MAPLE CAPITAL MANAGEMENT

FIXED INCOME COMMENTARY

October 2, 2019

KEY TAKEAWAYS

Rates were higher across the curve in September, with exception to rates inside one year. Overall, economic data out during the month was mixed. While the U.S. consumer remains strong, growth overseas is slowing. Heading into the fourth quarter, investors will be looking to see if the Fed will continue lowering rates as a preventative measure.

Key Rates (%)	Sep 30 2019	Aug 31 2019	Dec 31 2018
Treasury Yields			
2 Year	1.62	1.50	2.49
5 Year	1.54	1.39	2.51
10 Year	1.66	1.50	2.68
30 Year	2.11	1.96	3.01
Credit Yields			
BBB Industrial 10 Year	3.08	2.95	4.35
Muni Yields			
AAA 10 Year	1.47	1.27	2.32
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.61	2.39	3.50

SEPTEMBER IN REVIEW

- The 10- year Treasury yield finished the month with a yield of 1.66%, which is up 16 bps month over month.
- Munis had their first negative month on the year, down .80%
- High yield was positive on the month, up .36%.

Bond Returns and Leaves Both in the Red

Bond yields generally rose during September, giving back some of the gains from the big rally in August. The exception to this trend was short yields inside one year, which fell in response to the Fed's second rate cut of the year. Rate cuts and additional easing measures continue from other central banks in response to the trade war-induced decline in the manufacturing sector. With the ECB, BoJ, and Swiss National Bank already in negative territory, various other tools are being employed in an effort to prop up floundering growth rates such as the resumption of the bond-buying program by the ECB (now open-ended). These actions highlight how monetary policy is approaching limits and much more debate is occurring on the efficacy of negative interest rates. Who knew "efficacy" would become such an important word in our vocabulary when we were taking the SATs all those years ago!

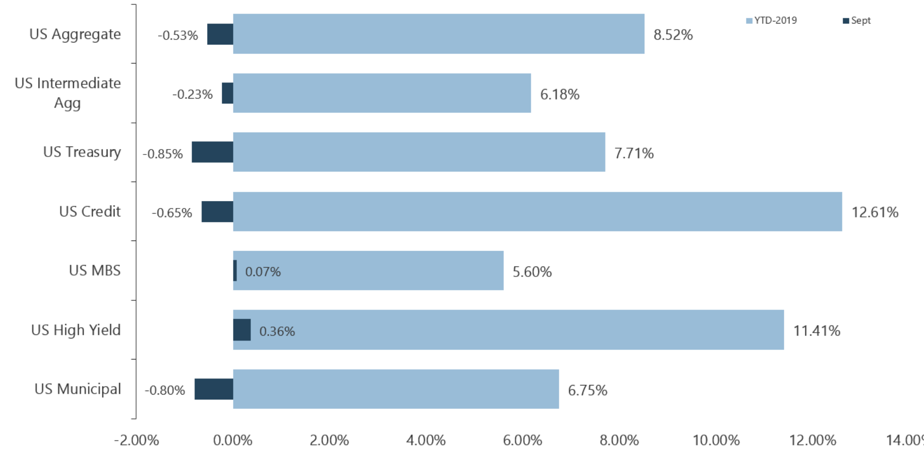
Economic data during the month was more mixed in that some releases pointed to an uptick in activity for a change. Retail sales were stronger than expected, demonstrating the resiliency of the consumer thanks to a robust labor market, and auto sales were a bright spot. Housing-related data also showed some life perhaps due to the marked decline in mortgage rates this year. August starts and building permits were both higher than expected, but activity levels in the housing industry remain below those prevailing before the financial crisis. Low rates in and of themselves are simply not enough to overcome the affordability problem plaguing many local real estate markets, and shortages of land and labor are also likely inhibiting new construction activity. Lastly, industrial production rebounded 0.6% in August with widespread gains, including manufacturing. One of the components of this series is mining/extraction which received a boost from higher oil production following cutbacks in July from hurricanes.

Offsetting these positive reports somewhat were weak consumer spending data (retail sales are not the only measure of consumption), slowing growth overseas, and weaker consumer confidence. In fairness, consumer confidence remains solid and consistent with steady consumption spending, but we bond investors are always looking for trends and any sign that the foundation of GDP growth could falter is worth paying attention to.

On the inflation front, CPI remained tame but core CPI ticked higher and the year-over-year pace of 2.4% is a cycle high. Some of this bump could be due to the pass-through of tariff costs to the consumer. Certain categories of consumer goods exposed to initial rounds of tariffs have displayed upward price pressure, reversing the trend of lower prices on goods that has been in place for the last decade. Still, the Fed continues to focus on core PCE which, at 1.6%, is below the 2% target.

Inflation is simply not high on anyone's list of problems as long as greater threats to global growth such as the trade war are the main concern.

EXHIBIT 2: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

Global bond markets have been signaling a higher risk of recession and another potential negative signal emerged in September. Dislocations in the overnight repurchase agreement (or "repo") market popped up out of nowhere and suddenly became the subject of much speculation. The repo market is a major source of funding and/or overnight investment for many institutional investors but primarily banks, so any trouble in that market can be interpreted as a signal of deeper systemic problems. In this instance, the Fed responded by providing ample funds (via reverse repo and 10-day term repo) to the banking system which appears to have alleviated the problem. In short, suffice it to say the level of excess bank reserves (akin to cash equivalents held by the Fed) has reached a low point and needs to increase to allow order to return to the market. Once Fed officials have determined how this increase should occur, we anticipate an announcement and action plan designed to address the shortage, likely at the next Fed meeting in late October. Bottom line: given what we know now, the banking system does not appear to be signaling any kind of fundamental problem.

With three quarters now behind us and leaves beginning to fall in Vermont, it appears bond yields are well-supported by a backdrop of weakening growth, monetary policy easing, and secular deflationary trends intact. At such absolute lows in yield, we believe it is vitally important to avoid "reaching for yield" which could result in mistakes should difficult economic conditions emerge. Spreads on corporate, municipal, and securitized bonds are all fairly tight and offer little incentive to take risk. Therefore, our recent investment actions have focused on safe havens such as Agency MBS (no credit risk, just timing risk from refis) and select corporate bonds that we expect will retain or improve their ratings through the cycle. Within the corporate sector, one area we are generally avoiding is the pharmaceutical sector since a considerable amount of debt has been taken on by these companies amidst an uncertain future for pharma pricing. We are also avoiding much of the energy complex, but particularly oil field services where poor pricing and technological changes continue to be a problem. As for the municipal sector, we are wary of underfunded pensions, risks from environmental factors, and deteriorating demographics that could lead to financial difficulties.

Thank you for your continued confidence in Maple Capital Management.

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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