Maple Capital Management

Fixed Income Commentary

September 4, 2015

KEY TAKEAWAYS

Turmoil in global equity markets in August will most likely keep the Fed on hold for September. China devalued the yuan in an effort to stimulate its economy as growth has slipped below 7%. U.S. Treasuries initially benefited from a flight-to-quality, but it was short lived as China began to sell them to prevent a major collapse in the yuan. U.S. interest rates actually rose slightly in the month.

Key Rates	Dec 31 2014	Jul 31 2015	Aug 31 2015
Treasury Yields			
2 Year	0.66	0.66	0.74
5 Year	1.65	1.53	1.55
10 Year	2.17	2.18	2.22
30 Year	2.75	2.91	2.96
Credit Yields			
BBB Industrial 10 Year	3.42	3.77	3.90
Muni Yields			
AAA Ten Year	2.10	2.30	2.22
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.83	3.10	2.96

AUGUST IN REVIEW

- Stocks got routed as a global correction in prices got underway.
- The U.S. dollar fell on a trade-weighted basis as both China and Japan liquidated them via U.S. Treasury sales.
- Building international pressure on global financial markets will likely keep the Fed on hold in September.
- Spreads on corporate bonds, mortgage-backed securities widened while municipals yields fell slightly.

The China Syndrome

The August meltdown in Chinese equity markets triggered sharp declines in global equity markets. China, the world's second largest economy, has been steadily cooling in recent years, slowing from greater than 10% growth rate at the beginning of the decade to a current level of around 6-to-7%. China has been the biggest importer of raw materials and finished goods, trading with virtually every country around the globe. A slowing China weighs on the economies of raw material exporters such as Brazil, Russia, Indonesia and Australia, as most commodity prices, from iron ore to wheat, have fallen to their lowest levels since the 1990's. In addition, a China slowdown impacts finished goods exporters such as the United States, with 8% of its export going to China, Japan at 20%, and South Korea at 30%. This has once again raised the specter of global deflation and instability, sending interest rates lower and stocks reeling.

The Chinese stock markets have always been perceived as a casino and heavily influenced by the central government. Beginning in 2014, the central government began urging people to buy stocks, as a way to divert money from real estate speculation and deflate a growing property bubble. The property market is far more important to China's economy than the stock market. Property fuels up to one-quarter of GDP and its value underpins the banking system. The Shanghai Composite Index rose from roughly 2,000 at the start of 2014 to over 5,000 in June of this year, a total return of over 150%! Investors began to take profits this summer, thinking the market was near a peak. The selloff was severe, forcing the government to take action. The government enacted stimulus measures: instituted new regulations, banned short selling, forced state-owned companies to buy back their shares, and even threw journalists reporting on events in jail for spreading rumors. On August 11th, China shocked the global markets by devaluing the yuan, a sign to the world this key engine of global growth great was in serious trouble. This has sparked renewed fears of a global currency war.

Initially, yields on the U.S. Treasury 10-year note fell 33 basis points (from 2.23% to 1.90%) as stocks plummeted. However, this knee-jerk reaction was short lived as China, the largest foreign holder of U.S. Treasuries, began to sell in order to prevent a collapse in the yuan. In other words, China sold U.S. Treasuries to raise dollars with which to buy Yuan and support their currency. Once bond investors recognized this

was happening, the flight-to-quality trade ended and yields returned to their pre-crisis levels. For the month of August, yields on U.S. Treasury securities actually increased slightly, with the 10-year note finishing the month at 2.22%, up from 2.18% the month prior. The trade-weighted US dollar actually declined in the month of August due to Chinese selling pressure.

There's a lot going on with the Chinese economy and it does influence global markets. China is transitioning from a command economy to a market-oriented one, from a heavy industrial base to services, and from foreign investment to domestic consumption. And these transitions aren't easy, as Russia found out in the 1990's. But China still has much it can do to stimulate its economy, unlike most Western countries. Growth is still near 7%, interest rates are relatively high versus other countries, and it has massive amounts of foreign exchange reserves. The real issue is that countries which relied heavily on exporting to China are vulnerable to it's slowdown. As global growth slows, the Fed has less incentive to raise U.S. interest rates. A month ago, there was a 50% chance that the Fed would hike rates in September; today that probability is 30%. In fact, the IMF and the G20 are petitioning the Fed not to raise interest rates this year. The world may not be able to rely on China to provide the lion's share of economic growth anymore.

Puerto Rico Update

An agency called the Public Finance Agency missed a $58 million debt payment on August 3rd, becoming the first island default. While the government does not face significant payments until December, other agency issuers will soon hit fiscal walls. The Puerto Rico Electric Power Authority, or PREPA, faces payment deadlines in September. PREPA has been negotiating with creditors and some form of an agreement is expected.

The territory simply does not have enough money to service its debts and write downs are expected. Estimates of recovery from 30-60% for uninsured bonds. Creditors of some agencies will have greater losses while others, such as the Sales Tax Financing Corp. (COFINA), will be more protected. However, bond insurers and investors will undoubtedly take a hit.

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