Maple Capital Management

Fixed Income Commentary

March 5, 2015

Wild Weather and Market Volatility

Boston 2015

FAST READ...

- Last month, the wild weather and the volatility in the fixed income markets grabbed headlines. Both caught many unprepared.
- Storms and severe cold raked the East Coast in February as interest rates rose and credit spreads tightened decisively – all unexpected in the consensus forecasts for January.
- We expect continued market volatility as the Fed gets closer to raising rates; we have no view on the weather.
- The fed funds rate needs to rise materially to normalize its spread above the CPI, yet a rapid rise could derail the still fragile recovery. What's the Fed to do?

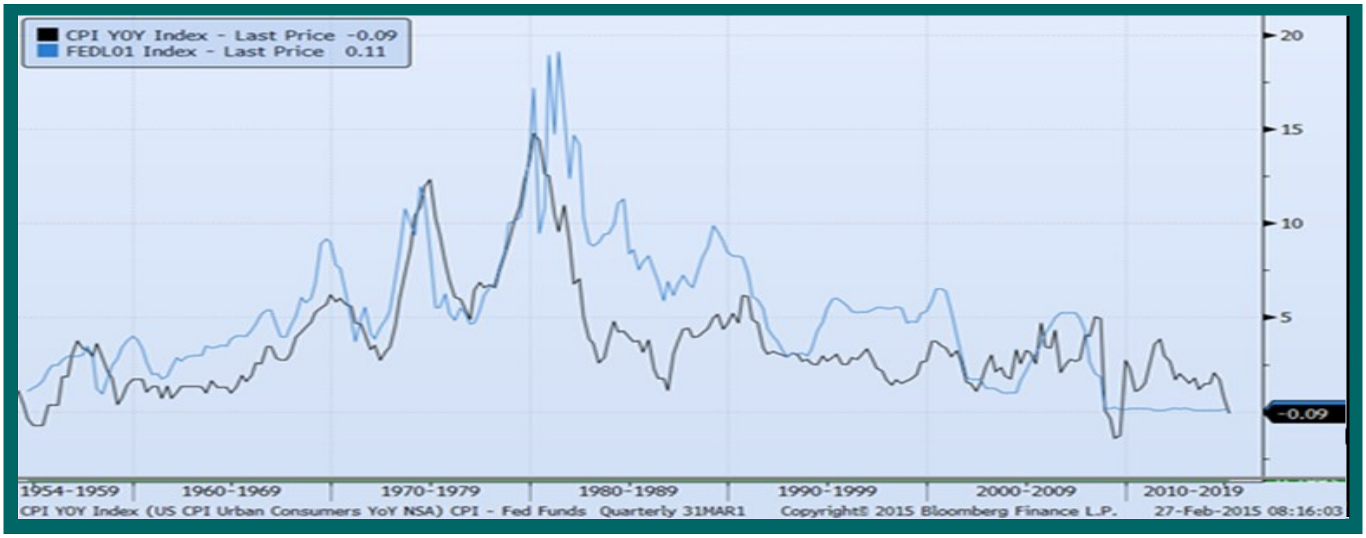
Janet Yellen kept markets guessing about the timing and the magnitude of the coming rise in the fed funds rate in her February Congressional testimony. The recent volatility in the fixed income markets reflects this uncertainty. Like a large coastal storm with an uncertain path, many investors don't know whether to move the family and pets to higher ground, or to just board up the windows and ride out the storm.

What we do know is equilibrium interest rates are higher than current levels. Historically, the fed funds rate floats at a premium to the rate of inflation. Chart 1 shows the long term relationship between the fed funds rate and inflation (as measured by the Consumer Price Index, CPI). While the spread of the fed funds rate above the CPI varies, it was common for the pre-Crisis level of this premium to be around 2 .0%.

This premium makes intuitive sense as investors should get a positive rate of return in excess of the rate of inflation. It is interesting to note that prior to the recent crisis, the Fed was more concerned about reducing inflation, while their post-crisis goal is increasing inflation.

The losers during this post-crisis period have been fixed income investors who have found it increasingly difficult to earn returns above the inflation rate. This may soon begin to change.

<u>Chart 1—The Fed Funds Target Rate (FEDL01) and Consumer Price Index ("CPI")</u>



Source: Bloomberg

If the Fed were to raise the fed funds rate to average historical levels, the rate would be about 3.5%. An orderly move to normalized rates would probably have little effect on U.S. output, although a swift increase in short term rates would be as disruptive as a massive storm in New York City. It seems very unlikely the Fed will risk making a dramatic move given the potential negative impact on the economy. This view underpins our expectation for interest rates to rise modestly. We have little doubt the Fed will continually assess the impact of every rate increase on the economy and capital markets and will refrain from further actions if the economy slows.

We do not expect forceful action unless the rate of inflation appears to significantly exceed their target of 2.0%.

Given recent economic data and news flow, the consensus view is that the Fed will begin tightening sometime in the second half of 2015. The U.S. economy is growing, unemployment continues to fall, the U.S. stock market is rising and the risk of a Greek exit from the Euro has been delayed for a few more months. Central banks around the world continue to ease in what is either a remarkably coordinated effort to boost demand, or an aggressive round of competitive currency devaluation. Either way, the global economy should pick up steam in the months ahead, barring a flare up in geopolitical risks.

In an environment where so much is going well, there is always the potential for negative news to push back the Fed's timetable for normalizing rates; timing of the coming storm is unpredictable.

Strategy

February was the mirror opposite of January, with interest rates rising and credit spreads contracting during the month. The yield on the benchmark ten-year Treasury note rose by 37 basis points (bps); one of the larger relative increases we have seen in a while. The best performing sectors were those with shorter duration and lower credit quality; indicative of a strengthening economy. This was reflected in MCM portfolios by the strength of our preferred stock and short duration BBB corporate bond holdings.

The Federal Reserve has clearly stated its desire to begin raising short-term rates in 2015, and the data in the last month supports this plan. However, we continue to believe the Fed will not be able to act as soon as it would like, and that interest rates will remain lower, and for longer, than the consensus view. While growth has been stronger than expected in the past two months, there are several data points that suggest the growth trend may still be vulnerable in the months ahead. It is unlikely we will see any tightening until self-sustaining growth has clearly taken hold. In the meantime, interest rate differentials continue to attract foreign capital, keeping domestic rates lower than many analysts had forecast.

Credit spreads rallied in February, but we believe the trend could again turn negative as prices reflect fundamentals that are about as good as they can get during this credit 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 continued to generate decent relative performance in 2015. We still see value in this asset class, which is supported by the risk of potential increases in income tax rates and further weakening in other credit related sectors. Taxable municipal bonds are also attractive on a yield basis, especially when compared to corporate bonds with comparable attributes.

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 government bonds 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. Unfortunately, many of these attractive preferreds are being called and not all can be replaced.

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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