Fixed Income Commentary

Maple Capital Management

July 2, 2014

"Pay no attention to that man behind the curtain" – The Wizard of Oz – 1939

Dorothy wanted to believe the Wizard possessed magic and could offer her and her friends courage, brains, heart and a one way ticket to Kansas. But the Great Oz was only a man with no magic and few tools outside of his considerable ability to persuade and a sense of the theatric. However, even with a limited tool kit the wizard was able to rid the land of the wicked witch and get Dorothy back to Kansas. Not bad!

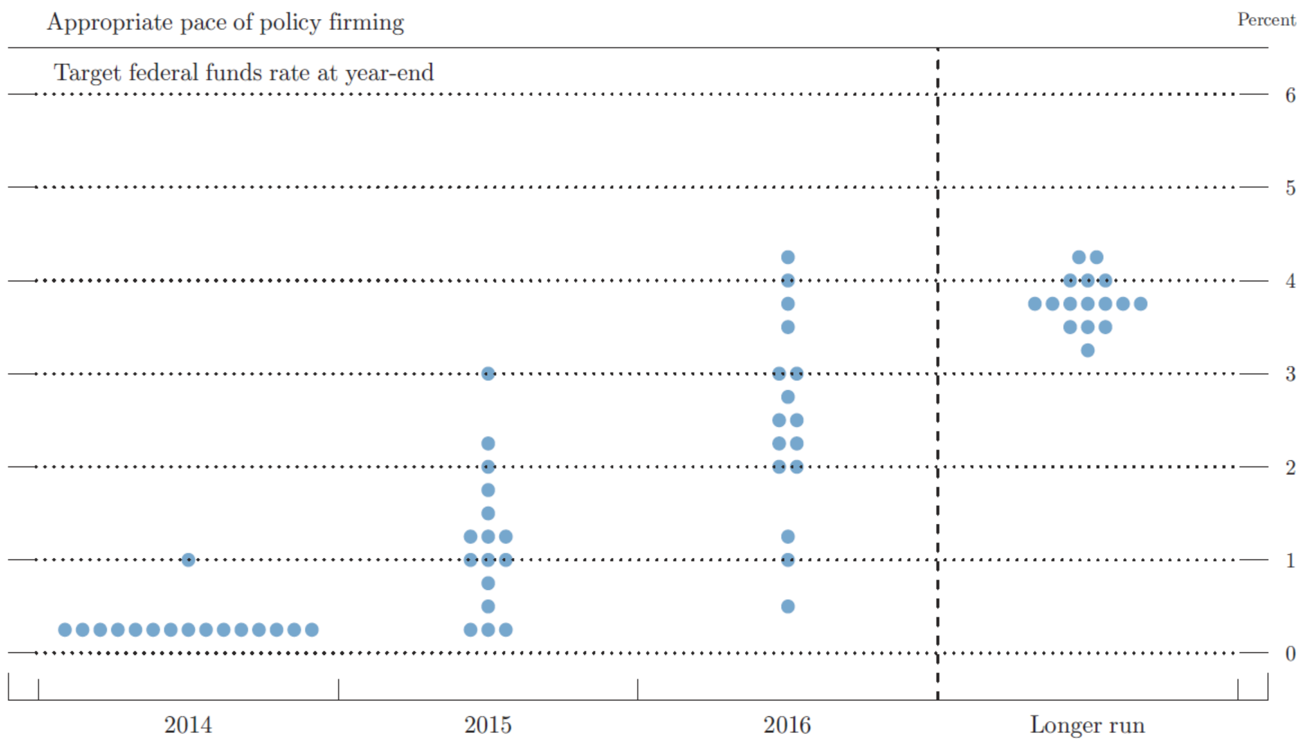
The Federal Reserve does not possess any magic and its tool kit is a bit limited, yet we all want to believe the Fed can put us back on the road to greater prosperity. Without magic, the Fed can only raise or lower short term rates and try to persuade us with forward guidance. With the tools in their possession they are trying to rid the land of low unemployment, reenergize prosperity and manage inflation to a 2.0% target. The Wizard had the easier job!

Fast Read……

- We should expect the Fed to start raising the fed funds rate by mid 2015.
- The reason for increased rates is a need to normalize policy. The crisis is over.
- The question for fixed income investors is what will happen when rates rise?
- As short rates rise modestly we anticipate some increase in longer rates, but there are pressures keeping longer term rates in check.

Every quarter the Federal Reserve shares its projections for interest rates and the economy; this is a key component of their forward guidance. The level of detail in these projections is a testament to their desire to be transparent. In the June report, a significant portion of the Committee projected the fed funds rate will be 1.0%-1.25% by the end of 2015; this is a big increase from the projections made last year. Since the Fed usually moves slowly and deliberately, if this projection comes to pass we should expect the Federal Reserve to move off the current 25 bps target sometime in mid 2015. In Chart 1 we see the Committee's projections for fed funds; each dot represents a committee member.

<u>Chart 1—June 2014 Fed Projections</u>



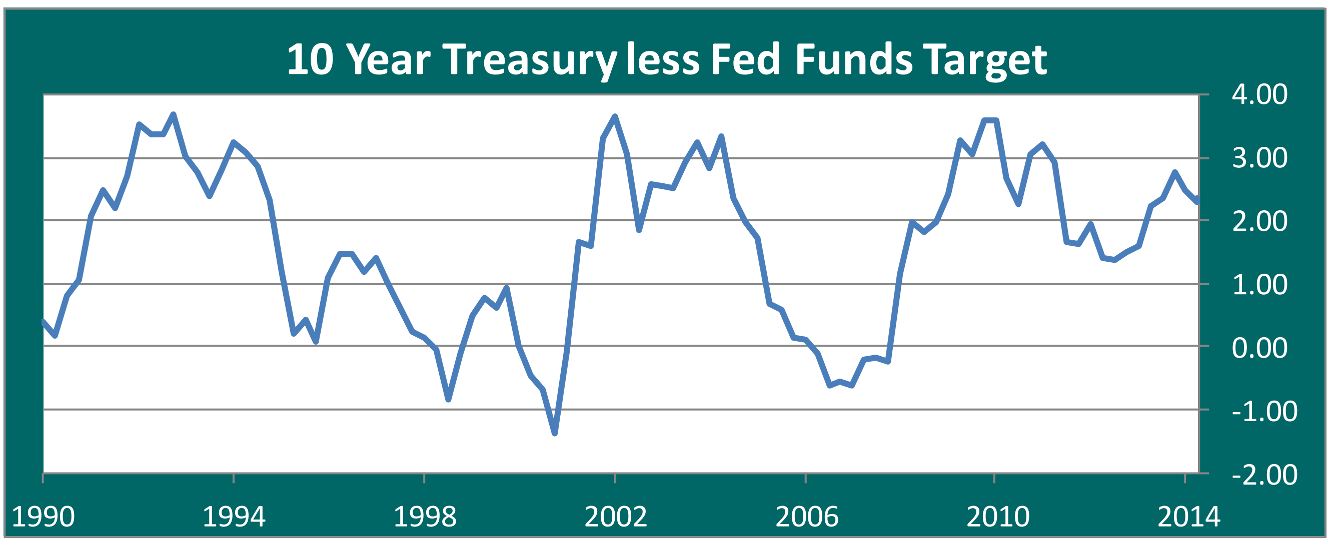
The Committee is generally anticipating a higher fed funds rate next year, and the projection seems to be more about policy normalization than a policy response to a robust economy. The Committee is seeing little improvement in GDP growth or inflation, but they do see continued reduction in unemployment.

- In June 2013 the Committee's PCE inflation projection for FYE 2015 was 1.6% - 2.0%, one year later projections for 2015 are lower at 1.5% to 2.0% - this in not progress.
- In June 2013 the GDP projection for the end of 2015 was 2.9% to 3.6%, and now it is 3.0% to 3.2%.
- In June 2013 unemployment expectation for FYE 2015 was 5.8% to 6.2% and now 5.4% to 5.7%.

Will a higher fed funds rate automatically lead to higher longer term rates, and how will this impact fixed income markets?

It is hard to see a one to one increase in longer term rates when the fed funds rate begins to normalize. The current spread between the fed funds rate and the ten-year treasury is historically quite high, and if the economy is still lackluster it is easy to see longer rates rising more slowly than the fed funds rate, or not at all (See Chart 2). Additionally, we continue to see lower than anticipated inflation pressures in Europe, China and Japan; these non-inflationary forces will help to keep rates in check in the United States. Finally, with rates in Europe and Japan still lower than the US, we will continue to see investors supporting US Treasury rates, as we discussed in last month's commentary.

Chart 2 —The Fed Funds Rate Could Rise with Little Impact on Longer Rates



With a rise in the fed funds rate, the impact on the fixed income markets should generally be negative. For example, if the Ford Motor credit three-year corporate bond with duration of 2.75 years is subject to a 50 basis point increase in rates, the price would fall 1.38%, which is material compared to its current yield of 1.65%. If the economy slows and credit spreads widen, returns could be further impacted. The impact will be worse for long duration high quality bonds, and the impact muted for BBB short duration corporate bonds. MCM portfolios hold more of the latter and very little of the former.

We still believe the trend is for rates to be lower for longer and for the credit cycle to remain strong. These powerful trends help to reduce risks in the fixed income markets. But we are at the end of a 30+ year bull market in interest rates, and credit spreads are historically tight. The risk return tradeoff is increasingly stretched.

Strategy

The rally in Treasury prices and the continued contraction in credit spreads so far this year have been positive for fixed income portfolios. Unfortunately, rising bond prices make it more difficult to find securities with attractive yields.

In the short term, we continue to expect the intermediate segment of the yield curve to continue to offer the best relative performance. Intermediate maturities offer a significant yield pick up over shorter term securities and are partially protected from the risk of rising rates by "rolling down the yield curve" as maturities approach.

Taking some credit risk continues to be an attractive way to add value. Corporate balance sheets continue to improve, liquidity is abundant and the Fed remains accommodative for now. To be safe, we remain comfortable having slightly more exposure to credit risk in the short end of the curve since short maturities will be least impacted when the credit cycle turns.

Municipal bonds remain attractive by historical valuation measures and would stand to gain with any increase in income tax rates. We believe it is more prudent to hold duration exposure in muni's than in corporates, especially since the average credit risk in municipals is lower than corporates.

As systemic risks continue to grow, we are increasingly looking at higher quality and lower duration assets and will continue to add these securities as conditions allow.

We remain optimistic about the risk/reward trade off in our bond portfolios. We are using sector selection, security selection and yield curve management to help mitigate interest rate and credit risks. Additionally, we are using high quality callable preferred stocks to add yield at the front end of the curve. Of course, we continue to scour the markets daily for cheap, safe and attractive yield in any sector.

As always, please call us with questions and comments.

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