Fixed Income Commentary

December 8, 2014

The Winds of Deflation

FAST READ...

- The winds of deflation are blowing stronger, helping to keep downward pressure on interest rates.
- These winds continue to build – they are currently stronger than a light breeze but still weaker than a storm warning.
- Lower oil prices and a stronger dollar are the latest deflationary gusts.
- In the short term cheaper gas and imports help the U.S. consumer. Longer term, deflation is a worrying symptom of slowing worldwide economic growth and may lead to more desperate measures by central bankers.

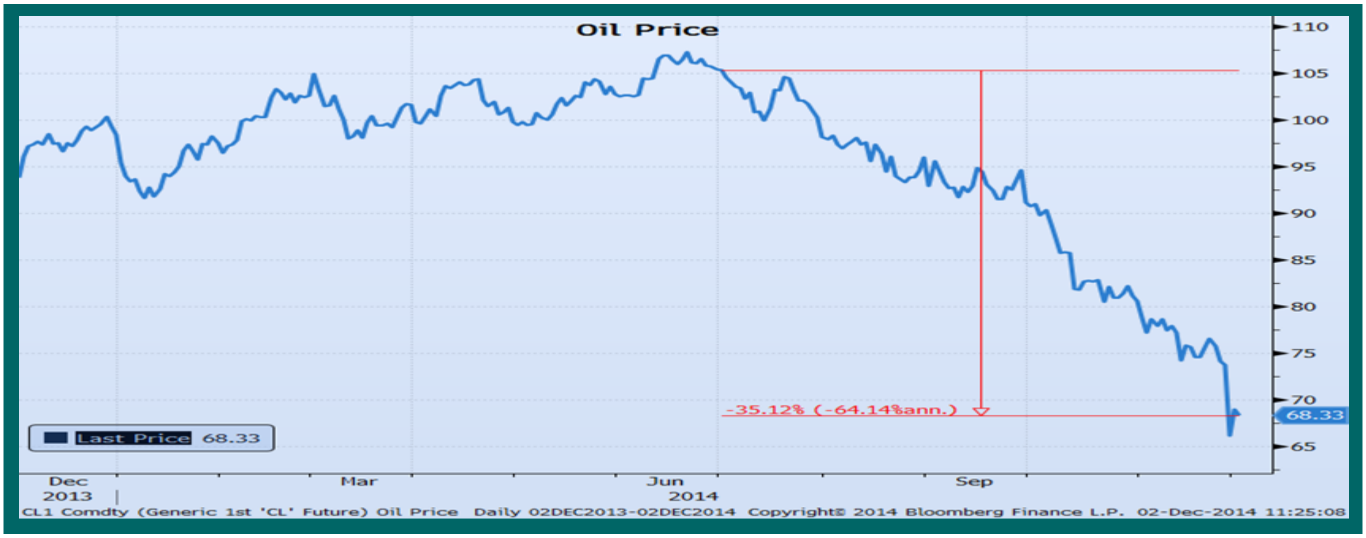
The winds of deflation continue to strengthen in 2014 as economic growth slows in many parts of the world. Central banks around the globe are trying to stimulate higher inflation, but these efforts have generally failed so far. The Bank of Japan has failed to generate inflation despite years of aggressive fiscal and monetary policies specifically designed to produce higher prices. The European Central Bank is on the verge of implementing large scale quantitative easing, also with the goal to boost growth and inflation. It is unclear if either effort will generate the desired level of increased inflation.

Two large drivers of deflation in the U.S. are lower oil prices and a stronger dollar. Oil prices, for example, are 35% lower than at the end of June, as supply is largely outpacing demand (Chart 1). A stronger U.S. dollar drives deflation by making imports cheaper and limiting price increases on domestic goods. While both of these forces are deflationary, they might not be signs of broader economic turmoil.

Oil prices typically fall when there is a meaningful disconnect between current supply and demand forces. Recent supply has surged due to a plethora of major shale gas & oil discoveries coupled with major advancements in production techniques. On the other hand, demand has been severely crimped by slower worldwide growth. Additionally, the largest swing producer in the world, Saudi Arabia, appears willing to sacrifice price in order to defend its market share.

Gas, oil and propane comprise a meaningful percentage of consumer's spending, so lower oil prices clearly help to reduce the overall inflation rate and interest rates. Gasoline alone is 3% of consumer spending, which means that a 20% drop in gas prices results in an estimated $70 billion of savings.

Chart 1—West Texas Intermediate Oil Prices



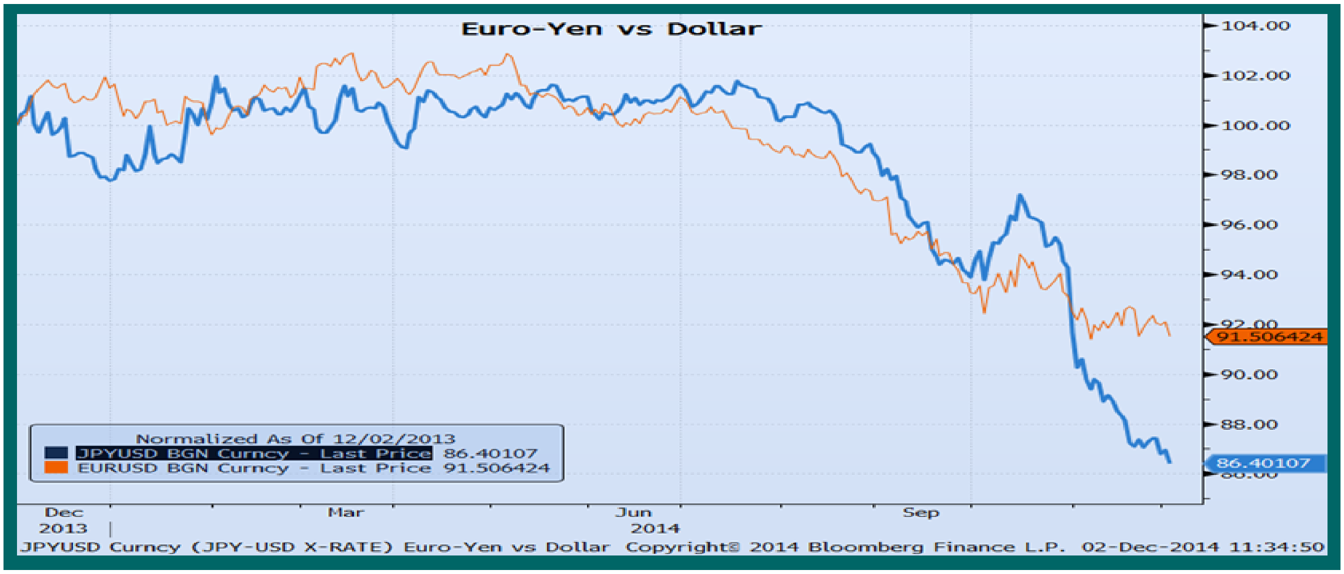
Source: Bloomberg

Consumers will also be supported by a strong U.S. dollar, which leads to cheaper imports on thousands of popular consumer items, such as the large screen televisions so coveted on Black Friday sales. Domestically produced goods, already facing discounting pressures from retailers, will now require further price cuts just to remain competitive.

The Japanese yen and the Euro have dropped 14.6% and 9.1% respectively since the end of the second quarter (Chart 2). We attribute these large currency moves to a number of factors, the most important being the end of quantitative easing by the Federal Reserve and accelerating economic trends in the U.S. Our interest rates are now very attractive to overseas investors who must buy dollars to invest in our markets.

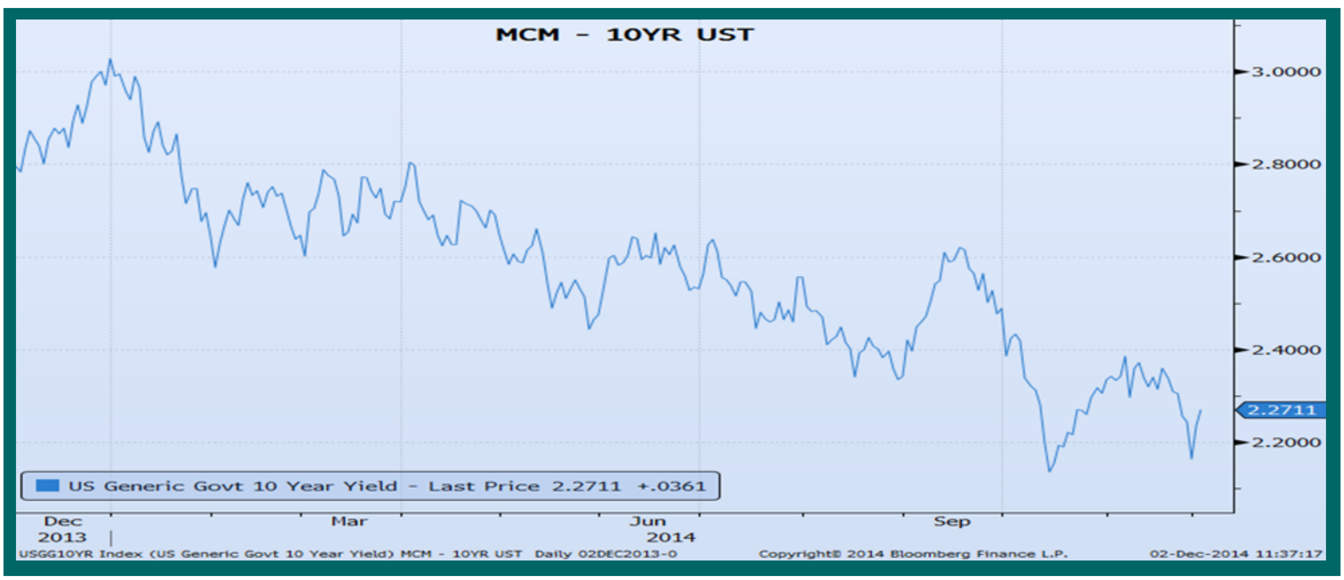
In contrast, many global economies are slowing or have recently entered a recession. In an effort to boost their economies, quantitative easing was recently enacted in the Euro region, massive and increasing easing is taking place in Japan. China is also pursuing looser monetary policies. Since the end of QE actions in the U.S., Evercore/ISI has counted at least 24 central bank easing actions around the globe. Lower interest rates overseas lead to lower currencies as capital flows towards domiciles offering higher returns. The U.S. is receiving these flows and this contributes to falling U.S. interest rates, along with lower inflation (Chart 3).

Chart 2 —The Yen and Euro vs. the Dollar



Source: Bloomberg

Chart 3—Lower Treasury Yields



Source: Bloomberg

In the short term, lower oil prices and cheaper imports are attractive – they result in more money in the pockets of consumers and that helps the U.S. economy. In the long term, however, persistent deflation is evidence of slower world growth and could lead to higher levels of central bank intervention, more sovereign deficit spending, and potentially destructive currency wars. Those government and central bank responses to deflation will eventually lead to inflation. The only question is when and how fast inflation increases. History has shown, time and time again, that it is unwise to make large bets on when an inflation cycle will turn.

Strategy

Benchmark fixed income prices rose last month with lower interest rates. The ten-year Treasury rate fell another 17 basis points (bps) in November. However, some of these price gains were surrendered as credit spreads widened modestly last month. In this environment, the best performing sectors have longer duration and higher quality assets, such as municipal bonds.

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

Credit spreads could continue to 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. As credit risks increase, we are directing money into government securities, mortgage-backed securities, and higher rated municipal bonds.

Municipal bonds have outperformed and prices are now back in line with historical valuation measures. We may see additional gains driven by potential 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 municipals than in corporate bonds, especially since the average credit risk in municipals is lower than corporate bonds.

We remain optimistic about the risk/reward trade off in our fixed income portfolios. 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 attractive preferreds are being called and not all can be replaced.

We continue to monitor these markets and winds 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

Maple Capital Management, Inc. is an independently owned, New England based, SEC Registered Investment Advisor with offices in Montpelier, Vermont and Atlanta, Georgia.

Contact Information

John T. Boland, CFA
President & Chief Investment Officer
jboland@maplecapital.com

Ken Frey, CFA
Sr.Vice President & Fixed Income Portfolio Manager
kfrey@maplecapital.com

Steven Killoran
Vice President Business Development—Shareholder
skilloran@maplecapital.com

Maple Capital Management, Inc.
535 Stone Cutters Way, Montpelier, VT 05602 • Tel: 802.229.2838 • Toll Free: 800.255.9946
Fax: 802.229.2837
533-D Johnson Ferry Rd • Suite 350 • Marietta, GA 30068 • Tel: 770.693.7690 • Fax: 770.512.5176
www.maplecapital.com