

June 5, 2018

## KEY TAKEAWAYS

Helped by a strong month-end rally, interest rates fell in May. Rates have continued the trend of trading higher on positive economic data and lower on policy driven events such as international trade. The one constant has been the trend of a flattening yield curve, which continued in May.

Key Rates (%)	May 31 2018	Apr 30 2018	Dec 31 2017
<b>Treasury Yields</b>			
2 Year	2.43	2.49	1.88
5 Year	2.70	2.80	2.21
10 Year	2.86	2.95	2.41
30 Year	3.03	3.12	2.74
<b>Credit Yields</b>			
BBB Industrial 10 Year	4.24	4.30	3.61
<b>Muni Yields</b>			
AAA 10 Year	2.43	2.53	2.01
<b>Mortgage Backed Securities</b>			
30 Year FNMA Current Coupon	3.58	3.65	3.00

## MAY IN REVIEW

- The 10- year Treasury was down 9 bps to finish May at 2.86%.
- While slightly negative on the month, high yield continues to be a strong performer on a relative basis, -.24% on the year.
- Municipals were the strongest performing fixed income sector in May, up +1.15%.

## “Pressure Pushing Down on Me, Pushing Down on You”

- Queen—”Under Pressure”

Interest rates fell in May, driven by renewed fears of a trade war. Trade wars are a proven detriment to economic activity and President Trump’s tariffs on steel and aluminum have led foreign leaders to impose their own tariffs on U.S. goods in retaliation. Treasury securities fared



particularly well relative to corporate bonds, due to credit spreads widening in the month. For the first time in months, higher quality issues outperformed lower quality. Municipal bonds posted a strong month, up 1.15%, due to continued investor demand.

May was the latest step in a now recognizable pattern of interest rates rising one month due to strong economic news, and then declining the next on policy driven “flight to quality” bond rallies. Bonds have been trading inversely with equities, oscillating between the noted risk-on/risk-off proclivities of global investors. Many still see a Goldilocks scenario for the U.S. economy, with modest inflation, and steady, but not red-hot, growth.

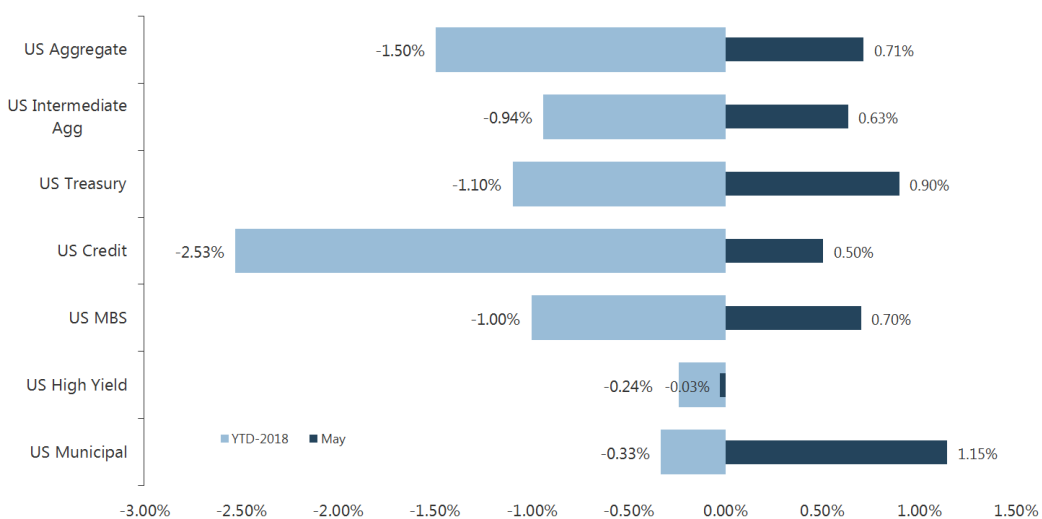
This trend should hold at least one more month, if the economic data released on June 1st is any indication of what we can expect in the weeks ahead. The closely watched employment figures were particularly strong, suggesting the economic momentum will continue throughout the summer. This growth will keep the pressure on interest rates, even if trade war concerns cause the occasional relief rally or two. June will also see an FOMC meeting at mid-month and there is near unanimous consent the Fed will raise reference interest rates at this meeting.

This will not be a one-direction move. We expect bond prices to get a reprieve later in the year. There are a wide range of trade talks and upcoming international events taking place in the near term and one overplayed negotiation – on either side – could lead to the next “risk off” bond rally.

Without a tangible policy shift, however, any rally should be viewed as temporary. Federal Reserve efforts to normalize monetary policy are expected to continue in the months ahead and increasing Federal budget deficits will only cause the pressure on bond yields to increase.

For now, we do not see a significant spike in interest rates. However, the Fed will continue the ever-increasing pace of its balance sheet liquidation process going forward. We continue to favor short-duration assets in all fixed-income sectors. We view the see-saw trading ranges as a good tool to pick up attractive bonds when rates are high and to sell bonds that no longer match our strategy in the rallies.

**EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS**



Source: Bloomberg Financial L.P. and Barclays Securities

Exhibit 1 shows the interest rate movement in May and for the year as reported by Bloomberg. The sector moves shown in the chart may provide a better indication of future trends than the rate moves. The stellar returns achieved by corporates in recent years were driven by tightening spreads, which remain near record tights. Spreads can widen significantly and still be below historic norms. We expect this credit strength to become a weakness as rates move higher in coming quarters. We have been advocating an increase in quality in our recent letters, as a result.

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