MAPLE CAPITAL MANAGEMENT

FIXED INCOME COMMENTARY

April 2, 2019

Markets Cheer the Fed's Pivot

The global growth narrative continued to deteriorate this quarter, providing further rationale for the Fed's pivot. Not only did the Fed pause the rate hike program, they also announced the balance sheet normalization program will end later this year. Now that the Fed tightening campaign is effectively over (barring a persistent spike in inflation or a dramatic pick-up in growth metrics), global central banks are largely in sync once again. The ECB is preparing to reignite their stimulus measures via loans to banks (for the third time), while the BoJ is probably still years away from being able to even contemplate raising rates or ending QE. China is also heaping stimulus on its economy to keep growth from slowing too sharply.

Performance Spike Thanks to the Fed

The Fed's decision to pause was likely a key factor in explaining market performance this quarter, both for equities and fixed income. Equities rallied strongly in both January and February and a bit less so in March. Earnings reports for the fourth quarter certainly helped, but the main impetus for the strong gains was likely the Fed pause. Meanwhile, fixed income markets rallied across the board. Government bond yields are down by approximately 30 basis points across most of the yield curve and spreads in nearly all sectors are tighter. Excess returns were greatest in the weaker segments of the markets, particularly the high yield segment, reflecting investors' belief that the Fed pause may extend the cycle even further and could produce the elusive soft landing.

Foreign Difficulties Led to Fed Pivot

Growth in the US may be slowing, but we do not believe a recession is imminent. Speculation on a rate cut by the Fed also appears overdone. With the economy at full employment, inflation just under the Fed's target, and strong consumer and business confidence measures, a rate cut in the near term is simply unnecessary barring some kind of major disruption. If the Trump administration is successful in negotiating a deal with China, or if growth improves a bit from the recent loosening of financial conditions, we believe the next move for bond yields is higher (albeit moderately so).

KEY TAKEAWAYS

Responding, in large part, to the deterioration of global growth, the Fed decided to pause its rate hike program and also announced the balance sheet normalization program will end later this year. The Fed's pivot unleashed strong performances by equity and fixed income markets in the first quarter of 2019.

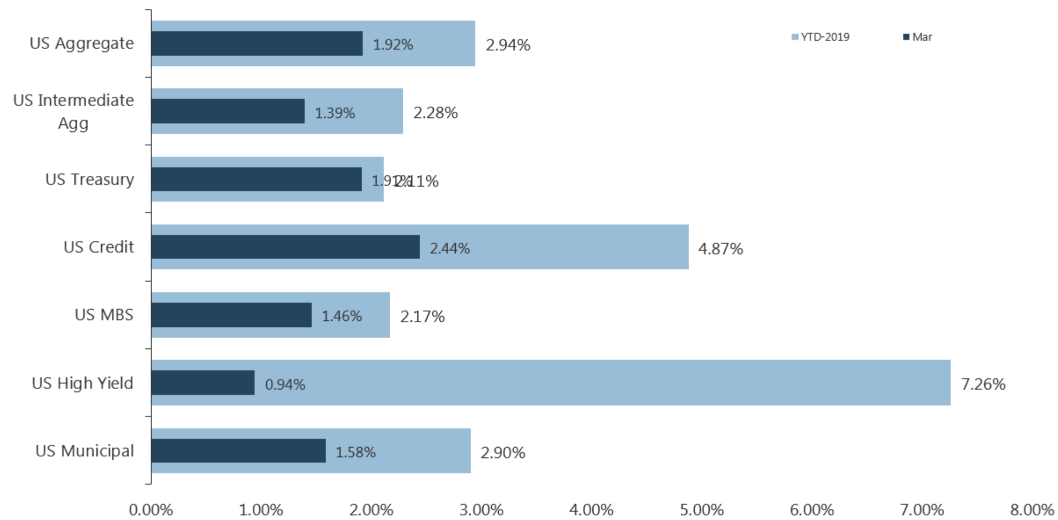
Key Rates (%)	Mar 31 2019	Feb 28 2019	Dec 31 2018
Treasury Yields			
2 Year	2.26	2.51	2.49
5 Year	2.23	2.51	2.51
10 Year	2.41	2.72	2.68
30 Year	2.81	3.08	3.01
Credit Yields			
BBB Industrial 10 Year	3.82	4.17	4.35
Muni Yields			
AAA 10 Year	1.89	2.14	2.32
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.11	3.48	3.50

MARCH IN REVIEW

- The 10- year Treasury yield was down 28 basis points through the first quarter of 2019, finishing March with a yield of 2.41%.
- High Yield was the best performing sector in the first quarter of 2019, up 7.26%.
- Munis also had a strong first quarter of 2019, up 2.90%.

Indeed, it remains difficult to identify any major imbalances in the US. What may have driven the Fed's pivot is the weakness overseas. Europe is once again struggling to grow, with even Germany suffering due to weak exports; Japan is stuck in neutral; Brazil is dealing with self-inflicted problems and weak commodities exports; and China, the 800-pound gorilla in terms of its contribution to global growth, is mired in a slow-down. Some of China's problems are due to the trade war, but even before that, China's leadership had been recalibrating the economy away from debt-reliant investment spending and more toward consumption. All of these examples of weak conditions are a threat to global financial conditions, and ultimately to the US economy. If the Fed had continued on its path, the likelihood of a recession in the US within the next year or two would have increased, and with the rest of the world dealing with difficult conditions, the Fed's pause seems well-timed.

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

It should come as little surprise that economies around the world are struggling to grow given the long term secular trends of slowing growth (or outright declines) of the working-age population, aging populations, and low productivity growth. There simply is no magic elixir that can counter these powerful trends and uncertainty on trade has only exacerbated the problem. On top of all that, debt levels are high for all types of borrowers, and in particular for governments in developed economies. Many studies have shown that once government debt reaches 100% of GDP, subsequent growth rates are sub-par. Look no further than Japan for ample proof of this theory.

Summary

The markets have spoken and the Fed listened: volatility and "risk off" in 4Q18 has led to a remarkable rebound in 1Q19. The stellar returns seen across the board are unlikely to be repeated as the year unfolds given valuations that appear on the rich side. While some give-back may be in store, we do agree the Fed's decision to end rate hikes, even if temporary, provides the right kind of conditions for this cycle to continue a bit longer --- goldilocks is here again.

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