MAPLE CAPITAL MANAGEMENT

FIXED INCOME COMMENTARY

August 5, 2019

Merely an Insurance Policy?

At its July 2019 meeting, the Federal Reserve opted to lower the federal funds target range by 25 basis points to 2.0%-2.25% and to immediately suspend their balance sheet runoff, both of which are stimulative measures. This was the first rate cut in a decade and it comes at a time in the economic cycle that is earlier than normal. In the past, the Fed would often raise rates until the economy clearly softened, but today it could be argued a rate cut is simply not necessary. It appears this Fed is attempting to show it has learned from mistakes of the past and seeks to foster the conditions that will enable the expansion to continue. By listening to the clear market signals from the fourth quarter of 2018, the Fed is cutting rates as an “insurance policy” that will ease financial conditions. Both equity and fixed income markets rejoiced in this news, but raised the question as to whether this was merely an insurance policy to keep the US economy moving forward or the beginning of a series of moves. The Fed cited a number of concerns such as weak global growth, the trade war, and a stubbornly low rate of inflation. In typical “Fed-speak’ fashion, Powell said this was a “midcycle adjustment” and it does not mean policymakers will follow up with an aggressive rate-reducing regime. At the same time, he did not rule out further rate reductions. Once again, the Fed is data-dependent. We would not rule out another rate reduction prior to year-end, but we do think the market has priced in too many rate cuts in too short a time.

Looking at some recently released US economic data, the first estimate of second quarter GDP was reported at 2.1%, a decent showing albeit down from a 3.1% growth rate in the first quarter. Helping the second quarter number were an impressive increase in personal consumption, up 4.3%, and growth in government spending, while lower fixed-business spending and net exports were a drag. Given these contradictions, the Fed is grappling with unusually great uncertainty about where the economy stands. In addition, it has to contend with an unprecedented lack of economic policy cooperation between the White House and Congress.

With interest rates already very low we believe the Fed’s options are very limited and question how effective rate reductions will be. After a decade of low interest rates most consumer loans already feature very low rates and there are fewer loans with adjustable rates compared to the years just before the financial crisis. For example, in 2007 hybrid adjustable-rate mortgages comprised over 30% of the residential mortgage-backed securities market according to Wells Fargo, but today it’s only 5%, highlighting how fewer consumers will benefit from lower rates. Also, lower interest rates may be good for some borrowers, but many of those relying on fixed incomes will be hurt by lower bond yields.

Turning to the fixed income market’s July performance, most bond sectors posted modest returns for the month. Municipal bonds led the way with a total return of

KEY TAKEAWAYS

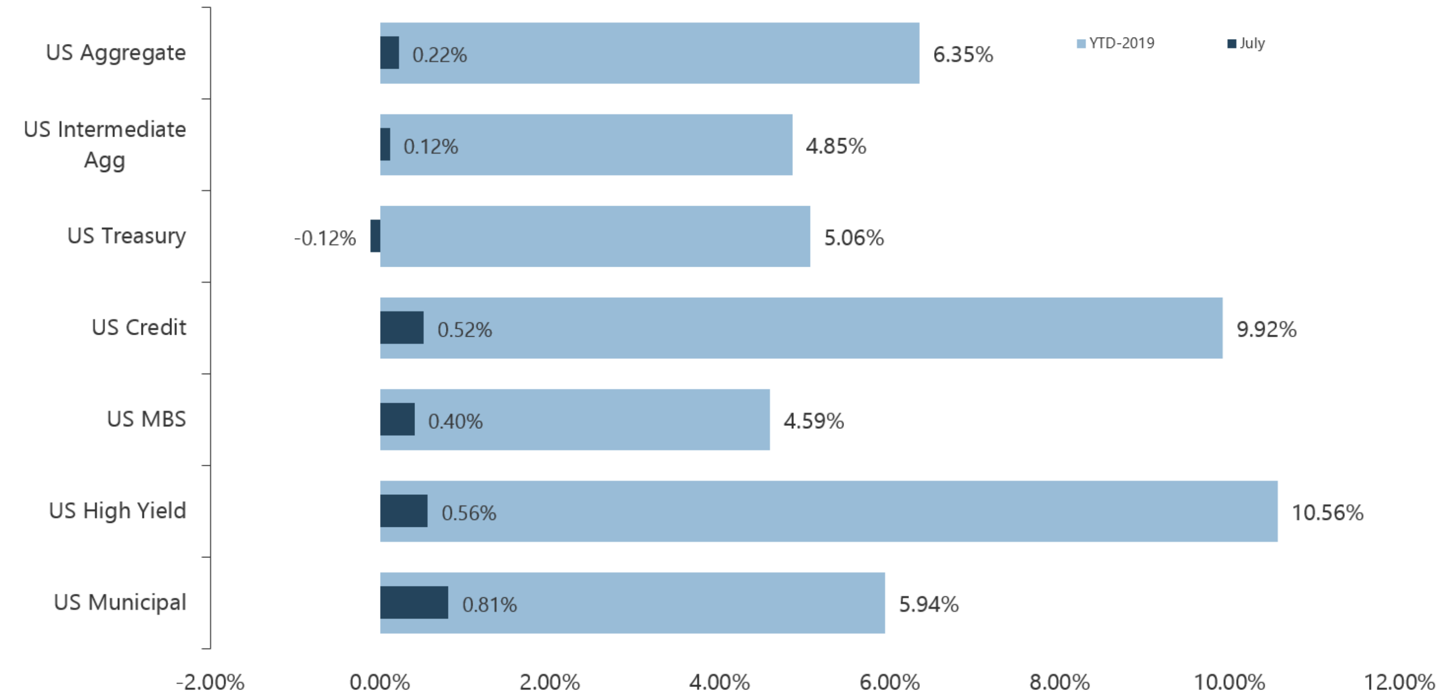
As expected, the Fed lowered rates by 0.25% in what is seen as an insurance policy to ensure the expansion can continue. Rates never got very high, so there are some doubts as to how effective it will be, but an easier Fed is a big boost to confidence and the markets initially responded well. Going forward, trade policy will be a big factor in market performance.

Key Rates (%)	Jul 31 2019	Jun 30 2019	Dec 31 2018
Treasury Yields			
2 Year	1.87	1.75	2.49
5 Year	1.83	1.77	2.51
10 Year	2.01	2.01	2.68
30 Year	2.52	2.53	3.01
Credit Yields			
BBB Industrial 10 Year	3.31	3.31	4.35
Muni Yields			
AAA 10 Year	1.54	1.62	2.32
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.78	2.74	3.50

JULY IN REVIEW

- The 10-year Treasury yield finished the month at 2.01%, which is flat month-over-month.
- High Yield was the strongest sector for the month, up 0.56%.
- Treasuries were negative for the month, down 0.12%.

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

0.81%, followed by high yield bonds at 0.56%. The spread sectors of the investment grade market, namely corporate bonds and mortgage-backed securities, also posted positive results of 0.52% and 0.40% respectively. The US Treasury Index was the only sector that posted negative returns for July: -0.12%. **Exhibit 1** shows the total returns of the various fixed income sectors for July and year-to-date 2019.

Going forward, markets will be fixated on US economic data and the trade war, and performance of the financial markets will likely remain choppy. Should the US economy start to re-accelerate or if a trade deal is reached with China, the bond market could sell off but equities will likely be mixed: some sectors may sell off if additional rate cuts are less likely, but some may rally due to the prospect of improved trade terms and faster global growth. Despite this short term uncertainty, we remain convinced that a portfolio of well-managed companies with distinctive growth opportunities across a broad array of industries is the best investment stance for the long term.

535 Stone Cutters Way, Montpelier, VT 05602 •
Tel: 802.229.2838 • Toll Free: 800.255.9946 Fax: 802.229.2837
533-D Johnson Ferry Rd • Suite 350 • Marietta, GA 30068 •
Tel: 770.693.7690 • Fax: 770.512.5176

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