Fixed Income Commentary

June 2, 2020

KEY TAKEAWAYS

Both equity and fixed income markets saw a "risk on" trade in May as progress was made on vaccines, economic re-openings, and the scale of government/central bank intervention. Spreads across corporate and municipal bonds tightened in May in response to the Fed's swift and significant actions to ensure credit availability and liquidity.

Key Rates (%)	May 31 2020	Apr 30 2020	Dec 31 2019
Treasury Yields			
2 Year	0.16	0.20	1.57
5 Year	0.30	0.36	1.69
10 Year	0.65	0.64	1.92
30 Year	1.41	1.28	2.39
Credit Yields			
BBB Industrial 10 Year	2.68	2.88	3.10
Muni Yields			
AAA 10 Year	0.82	1.44	1.48
Mortgage Backed Securities			
30 Year FNMA Current Coupon	1.65	1.52	2.71

MAY IN REVIEW

- The 10- year Treasury yield finished the month with a yield of 0.65%, up 1 bp month over month.
- Treasuries were weak on the month, down -0.25% in May.
- Municipals were the second best sector behind High Yield, up 3.18%.

Take a Seat...Let's Chat About Fixed Income

We hope you are well at this unusual time in our lives.

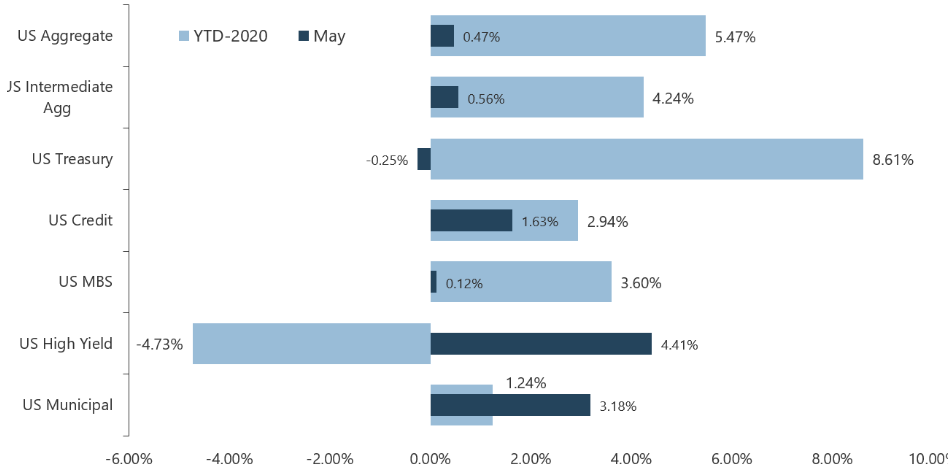
With Treasury yields nearly as low as they can go and the Fed actively buying Treasuries and MBS again, rates are expected to remain range-bound which was certainly the case last month. May's largest yield change was 12 bps on the 30-year Treasury, with all other points on the yield curve remaining within 7 bps from where they started the month. A range-bound rate environment leaves spread changes and starting yield as the main drivers of total return and May was a good month for spreads as investor sentiment turned positive with the economy gradually beginning to re-open.

- Corporate and municipal bond spreads narrowed as confidence broadly improved following the Fed's swift and significant actions designed to improve market conditions and credit availability.
- MBS also performed well as the Fed continues to actively buy Agency pass-throughs on the open market.

Corporate spread tightening has been steady even as supply has been substantial, aimed at fortifying balance sheets for the crisis while also taking advantage of lower Treasury yields. Year-to-date issuance is now over $1 trillion and growing. While being able to issue so much debt in so short a time is certainly a sign of a healthy market, it is also a concern since corporate leverage was already high to begin with. This leverage problem is somewhat alleviated by the low cost to service the debt as well as the terming out of new debt, but it could prove difficult for many if the economic recovery falters or if there's another lockdown.

One of the key challenges during such a difficult economic climate is maintaining credit ratings and this is true for both corporate and municipal borrowers. According to JP Morgan, 11% of non-Financial IG debt has been downgraded YTD, of which 4% has fallen to below IG. Ratings on municipal bonds tend to be more stable and many borrowers can take measures to close budget gaps but going forward the ratings trajectory will depend to a great extent on whether additional federal aid is forthcoming.

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

Evaluating economic data following a forced lockdown remains a futile exercise: nearly all figures are record-breaking declines or all-time lows, though many statistics may be inaccurate due to fewer or less timely respondents. Instead, we are focused on the pace of the re-opening, the fiscal response, and financial conditions to gauge where the economy is headed. The damage that has been done to leisure, hospitality, travel, and other sectors which employ millions of people will, in our opinion, take years to return to health. If unemployment remains significantly above the pre-crisis level for an extended period, many segments of the economy will be negatively impacted. It is easy to envision significant challenges in autos, consumer finance, and retail sales.

We are concerned about the ability of growth to return to its prior pace due to the expected retreat in global trade. The US-China relationship is deteriorating rapidly and is one of the most important trade relationships in the world. China's pivot toward more aggressive policies in Hong Kong and other areas threatens to rip apart the delicate rapprochement that seemed to accompany the recent trade deal. If globalization is in retreat --- supply chains being re-domesticated, concentrations to countries being reconsidered, trust being eroded --- then global growth will likely suffer a harmful blow that will be very difficult to remedy.

China's recent decision to refrain from setting a specific GDP growth target is a marked departure from their pattern. This decision is evidence that China's growth will be impaired as the rest of the world deals with a post-Covid reality, which is another reason our own growth in the US will be hard-pressed to return to trend.

With concerns about future economic growth and vitality, we believe our focus on quality corporate issuers is vital in this environment. Risk spreads have been well-supported by voracious demand from investors for new issues even from companies acutely impacted by the pandemic such as hotel operators and airlines. While municipal bond spreads have also rallied, spreads on taxable municipal bonds have lagged and we continue to find good value in recent new issues. We have always touted the resiliency of the municipal sector and even though the pandemic crisis is unparalleled and multifaceted in its dimensions, many municipal borrowers retain good access to funding and flexible budget options to deal with the situation responsibly.

Thanks for reading and stay safe.

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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