $600 checks to individuals, which he argued should have been $2,000. He eventually relented and signed the bill. Afterwards, the House passed a bill to increase the checks to individuals to $2,000, which has been held up in the Senate. The debate around checks to individuals aside, the package includes a 10 week extension to enhanced unemployment benefits, significant support for small businesses, and vaccine funding among other expenditures. Notably, the bill did not include direct aid to states or the liability shield for businesses sought by Democrats and Republicans, respectively.
- On January 5, the two remaining open senate seats will be chosen by Georgia voters. With those two seats come control of the senate. If Republicans win one or both of the seats, they will retain control of the senate with a 51 or 52 seat majority. Democrats need to win both seats to have a 50-50 tie, which would then be broken by Vice President Harris. A win by Democrats, combined with Biden becoming president and control of the house would likely lead to more short-term stimulus, while a Republican win would split control of government, which has historically been positive for markets.

Outlook and conclusions:

Monetary policy:

- The Federal Open Market Committee's statement from their December 15-16 meeting continued to message strong support for markets. As expected, and to be expected for a prolonged period, the Fed did not change the Fed Funds Rate. The Fed affirmed that asset purchases of at least $120 billion a month would continue "until substantial further progress has been made toward the Committee's maximum employment and price stability goals."
- While stating their goal of aiding the economic recovery, the Fed also acknowledged the importance of combatting the coronavirus, noting that "a full economic recovery is not likely until people know it's safe to engage in a broad range of activities."

Outlook:

- In our view, it is remarkable that for all the unprecedented events of 2020, fixed income markets enter the new year with roughly similar spreads as they did to begin 2020. While spreads are nearly the same, all-in yields are noticeably lower due to the decline in Treasury rates. Similarly, while we described monetary policy as accommodative entering 2020 and would use a similar descriptor for 2021, the scale is meaningfully different. The same is true of fiscal policy, where the U.S. government has long engaged in deficit spending, but is now in an entirely different category of spending. Coronavirus and its attached policies aside, the largest difference is in some ways the economic momentum entering the year. Entering 2020, projections were for a slowing, but positive economic growth year, while this year most views are for an economic acceleration as the pains of the virus subside and pent-up demand spurs the economy to growth. The rosiness of economic projections is near ubiquitous, which in itself gives us pause. We see a recovery in 2021 as the base case, but remain mindful of the economic damage wrought in the past year, which cannot be repaired as quickly as markets have healed. Credit markets appear priced to this base case and are likely to be well supported by accommodative monetary and fiscal policy as well as strong demand for income generating assets. In this scenario, rates are likely to drift higher, but we also view duration as a valuable tool against those unexpected occurrences sure to surprise markets that are priced to a strong recovery. Here's to hoping the 2021 surprises are less severe than those in 2020.

Fixed income returns as of December 31, 2020

Index Returns as of December 31, 2020						
	Total Return (%)			**Excess Return (%)**		
	Month-to-Date	**Quarter-to- Date**	**Year-to- Date**	**Month-to-Date**	**Quarter-to- Date**	**Year-to- Date**
U.S. Aggregate	0.14	0.67	7.51	0.33	1.34	0.28
U.S. Treasury	-0.23	-0.83	8.00	-	-	-
Intermediate	0.03	-0.23	5.77	-	-	-
Long	-1.18	-3.00	17.70	-	-	-
TIPS	1.15	1.62	10.99	-	-	-
Agencies	0.11	0.04	5.48	0.14	0.31	-0.07
U.S. MBS	0.22	0.24	3.87	0.22	0.34	-0.17
ABS	0.20	0.36	4.52	0.15	0.34	1.06
CMBS	0.73	1.05	8.11	0.77	1.50	0.51
U.S. Credit	0.46	2.79	9.35	0.79	3.80	0.18
Intermediate	0.47	1.55	7.08	0.47	1.85	0.93
Long	0.44	4.92	13.32	1.31	7.14	-1.78
Industrial	0.47	3.27	9.90	0.88	4.45	-0.03
Utility	-0.02	2.73	12.17	0.52	4.22	0.22
Financial	0.48	2.69	9.31	0.66	3.38	1.51
Non-Corporate	0.58	1.26	6.22	0.79	1.99	-1.75
Aaa	0.03	0.28	6.51	0.14	0.76	-0.03
Aa	0.27	1.46	9.10	0.65	2.58	0.27
A	0.20	2.12	10.01	0.54	3.16	0.66
Baa	0.77	4.03	9.43	1.12	5.09	-0.13
High Yield	1.88	6.45	7.11	1.90	6.69	2.25
Floating Rate Notes	0.10	0.37	1.38	0.09	0.34	0.76

Source: Bloomberg Barclays

Disclosures

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

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The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Basis points (bps) represent 1/100th of a percent (for example: 50 bps equals 0.50%)

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