Fixed Income Commentary

April 2, 2020

KEY TAKEAWAYS

COVID-19 had a dramatic impact on markets across the globe in March. Liquidity quickly evaporated as markets assessed the enormity of the revenue, profit, and cash flow implications resulting from the economic shut-downs. Short term policy rates were cut and risk spreads widened to levels last seen during the Great Financial Crisis.

Key Rates (%)	Mar 31 2020	Feb 29 2020	Dec 31 2019
Treasury Yields			
2 Year	0.25	0.93	1.57
5 Year	0.38	0.94	1.69
10 Year	0.67	1.15	1.92
30 Year	1.32	1.68	2.39
Credit Yields			
BBB Industrial 10 Year	3.39	2.41	3.10
Muni Yields			
AAA 10 Year	1.44	0.98	1.48
Mortgage Backed Securities			
30 Year FNMA Current Coupon	1.80	2.18	2.71

MARCH IN REVIEW

- The 10- year Treasury yield finished the month with a yield of 0.67%, down 48 bps month over month.
- Treasuries were the strongest performing fixed income sector, up 2.89% on the month.
- Municipals had a weak month, down 3.63%.

A Month We'll Never Forget

Unprecedented, unparalleled, unbelievable – words that could populate every sentence of this month's commentary. As the COVID-19 health crisis became a global pandemic the bond market quickly became a focal point with the prescribed medicine, a shut-down of the economy, suddenly exposing the entire country to a credit squeeze. Here are just a few of the key developments during the month:

- Short-term policy rates were cut dramatically by nearly every central bank (CB) including the Fed which brought the fed funds target rate to the 0.0-0.25% range
- Liquidity quickly evaporated as the markets assessed the enormity of the revenue, profit, and cash flow implications from an economic shut-down
- Government intervention took the form of almost-daily programs, old and new, aimed at restoring normal market functioning for everything from commercial paper (CP) to investment grade bonds to currencies (see **Exhibit 1** on the next page)
- Risk spreads widened to levels last seen in the Great Financial Crisis (GFC) of '08 in nearly every corner of the bond market as companies issued large bond deals to raise cash and/or term out CP while investor outflows from ETFs and mutual funds spiked higher
- Borrowers tapped bank credit lines, suspended dividends, ceased shareholder buybacks, and generally adopted crisis mode to deal with the broad economic calamity; maintaining access to credit during this type of crisis is crucial, so we view these actions favorably, but they do highlight the deep and pervasive nature of this crisis

In observing current market valuations of bond holdings, we want to emphasize the emotional elements that affect risk spreads: investor sentiment, fear, and paranoia seep into the yield spread at which they are willing to part with cash to take on a position. Economic reality may differ markedly from the market valuation during such extraordinary periods of volatility, with conditions quickly evolving amid substantial, coordinated government intervention. Liquidity --- the immediate demand for cash from nearly all market participants --- also plays a huge part in these spread movements which have been exacerbated by massive outflows from ETFs and mutual funds.

Over the past year, we have written extensively on the low risk premiums in fixed income markets and our desire to avoid taking risk. This stance generally led us to favor bonds with shorter tenors and in sectors with less economic sensitivity. Unfortunately, the scale of this crisis and the economic disruption it has caused have left few safe harbors. Translation: everything except Treasuries has been hurt in this crisis. Still, the recent measures taken by the Fed to improve liquidity should help soon, so we advise patience and we counsel against selling into illiquid markets.

As a result of the sudden shock to the markets, government intervention around the world has been significant and varied. The table in **Exhibit 1** below summarizes these measures taken by global authorities thus far to address the crisis since they are simply too numerous and detailed for this commentary. These steps, while enormous, still may not be adequate depending on how long the economic shut-down continues. In addition, the path of the recovery may be less predictable given the intensity and widespread nature of the panic.

EXHIBIT 1: MONETARY AND FISCAL POLICY RESPONSES TO THE CORONAVIRUS

Monetary and Fiscal Policy Responses to the Coronacrisis in the US, Euro Area and China				
		US	**Euro Area**	**China**
Monetary Policy	Policy Rate	- Fed cut the funds rate by 150bp in two steps to 0-0.25%, and provided soft forward guidance.	ECB kept the deposit rate unchanged at -0.5%.	- PBOC cut the Open Market Operations (OMO) 7-day and 14-day rates and the Medium-Term Lending Facility (MLF) 1-year rate by 10bp each. - PBOC cut the reserve requirement ratio (RRR) by 50bps and then delivered a targeted cut, unleashing RMB 550bn (0.6% of GDP) of liquidity to the market. - 1-year and 5-year LPRs were cut by 10bps and by 5bps, respectively.
	Large Scale Asset Purchases	- Fed will purchase US Treasuries and agency MBS "in the amounts needed to support smooth market functioning and effective transmission of monetary policy to broader financial conditions and the economy."	- ECB has increased the asset purchase programme (APP) by EUR 120bn (1% of GDP) until end-2020. -ECB Launched Pandemic Emergency Purchase Programme (PEPP) with envelope of EUR 750bn (6.5% of GDP) until end-2020 with flexibility over purchase limits, country allocations, time profile and asset types, and inclusion of Greek government debt and non-financial commercial paper of sufficient credit quality.	NA
	Lending Facilities	- The Commercial Paper Funding Facility (CPFF) funds a SPV that purchases unsecured and asset-backed commercial paper. - The Primary Market Corporate Credit Facility (PMCCF) provides IG firms access to new bond and loan issues. - The Secondary Market Corporate Credit Facility (SMCCF) purchases corporate bonds issued by US IG firms and ETFS. - The Term Asset-Backed Securities Loan Facility (TALF) supports ABS issues, backed by student loans, auto loans, and credit card loans. - The Primary Dealer Credit Facility (PDCF) offers credit to primary dealers, which can be collateralized by investment grade debt and equity securities. - The Money Market Mutual Fund Liquidity Facility (MMLF) offers loans to eligible financial institutions secured by high-quality assets purchased from money market mutual funds.	- Longer-Term Refinancing Operations (LTROs) are intended to backstop funding liquidity needs of banks until June 2020. -The Targeted Longer-Term Refinancing operations (TLTROs) will be expanded (from 30 to 50% of banks' eligible loan book) and the funding rate will be cut to -0.75%, conditional on lending.	- PBOC is providing liquidity support directly through relending/rediscount tools to alleviate illiquidity pressures. - PBOC injected RMB1.2 trillion (~1.3% of GDP) via reverse repo.

Source: Goldman Sachs Global Investment Research (continued on next page)

Monetary and Fiscal Policy Responses to the Coronacrisis in the US, Euro Area and China				
		US	Euro Area	China
Fiscal Policy	Bridging Measures	- Recently-enacted Phase 2 package worth around 0.75% of GDP increases fiscal aid to states, funds small business sick/family leave, and expands unemployment insurance and food stamps. - The Treasury will delay up to $300bn (1.4% of GDP) in tax payments due April 15 for up to 90 days. Broad forbearance for federally backed mortgage and student loans is also under consideration.	- The EU Finance Ministers agreed to provide liquidity facilities of at least 10% of GDP, consisting of public guarantee programs and deferred tax payments. - More flexible access to short-term work in Germany and France.	- Authorities push banks to provide short-term loans, roll over maturig loans, allow firms to postpone repayment, reduce tax/fee burdens and subsidize firms for stabilizing employment. - CBIRC announced that virus-related defaults would not affect SME credit records if loans are repaid during the extension period.
	Stimulus and Unconventional Fiscal	- The Senate passed a "Phase 3" stimulus package totalling nearly $2 trillion (9.5% of GDP). It includes forgivable small business payroll loans, capital for loans and loan guarantees, payments to individuals, expanded unemployment insurance, fiscal aid to states, and federal spending.	- The Eurogroup recognised the need for countries to implement discretionary fiscal measures of at least 1% of GDP (independently of existing fiscal space); but the EU coordinated action is a package of EUR95bn (0.8% of GDP) in the form of guarantees and loans to firms (jointly supported by the European Commission and the European Investment Bank). - Stimulus measures would also be increased if necessary.	- We expect the augmented fiscal deficit to rise by 3pp to 14.5% of GDP in 2020, driven by greater special bond issuance, public investment, and stronger policy bank support. - We expect the quota for new special bonds for this year to increase to Rmb3.3tn (~3.3% of GDP) from Rmb2.15tn in 2019. - Provincial governments can grant approvals of changes land use (e.g. from agricultural purposes to construction purposes). - Some cities are planning on giving out coupons to spend in restaurants/malls.

Source: Goldman Sachs Global Investment Research

Consumers, businesses, and governments alike will almost certainly change some behaviors as a result of the crisis. This will be the quickest and sharpest decline into recession the world has ever seen, and some of the consequences we expect are higher unemployment, more corporate defaults, rising consumer loan delinquencies, ratings downgrades of corporate and municipal borrowers, and perhaps sovereign defaults.

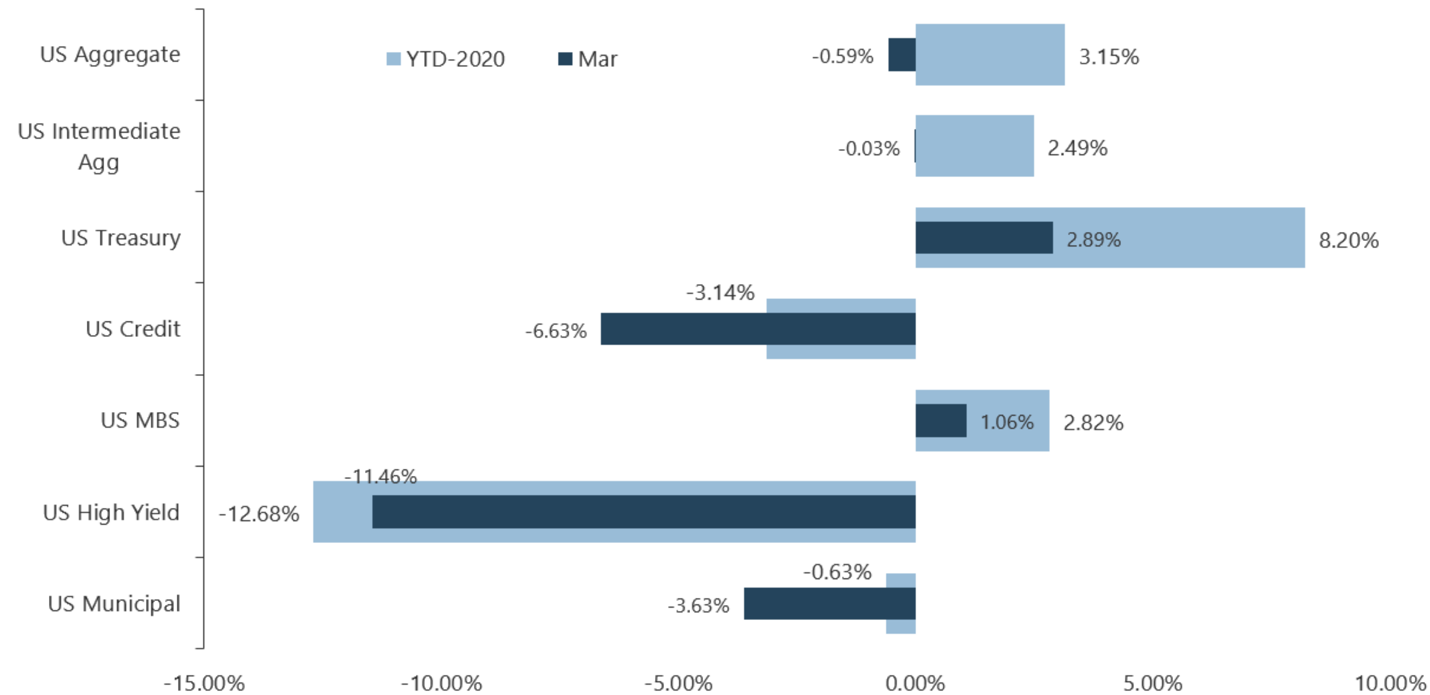
Energy markets are the most dislocated of all due to the breakdown between Russia and Saudi Arabia which resulted in plunging oil prices even as demand collapsed and storage became scarce. This market was already suffering from investors' apprehension over ESG concerns but now faces an almost existential crisis that will likely lead to more bankruptcies soon, mainly of smaller exploration and production companies. Low oil prices are also expected to prove extremely challenging for oil-exporting nations, many of which are classified as emerging markets, which could lead to social instability, default, or both.

The dramatic actions and economic shut-downs to try to reduce the spread of the virus and the success of these mitigation actions, along with possible treatments, could lead to a faster return to normal economic activity and recovery. In addition, various financial measures have been targeted at the consumer, business, and government sectors which will hopefully reduce the financial losses for investors. There is a great deal of uncertainty, however, which we believe is likely to persist for a while. Therefore, financial markets are likely to remain volatile as the situation evolves. Higher risk spreads are likely to endure, which is favorable for any new investments being made but negative for existing holdings.

Although much uncertainty exists at this writing, it is important to remember the economy entered this crisis from relative strength. The financial industry stands out as one of those much better positioned than at the start of the GFC. Many state and local governments are also better-prepared financially, and the American spirit and resolve during a crisis will surely help recovery come faster than many fear at this time. When a crisis suddenly appears, it is always difficult to see a path forward, but the world has seen many crises and financial markets eventually recover and resume normal patterns. This crisis will end and we believe the markets will reward those who are patient and who can identify value along the way.

We understand this is a difficult time for everyone and we are here should you wish to discuss your portfolio in greater detail. All of us at Maple Capital Management are grateful for your confidence and trust and we hope you and yours remain healthy and safe.

EXHIBIT 2: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

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