MAPLE CAPITAL MANAGEMENT

Fixed Income Commentary

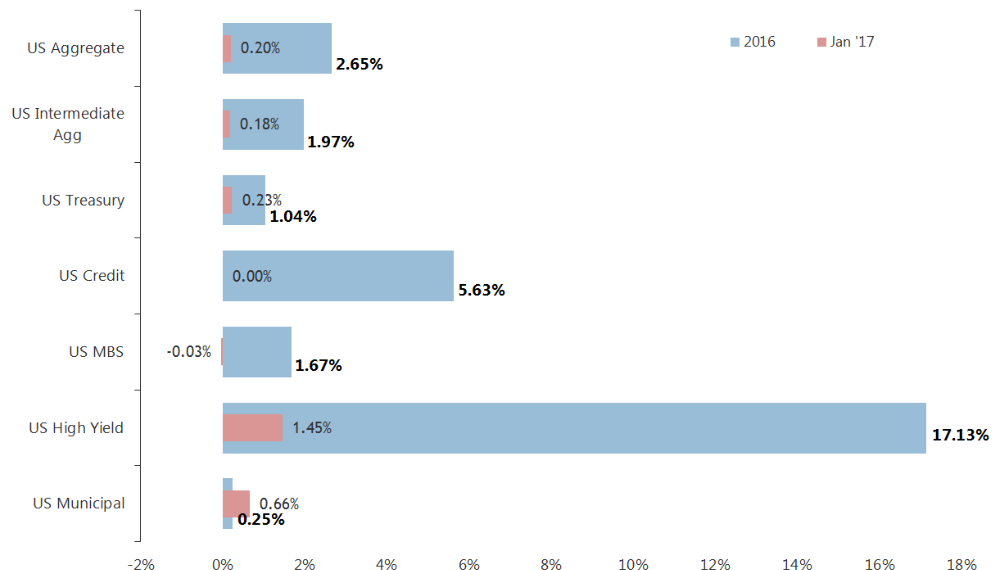
February 8, 2017

Caution

Interest rates barely budged in January, providing a welcome calm to the bond market. The U.S. Treasury 10-year note was up less than a basis point (2.445 to 2.454 at month end). The fourth quarter economic data released during the month contained few surprises. Growth continued to improve, albeit at modest rates. Although the Trump administration hit the ground running, issuing executive orders consistent with campaign rhetoric, many of the high profile pledges need to be legislated and may not come to pass. Markets seem to have priced in as many of the hoped policy changes as probabilities would allow, but further moves will require more tangible catalysts. With the smooth transition of power behind us, the focus must now shift to the legislative process. This will take time and several of the executive orders issued in the opening days of the new administration have shown that not all ideas will be met with open arms. The stability of the markets in the face of higher inflation, fiscal policy "trial balloons", and a potentially aggressive Federal Reserve, suggests investors still place some value in the safety of Treasury securities.

In terms of fixed-income performance in January, 2017, returns were very modest to say the least. The table in **Exhibit 1** states the various performance of the bond market sectors according to the Bloomberg Barclays Indices. As can be seen from the table, Treasury securities provided the Aggregate Index with all of its performance. The spread sectors of the bond market, namely corporate bonds and

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

KEY TAKEAWAYS

Bond markets started 2017 with modest gains, providing a needed sense of calm after a volatile end to 2016. Markets, however, continue to watch the initiatives and priorities set by the Trump administration, with hopes the economy will continue to improve with a new regime pulling the strings.

Key Rates (%)	Jan 31 2017	Dec 31 2016	Dec 31 2015
Treasury Yields			
2 Year	1.20	1.19	1.05
5 Year	1.91	1.93	1.76
10 Year	2.45	2.44	2.27
30 Year	3.06	3.07	3.02
Credit Yields			
BBB Industrial 10 Year	3.66	3.68	3.99
Muni Yields			
AAA 10 Year	2.31	2.35	2.00
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.19	3.13	3.02

JANUARY IN REVIEW

- High yield started the year right where it left off in 2016; as the group's top performer, up 1.45% on the month.
- Mortgage-backed securities were down .03% on the month, as a steepening yield curve led investors to trade with the expectation of extension risk on the horizon.
- Municipal bonds rallied after a December sell off, up .66% on the month.

mortgage-backed securities, showed the trepidation of investors. Only high yield bonds showed any type of euphoria, rising 1.45% in the month. Municipal bonds experienced a nice rebound from their fourth quarter 2016 sell off sparked by the specter of lower tax rates on the heels of the Trump electoral victory.

Going forward, we are growing increasingly cautious on the prospects for both the bond and equity markets, if only because of the contradictory messages they are sending. Stocks remain near all-time highs, implying an economic rebound will soon be forthcoming. Bond yields remain relatively subdued, however, even after the bounce off last summer's record low prints. This suggests bond investors do not believe such a recovery is imminent. While global monetary easing is partly to blame for continued low rates, investor pessimism is also a factor.

Government bond yields, including those of U.S. Treasuries, reflect the uncertainties facing the market. In turn, these low rates continue to push money into other segments of the bond market, potentially raising the risk of an asset bubble developing. Corporate bond spreads, for example, are at 5-year narrows and the high-yield market has produced returns of more than 18% over the last 13 months. Even mortgaged-backed securities are getting rich, with 15-year bonds in particular trading on the richer side of fair value.

The Treasury yield curve is bound to steepen in the face of increased inflationary pressures and a Federal Reserve determined to normalize interest rates. Corporate bonds, however, carry the added risk that policy missteps will place the hoped for improvements to the economic system in jeopardy. With much uncertainty still surrounding the final versions of President Trump's policies, markets may be pricing in too much optimism. Furthermore, his impulsive tweets have disrupted markets and angered world leaders; putting a tremendous amount of unease in investor psychology.

Against this backdrop, we are reducing risk exposures in equities. On the fixed income side, we are keeping durations relatively short in portfolios and focusing on security selection to enhance performance. This includes adding to higher quality holdings as lower rated securities mature or are sold. We will not be making a wholesale shift in allocations and we will seek to maintain portfolio yields. We do believe, however, that an adjustment in risk exposure is warranted under these conditions.

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