Maple Capital Management

Fixed Income Commentary

August 3, 2018

KEY TAKEAWAYS

Economic news continues to point to a strong economy, highlighted by the 4.1% annualized growth rate for the second quarter GDP. Based on latest comments, the Federal Reserve is still intent on raising interest rates to "normal" levels. Looking forward, investors will want to keep the pulse of any potential impact tariffs or trade wars may have on the overall global economy.

Key Rates (%)	Jul 31 2018	Jun 30 2018	Dec 31 2017
Treasury Yields			
2 Year	2.67	2.53	1.88
5 Year	2.85	2.74	2.21
10 Year	2.96	2.86	2.41
30 Year	3.08	2.99	2.74
Credit Yields			
BBB Industrial 10 Year	4.34	4.34	3.61
Muni Yields			
AAA 10 Year	2.49	2.47	2.01
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.68	3.60	3.00

JULY IN REVIEW

- The 10-year Treasury yield rose 10 bps month over month to 2.96%.
- High yield continued its strong performance, up 1.09% on the month.
- Credit was also a strong performer on the month, up .72%.

As Good As It Gets?

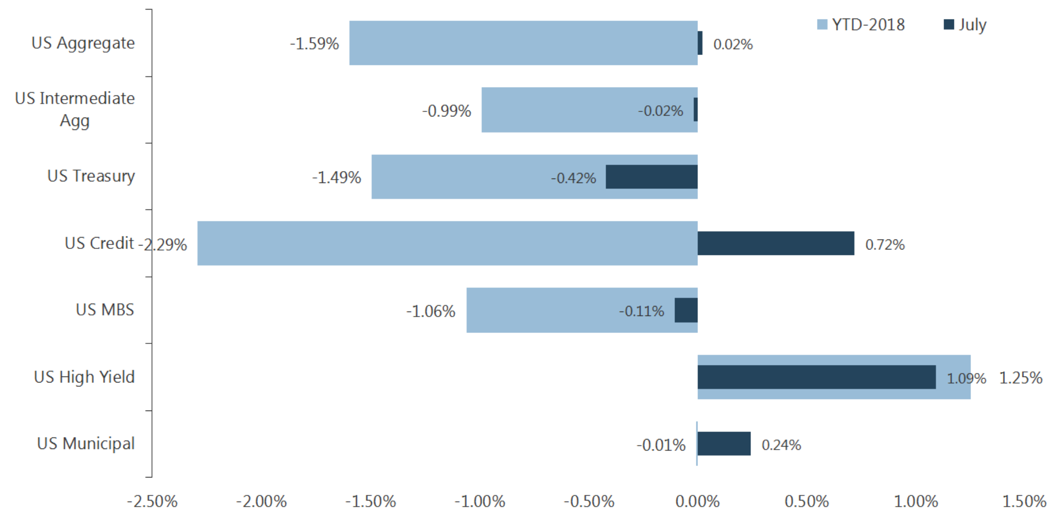
With the US economy at or near full employment, a stellar 4.1% annualized growth rate for second quarter GDP, and still relatively timid inflation statistics, we are asking ourselves "is this as good as it gets?" Strong economic growth is a primary driver of higher interest rates (low bond prices). With the Federal Reserve still intent on raising interest rates to "normal" levels, this pressure on the bond market will only intensify. Rate movements may be even more pronounced in particular sectors of the market. Corporate bond spreads, for example, remain near five-year lows, despite tightening in recent months. We expect this sector to experience more pain than Treasuries, at least in the short term.

Of course, rate moves are not linear. Higher interest rates will hurt growth in several ways. Housing starts and existing home sales have fallen, along with refinancing activity. A slowdown in housing activity has always been a red flag for the US economy. Higher interest rates also make consumer and small business spending less affordable relative to wage gains. The biggest unknown on the horizon, however, is the risk of a global trade war.

As we noted last month, it is widely accepted that trade wars are detrimental to global economic growth. While some countries may gain in the short run, the long-term pain eventually hits all countries and global GDP suffers. Counter tariffs from foreign nations will also cause pain. U.S. agriculture may be particularly hard hit, with everything from grains to dairy products being targeted. Foreign tariffs lower demand, cause prices to fall, and may cause unemployment to rise. With higher production costs domestically, U.S. imposed tariffs raise prices throughout the supply chain, causing higher inflation. In aggregate, these forces risk pushing the economy into a period of stagflation, with slower growth and higher inflation—or at least higher interest rates—becoming the new norm.

With little chance of another rate hike until September, interest rates barely moved in July. Worries about trade tensions kept the "risk off" trade intact for much of the month. Yields on the 2-year U.S. Treasury note rose 14 basis points to 2.67%, while yields on the 10-yr. Treasury note rose 10 basis points to 2.96%. The U.S. Treasury yield curve continued the recent flattening trend, as the spread between the 2-year and 10-year notes spread to a scant 24 basis points before rebounding to 29 basis points at month end. Investment-grade and high-yield corporate bonds and municipal bonds posted positive returns for July, while US Treasuries and MBS were slightly negative. **Exhibit 1** shows the sector returns within the fixed-income market according to the Bloomberg Barclays Indices for both July and on a year-to-date basis.

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

Going forward, it is important to remember the bond market moves far slower than the stock market. Investors still have a long wait to see how the trade wars and new tax rates will impact the economy. In the meantime, new tensions and policy changes will arise. We have yet to see signs of how new sanctions on Turkey and Iran will impact economic activity or if the increased tensions with Russia will fuel investor fear. Treasury rates have held relatively steady since May, with long interest rates actually falling from the highs set in May. With the Federal Reserve signaling two more rate increases this year (we believe there may only be one) and three more in 2019, we are keeping our bond portfolios on the shorter side of their duration targets. Short– and intermediate-term Treasuries now offer 90% of the yield available on 10-year Treasury securities. The sharp rise of short term interest rates in the past two years means front end maturities now provide more than enough income to buffer their durations.

Short term bonds now offer noticeably superior risk/reward profiles. We expect to maintain an over-weight to this maturity range relative to portfolio benchmarks. We will, of course, maintain exposure to longer duration assets, as they will outperform if the economy slows or the yield curve flattens. We continue to emphasize quality over higher yield when we evaluate new investments. This should lead to higher average credit ratings in our portfolios over time.

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