

April 4, 2018

KEY TAKEAWAYS

Protectionist rhetoric from politicians across the globe have left fixed income markets to ponder the Fed's response to a trade war. Given subdued inflationary pressures over the course of the past decade, the Fed has had the luxury of adopting a slow and gradual pace in normalizing interest rates. If trade wars fuel inflation, the Fed might need to hasten the speed in which they increase rates. Time will tell.

Key Rates (%)	Mar 31 2018	Feb 28 2018	Dec 31 2017
Treasury Yields			
2 Year	2.26	2.25	1.88
5 Year	2.56	2.64	2.21
10 Year	2.74	2.86	2.41
30 Year	2.97	3.12	2.74
Credit Yields			
BBB Industrial 10 Year	4.11	4.12	3.61
Muni Yields			
AAA 10 Year	2.48	2.50	2.01
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.46	3.53	3.00

MARCH IN REVIEW

- Treasuries had a strong month, up .94%, but are still down 1.18% on the year.
- High Yield was hit the hardest on the month, down .60%, but is still the best performing fixed income sector on the year, although negative, -.86%.
- Municipals have been hit relatively hard through the first three months and are down 1.11% on the year.

Trade Wars, Cold Wars, and the Fed

Bonds experienced their best monthly returns in several quarters in March. Despite a Federal Reserve rate hike and nearly \$300 billion in government debt issuance during the month, prices rose (yields fell) as rising trade, economic, and political tensions weighed on investor confidence. The notable exception was in short term rates (inside two-years), which rose to reflect the FOMC rate hike and technical issues related to LIBOR mechanics.

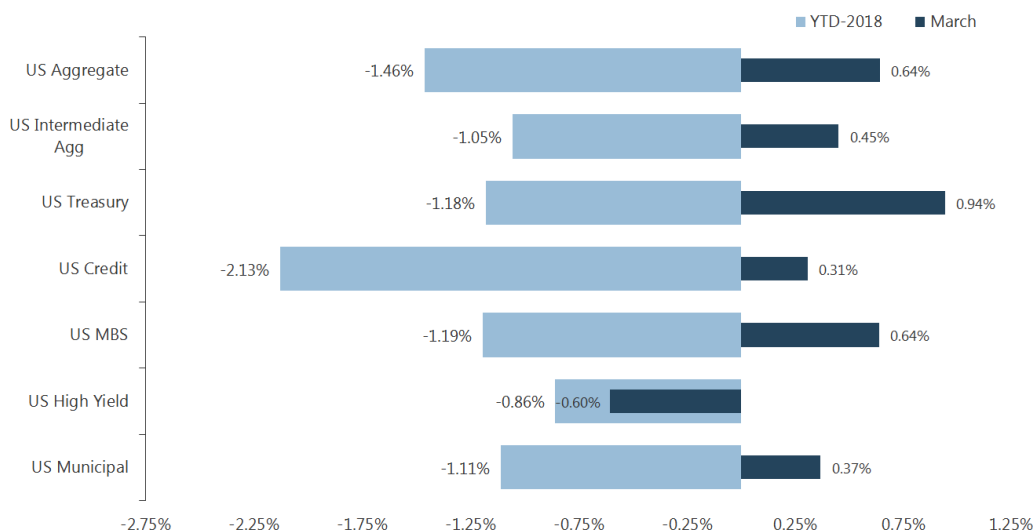


The bond market's "flight to quality" last month may become the new normal as investors react to increasing tariff, trade, and policy shifts. The immediate fear is the risk of damage to global economic growth rates that might be caused by a trade war or the introduction of non-tariff trade barriers. As calls for protectionism grow exponentially, retaliatory positions are being swiftly enacted by foreign governments to counteract the U.S. measures. This is a dangerous outcome for highly indebted countries, such as the U.S. Indeed, our economy might be even more sensitive than many others, since the booming high tech and aerospace industries are more exposed to free trade than other sectors. Any slowing of U.S. GDP growth rates - whether or not such a slowing is related to trade issues - would represent a significant divergence from the prevailing outlook. Our rate outlook for the past two years has been predicated on the belief that monetary policy normalization and the stimulative effect of tax and policy changes would lead to a meaningful increase in interest rates. We now face the specter of interest rates remaining lower than expected for the balance of the year.

These fears have had an impact well beyond the bond market. The growing reluctance of investors to take risk has led to stock market declines and contributed to the recent weakness of the dollar. A strong currency is a key linchpin to stable interest rates. A strong dollar, for example, enticed foreign capital to come to the U.S., as investors believed currency risk to be minimal. Countries with weaker currencies must pay higher rates to compensate lenders for the added risk of foreign exchange losses. A trade war would almost certainly pressure the dollar and nudge interest rates higher.

Perhaps more concerning, tariffs could trigger inflation from two fronts. In an environment where the economy demands more goods and services than available, imports act as a natural brake on pricing pressures. If imports are curbed, this brake is removed. Furthermore, tariffs increase the prices of production inputs such as raw materials and intermediate goods. Just as unfettered global trade precipitated a deflationary environment, protectionism will create an inflationary one.

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

This leaves a very muddled picture for the rate outlook. Trade wars have been known to crush economies (i.e. the Great Depression) and put interest rates into record low territory. However, a weaker dollar, higher tariffs, a decade of bloated budget deficits, and continued strength in economic fundamentals all point to the likelihood of inflation and interest rates moving higher. Global inflationary pressures have been dormant for more than a decade, giving the Fed the luxury of adopting a slow and gradual pace in normalizing interest rates. We believe the Fed may need to abandon this approach in order to combat rising inflationary pressures, even as the stock market faces increased volatility.

Exhibit 1 above illustrates the performance of the various fixed-income sectors as reported by the Bloomberg Barclays Indices for the first quarter of 2018. Despite the strength in March, bonds continue to be off to a weak start to the year. The U.S. Treasury Index posted a -1.18% return. Long term maturities lagged shorter durations. For example, the 2-year Treasury note was down just -0.17%, versus a -2.39% return on the 10-year note. Investment-grade credit and mortgage-backed securities returned -2.13% and -1.19% respectively, while the High Yield Index was down -0.86%. The Municipal Index declined -1.11%, although the securities of the Commonwealth of Puerto Rico and the Territories of the Virgin Islands posted positive returns for the quarter.

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