MAPLE CAPITAL MANAGEMENT

Fixed Income Commentary

January 7, 2015

The Countdown Begins

FAST READ...

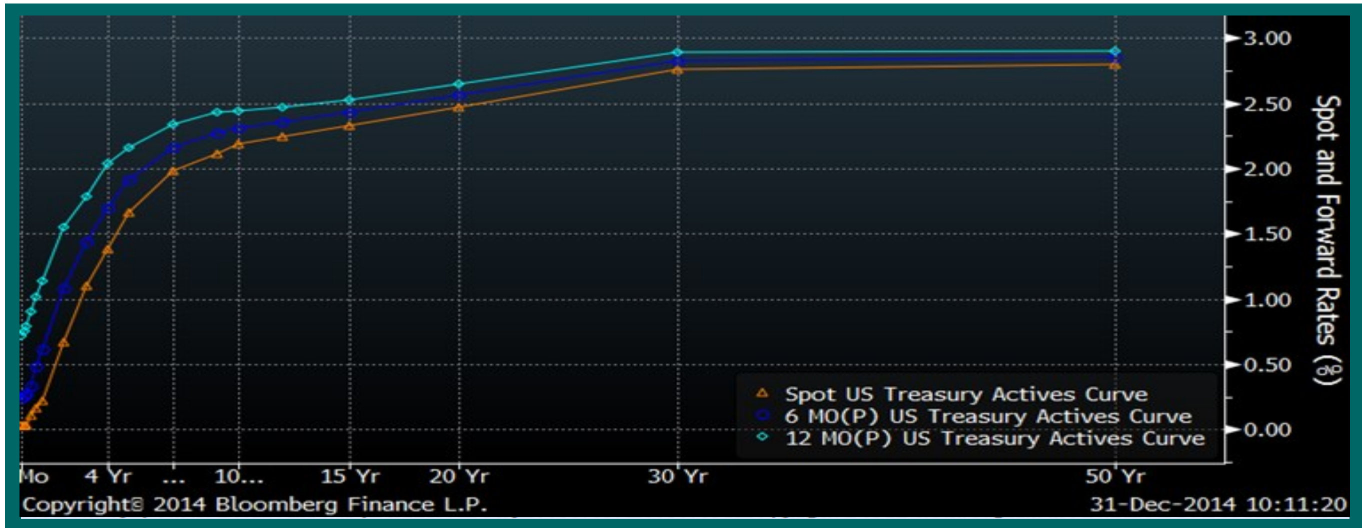
- The countdown begins for the Federal Reserve's projected rate hike in 2015.
- The Federal Reserve should begin normalizing short term interest rates as the U.S. economy continues to strengthen, unemployment falls and inflation remains stable.
- However, there are many wildcards that could delay the normalization of interest rates.
- We believe the Fed's rate "liftoff" will not begin until the second half of the year, consistent with our "lower for longer" interest rate theme.

The countdown for the Federal Reserve to begin interest rate hikes has started. The Federal Reserve has made it clear the federal funds rate should start to rise, perhaps as early as the second quarter, of 2015. This outlook, of course, is dependent on the continuation of positive economic trends.

So far, the numbers are good. The economy continues to recover as evidenced by the strong, five percent real GDP growth rate in the third quarter and continued lower unemployment rates. Furthermore, inflation remains controlled. Indeed, short-term inflation trends might be too low, but the Fed still believes their long-term target inflation target can be achieved.

The market believes the Fed is as good as its word and this faith is reflected in the forward interest rate curve. A one-year Treasury trades at a yield of 0.22% today, while the forward interest rate curve implies a rise to 0.62% in six months and 1.13% in one year. See Chart 1.

Chart 1—Spot and Forward Interest Rate Curves



Source: Bloomberg

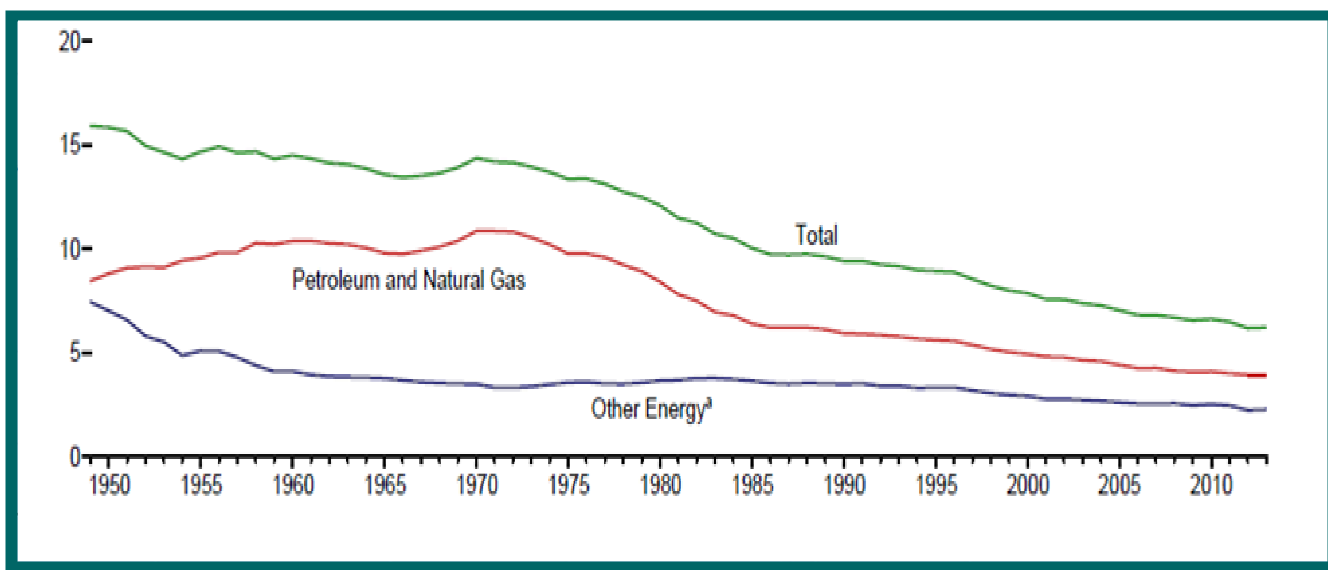
This forward curve anticipates short term (1-5 years) interest rates rising faster than longer term (5-30 years) interest rates. This makes sense as the Federal Reserve can exert more control over the front end of the curve than the long end. The Fed's primary tool is the management of short-term rates by setting the fed funds and discount rates. The Federal Reserve has maintained historically low rates since the financial crisis in an effort to stimulate the economy and reduce unemployment. As the Fed adjusts to continued improvements in economic data, changes to monetary policy will be almost immediately reflected in short term rates. Longer term rates typically reflect more factors and often take longer to react.

While the Fed has plenty of supporting data to raise rates, we believe the countdown to a change in policy direction will take longer than consensus forecasts. Fed actions can only exert so much influence over inflation trends, as we highlighted in December's Fixed Income Commentary. We believe the market continues to overestimate the Federal Reserve's and other Central bank's ability to achieve their stated inflation targets. For example, inflation expectations in the U.S. took a steep downward slide in 2014, reflecting slower worldwide growth, the recent fall in oil prices and the continued strength of the U.S. dollar.

Chart 2 —Ten Year Inflation Expectations

The recent collapse in the price of oil certainly contributes to lower inflation expectations. It may also slow employment growth, as the oil and gas industry reduces capital expenditures and payrolls over the next few years. Oil producing regions like Texas will slow economically, state and local budgets will weaken, and some highly leveraged oil companies will fail. These negative factors may counterbalance some of benefit to consumers from lower energy prices; an input many economists are factoring in to their forecasts for stronger demand in the year ahead. The production of oil and natural gas has become an increasingly important driver of U.S. economic growth over the past ten years while the cost of energy as a percentage of GDP consumption has been steadily shrinking since the 1970's (See Chart 3). This suggests the added dollars in consumers wallets from lower energy costs may have less of an impact compared to prior periods of falling energy prices.

Chart 3—Energy Consumption as a Percent of GDP



Source: EIA.gov

Finally, uncertainty is likely to be one of the more certain sources of support for U.S. bond prices and continued lower yields. The world is full of wildcards as we go into 2015 and uncertainty often results in a flight to quality. Oil was a wildcard in 2014 and should be just as unpredictable in 2015. Chinese economic growth is slowing and even the most knowledgeable China watchers are uncertain about the rate of decline. Japan continues to muddle through while Europe (and the Euro) could be thrown into another crisis if Greek politics turn sharply left and Greece exits the Euro. Throw in a wounded Russian bear that could become even more unpredictable and continued fighting in the Middle East and it is easy to envision a flight to the safety of Treasuries and the U.S. dollar. A strong dollar could hurt U.S. exports and make imports more attractive to domestic consumers, which in turn would slow U.S. growth. Any of these factors could force the Fed to keep its accommodative policy in place.

Lower for longer continues to look like a safe bet for at least the first half of 2015, if not longer.

Strategy

Fixed income security prices generally fell last month as interest rates rose. The ten-year Treasury yield rose 4 basis points (bps) and the five-year Treasury rose 13 bps. Credit spreads also widened last month adding to losses.

The best performing sectors had shorter duration and higher credit quality, such as seasoned government agency mortgage backed securities.

We believe the Federal Reserve will raise short-term rates in 2015, yet 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, with the exception of the energy sector. 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. In recognition of increasing credit risks, we are directing money into government securities, seasoned mortgage-backed securities, and higher rated municipal bonds.

Municipal bonds outperformed in 2014 and prices are now back in line with historical valuation measures. We see support for this asset class driven by potential increases in income tax rates or further weakening in other credit related sectors. We are particularly attracted to “kicker” bonds in this environment. Kicker bonds are callable bonds with longer maturities. These bonds trade as if they will be called, creating prices that produce very attractive yield to maturity levels if the bonds are not called. We are finding structures with lower call risk and are purchasing these bonds with the assumption they will be held to maturity. These holdings are very attractive when compared to comparable maturity bonds without call features.

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 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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