MAPLE CAPITAL MANAGEMENT

# Fixed Income Commentary

April 8, 2015

## Spring Comes to Vermont!

**_FAST READ..._**

- March brought a thaw in both the winter weather and the Federal Reserve's outlook on monetary policy.
- Comments from the March meeting were dovish and the market is now expecting a more gradual approach to raising rates.
- Interest rate suppression will still end, but the start date has been pushed out and many now believe the process will take longer than originally expected.
- Markets reacted accordingly, with the dollar and interest rates falling, and credit spreads widening.

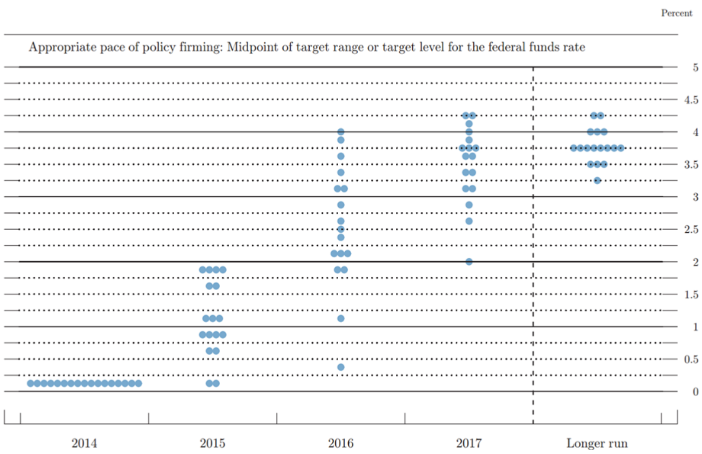
Analysts and the media focused on one word as the Federal Reserve's March meeting drew to a close. The Fed had steadfastly used the word "patient" to describe how they would approach the subject of raising rates in the future. The word had been frozen into the regular post-meeting press releases for nearly a year. Removal of this word was expected to signal the markets that the Fed was just a meeting away from beginning the effort to normalize interest rates.

On the surface, it seemed like a foregone conclusion the Fed would set the stage for higher rates. It therefore felt like the first warm day of spring when the press release omitted the "P" word but still confirmed the economy was too fragile to raise interest rates any time soon. Data points such as wage growth and inflation have continued to be soft for this stage of the economic cycle. Factors like the surging U.S. dollar and large layoffs in the oil and gas industry also pointed to additional weakness in the months ahead. The focus on this weakness was more than enough to mitigate any concern over the wording of the release. Indeed, the bigger surprise was the level of concern among the FOMC members over the state of the economy.

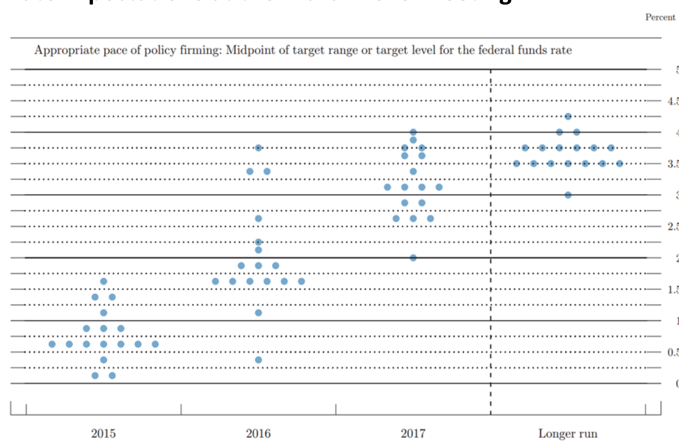
The Federal Reserve shares the individual fed funds rate expectations of their governors with the public using the now famous “dot” charts. These charts plot where each member of the Open Market Committee expects interest rates to be at various points in the future. This quarter, the dots moved down for most all periods, reflecting the collective concern about lack of strength in the U.S. economy. The market was particularly focused on the much lower expectations for year-end 2015. In December, expectations for year-end 2015 were above 1.0%; these expectations are now below 0.75%. This implies the Fed is now less optimistic after an analysis of the new data.

**Chart 1: The Fed Dots Signal a More Dovish Outlook**

**Rate Expectations at the December 2014 Meeting**




**Rate Expectations at the March 2015 Meeting**

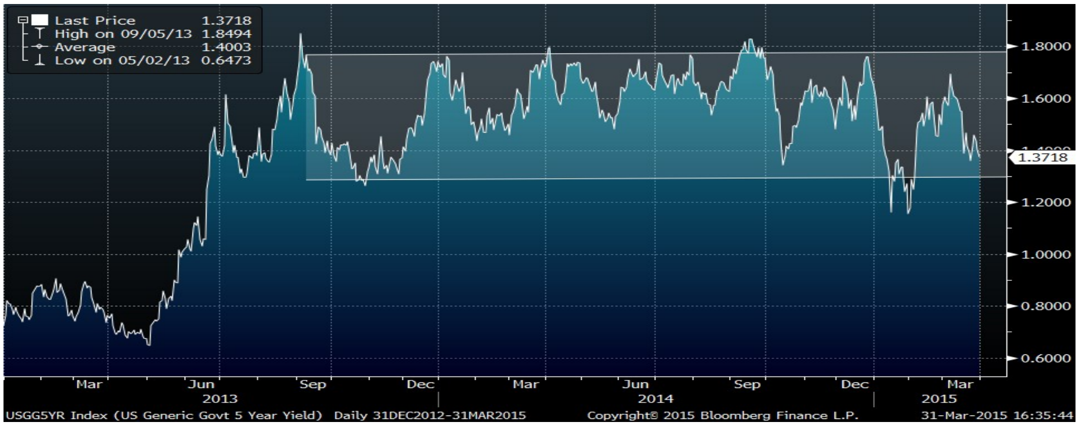



Source: The Federal Reserve

One of the more pronounced reactions to the release was the reversal of the US dollar. The dollar had been strengthening dramatically since last summer as stronger growth prospects and higher interest rates in the U.S. pulled in funds from overseas. The prospect of slower growth and corresponding lower rates signaled the dollar’s rise may have been over-done and it subsequently fell from its recent highs. Despite this slight pull back, the dollar remains strong and U.S. based multi-nationals are likely to experience earning headwinds in the quarters ahead.

In line with the meeting announcement, interest rates fell modestly during the month. The economic news, while still encouraging, is not signaling a rush to inflation. This is being reflected in Treasury prices. As seen in Chart 2, the five-year Treasury yield has been range-bound for the better part of the last 18 months and is now at the lower end of this band. The economic releases since the March Fed meeting suggest yields may continue trending down. Lower yields are typically not a sign the Fed is behind the curve on raising rates.

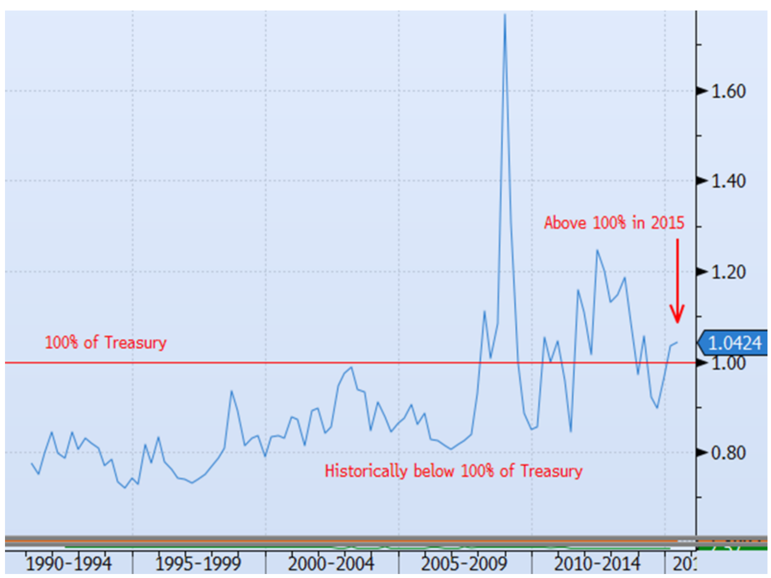
**Chart 2: Five Year Treasury Yields - Range Bound**




Source: Bloomberg

The strength in Treasury prices is not just a function of slow growth and falling inflation. Investors are faced with a growing list of geopolitical and economic risks. There is also a "flight to safety" component in the current move in Treasury prices. Segments of the market with credit risk, such as corporate bonds and municipal bonds, have seen their spreads widen since the start of the year. Municipal bonds have seen significant widening as new issuance and renewed pension liability concerns have weighed on the sector. Tax free municipals have yielded more than Treasuries for most of this year; a significant move from historic norms.

**Chart 3: Widening Trends in Tax-free Municipal bonds**




Source: Bloomberg

## Strategy

March felt mild in the fixed income markets after the volatility of January and February. The yield on the benchmark ten-year Treasury note fell by 7 basis points (bps); one of the more modest monthly moves we have seen in a while. Credit spreads widened a few basis points during the month. In a market that is treading water, it is best to be positioned in diversified fixed income asset classes with some yield and intermediate duration.

The Federal Reserve has clearly stated its desire to begin raising short-term rates in 2015, although it is becoming increasing difficult to do so in the near term. We continue to believe the Fed will not be able to act as aggressively as it would like, and interest rates will remain lower, and for longer, than the consensus view. While growth has been stronger than expected in the past few months, there are several recent data points that suggest this trend may be vulnerable in the months ahead. In the meantime, interest rate differentials across borders continue to attract foreign capital, keeping domestic rates lower than many had forecast.

Credit spreads widened modestly in March. We believe this trend could continue as spreads reflect corporate fundamentals that are about as good as they can get. It is also not uncommon to see credit spreads widen into a tightening cycle. Still, corporate earnings remain strong, with the exception of the energy sector, and we do not anticipate a major credit correction absent a large systemic shock. Taking some credit risk continues as a strategy, primarily with higher quality and shorter duration issues.

Municipal bonds outperformed in 2014 and continue to generate decent relative performance in 2015. Muni prices have not risen in line with Treasuries due to a heavy wave of new issuance. The nominal yields of this asset class are once again higher than comparable maturities in other segments of the bond market. Tax free bonds will also rise in value if tax rates increase, providing investors with the potential for capital gains. Taxable municipal bonds remain attractive when compared to corporate bonds with comparable credit ratings due to their higher yields, the perpetual nature of municipal entities and their associated taxing authority.

We remain optimistic about the risk/reward trade-off in our fixed income portfolios. Our strategy uses sector and security selection in conjunction with an intermediate duration target to mitigate interest rate and credit risks. Our move towards more exposure to agency mortgage-backed securities and high quality taxable municipals is consistent with our focus on preserving capital. High quality callable preferred stocks and a modest exposure to some short duration, higher yielding bonds are employed to add yield at the front end of the curve.

We continue to monitor the markets closely, and our strategies will continue to evolve with changes in fundamentals and market data.

As always, please contact us should you have questions.

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