Quarterly Fixed Income Strategy

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In this report, we highlight our fixed income positioning strategies for the second quarter.

Duration

- In the last three months, the tone of the Bank of Canada's (BoC) monetary policy has changed dramatically, with COVID-19 concerns landing on North American shores. What seemed like an outlier event in January quickly became a reality as most of North America remains in self-isolation, putting a clamp down on demand.
- In an attempt to kick-start demand, both the U.S. Federal Reserve (Fed) and the BoC made a number of emergency rate cuts between regular meetings to effectively bring its overnight rate to zero or "near-zero." Both central banks introduced quantitative easing programs, with the BoC making this move for the first time in history.
- Both the Fed and the BoC's bond-buying program took rates lower across the yield curve, but the short-end moved notably lower as a result of the emergency rate cuts. The yield curve has now steepened over the last three months on a combination of rate cuts and a period of treasury selling, as investors looked to fund liquidity by any means possible in mid-March.
- The bond-buying programs may lead to an eventual flattening of the curve, but risk-taking behaviour may lead to a rise in long bond yields as investors eventually move into riskier assets such as equities, especially as valuations become increasingly attractive.

Credit

- The sell-off in the bond market is best characterized as a liquidity funding event. As low interest rates persisted throughout the last decade, investors have been enticed to use leverage. With a global sell-off, however, margin calls were quickly triggered, which has driven investors to move to cash, with fund redemptions prevalent across the asset management industry.
- In the fixed income market, investors looked to fund liquidity through more liquid assets, which resulted in higher-quality investment-grade bonds amassing an unfair share of the selling activity. Interestingly, during the height of the market decline between March 9 and 20, U.S. investment-grade bonds underperformed both U.S. high-yield bonds and the S&P 500 Composite.
- The sell-off in investment-grade bonds was a result of investors wanting to source liquidity through higher-quality debt. As bond dealers reach capacity on their balance sheets, some high-quality bonds went "no-bid," or bid well below fundamental values. This has created a buying opportunity for higher-quality credit, especially for higher-rated A-and above bonds on the shorter-end of the curve (1-10 Years).
- CDX HY spreads currently sit at 778 basis points (bps), while CDX IG spreads sit at 129bps; both the widest levels since 2011. In Canada, we experienced a similar credit spread widening, which was also impacted by lower oil prices. Canadian AAA/AA credit spreads are currently 140bps above Federal bonds, while BBB spreads are 315bps above, the widest since December 2008.
- We continue to believe there is an opportunity to take advantage of pricing dislocations in the market, particularly with bonds rated A and higher. This also allows investors to protect themselves from any credit downgrade that may arise if lock-ups persist longer than expected.

Currency

- The US dollar has seen a tremendous run, gaining 4.89% in March. The gain was larger intra-month, until major central banks co-ordinated swap lines to ensure a US dollar shortage would not ensue. Its direction in Q2 will be largely dependent on whether Europe and North America will be able to "flatten the curve" in their infection rates. We believe US dollar exposure provides a hedge, should markets head even lower.

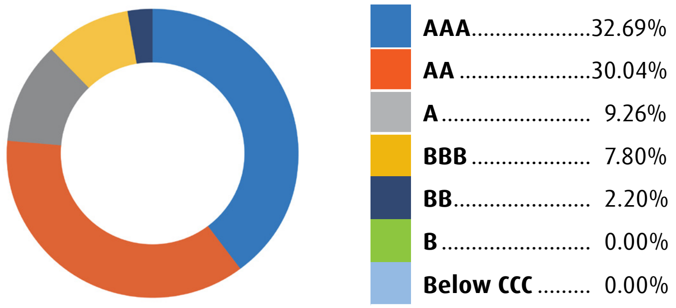
Buy	Ticker	%	Sell	Ticker	%
BMO HIGH QUALITY CORPORATE BOND INDEX ETF	ZQB	16%	BMO GLOBAL MULTI SECTOR BOND ETF	ZMSB	4%
BMO MID-TERM US IG CORPORATE BOND INDEX ETF	ZIC	5%	BMO CORPORATE BOND INDEX ETF	ZCB	17%
TOTAL		**21%**			**21%**

Model Portfolio

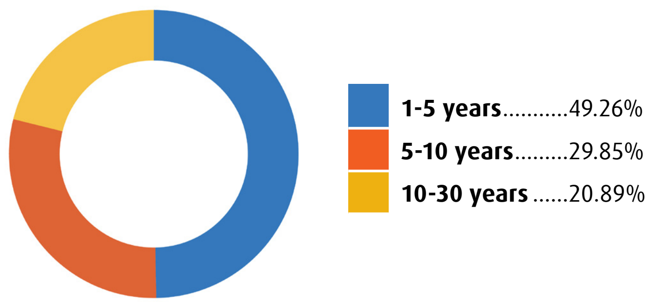
Ticker	ETF Name	Weight (%)	Duration*	Yield-to-Maturity*	Management Fee	Exposure	Positioning
ZAG	BMO AGGREGATE BOND INDEX ETF	62.0%	8.00	2.00%	0.08%	Canadian	Core
ZQB	BMO HIGH QUALITY CORPORATE BOND INDEX ETF	16.0%	3.37	2.67%	0.10%	Canadian	Core
ZIC	BMO MID-TERM US IG CORPORATE BOND INDEX ETF	5.0%	6.10	4.65%	0.25%	U.S.	Core
ZTM	BMO MID-TERM US TREASURY BOND INDEX ETF	7.0%	6.51	0.87%	0.20%	U.S.	Core
ZPR	BMO LADDERED PREFERRED SHARE INDEX ETF	4.0%	3.11	7.79%	0.45%	Canadian	Non-Traditional
ZHP	BMO US PREFERRED SHARE HEDGED TO CAD INDEX ETF	6.0%	5.00	6.66%	0.45%	U.S.	Non-Traditional
	Portfolio	**100.0%**	**6.69**	**2.67%**	**0.14%**		

Exposures	Duration	Yield	Weight
CORE	6.96	2.18%	90.0%
NON-TRADITIONAL	4.24	7.11%	10.0%
Total	**6.69**	**2.67%**	**100.0%**
CANADIAN	6.86	2.41%	82.0%
U.S.	5.89	3.85%	18.0%
Total	**6.69**	**2.67%**	**100.0%**

Credit Summary



Term Summary



*As of March 31, 2020. Please note yields will change from month to month based on market conditions.
Source: BMO Global Asset Management, Bloomberg.

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