# FIXED INCOME COMMENTARY

November 4, 2019

## KEY TAKEAWAYS

The Federal Reserve lowered the federal funds rate by 25 basis points, the third consecutive cut, to a range of 1.50%-1.75%. Going forward, it is widely expected that the Fed will pause its easing to assess the impact of the most recent cuts. Spreads widened in the high yield market during the month, a trend that warrants watching as it could be a signal of increasing risks to the overall economy.

| Key Rates (%) | Oct 31 2019 | Sep 30 2019 | Dec 31 2018 |
|---|---|---|---|
| **Treasury Yields** | | | |
| 2 Year | 1.52 | 1.62 | 2.49 |
| 5 Year | 1.52 | 1.54 | 2.51 |
| 10 Year | 1.69 | 1.66 | 2.68 |
| 30 Year | 2.18 | 2.11 | 3.01 |
| **Credit Yields** | | | |
| BBB Industrial 10 Year | 2.98 | 3.08 | 4.35 |
| **Muni Yields** | | | |
| AAA 10 Year | 1.48 | 1.47 | 2.32 |
| **Mortgage Backed Securities** | | | |
| 30 Year FNMA Current Coupon | 2.61 | 2.61 | 3.50 |

## OCTOBER IN REVIEW

- The 10-year Treasury yield finished the month with a yield of 1.69%, up 3 bps month over month.
- Munis were up 0.18%, building on the earlier gains of the year.
- High yield total return was positive for the month, up 0.28%, but CCCs are lagging.

## Rate Cuts to the Rescue


**Monetary policy delivers again.** On October 30, the Federal Reserve's Federal Open Market Committee (FOMC) lowered the federal funds rate by 25 basis points to 1.5% -1.75%. This was the third cut this year and probably the last for a while given the accompanying statement indicating current policy was "likely to remain appropriate." Of course, incoming economic data may lead Fed officials to consider another cut if it proves unexpectedly weak, but the bar now appears fairly high for that to occur even though inflation is below-target. Viewed on its own, below-target inflation could be an excuse to continue easing policy, but the obvious problem is that inflation may not move higher before the Fed reaches the zero bound again…and then what? The Fed would surely like to avoid having to consider cutting rates into negative territory, particularly since the efficacy of going negative is a matter of much debate. In any event, after 75 basis points of cuts at three consecutive FOMC meetings, a pause appears sensible in order to assess the impact from these actions since monetary policy acts with a lag.

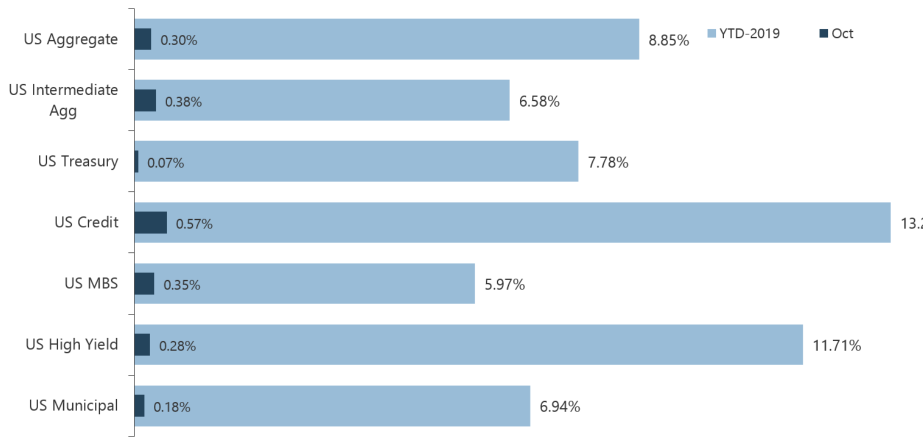
**Bond yields generally declined during the month**, but these declines were mainly for one year and shorter maturities and a direct response to the Fed's action. Yields on 10- and 30-year bonds rose slightly, but both remain firmly within the trading range of the last three months.

**Spreads, the other factor impacting bond valuations, were mixed during the month:**

- **Investment grade corporate** spreads narrowed by four basis points, but high yield spreads moved wider. This widening was more pronounced for the weakest ("CCC or lower") segment of the high yield market. Deteriorating conditions in the high yield market can be a signal that recession risk is rising, so this trend will be closely monitored.
- **Residential MBS** spreads narrowed a bit toward the end of the month but remain elevated compared to their three-year average. Significantly lower rates have caused prepayment rates to increase this year which is likely behind some of this widening. In addition, the end of the Fed's quantitative easing program has removed a large buyer from the market, so it can be argued the MBS market is no longer distorted as it was for so long.
- **Municipal bonds** outperformed Treasuries even as supply was elevated, perhaps because buyer demand has also remained buoyant throughout the year.

**Economic data during October revealed a slow-growth economy** supported mainly by the consumer. The first estimate of third quarter GDP came in at 1.9% (annualized), a bit higher than expected and almost entirely comprised of the gain in personal consumption. Business equipment spending declined by 3.8% due in part to the production cuts at Boeing, but the on-going uncertainty over trade was surely a contributing factor. The ISM manufacturing index improved modestly in October, but it remains below 50 for the third straight month (indicating contracting activity).

**EXHIBIT 2: FIXED INCOME MARKET TOTAL RETURNS**




Source: Bloomberg Financial L.P. and Barclays Securities

**As for other economic indicators**, housing does appear to be rebounding a bit due to lower mortgage rates, but prevailing home prices still leave many unable to afford a home. Meanwhile, the pace of auto sales has been flat compared to last year even with consumers appearing flush from the strong labor market. Perhaps this is due to consumers waiting for the wave of new electric models to become available or perhaps the use of ridesharing services has convinced more consumers they simply don't need their own vehicle. In any event, both consumers and businesses are now accustomed to low rates so the stimulative affect of rate cuts is likely diminished relative to prior cycles.

**Weak economic performance overseas** remains a powerful theme, but the risk of a "hard Brexit" has diminished. Mario Draghi's term as head of the European Central Bank ended and Christine Lagarde, former IMF head, is now at the helm. This transition provides hope that fiscal policy may begin to gain traction in Europe since monetary policy alone has proven to be inadequate in reviving growth for the continent.

**Where do we go from here? Bond yields have declined dramatically in 2019 as a result of Treasury yields plummeting and spreads compressing, and the Fed's pause is likely to spawn a period of relative calm in the bond market. Incoming data will be key to determining whether the Fed's policy cuts were enough to achieve a soft landing or whether more cuts are needed. Bottom line: we expect bond returns to be more muted through year-end barring a major event.**

## It's November—let's get ready to eat some pie!




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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