Fixed Income Commentary

April 7, 2017

KEY TAKEAWAYS

The bond market finished the month essentially where it started, with Treasury prices relatively unchanged and credit spreads widening modestly. President Trump's first attempt at health care reform failed, leaving many wondering if other key reforms will also find the same fate, including tax reform. The pro-growth Trump trade is still in favor, but that could change with any more legislative delays.

Key Rates (%)	Mar 31 2017	Feb 28 2017	Dec 31 2016
Treasury Yields			
2 Year	1.25	1.26	1.19
5 Year	1.92	1.93	1.93
10 Year	2.39	2.39	2.44
30 Year	3.01	3.00	3.07
Credit Yields			
BBB Industrial 10 Year	3.65	3.57	3.68
Muni Yields			
AAA 10 Year	2.26	2.30	2.35
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.13	3.15	3.13

MARCH IN REVIEW

- High yield continues to be the outperformer in 2017, up 2.7% for the first quarter.
- Mortgage-backed securities lagged in relative performance due to fears of extension risk with rising interest rates.
- The 2-10 Treasury spread narrowed 12 basis points during the quarter to a spread of 113.

"Sideways"

The February predictions for a turbulent March seemed to be shaping up well. Economic data was strong, the Fed raised interest rates at the March FOMC meeting and the media ran stories of the many rate hikes yet to come. And then the healthcare reform bill failed in Congress.

While the healthcare bill would have had little direct impact on the financial markets, its failure exposed the difficulties facing many of the legislative initiatives investors had assumed would be forth coming in the months ahead. Many investors were eagerly anticipating quick passage of new spending initiatives, deregulation, sweeping tax reform and trade policy adjustments. Many economic models and earnings forecasts have been updated to incorporate the pro-growth policies of the Trump Administration. If these policies do not pass, growth may not accelerate and expectations may be reversed.

The financial markets have been on a bit of a binge since the November elections. Investors have eagerly imbibed visions of future growth with little consideration of how quickly such an expansion might occur. This failure to remember the limits of how much change could be consumed by the system in a short period of time has taken stock prices sharply higher and bond prices lower (interest rates rising) for most of this year.

At the beginning of March, it was widely assumed the party would continue well into the second quarter. However, the press release and minutes of the March FOMC meeting and the failure of the health care reform bill brought the market back to reality. Instead of falling further (interest rates rising), the bond market recovered its early losses and moved sideways for the month. Treasury prices were essentially unchanged and credit spreads widened modestly. The 10-year Treasury, for example, started the month with a yield of just over 2.39% on March 1st and finished the month with a yield of 2.39%. We now see an environment in which this pattern may be repeated in the months ahead. Until we see concrete signs that growth will be sustained, we are comfortable with the "sideways" view, at least in the short term.

The main risk to this viewpoint is the Federal Reserve's balance sheet. Quantitative easing—the purchase of bonds in the open market by the Federal Reserve—had been the Fed's

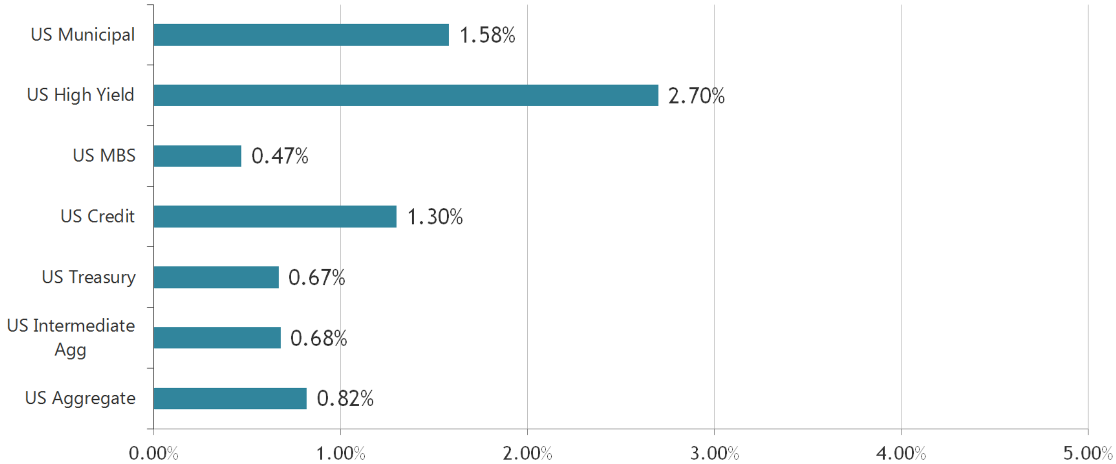
EXHIBIT 1: TREASURY RATE CHANGE AND TOTAL RETURN

Treasury	12/30/16	3/31/17	Change	Range	Total Return
2-yr Note	1.19%	1.25%	+6 bps	1.14 to 1.38%	0.26%
5-yr Note	1.93%	1.92%	-1 bps	1.80 to 2.14%	0.46%
10-yr Note	2.44%	2.39%	-5 bps	2.31 to 2.63%	0.79%
30-yr Bond	3.07%	3.01%	-6 bps	2.93 to 3.21%	1.30%

Source: Bloomberg Financial L.P.

primary tool to lower longer term interest rates after the 2008 Financial Crisis. The policy was successful and any unwinding of the process is sure to produce a reaction. If the Fed begins to unwind its securities portfolio, even by simply halting reinvestments, the market will react. The Fed holds approximately $4.5 trillion of government bonds and mortgage-backed securities. Placing even a portion of these securities back in the market — either through outright sale or by simply not reinvesting maturities - should move rates higher. The vision of Janet Yellen calmly sipping a glass of wine as she peels away these holdings is worrisome. We remain patient for now, but if she orders a bottle of merlot, we are leaving.

EXHIBIT 2: FIXED INCOME MARKET TOTAL RETURNS - FIRST QUARTER 2017



Source: Bloomberg Financial L.P. and Barclays Securities

Interest rates were little changed during the first quarter of 2017, with the exception of U.S. Treasury Bills, which moved higher in conjunction with the hike in the Federal funds rate in March. The rest of the U.S. Treasury yield curve was basically unchanged, as investors had already priced in the interest rate move. Even with Fed guidance of at least two more rate moves this year, intermediate rates barely budged, while long-term rates actually fell slightly. The steepness of the U.S. Treasury yield curve, as measured by the spread between the 2-year note and the 10-year note, narrowed twelve basis points to a current spread of +113 basis points. **Exhibit 1** illustrates the year to date movements of the Treasury yield curve, per Bloomberg.

As can be seen from the table, longer-maturity U.S. Treasuries outperformed shorter-maturity securities by a small margin.

In terms of sector performance within the fixed-income market, corporate bonds, both investment-grade and high yield, continue their multi-quarter dominance in terms of relative performance. Despite a slight widening in March, spreads in the corporate bond market remain near five-year narrows, both in terms of quality spreads within the sector and relative to other fixed-income sectors. Treasuries essentially earned their coupon in the quarter, while mortgage-backed securities lagged on a relative basis due to fears of extension risk with rising interest rates. **Exhibit 2** highlights the relative performance of the fixed-income market according to the Bloomberg Barclays Indices.

Municipal bonds performed well in the quarter after posting weak returns in 2016. Municipal bond prices are sensitive to changes in the tax code. Higher marginal rates make the bonds more appealing, causing their prices to rise. Conversely, lower marginal rates make the bond less attractive, causing prices to fall. Municipal bond prices have been under pressure since the election due to President Trump's pledge to slash Federal tax rates. The legislative difficulties encountered with the health care reform effort suggest a drastic overhaul of the country's tax code might face more hurdles than previously expected. While we think it is too early to suggest tax reform is dead, we have used recent strength to reposition portfolios and lock in gains where appropriate.

Without better clarity on the interest rate cycle, we are moving slowly on dramatic duration shifts. Maturing securities will be reinvested according to portfolio needs, but we anticipate a slower rate of active repositioning of portfolio holdings. We are looking at increasing the credit quality of portfolios due to concerns the credit cycle may be showing signs of age. Spreads are now quite tight across all sectors of the corporate bond market and any slowdown in domestic growth rates may lead to an increase in credit risk. We do not see the need to begin a wholesale shift toward higher quality assets at this time. However, we will look to invest new money and the proceeds of future maturities into higher grade securities.

For further information, please contact Steven Killoran, Vice President Business Development at 1-802-229-2838 or at skilloran@maplecapital.com. For further information about Maple Capital, including a copy of our informational brochure, please visit our website at www.maplecapital.com.

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