Maple Capital Management

Fixed Income Commentary

May 5, 2016

Mixed Emotions

"You're not the only one with mixed emotions"
- Jagger/Richards

Despite Federal Reserve efforts to be transparent, there continues to be confusion in the financial markets. Conflicting data points and diverging central bank policies are leaving investors puzzled. For example, the first look at real Gross Domestic Product (GDP) for the first quarter of 2016 was reported as a scant 0.5%, its weakest reading since the first quarter of 2014. However, nonfarm payrolls continue to come in above 200,000 a month, on average, and the April initial claims releases were the lowest since the early 1970's. While there are questions as to the quality of the jobs being created, the Fed specifically cited job growth as one of the bright spots in the economy.

Some Federal Reserve members have pushed for the resumption of the interest-rate normalization process in speeches, although they voted unanimously to leave interest-rate policy unchanged at their January 2016 meeting. However, at the March meeting, Kansas City Governor Esther George voted to increase the Fed Funds target by 25 basis points. In addition, the Fed press release following the April meeting dropped the phrase "Global economic and financial developments continue to pose risks" thereby signaling an increased willingness to move. The Fed appears to be overly hyping the marginal improvements in the labor markets, while underestimating weakening economic growth. This has led many market participants to overreact to both weak and strong data and increased market volatility.

We suggest part of the confusion may stem from conflicting rationales for raising rates. The present rate policy is a legacy of the fallout from the financial crisis. Monetary policy is still set at emergency levels. It is doubtful any economist or economic model - when looking at current conditions in a vacuum - would suggest a 50 basis point (0.50%) funds rate would be the appropriate level for an economy with a 5% unemployment rate and stable, positive GDP growth rates. Investors looking at Fed policy with the traditional view of hiking rates to reign in an overheating economy do not expect Fed action given the mixed data. The Fed, however, must view current rates from the higher bar of suitability for prevailing conditions and may well hike rates sooner than expected, if only to remove the excesses building in the system.

The ripple effects are far reaching. This confusion over the direction of rates has spurred a decline in the US dollar and a sharp rebound in commodity prices. From the recent lows, oil is up 75%, gold 23%, and copper 17%. The US dollar has fallen 7.5% from its recent highs. Historically, commodity prices have a negative correlation with the value of the US dollar.

Some might argue that the decline in the US dollar was a function of global currencies being vastly oversold and the recent dollar weakness is just reversion to the mean. It may also be a reaction to the view that foreign central banks are close to a floor on their interest rate cuts, as evidenced by the recent inaction by the Bank of Japan on further stimulus (interest rates are already negative in Japan). Finally, with recent data pointing to an economic slowdown in the US economy and the Fed showing signs of inaction, global investors may simply be shunning the currency.

KEY TAKEAWAYS

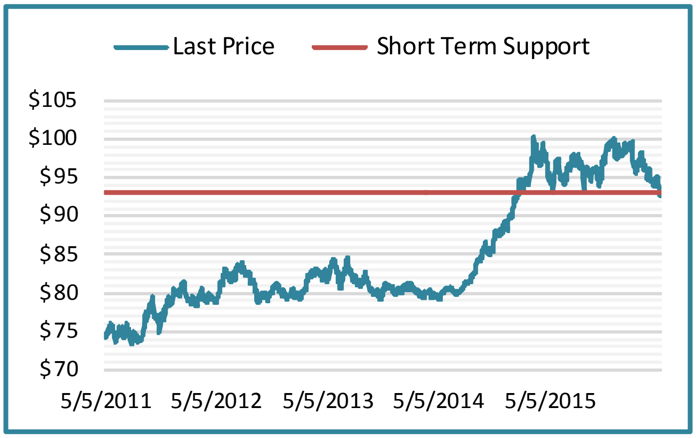
Financial markets are confused about the data that should be in focus when determining future actions of the Federal Reserve. The Fed appears to be overly hyping the marginal improvements in the labor markets, while underestimating weakening economic growth. As might be expected, confusing messages from the Fed have led to sharp moves in the US dollar and commodities, but in the end, a declining US dollar could be what the Fed has wanted all along to help spur inflation.

Key Rates	Apr 30 2016	Mar 31 2016	Dec 31 2015
Treasury Yields			
2 Year	0.78	0.72	1.05
5 Year	1.29	1.20	1.76
10 Year	1.83	1.77	2.27
30 Year	2.68	2.61	3.02
Credit Yields			
BBB Industrial 10 Year	3.29	3.41	3.99
Muni Yields			
AAA 10 Year	1.65	1.75	2.00
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.60	2.57	3.02

APRIL IN REVIEW

- Strong rebound in credit spreads, both in investment grade and high yield sectors—investment grade spreads narrowed 15bps on the month while high yield was in 78bps.
- The first reading of Q1 GDP was 0.5%.
- 10-Year US Treasury finished month up 6bps, with a trading range of 1.69% to 1.93%.

EXHIBIT 1: DOLLAR INDEX



Source: Bloomberg Financial L.P.

In the fixed-income markets, interest rates rose modestly in April, with the benchmark US Treasury 10-year Treasury note closing at 1.83%; up 6 basis points from quarter end. Bonds traded in a tight range during the month. The real story for the bond market in April was the strong rebound in credit spreads, as both the investment grade and high-yield sectors rebounded from first quarter lows. According to the Bank of America/Merrill Lynch index data, investment grade spreads narrowed 15 basis points in the month, while high-yield spreads tightened a whopping 78 basis points. The following table highlights the April and year-to-date total returns of the various fixed-income sectors according to Barclays:

EXHIBIT 2: FIXED INCOME SECTOR PERFORMANCE

Index	April %	Year-to-date (%)	2016 Initial Yield (%)
US Aggregate	0.38	3.43	2.59
US Intermediate Agg.	0.23	2.54	2.32
US Treasury	-0.11	3.09	1.73
US MBS	0.16	2.14	2.77
US Credit	1.22	5.19	3.54
High Yield	3.92	7.40	8.74
Municipal	0.74	2.42	2.11

Source: Barclays Securities.

As shown above, corporate bonds have had vastly superior returns so far this year and most of the move has occurred in the last two months. This rally has created an interesting dilemma for bond investors. The move in Treasuries and high-grade bonds suggests either the economy is slowing or investors are more nervous about the economy than at the start of the year. However, the rally in corporate bonds, especially in the high-yield segment, suggests the economy is strengthening.

Furthermore, rational investors will only accept a yield-to-maturity that will at least produce a minimum positive return over a foreseeable time horizon. The year-to-date returns of most bond sectors have greatly surpassed the initial yield levels of the respective bond indices. In other words, bond investors have already achieved their expected 2016 returns (based on initial yield levels) in the first four months of the year. This leaves us cautious on the near-term prospects of the bond market.

Given the strong performance of the fixed-income market in the first four months, we are maintaining our bias towards shorter rather than longer duration exposures. The credit markets have had wild swings in both spreads and total returns so far this year, particularly in high-yield where the index was down 5.15% as recently as February 11th. In addition, there is a deluge of new corporate bond issuance looming on the horizon. We continue to reduce corporate bond exposure and increase higher grade holdings.

We believe the key to the bond market near term is the US dollar. A collapse in the US dollar could discourage foreign inflows and fan the embers of inflation the Fed so desperately wants to see. In such a case, they would have the justification they need to resume the interest-rate normalization process. Dollar strength will keep the gates open for continued inflows of foreign capital attracted to higher domestic yields. We will be watching exchange rates closely.

For further information, please contact Steven Killoran, Vice President Business Development at 1-802-229-2838 or at skilloran@maplecapital.com. For further information about Maple Capital, including a copy of our informational brochure, please visit our website at 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 •
Tel: 770.693.7690 • Fax: 770.512.5176

MAPLE CAPITAL MANAGEMENT