MAPLE CAPITAL MANAGEMENT

Fixed Income Commentary

November 6, 2014

How Low Can Rates Go?

All around the limbo world
Gonna do the limbo rock
- Limbo Rock—Chubby Checker

FAST READ...

- Our long-term interest rate outlook continues to be "Lower for Longer". Lower global inflation and growth outlooks should hold rates down, despite somewhat better economic trends in the United States.
- Short-term rates could move up from zero as the Fed moves to normalize rates, perhaps beginning in 2015. If longer term rates remain in check, the yield curve could continue to flatten.
- We continue to emphasize positioning on the intermediate portion of the yield curve.
- The credit environment is supported by strong fundamentals, but we are using this continued strength to reduce credit exposure.

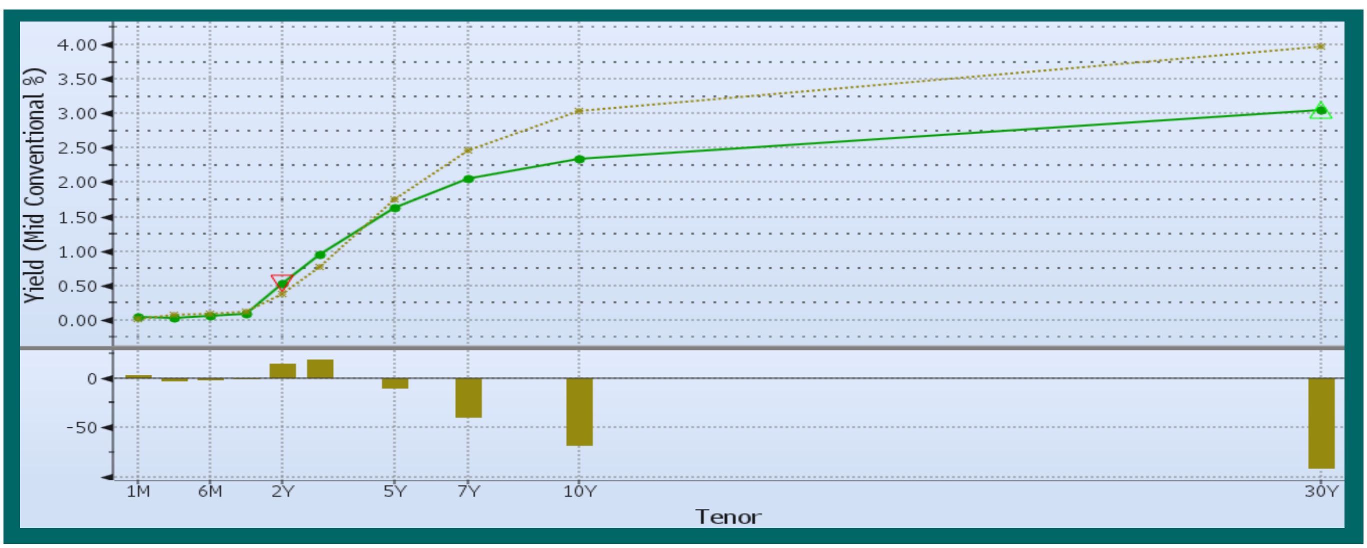
Longer term interest rates took a significant step down last month. The ten-year Treasury yield fell 30 basis points by October 15th, and has only partially rebounded from this large move. There are a number of catalysts to sustain lower rates – continued deceleration of global economic growth, lower inflation expectations in Europe and China, falling commodity prices (most notably oil) and the continued movement of capital to the U.S. (see last month's Fixed Income Commentary). The outlook for shorter rates is different.

Chart 1—Interest Rates Fall Again Last Month - Ten Year U.S. Treasury

Source: Bloomberg

Short-term interest rates could rise next year as the Fed suggests they will raise the federal funds rate starting in 2015. We are skeptical the Fed can raise rates as much as they think is necessary for normalization (see The Fixed Income Commentary from June 2014). As we know, the Fed projections are usually optimistic.

Chart 2—The Yield Curve has Flattened in 2014



Source: Bloomberg

Less optimism, weaker global economic trends, lower inflation and lower earnings can all widen credit spreads. As we saw last month commodity producers earn less as commodities prices fall, banks earn less when rates stay lower for longer, and companies with multinational exposure are impacted by the stronger dollar and softer economies in developed and developing countries.

Credit spreads are off the tight levels of early summer and we may not see spreads this tight again during this credit cycle. Credit spreads should widen modestly as systematic risks increase. However, credit fundamentals and spreads are still well supported; operating margins (for most) are still very high, interest expense is manageable, net debt levels are generally moderate by historical standards, and bank and capital markets provide generous amounts of liquidity. Defaults should remain low in this environment.

Chart 3 —Investment Grade Credit Default Swaps

Source: Bloomberg

Strategy

Benchmark fixed income returns were strong last month with interest rates much lower, as the ten-year Treasury rate fell 18 basis points (bps) in October. Some of the price gains attributable to lower Treasury rates were given up as credit spreads widened modestly last month. In this environment, the best performing sectors have had longer duration and higher quality – like municipal bonds. Sectors with shorter average duration and generally lower credit quality have posted more modest returns.

We anticipate interest rates will remain lower and stay lower for longer than the consensus view. Our outlook is supported by the established trends of continued lower inflation and growth prospects around the world. In this environment proper positioning on the yield curve remains vital.

Credit spreads may come under modest pressure in this risk-off environment, but corporate fundamentals remain strong and we do not anticipate a major credit correction absent a large systemic shock. Taking some credit risk continues as a strategy, although primarily with higher quality and shorter duration issues. We are increasingly directing money into government securities, mortgage-backed securities, and higher rated municipal bonds.

Municipal bonds have outperformed and we are now back in line with historical valuation measures, yet we may see additional gains with any potential for increases in income tax rates or further weakening in other credit related sectors. We believe it is more prudent to hold longer duration exposure in muni's than in corporates, especially since the average credit risk in municipals is lower than corporates.

We remain optimistic about the risk/reward trade off in our fixed income portfolios, despite the recent market volatility. We are using sector selection, security selection, and yield curve management to help mitigate interest rate and credit risks. We are still using high quality callable preferred stocks to add yield at the front end of the curve. Unfortunately, many of these preferreds are being called and not all will be replaced.

We continue to monitor these volatile 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.

Maple Capital

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We currently manage over $600 million for high net worth individuals, families and institutions nationwide. Our size allows us to have the resources of a large firm while retaining the ability to provide our clients with a level of service rarely seen in the marketplace today.

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