MAPLE CAPITAL MANAGEMENT

FIXED INCOME COMMENTARY

September 4, 2019

KEY TAKEAWAYS

- Bond rally gained momentum in August.
- Growing volume of global debt with negative yields is worrying US investors.
- Monetary policy is moving in sync across the globe, but rate cuts alone will likely not be enough to alleviate the myriad problems in the global economy.
- Maple is focused on after-tax yield optimization and risk management via diversification to fortify portfolios for whatever unfolds in the economy.

Key Rates (%)	Aug 31 2019	Jul 31 2019	Dec 31 2018
Treasury Yields			
2 Year	1.50	1.87	2.49
5 Year	1.39	1.83	2.51
10 Year	1.50	2.01	2.68
30 Year	1.96	2.52	3.01
Credit Yields			
BBB Industrial 10 Year	2.95	3.31	4.35
Muni Yields			
AAA 10 Year	1.27	1.54	2.32
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.39	2.78	3.50

AUGUST IN REVIEW

- The 10- year Treasury yield finished the month with a yield of 1.50%, which is down 51 bps month over month.
- Treasuries were the strongest sector on the month, up 3.40%.
- High yield was up 0.40%.

How Low Can They Go?

Bond yields continued their steep decline in August as investors became more worried about a number of issues such as the escalation of the trade war, weaker economic data out of Europe and China, increased potential for a "hard Brexit," the slowing pace of growth of corporate earnings, and heightened geopolitical tensions, all of which threaten the already tepid pace of global growth. Global central banks have been cutting rates in synchronous fashion in response to this onslaught due in part to their fear of deflation (see Exhibit 1 below). These actions along with volatile equity market activity during August led to yields on ten- and thirty-year bonds declining the most --- by a whopping 51 and 56 basis points respectively! Short term yields also fell markedly, all of which left the yield curve inverted out to five years (i.e. short-term yields higher than longer terms).

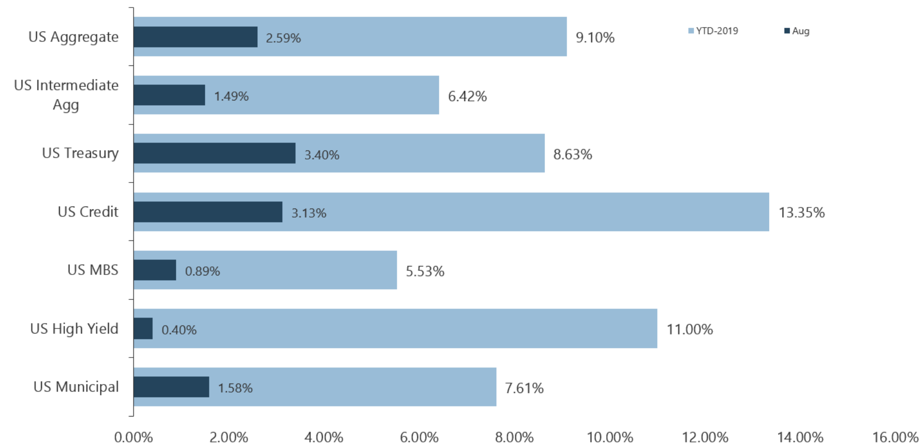
EXHIBIT 1: MOVEMENT OF CENTRAL BANKS SINCE JULY 2019

Country	Current Rate	Change		Decision Date	Beginning of year	Year-to-Date
Policy Rate Changes in August						
Mexico	8.00%	-25 bps	▼	Aug 15	8.25%	-25 bps
Thailand	1.50%	-25 bps	▼	Aug 07	1.75%	-25 bps
India	5.40%	-35 bps	▼	Aug 07	6.50%	-110 bps
New Zealand	1.00%	-50 bps	▼	Aug 07	1.50%	-50 bps
Policy Rate Changes in July						
USA	2.25%	-25 bps	▼	Jul 31	2.50%	-25 bps
Brazil	6.00%	-50 bps	▼	Jul 31	6.50%	-50 bps
Russia	7.25%	-25 bps	▼	Jul 26	7.75%	-50 bps
Turkey	19.75%	-425 bps	▼	Jul 25	24.00%	-425 bps
Indonesia	5.75%	-25 bps	▼	Jul 18	6.00%	-25 bps
South Korea	1.50%	-25 bps	▼	Jul 18	1.75%	-25 bps
South Africa	6.50%	-25 bps	▼	Jul 18	6.75%	-25 bps
Australia	1.00%	-25 bps	▼	Jul 02	1.50%	-50 bps
Argentina	58.00%	-450 bps	▼	Jul 01	62.50%	-450 bps

Source: Moody's Investors Service, Haver Analytics

Another matter of concern to investors is the increasing volume of global bonds trading at negative yields. Investors are worried that the conditions which have fostered this unprecedented situation are now hitting the US and the potential for negative rates developing in the US is very real. Earlier this year, we noted how the Global Financial Crisis of '08-'09 (GFC) continues to impact financial markets, and this negative yield phenomenon is certainly one of the most obvious distortions arising from that event. We are hopeful that negative yields do not develop in the US, but we are not ruling out the possibility.

EXHIBIT 2: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

The Fed's rate cut of July 31 will likely be followed by another at the conclusion of their meeting on September 18. While this preemptive return to an easing policy is welcome relief for anyone concerned about the economy, it is also worth noting that monetary policy is not a panacea for the myriad problems facing policymakers. Many of the issues plaguing the global economy are structural and secular in nature such as poor demographic conditions, but others stem from the policy choices made after the GFC which resulted in higher debt burdens for the government sector. Extraordinary and uncharted policies such as negative official policy rates and quantitative easing have simply not extricated the global economy from the grip of these powerful forces.

The worry over negative yields has resulted in a scramble for the relatively high yields still available in the US bond market from foreign and domestic investors alike. This torrid pace of buying has pushed government bond yields lower and spreads on corporate, municipal, and securitized bonds generally tighter, although spreads on corporates widened during August. Spreads typically lag when Treasury yields experience large moves as they did in August.

In response to this market action, our recent taxable investment activity has emphasized a blend of two-year Treasuries, 15-year MBS, selective corporate bonds in the five to ten year maturity range, and preferred stock in order to optimize after-tax yield for our client portfolios. Treasuries and MBS are defensive holdings that provide an anchor for portfolios. Within the corporate sector, we have focused our efforts on identifying companies that are well-positioned to withstand any potential recession that may develop. Some examples of resilient companies we have favored include O'Reilly Automotive, the auto parts retailer, and Valero Energy Corporation, one of the leading refining companies. In the preferred stock sector, we recently purchased Allstate, a leading property/casualty insurer with solid underwriting, prudent risk management, and good earnings prospects even as interest rates decline. Within tax-exempts, our focus is on selectivity since some municipal issuers will likely encounter difficulties in handling an economic downturn.

While recent events have been surprising even to the most pessimistic among us, we believe our investment decisions have positioned our client portfolios well for any kind of economic developments that may unfold. Focusing on cash flow, ratings resiliency, relative value, and capital structure all remain critical ingredients for long-term investment performance. Our focus on prudent risk management and after-tax yield are also critical elements that will remain at the forefront as the global economic storm clouds grow darker.

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