MAPLE CAPITAL MANAGEMENT

FIXED INCOME COMMENTARY

July 3, 2019

KEY TAKEAWAYS

Despite an unemployment rate of 3.6%, the Fed Funds rate at just 2.25%-2.50%, and labor shortages across many industries, many economists are forecasting the Fed will begin cutting rates starting as early as July. As a result, the move lower in rates that began in May continued in June, leading to strong fixed income sector returns for the month of June.

Key Rates (%)	Jun 30 2019	May 31 2019	Dec 31 2018
Treasury Yields			
2 Year	1.75	1.92	2.49
5 Year	1.77	1.91	2.51
10 Year	2.01	2.12	2.68
30 Year	2.53	2.57	3.01
Credit Yields			
BBB Industrial 10 Year	3.31	3.57	4.35
Muni Yields			
AAA 10 Year	1.62	1.66	2.32
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.74	2.86	3.50

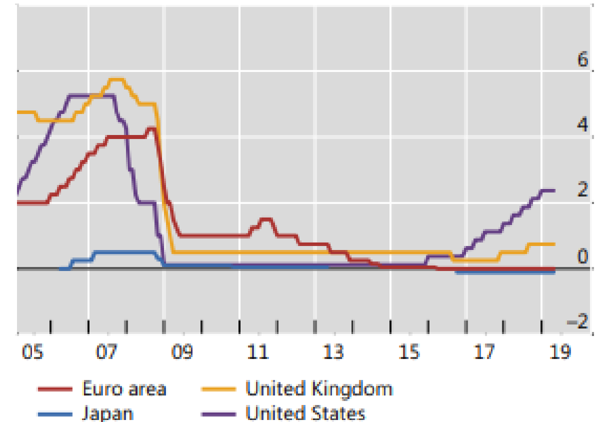
JUNE IN REVIEW

- The 10-year Treasury yield was down 11 basis points, finishing the month at 2.01%.
- High Yield rebounded from a negative May to have a strong June, up 2.28%.
- Total return on Treasuries was 0.92% for the month.

Bonds Still Hugely Impacted by GFC of '08

As of July 1, the current economic expansion is now officially the longest since 1854, which is as far back as economists have attempted to date business cycles.

EXHIBIT 1: Central Bank Policy Rates



A quick look at Exhibit 1, however, reveals a somewhat disturbing situation. Only the US and the UK have been able to raise overnight rates at all since the Great Financial Crisis (although the ECB tried in 2011 for a brief period). As eager as the Fed was to move away from the zero bound, the tightening campaign couldn't even get the Fed Funds rate to 2.5% before the financial markets sent sharp signals that no more tightening could be tolerated. With the global economy handcuffed by a massive debt burden, the costs of servicing the debt simply can't rise much without causing serious distress in the real economy. Economic growth itself is difficult to achieve due to this debt burden, aging demographics, slow growth (or outright contraction) of the working age population, and disruptive technology that keeps inflation at bay while widening the wealth gap.

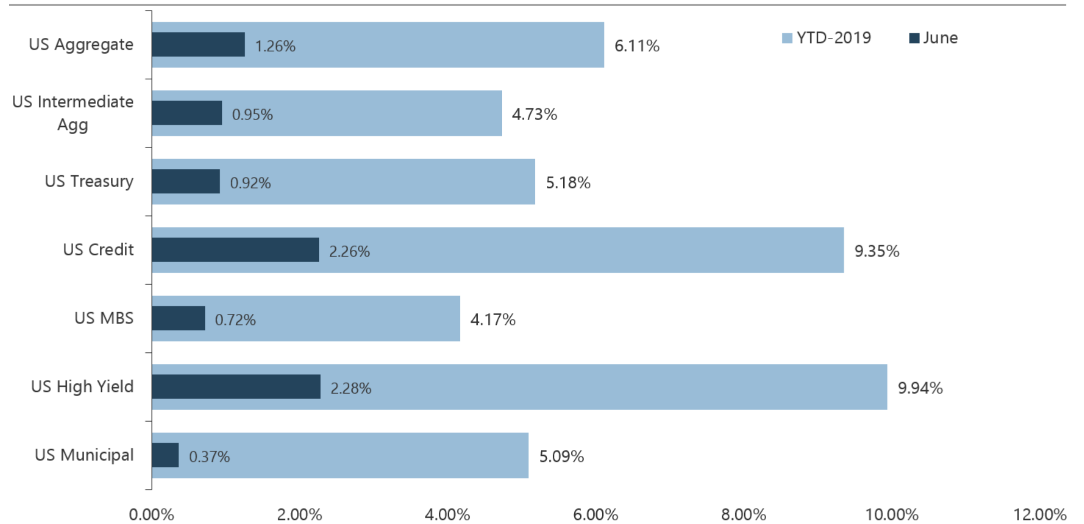
Perhaps the strangest outcome stemming from the extraordinary measures taken by central banks to deal with the aftermath of the GFC is the vast amount of

EXHIBIT 2: TOTAL GLOBAL DEBT WITH NEGATIVE YIELDS ~$13T

Source: Bloomberg Financial L.P.

government and private sector debt that trades at negative yields. Still, economic growth rates remain uncomfortably low; the Fed and the ECB now appear ready to layer even more stimulus on bond markets by lowering rates and/or buying more debt, which will make it easier for debt to be rolled over and perhaps buy more time for this record-breaking recovery. It certainly makes for interesting times to observe a Fed that appears willing to learn from mistakes of the past and try just about anything to avoid a recession and the potential for deflation. Time will tell whether monetary policy can finally prove effective or whether this perpetual cycle of stimulus will produce another bad ending of its own.

EXHIBIT 3: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

Second Quarter Bond Returns

US Treasury yields fell further in June due to a clear signal from Fed Chair Powell that a rate cut is likely, perhaps as soon as July 31, and risk spreads tightened. As a result, bond index returns were nicely positive. Based on the marked tightening of corporate bond spreads, investors are signaling a belief that this early about-face by the Fed will allow the economy to avoid or at least delay a recession which should keep corporate profits from declining any time soon. Equity markets appear to be corroborating this more favorable view as at least one major index, the S&P 500, reached a new high in June.

Municipal bonds have been on a tear due to their status as one of the last ways to reduce taxes following last year's tax reform, but they took a pause in June and lagged Treasuries a bit. Residential MBS (RMBS) also did not fare quite as well due to some spread widening with the return of prepayment risk. Investors have been steadily absorbing corporate and municipal bonds due in part to the rapid decline of Treasury bond yields and the need for absolute yield by the world's pension funds, insurance companies, and other large bond investors who have been struggling with low bond yields for some time. Supply is also down on a year-over-year basis so the buying frenzy feels even more acute.

What seems certain is that "low for longer" is back with a vengeance but economic growth may not respond as hoped given the high hurdles mentioned above. This global reliance on monetary stimulus leaves us believing the bond market remains vulnerable to another round of spread widening similar to the fourth quarter of 2018 if growth and/or profits disappoint. At the least, spreads appear more likely to widen from here than to tighten, particularly since interest coverage and other fundamental metrics remain thinner than we prefer at this stage of the expansion. Therefore, we remain of the belief that taking risk is not particularly appealing at this juncture and at prevailing spread levels. We will continue to tread carefully and position portfolios with sector and issuer diversification aimed squarely at risk mitigation.

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