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The Aerial View

Fixed Income & Markets Update

Monthly Review – A January to Remember

- **5.6% monthly gain in S&P 500 strongest performance since 1997**
- **IG and HY tighter on the month, oil hits highest level since 2014**
- **USD weakness continued with DXY back to levels last seen in 2014**

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January is now in the record books and while the waters were choppy near the end of the month, there were still many records set and broken.

Stocks, of course, were in the spotlight, and the +5.6% gain on the S&P is a high water mark last seen in 1997. While the January effect is often written about, it is been in sparse supply over the past few years, so the 5%+ gain last month also has the historical precedence in that a 5-handle has only been seen eight times since 1980.

Other risk assets have also preformed relatively well, with IG and HY spreads tighter on the month, while oil, particularly WTI, hit its highest level since 2014. The Brent/WTI spread also hit its tightest levels since 2014, with indications of US demand driving global gains.

Fixed income from a total return perspective was on the back foot for the better part of the month as yields closed up to 30 bps higher during the month. Treasuries were not alone in seeing its yields rise, with Bunds, Gilts and Canadian yields rising in comparable fashion during the month.

The price action on EGBs proved interesting, as we saw a fairly significant narrowing in risk premium of the periphery yields vs the core. Bunds were the worst performing sovereign in the Eurozone, although they certainly was also the tightest and therefore had the most to fall. At 72 bps, 10Y bunds are now at their highest levels since 2015, which has normalized its spread closer to recent historical averages relative to other core yields.

Selected Asset Class Returns Jan, 2018

Fixed Income Sectors*	Jan	YTD 2018	Current YTW	Current Duration
Aggregate	-1.5%	-1.5%	3.0%	6.07
Treasury	-1.4%	-1.4%	2.5%	6.11
Corporate	-1.0%	-1.0%	3.5%	7.52
High Yield	0.6%	0.6%	5.8%	3.94
Preferred	-1.2%	-1.2%	6.1%	N/A
Agencies	-0.6%	-0.6%	2.6%	4.32
MBS (fixed coupon)	-1.2%	-1.2%	3.2%	4.99
Municipals	-1.2%	-1.2%	2.6%	6.14
Taxable Munis	-1.4%	-1.4%	3.7%	9.08
EM (Sovereigns)	-0.2%	-0.2%	5.9%	7.31
EM (Corporates)	0.1%	0.1%	4.6%	4.70
Equity Indices	31-Jan	Jan MTD Absolute	YTD 2018 Absolute	YTD USD Adjusted
DJIA	26,149	5.8%	5.8%	5.8%
S&P 500	2,824	5.6%	5.6%	5.6%
NASDAQ	7,411	7.4%	7.4%	7.4%
Toronto	15,952	-1.6%	-1.6%	0.1%
Mexico IPC	50,456	2.2%	2.2%	8.1%
Brazil Bovespa	84,913	11.1%	11.1%	15.4%
Euro Stoxx	3,609	3.0%	3.0%	6.4%
FTSE	7,534	-2.0%	-2.0%	2.8%
Nikkei	23,098	1.5%	1.5%	4.5%
Hang Seng	32,887	9.9%	9.9%	9.8%
Shanghai Comp	3,481	5.3%	5.3%	8.9%
India Sensex	35,965	5.6%	5.6%	5.9%

Source: Barclays Capital/Bloomberg/S&P
* All fixed income sectors returns measured by Barclay's indicies, except Preferred Stock, which represents returns from Ishares

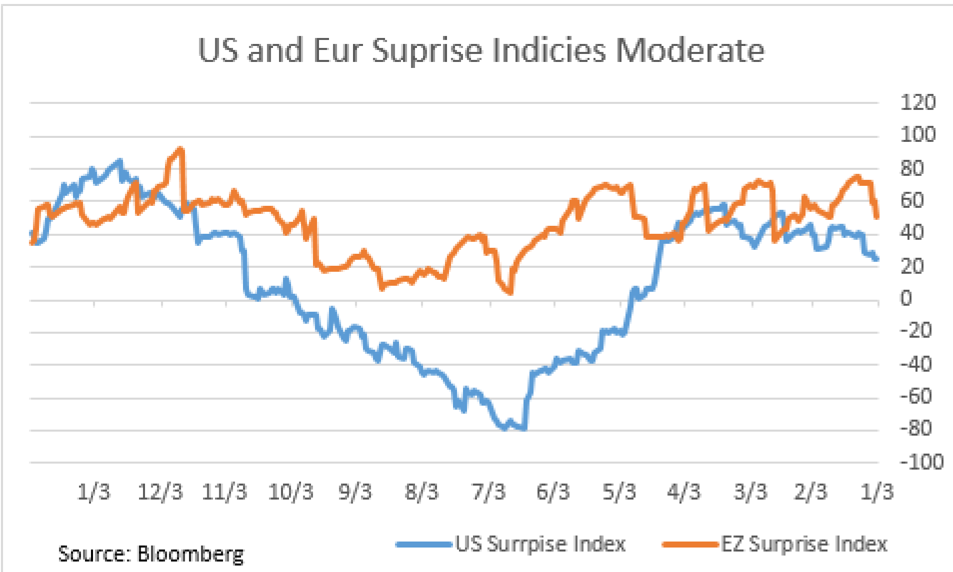
As the above returns table indicates, most fixed income asset classes were negative for the month, with the aggregate posting a -1.5% total return, a negative result that was last seen in 2013 in the midst of the taper tantrum. The Treasury Index posted a 1.4% total return, which was matched by the -1.4% in the Taxable Muni Index.

Ultimately, there were just two fixed income asset classes that posted positive results during the month: high yield and hard currency emerging markets, posting a +0.6% and +0.1% return, respectively. Current corporate and high yield spreads are still near their 2007 rights despite the recent volatility.

Despite these mostly positive risk metrics, it was very much a bifurcated month, where the land grab for risk assets pushed practically all asset classes to multi-year, if not all-time tights, only to show signs of instability near the end of the month.

Whether recent volatility will become a new normal for the markets, or prove to be yet another buy-the-dip opportunity is of course to be seen. What has been clear over the last few days of January was that there has been a reversal of some strong themes, at least temporarily. Of particular note is the weak USD, rising yields, flattening curve and equities that are able to look past higher yields.

Up until the past week, the goldilocks interpretation of higher yields in response to strong economic data paired well with low inflation which ultimately supported stocks that also benefitted from tax reform initiatives. Even the weakening was viewed mostly positive, as higher commodities and firming EM currencies were within a tolerable range.



A few days of trading certainly does not form a trend, although higher sovereign yields have been a fairly consistent theme throughout the month. While Treasuries have been on a stable march higher (in yields), other sovereign markets have seen a reversal of stability in just the past few weeks.

Central bank meetings have occurred in the midst of the recent widening, which is notable in that other than the FOMC and BOC, most central bank commentary can be viewed as relatively dovish. If the market is in fact pushing back on the ECB, BOE, and to a more limited extent the BOJ, we may see a far more synchronized increase in yields than we have over the past year, when coordinated tightening become a trading theme. In this instance, we have seen a more synchronized increase in yields over the past few weeks, which can be interpreted as declining central bank credibility in light of generally strong global growth.

USD Weakness

USD weakness has been an equally consistent theme, with the 3.2% decline in the DXY last month, the largest loss that the basket has seen since 2016, which returned the index back to levels last seen in 2014. Currency strength against the dollar has been fairly universal across DM and EM markets, although the high beta gains of LatAm currencies near the start of the month have since moderated back to matching the broader basket. Amongst the volatility near the end of the month, the USD was able to stabilize, although that is proving fleeting as today the DXY again is under pressure. These moves have certainly proven dramatic, with currency wars again emerging into trading lexicon.

The convoluted messaging from the Trump administration will likely continue to keep the FX markets offside as we have seen volatility measures bounce off the lows they established near the end of last year. Of immediate focus is CNY and CNH, which have risen over 3% in January, with the past few weeks seeing the larger proportion of those moves.

This week has proven to be one of the few weeks that we have a pause in the strength exhibited in risk assets. For instance, HY spreads have tightened throughout the month, only to retrace a quarter of that tightening since Monday.

Oil, commodities and global stocks have seen similar volatility, with the two-day decline in the S&P the biggest loss that it has seen in well over a year. The fall in yields was also accompanied by higher yields, which did not happen in any of the instances that we saw a 1% of greater loss in the S&P in 2017.

Any increased sensitivity of stocks to higher yields would certainly represent a changing tone for the markets as the goldilocks interpretation has kept rates driven volatility at bay. Ultimately equity and most asset classes have been rich for a while, and while earnings have proven fairly strong given elevated EPS expectations, forward expectations of 18x+ are well above the 14x – 15x average over the past 10 and five-year periods.

Key Economic Releases for February 2 - 9, 2018

	Time	Event	Period	Survey	Prior
2/2/2018	8:30	Change in Non-Farm Payrolls	Jan	180k	148k
2/2/2018	8:30	Unemployment Rate	Jan	4.1%	4.1%
2/2/2018	8:30	Average Hourly Earnings (y/y)	Jan	2.6%	2.5%
2/2/2018	8:30	Underemployment Rate	Jan	N/A	8.1%
2/2/2018	8:30	Participation Rate	Jan	N/A	62.7%
2/2/2018	10:00	Factory Orders	Dec	1.5%	1.3%
2/2/2018	10:00	University of Michigan	Jan-F	95.0	94.4
2/5/2018	10:00	ISM Non-Manufacturing	Jan	56.5	55.9
2/6/2018	8:30	Trade Balances	Dec	-$52.0 B	-$50.5 B
2/6/2018	10:00	JOLTs Job Openings	Dec	N/A	5879
2/8/2018	8:30	Initial Jobless Claims	3-Feb	N/A	230k
2/9/2018	10:00	Wholesale Inventories	Dec-F	0.2%	0.2%

Source: Bloomberg

Please direct questions or comments to:

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