Maple Capital Management

Fixed Income Commentary

December 3, 2019

KEY TAKEAWAYS

Equity markets continued to put in new highs and bond yields rose modestly across the curve. While a lot of talking heads have focused on the potential BBB downgrade wave, the current overall macro environment consists of near-record low unemployment, contained inflation, and strong consumer confidence. It is tough to trade around a potential exogenous event, but investors will be keen to be aware of the potential headwinds the market may face in 2020.

Key Rates (%)	Nov 30 2019	Oct 31 2019	Dec 31 2018
Treasury Yields			
2 Year	1.61	1.52	2.49
5 Year	1.63	1.52	2.51
10 Year	1.78	1.69	2.68
30 Year	2.21	2.18	3.01
Credit Yields			
BBB Industrial 10 Year	3.06	2.98	4.35
Muni Yields			
AAA 10 Year	1.50	1.48	2.32
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.70	2.61	3.50

NOVEMBER IN REVIEW

- The 10- year Treasury yield finished the month with a yield of 1.78%, up 9 bps month over month.
- Munis were up 0.25%, the second strongest fixed income sector, behind high yield.
- High yield was up 0.33% in November and is up 11.41% on the year.

"Thank You" - *Sly & The Family Stone*

We are thankful for the opportunity to serve you and mindful of the trust you place in us as financial stewards of your assets. The holiday season is the perfect time to reflect on year-to-date performance and the factors that may impact markets in the year ahead.

Bond yields rose modestly in November as equity markets achieved new records and the market's recession fears began to ebb. Total return results for November were -0.05% for the broad market* and bond market conditions remain stable as spreads are firm (providing cheap funding for issuers) and liquidity is readily available. From a fundamental standpoint, recent trends indicate modestly improving credit metrics across both corporate and municipal markets, albeit from relatively elevated levels. The fears expressed late last year about massive downgrades of BBB issuers simply never materialized. Instead, many of the most heavily levered BBB issuers have been paying down debt with fervor. This makes sense since a downgrade to "junk" would result in significantly higher funding costs, so avoiding a downgrade is imperative.

Now that December is here, a look ahead at 2020 is in order. There's certainly a lot to like about the economic landscape as the year comes to a close:

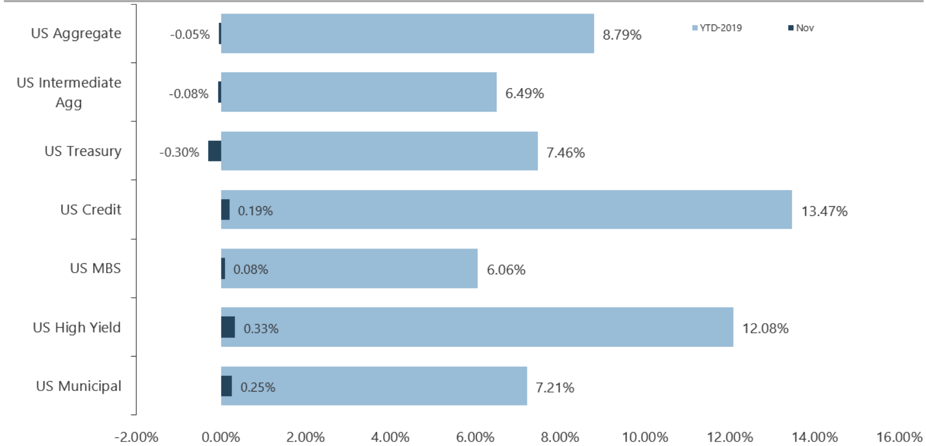
- unemployment is at a near-record low and wages are growing at a nominal rate of 4.7%,
- inflation is low and shows no signs of accelerating,
- equity markets are near all-time highs,
- borrowing costs are ultra-low for the government, business, and consumer sectors, and monetary policy is accommodative after a brief attempt at normalization,
- commodity prices, particularly energy, are low, and
- consumer confidence measures are strong.

On the other hand, worries are never scarce when a bond investor is doing the writing! Here are just a few:

- the high degree of uncertainty stemming from multiple trade disputes with China and Europe have held back business investment spending,
- overall growth rates across most major economies are low and slowing,

- central banks have little room to lower interest rates should conditions deteriorate and many governments would find fiscal stimulus difficult to pull off due to their significant deficits and debt loads,
- traditional sources of economic growth like housing are adding little to economic growth due in part to high home prices that have priced many out of the market.

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

What is our outlook for the economy in 2020? An abrupt halt to the longest-running economic expansion on record appears unlikely, but an exogenous event could cause the consumer to rein in spending. Since consumer spending generally accounts for about 70% of the economy and has been the linchpin of recent growth, any shortfall would be consequential. It is difficult to pinpoint what catalyst could disrupt the current trajectory other than a total collapse to the trade talks, which appears to have the potential to cause an equity market correction along with a hit to business and consumer confidence measures. In addition, since 2020 is an election year, a marked acceleration in business investment spending appears unlikely. Policy uncertainty remains quite high and some of the proposals from leading Democrats could lead to upheaval in several key parts of the economy.

The most likely outcome, then, appears to be another year of slow growth and low inflation. The Fed will likely stay on the sidelines unless something drastic happens such as a sudden downshift in monthly job gains. The three rate cuts enacted by the Fed may be just the insurance that was needed to enable a soft landing.

If this placid outlook takes shape, the bond market stands a good chance of remaining relatively range-bound over the next year. Negative yields are likely to remain in place in Europe and Japan, so demand for the relatively high yields prevailing in the U.S. should stay strong. Meanwhile, corporate bond yields may also prove to be a stable source of returns due to the modestly improving credit metrics noted earlier, enhancing investor confidence in this sector. Combined with robust demand from abroad and lower expected net supply, this should allow their yield spreads over Treasuries to tighten further or remain range-bound. Similarly, if Treasury yields remain in a relatively tight range, mortgage-backed securities should also prove a good source of yield since refinancing activity will occur at a more predictable pace.

Thank you for reading this update and best wishes for a happy holiday season filled with joy!

**Market return represented by the Bloomberg Barclays U.S. Aggregate Bond Index*

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