Maple Capital Management

Fixed Income Commentary

November 7, 2018

KEY TAKEAWAYS

By many measures, the U.S. is experiencing the strongest period of growth in decades. Rising interest rates should not be a surprise to investors in such an environment. Higher-grade assets outperformed lower rated issues in October. Investors will want to keep a close eye on this trend, as it could be an indication that the credit cycle is about to turn.

Key Rates (%)	Oct 31 2018	Sep 30 2018	Dec 31 2017
Treasury Yields			
2 Year	2.87	2.82	1.88
5 Year	2.97	2.95	2.21
10 Year	3.14	3.06	2.41
30 Year	3.39	3.21	2.74
Credit Yields			
BBB Industrial 10 Year	4.53	4.40	3.61
Muni Yields			
AAA 10 Year	2.76	2.62	2.01
Mortgage Backed Securities			
30 Year FNMA Current Coupon	4.00	3.81	3.00

OCTOBER IN REVIEW

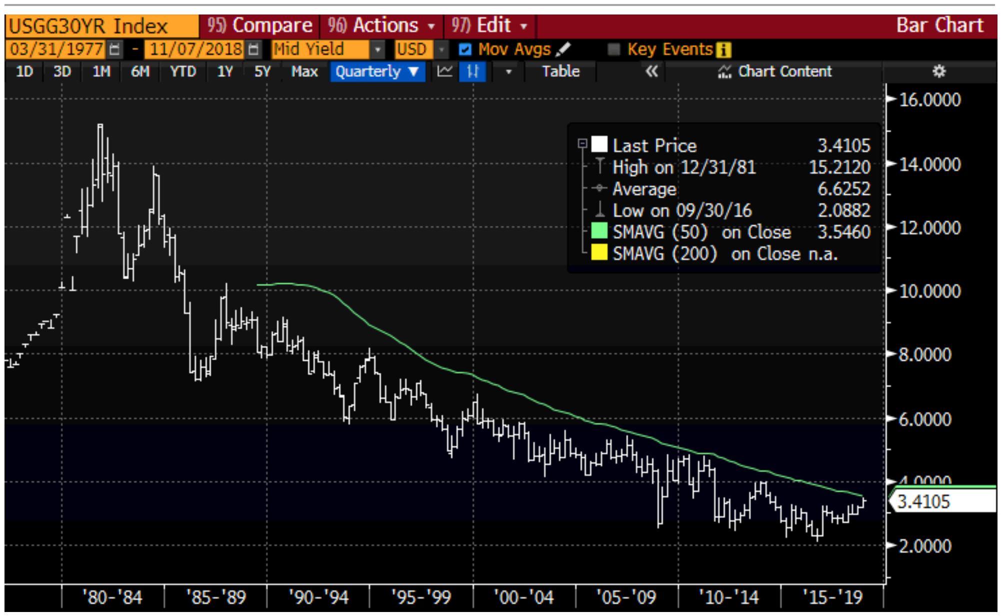
- The 10- year Treasury yield was up 8 basis points on a month over month basis, finishing October with a yield of 3.14%.
- High yield was the worst performing sector on the month, down 1.60%.
- Treasuries were also down on the month, down .48%.

Feelin' Hot, Hot, Hot

It was easy to overlook one point amidst the turmoil in the financial markets last month - the economy is hot and the bond market machinery is acting accordingly. Robust economic data and hawkish comments from the Federal Reserve continued to press interest rates higher in October. Employment related data were particularly strong. Unemployment is now at the lowest level since December, 1969. Initial claims for jobless benefits are at the lowest level since September, 1969. Real average hourly wages are increasing at the highest level since the Great Recession. By many measures, the U.S. is experiencing the strongest period of growth in decades.

Rising interest rates should not be a surprise to anyone in such an environment. The fact that many market participants were apparently caught off guard by this outcome – as shown by the sharp moves in both the stock and bond market in October – illustrates just how complacent investors have become after ten years of benign Federal Reserve monetary policy. In the Post-Crisis era, investors could reliably expect the Federal Reserve to defer any action that would appear to tighten monetary conditions. The decision to accommodate rather than disturb the status quo reflected the fear that market conditions were too fragile to handle change of any scale. This so-called "Fed Put" allowed investors to buy into market declines with confidence. Given recent events, it is safe to say this policy option is no longer in place.

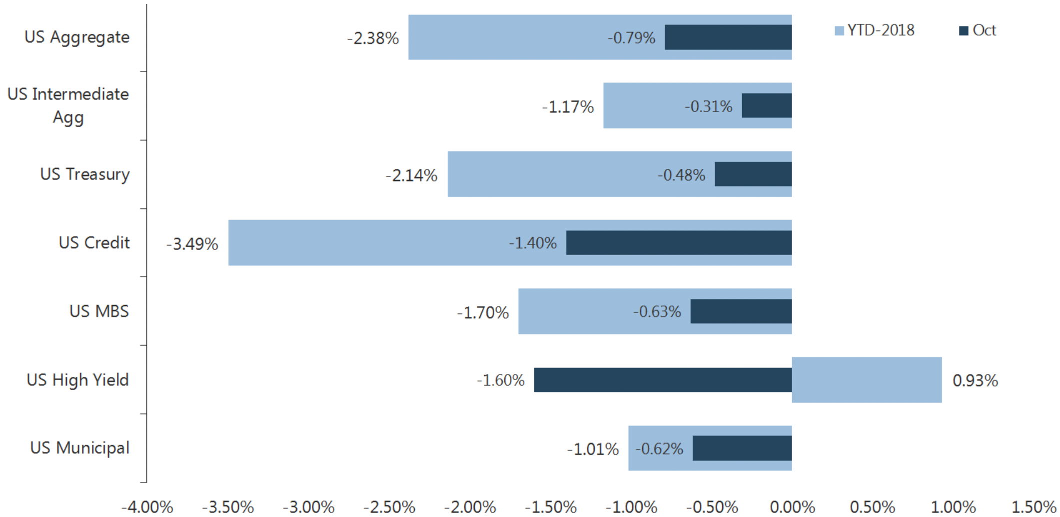
EXHIBIT 1: THE GREAT BOND BULL MARKET — 30-yr. Treasury Yields



Source: Bloomberg Financial L.P.

Fed Chairman Jay Powell has far less room to defer action in the face of market uncertainty than his predecessor and seems less willing to do so even if he had more latitude. By not taking modest steps earlier, the Yellen Fed forced Powell to act decisively when growth accelerated. The added stimuli of the tax cuts and broad de-regulation have limited his options even further as growth and inflationary pressures build. Powell is also very cognizant of the risks posed by inflation, and has stated his desire to ensure such pressures do not take hold.

EXHIBIT 2: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

The era of a paternal Federal Reserve is also nearing the end. In 2014, the phrase "we are data dependent" was almost synonymous with no action. Today, it leads us to expect further rate moves, regardless of outside news events. With the full employment portion of the dual mandate satisfied, the Powell Fed is free to focus entirely on the price stability side. It seems like the days of the Great Bond Bull Market may be numbered.

Yields rose across the board in October, with the 30-year Treasury bond yield increasing by 19 basis points during the month. This yield change produced a -5.64% return for the bond. Shorter-duration assets outperformed again, with the 2-year note gaining 0.16% in the period. Unlike previous periods, higher-grade assets outperformed lower rated issues. These moves collectively point to several paradigm shifts forming in the bond market. The credit cycle, which has been on an upswing for years, may be about to turn, leading to widening spreads on lower rated securities and increased resiliency for higher rated securities.

We continue to favor shorter duration assets in this environment. The math says rates are likely to keep rising and longer dated securities will have risk. However, we believe the economy can sustain growth for several more quarters and have tempered our focus on higher-grade securities for new money. The data suggest more risk can be borne in the near term. Short duration corporate bonds are not glamorous, but there will be few shocks with this approach. **Exhibit 2** above highlights the performance of the various sectors of the fixed-income market according to the Bloomberg Barclays Indices.

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