Fixed Income Commentary

June 12, 2015

KEY TAKEAWAYS

The market is seeing increased volatility in both interest rates and currencies. At the same time, liquidity is decreasing and the Fed has made it clear it plans to move forward with raising rates in the next 6 to 9 months.

Key Rates	May 31 2014	Apr 30 2015	May 31 2015
Treasury Yields			
2 Year	0.37	0.57	0.61
5 Year	1.54	1.43	1.49
10 Year	2.48	2.03	2.12
30 Year	3.33	2.74	2.88
Credit Yields			
BBB Industrial 10 Year	3.46	3.41	3.54
Muni Yields			
AAA Ten Year	2.40	2.12	2.31
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.16	2.74	2.83

MAY IN REVIEW

- Volatility increased in the month of May.
- Treasury rates initially rose rapidly then reversed course, ending the month only a few basis points higher.
- Credit spreads were stable to slightly wider.
- Higher quality muni's and MBS tracked treasuries.

Irrational Pessimism

The month of May saw bond prices fall as interest rates continued to grind higher. A surge in European yields and volatility in the dollar were the main culprits. Money has poured into U.S. markets in recent months, as investors desperately sought higher yielding alternatives to the negative real interest rates being paid on most European government bonds. This has pushed U.S. rates lower and increased the demand for dollars.

The rising dollar had been a significant source of return for the "carry trade" and helped entice more capital to our markets. Any sign of dollar weakness is concerning. Higher rates overseas have curbed the dollar's rise as more foreign capital remains at home. Weaker U.S. economic data has also weighed on the dollar's strength. This suggests less foreign capital will be attracted to our shores in the months ahead. Without the support of a rising currency, U.S. rates will continue to face upward pressure.

Interestingly, foreign interest rates have continued to climb despite the narrowing of rate differentials and shrinking opportunities for currency gains. This reflects the fact that interest rates in the Eurozone were simply too low. Fear of a Greek default, tensions with Russia and fractures in the facade of European unity have led to a flight to quality. Technical factors, such as new bank regulations and the advent of ECB quantitative easing have only exacerbated the situation. With the benefit of hindsight, it is clear there was too much fear, especially in Europe. This pessimism led to a situation where the German Bund had more influence on global interest rates than the U.S. Treasury note.

Accepting negative real interest rates to invest in a 10-yr government bond is irrational and markets eventually correct irrational behavior. Much of the recent rise in trans-Atlantic rates is a function of market interest rates returning to normal levels. This suggests further moves may be likely. U.S. bond investors tend to be inward looking and many attribute most of the plunge in domestic rates last year to a weak U.S. economy, not to cross-border influences. The bounce off the April lows has been almost entirely due to a surge in Bund yields. Very little of the May move appears to be an anticipation of changes in monetary policy and has yet to be widely priced in to rate levels. Further volatility should be expected as the market continues to factor in Fed efforts to normalize interest rates in this country. If the 2013 "Taper Tantrum" is a reliable precedent, interest rates may still have reason to move higher this summer.

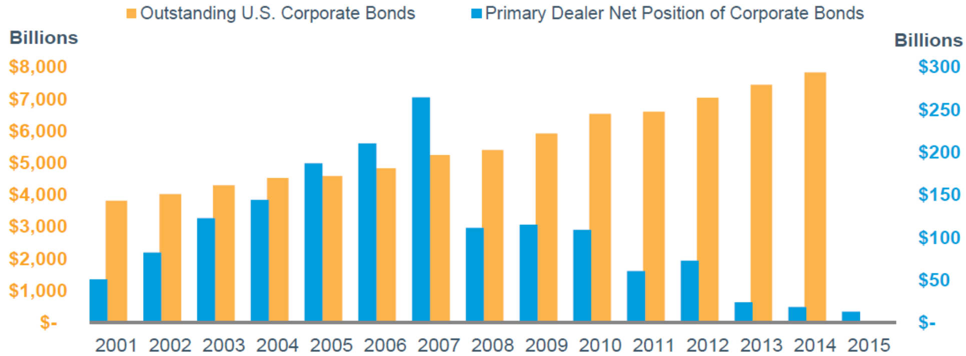
Investment Outlook

The Fed is widely seen as moving towards normalizing interest rate levels by year end. Fed Chair Janet Yellen specifically voiced this objective during her Humphrey Hawkins testimony in May.

There is much debate over the merits of this policy change. Academically speaking, few would be able to justify a "zero bound" fed funds target and maintaining massive Fed balance sheet expansion (the result of QE bond purchases) as rational policy actions with only a 5.5% unemployment rate. There is a strong case to be made for the end of interest rate suppression.

Yet, these policies seem prudent given the depth of the 2008-09 recession. There are also concerns that domestic growth is still quite fragile. The International Monetary Fund (IMF) recently cautioned the Fed not to act until 2016 because the U.S. and global economies were too frail. Comments by the Federal Reserve and recent economic releases suggest growth estimates might indeed be too optimistic.

EXHIBIT 1: REDUCED CORPORATE BOND LIQUIDITY



Source: Charles Schwab & Co.

It is important to note that the arguments for an end to current monetary policies revolve solely around the timing of such a move. Rates will have to normalize at some point. We believe the Fed would need to see a significant deterioration of global conditions to defer action beyond early 2016. This time frame is such that bond markets have likely started to reflect the risk of rate increases in market levels, although we are still early in the process. We expect to see additional movement in the weeks and months ahead.

At the same time, there is a growing concern about the levels of liquidity in the bond markets. Nouriel Roubini, the noted NYU professor lovingly referred to as “Dr. Doom,” recently penned a paper titled “The Liquidity Time Bomb” in which he describes the rapidly shrinking levels of market liquidity despite the oceans of money being injected into the financial system by central banks around the world. This is a growing concern for investors and regulators alike.

Interest rate moves are exaggerated under such conditions. Without the ability or incentive to act, market makers are not stepping in to curb market excess. This was abundantly clear when the 10-yr Bund traded at a yield of near 0% in April and when 10-yr Treasury yields plunged 40 basis points in one day last October.

As dealer liquidity dries up, group behavior quickly produces wide swings in asset prices. Roubini notes, “as more investors pile into increasingly illiquid (markets), the risk of a long term crash increases.” While we do not expect a crash in bond prices, it does not take a runaway imagination to see how fear of higher rates could easily lead to excessive price swings. Unfortunately, investors are more prone to head for the exits at the same time during market corrections than they are to participate as a group in market rallies. The “melt up” in bond prices in the fourth quarter may only hint at what is possible during a sustained sell off. We understand why the IMF is so concerned about U.S. rate policy.

As always, please contact us should you have questions.

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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