MAPLE CAPITAL MANAGEMENT

Fixed Income Commentary

October 2, 2014

"That Giant Sucking Sound…."

\- Ross Perot

FAST READ...

- The Fed continues to taper the scale of bond purchases with an end to QE likely in October.
- The Fed continues on its path to increase the fed funds rates in 2015
- Other central banks, notably the European Central Bank and the Bank of Japan, are embarking on or expanding their own versions of QE as the U.S. is winding down.
- While many are preparing for higher rates with the end of QE, we believe foreign interest rate declines will help to hold domestic rate lower than expected.

During the Presidential debates of 1992, Ross Perot famously predicted the passage of the North American Free Trade Agreement, or NAFTA, would be the catalyst for a massive outflow of jobs from the United States to Mexico. He used the metaphor of "a giant sucking sound" to convey the strong possibility that capital, in the form of plants and assembly lines, would be placed where it would earn the best return. With the removal of trade barriers, Mr. Perot reasoned that capital – and therefore jobs – would flock to the cheaper costs of Mexico.

While Perot's thinking was grounded in theoretical economics, the flow of jobs to Mexico never really developed as predicted, for a variety of reasons. Foremost, he missed the bigger global picture. Capital did indeed flow to where it earned the highest returns: the newly opened developing markets of Asia, which had even cheaper production costs than Mexico. Furthermore, the risks in Asia were perceived to be lower due to higher quality production standards relative to Mexico. Finally, the U.S. "strong dollar policy" of the 1990's actually gave an incentive to domestic companies to move production to China, which had a – to be polite – less than free floating currency. Domestic production moved to Asia could actually reap additional gains from currency returns due to the government policies in place on both sides of the Pacific. In short, higher returns, lower risks and the potential for currency benefits attracted the most capital.

The forces that Perot missed twenty years ago are potentially being overlooked again today, only this time by the bond market. Many bond investors are focused on the end of quantitative easing and fear the disappearance of the largest buyer of U.S. securities will lead to a rapid rise in U.S. interest rates. However, the market seems to be overlooking the fact that there are many places for money to flow to and from. While the Fed is beginning to normalize policy, other Central Banks are starting, or accelerating, unconventional monetary easing just as the U.S. is winding down such actions. It is very likely some of the recent strength in the U.S. bond market is due to foreign money flowing into the U.S. bond market, especially into Treasury and agency securities.

The global nature of money flows makes interest rate differentials very conducive to arbitrage. Treasury notes currently yield more than twice the rate available on comparable maturity German Bunds, as shown in Chart 1. European capital now has a strong incentive to be invested here. Large investors have the ability to borrow funds at low rates in Europe and invest in higher yielding Treasury securities with little risk of default.

<u>Chart 1—German Rates Relative to U.S. of Same Maturity</u>

Source: Bloomberg

It is also safe to assume additional funds will come to the U.S. simply as a flight to safety in the face of mounting geopolitical risks. The list of regions with shooting wars and increased tensions between neighboring countries seems to be growing weekly. Geopolitical risks also include the risk of government seizure/freezing of assets, either through fiat, legal action or fines, are also increasing. Money continues to flee obstacles such as currency controls in Russia, increased taxes in France and, to a lesser extent, government crack downs in China and Hong Kong.

Foreign buyers of Treasury notes may be rewarded from a currency standpoint as well. Money flows into the U.S. strengthen our dollar. Furthermore, most European economies are far weaker than the U.S., which implies the Euro deserves to be weaker than it is, possibly trading down to 1.20 to the dollar. This opportunity for currency gains is an added benefit for overseas investors.

Chart 2: EUR / USD

Source: Bloomberg

Of course, money flows and currency are just two of many factors affecting the direction of rates, and are often minor influences at best. Economic growth and inflation are greater influences on the direction of rates. We continue to believe economic growth will fall short of forecasts and inflation also remains tame. The wind down of quantitative easing is the variable with the most potential to roil markets. Money flows have gained importance as foreign money has the potential to be the marginal dollar coming in to fill the void of tapering actions.

While it is never a good idea to fight the Fed, we do believe capital flows and weaker than expected economic growth will buttress our "lower for longer" interest rate outlook for a few more quarters. We do not believe an interest rate surge is imminent in the next year or so, but pressures could begin to mount by the second half of 2015. Federal Reserve actions until then will continue to be partially offset by foreign central banks acting in the opposite direction. Longer term, this framework raises significant concerns for both the bond market and global monetary system. The longer the day of reckoning is delayed, the worse the ultimate outcome will be impacted. Artificially low rates distort investment decisions. Those buying massive amounts of debt at the low end of the interest rate cycle, including central banks and arbitrageurs, will be hurt when rates rebound. Until then, however, their actions will allow us to avoid some of the pain as quantitative easing comes to an end.

Strategy

Wider credit spreads and higher short and intermediate term treasury rates resulted in weak performance in fixed income markets in September, although year-to-date performance is still positive. Credit spreads widened by 13 basis points for "BBB" corporate issuers during the month and the yield on the five-year Treasury rose by 13 basis points. These moves are large, so we caution against extrapolating one month of data for the rest of the year.

We anticipate interest rates to remain low and stable for several quarters before increasing in the second half of next year. Our view is supported by the ongoing sell-off in equity markets, continued low inflation prospects and our below consensus view of weaker global growth. Positioning on the yield curve remains important in this environment, as we seek to balance safe yield with the risks of longer duration.

Credit spreads could continue to come under pressure in this risk-off environment, but corporate fundamentals remain strong and we do not anticipate a major credit correction absent a large systemic shock. Taking some credit risk continues as a strategy, although primarily with higher quality and shorter duration issues. We are increasingly directing money into government securities, mortgage-backed securities, and higher rated municipal bonds.

Municipal bonds are now back in line with historical valuation measures but may see additional gains with any increase in income tax rates. We believe it is more prudent to hold longer duration exposure in muni's than in corporates, especially since the average credit risk in municipals is lower than corporates.

We remain optimistic about the risk/reward trade off in our bond portfolios, despite the recent market downdraft. We are using sector selection, security selection, and yield curve management to help mitigate interest rate and credit risks. We are still using high quality callable preferred stocks to add yield at the front end of the curve, yet many of these preferreds are currently being called and not all will be replaced.

Of course, we continue to monitor these volatile markets closely, and our strategies will continue to evolve with changes in fundamentals and market data.

As always, please call us with questions and comments.

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