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## KEY TAKEAWAYS

The Federal Reserve began the process of interest rate normalization with December's announcement of the first rate increase since 2006. With the ECB and other central banks continuing to lower rates, market disruptions are inevitable. The U.S. Treasury yield curve flattened after the move, with front end yields rising and longer terms yields falling.

### Key Rates

#### Treasury Yields

	Dec 31 2015	Nov 30 2015	Dec 31 2014
2 Year	1.05	0.93	0.66
5 Year	1.76	1.64	1.65
10 Year	2.27	2.21	2.17
30 Year	3.02	2.97	2.75

#### Credit Yields

	Dec 31 2015	Nov 30 2015	Dec 31 2014
BBB Industrial 10 Year	3.99	3.92	3.42

#### Muni Yields

	Dec 31 2015	Nov 30 2015	Dec 31 2014
AAA 10 Year	2.00	2.07	2.10

#### Mortgage Backed Securities

	Dec 31 2015	Nov 30 2015	Dec 31 2014
30 Year FNMA Current Coupon	3.00	2.95	2.83

## DECEMBER IN REVIEW

- Stocks and bonds appear to be de-linking.
- U.S. Treasury yield curve continues to flatten.
- The longer end of the U.S. Treasury yield curve continues to rally despite the Fed interest rate hike.
- Spreads are widening for corporate and foreign bonds, especially for lower quality issues.

Stocks and bonds began 2015 with polar opposite return expectations. The consensus view for the year was that stocks would rally on the strength of the economy while bonds would be weak for the same reason. The U.S. economy started the year on solid footing. Unemployment stood at 5.6% and was falling, GDP was growing at a 2.4% annualized real rate, and inflation was tame with CPI (ex food & energy) running at a manageable 1.6% year-over-year rate. Many expected the Federal Reserve to commence its interest-rate normalization process early in the year. We cautioned investors to be patient and be prepared for a “lower for longer” rate scenario, given the many headwinds facing the global financial markets. The headwinds did not take long to appear.

In the first half of the year, Europe was a visible cause for concern. The European Central Bank announced a long awaited Quantitative Easing program involving large scale purchases of sovereign and public debt. The Euro sank over 13% against the U.S. dollar in a matter of weeks. The Euro's woes worsened with the Syriza coalition victory in Greek elections and the heightened risk of Greece being kicked out of the Eurozone. The resulting flight to quality caused German government bonds to trade with negative yields and U.S interest rates to fall with the influx of foreign capital seeking higher returns than those available overseas.

Even as Europe and the Euro stabilized, global financial markets latched onto the next problem area: China. The world's second largest economy has been cooling in recent years. Growth in the country has slowed from double digits at the start of the decade to just over 6% at the end of last year. China had been the biggest importer of raw materials and finished goods, trading with virtually every country in the world. A slowing China weighed heavily on the economies of raw material exporters such as Brazil, Russia, Indonesia, and Australia. Commodity prices from iron ore to wheat fell to their lowest levels since the 1990's— raising the specter of global deflation and instability, sending interest rates lower, the dollar soaring and stocks reeling. Against this backdrop, the Fed could only wait on raising rates.

### EXHIBIT 1: 2015 INTEREST RATE MOVEMENTS (%)

	12/31/14	12/31/15	Change (BP)
UST 1-yr Bill	0.22	0.60	+38
UST 2-yr Note	0.67	1.05	+38
UST 5-yr Note	1.65	1.76	+11
UST 10-yr Note	2.17	2.27	+10
UST 30-yr Bond	2.75	3.02	+27

Source: Bloomberg Financial L.P.

Equity prices, meanwhile, experienced a sharp increase in volatility. Against a background of increasing global tensions, weakening economic fundamentals and the threat of Fed rate increases, valuation multiples cannot expand. Stock prices can only rise in such an environment if earnings increase and earnings cannot rise if the global economy does not expand. The same forces that drove investors to the safety of government bonds also drove stock prices into correction territory. Highlighting this shift in investor focus, stocks plunged in September after the FOMC announced it would not hike rates due to weaker global conditions. In recent years, such an announcement would have caused a sharp market rally.

Stock indices were only able to turn positive after strong employment reports in the fourth quarter, helped by strong central bank and regulatory action in foreign markets, notably China. These same signs of stability also gave the Fed the cover to raise base interest rates by 25 basis points at the December meeting. The hike was the first rate hike since 2006; thus ending the longest Post-War stretch without an increase.

We provide this recap to illustrate two key themes for the year ahead. Foremost, stocks and bonds are de-linking. The past decade has been characterized by a stock market that valued lower interest rates more than rising earnings, leading to stock and bond prices often moving in the same direction. In the coming year, this may no longer be true. Economic strength will help equity prices rally, but will also lead to higher interest rates and therefore lower bond prices. We expect an inverse relationship between stock and bond prices to dominate market activity in 2016 and both asset classes should see increased volatility in the coming year.

More importantly, the Fed move on December 16th marked the end of what is probably the longest period of globally synchronized monetary policy in history. The Fed and the ECB, for example, have moved in the same direction, albeit with varying degrees of magnitude, since the late 1990's. We expect the Fed moving in a different direction than the rest of the world will inevitably lead to disruption of the status quo and increased volatility in many segments of the financial markets. Higher rates here should lead to a stronger dollar. A stronger dollar and increasing geo-political risks should in turn lead to capital flight out of second and third world nations. Currency fluctuations and capital flight are very disruptive forces and global growth will likely suffer the consequences. Even U.S. growth rates will be hurt as goods manufactured here become less competitive due to currency fluctuations.

Interest rate hikes are disruptive in the long run. The first move rarely causes much pain. It is the cumulative effect of multiple hikes that eventually impacts market fundamentals. A great deal of attention will be focused on the frequency and magnitude of rate increases in 2016. We believe the Fed will continue to be constrained by the

same forces that tempered rate increases last year. Like last year, we believe these conditions will lead to rates staying lower than many are currently forecasting and will do so for a longer period of time than many expect. "Lower for longer" should still be a viable theme to follow in 2016.

In terms of Sector performance, within the fixed-income markets, the Exhibit 2 shows sector 2015 returns as reported by Barclays.

#### EXHIBIT 2: 2015 MARKET SECTOR RETURNS (%)

US Aggregate	+0.55	US MBS	+1.51
US Treasury	+0.84	Municipal Bonds	+3.30
US Credit	-0.77	High Yield	-4.47

Source: Barclays

Higher quality sectors vastly outperformed lower-quality sectors, as credit spreads widened through the year. The AAA Index returned +0.84%, the AA Index +0.95%, the A Index +0.55, while the BBB Index returned -2.73% for the year.

Going forward, we are adhering to the strategy set forth in our December commentary. We expect the Fed to continue to raise rates at a steady pace, although we expect fewer increases than the consensus four 25-basis point hikes in 2016. We believe the front end of the U.S. Treasury yield curve will bear the brunt of these moves, but eventually the longer end will have to catch up. The big unknown is whether the catch up will take place this year or whether the curve will continue to flatten in 2016. We continue to keep portfolio durations on the shorter side and look to exploit bond market inefficiencies throughout 2016.

We expect corporate spreads to continue to widen, with high yield issues underperforming those of higher credit ratings. We expect the MBS basis to hold steady as originations and prepayments abate, at least until the Fed stops re-investing their MBS portfolio run off. Finally, we are very constructive on municipal bonds, which should continue their strong relative performance. We expect Munis to once again trade solidly through comparable U.S. Treasury securities.

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*For further information, please contact Steven Killoran, Vice President Business Development at 1-802-229-2838 or at [skilloran@maplecapital.com](mailto:skilloran@maplecapital.com). For further information about Maple Capital, including a copy of our informational brochure, please visit our website at [www.maplecapital.com](http://www.maplecapital.com).*

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 •

