Maple Capital Management

Fixed Income Commentary

May 4, 2017

Key Takeaways

While all eyes have been on the Federal Funds rate, the Fed's balance sheet will be getting increasing attention in the coming months. FOMC participants hinted at their last meeting in March that tapering its Treasury and mortgage-backed securities would begin sometime later this year. Time will tell whether the unwind will be orderly, but one could safely assume that the Treasury yield curve will be flatter as a result.

Key Rates (%)	Apr 30 2017	Mar 31 2017	Dec 31 2016
Treasury Yields			
2 Year	1.26	1.25	1.19
5 Year	1.81	1.92	1.93
10 Year	2.28	2.39	2.44
30 Year	2.95	3.01	3.07
Credit Yields			
BBB Industrial 10 Year	3.54	3.65	3.68
Muni Yields			
AAA 10 Year	2.16	2.26	2.35
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.02	3.13	3.13

April in Review

- High yield continues to be the outperformer in 2017, up 1.15% for the month and 3.89% on the year.
- The first report on the first quarter 2017 GDP came in at 0.7%, the weakest reading since Q1 2014.
- The 10-year Treasury finished the month at 2.28%, down from March's 2.39%.

Tapering on the Horizon

The bifurcation between sentiment and reality continues to puzzle many market observers. While corporate earnings have been strong, the rise in equity prices since the election has clearly factored in some strong forward looking assumptions. It seems clear there is a great deal of optimism among members of the "risk on" camp. If this view is correct, economic growth should begin to accelerate in the months ahead and bond prices should be under pressure.

The trends in recent economic data, however, have yet to corroborate these expectations. The April data was particularly disappointing. The March employment report showed a net gain of just 98,000 new jobs, while the preliminary report on first quarter 2017 GDP growth was a disappointing 0.7%; the weakest reading since the first quarter of 2014. Consumer spending in the quarter posted a scant 0.3% increase, the lowest level since 2009. Instead of falling, bond prices have been rising since mid-March, with the yield on the 10-year Treasury note falling by another 11 basis points in April.

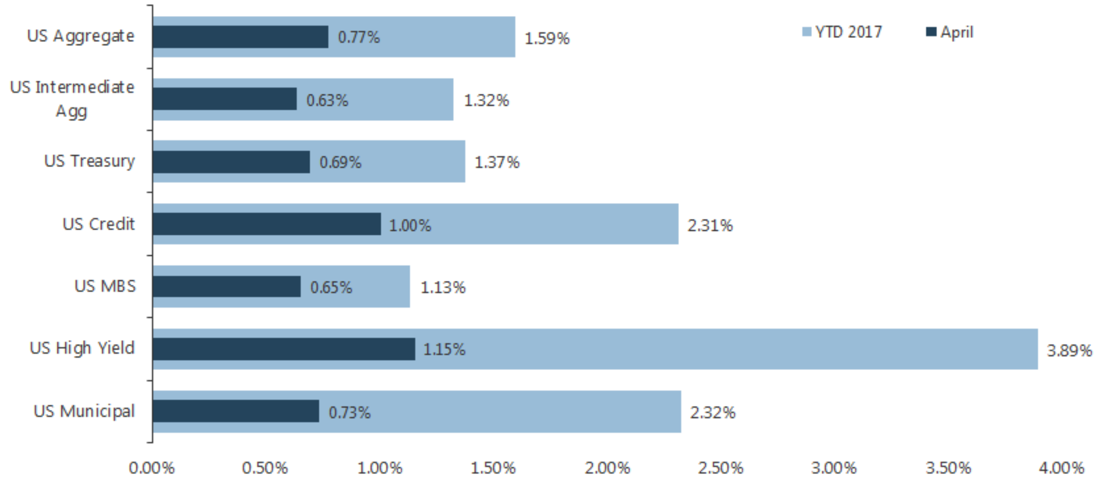
The Federal Reserve might be the most independent arbitrator as to which side is correct. The Fed has made it clear they believe growth will be strong enough to continue hiking interest rates in the month ahead. Fed governors seem to use every speaking engagement as an opportunity to warn markets about the certainty of further rate hikes in the near term. The Fed may eventually choose to move a little slower and add more time between tightening moves in response to weaker economic data, but they are confident growth will be strong enough to continue with moves to normalize rates.

While most eyes are focused on the Federal funds rate and the discount rate, the Fed will eventually have to begin to taper the reinvestment of their US Treasury and MBS portfolio, as part of the rate normalization process. This has been an increasingly discussed topic in the speeches of Federal Reserve officials. However, it remains a relatively overlooked factor in most financial outlook commentaries.

The Fed's balance sheet currently holds approximately $4.5 trillion in Treasury and mortgage-backed securities and throws off close to $700 billion of annual cash flow (principal/maturity and interest payments). Until now, the Fed has methodically reinvested the runoff back into the respective sectors. But as they try to normalize monetary policy - which is still hugely accommodative - this program will have to end. Several Federal Reserve members have specifically discussed this in recent FOMC meetings.

We expect the Fed to gradually scale back their monthly buying of both US Treasuries and mortgage-backed securities, either in dollar terms or as a percentage of maturities to be reinvested. Longer term, we expect the Fed to cease the reinvestment program altogether. As the "taper" rate increases, the effect on the market should be a widening on spreads in the MBS sector and a potential flattening of the U.S. Treasury yield curve as notes mature without being reinvested. The Treasury might offset some of the impact on the front end of the curve by shifting new security issuance toward longer dated maturities. Secretary Mnuchin has already floated the idea of issuing ultra-long maturity notes (50 years or longer) to lock in funding costs before the Fed begins to unwind its holdings and rates begin to rise.

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

For the month of April, bonds put in another good showing given the low absolute level of rates. Quality spreads continue in the credit markets and MBS returns continue to lag albeit not by much. **Exhibit 1** highlights the total returns for April and year-to-date as reported by the Bloomberg Barclays Indices.

Economic data remained on the weak side in recent months, giving bond market participants some comfort that the Fed will not be overly aggressive in the coming months.

Going forward, we remain cautious on the longer term prospects for the bond market. Total returns have been positive through the first four months of the year. The Fed has been extremely transparent on their outlook. With unemployment and inflation at the Fed's stated long-term targets - 4.5% and 2.0%, respectively - they have the freedom to remove excessive accommodation at whatever point they choose. However, many bond investors seem to be disregarding the Fed's commentary and continue to remain long duration exposure. Risk versus reward is not an equal outcome decision tree if the Fed's talking points become Fed actions.

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