MAPLE CAPITAL MANAGEMENT

FIXED INCOME COMMENTARY

June 9, 2017

KEY TAKEAWAYS

While all eyes have been on the Federal Funds rate, the Fed's balance sheet will be getting more and more attention in the coming months. FOMC participants hinted at their last meeting in March that tapering its Treasury and mortgage-backed securities would begin sometime later this year. Time will tell whether the unwind will be orderly, but one could safely assume that the Treasury yield curve will be flatter as a result.

Key Rates (%)	May 31 2017	Apr 30 2017	Dec 31 2016
Treasury Yields			
2 Year	1.28	1.26	1.19
5 Year	1.75	1.81	1.93
10 Year	2.20	2.28	2.44
30 Year	2.86	2.95	3.07
Credit Yields			
BBB Industrial 10 Year	3.45	3.54	3.68
Muni Yields			
AAA 10 Year	1.90	2.16	2.35
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.94	3.02	3.13

MAY IN REVIEW

- High yield continues to be the outperformer in 2017, up 1.15% during the month and up 3.89% on the year.
- The first report on first quarter 2017 GDP came in at 0.7%, the weakest reading since the first quarter of 2014.
- The 10 yr. Treasury yield finished the month at 2.28%, down from March's 2.39%.

"Not Going Anywhere?"

A growing sense of legislative gridlock and rising political discourse continued to support bond prices in May. Weaker-than-expected economic data and dampened inflation expectations also helped the market. Although the front end segment of the yield curve (two-year maturities and shorter) continued to rise with FOMC rate hike concerns, yields across the rest of the Treasury curve fell during the month. Credit and sector spreads continued to tighten with this rally.

The minutes of the May Federal Reserve meeting and comments from Fed officials during the month suggest a June rate hike is all but inevitable. These statements also pointed to a slower pace of rate hikes than had been feared. Markets had effectively priced a June move prior to the meeting, so the guidance came as no surprise. However, the insight into the Fed's tempo on future rate hikes gave comfort to market participants.

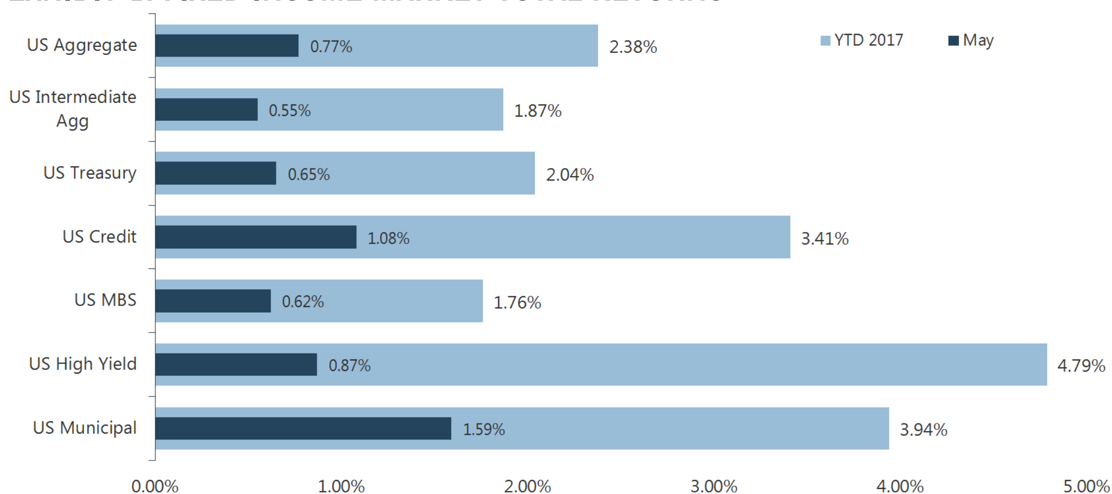
The FOMC meeting minutes also pointed to an earnest effort to implement a plan for the unwinding of the Federal Reserve's balance sheet. The initial wording suggests the Fed will reduce their holdings, either through sale or maturity, by a set dollar amount each month. This is uncharted territory for both the Fed and the market place. The Fed has purchased securities (Treasuries and MBS) equal to nearly half of the net public debt (national debt less the amount held by government agencies and accounts) issued over the past eight years. The proposed liquidations will have to be absorbed in the public markets, adding to the already high level of bond sales currently taking place. This impact may be magnified on a global basis as other central banks eventually follow the same course of action. It is estimated that over one-third of the $54 trillion of global government debt outstanding is now owned by central banks. The bond market has shrugged off this risk, at least for now. However, if Fed officials are to be taken at their word, the day of reckoning may be closer than many think.

The recent trends of the fixed-income markets, namely, a slow grind to lower long-term interest rates, a flattening of the US Treasury yield curve, and a compression of quality spreads within the corporate bond sector, remained intact for the month of May. It was a good month for bond market returns in general, and for the high-yield market in particular. Despite the risk of a June rate hike, the 10-year Treasury note yield fell 8 basis points to end the month at 2.20%.

Recent economic data such as retail sales, housing starts, employment, and manufacturing data have been on the softer side. This has given bond market

participants some comfort with regards to the Fed being overly aggressive in tightening monetary policy. However, the Fed's desire to shrink their balance sheet is a work-in-progress. The bond market has shrugged off these headwinds and continues to grind lower in rates. The table in **Exhibit 1** highlights the performance of the various sectors of the fixed-income market for the month of May and year-to-date according to the Bloomberg Barclays Indices.

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



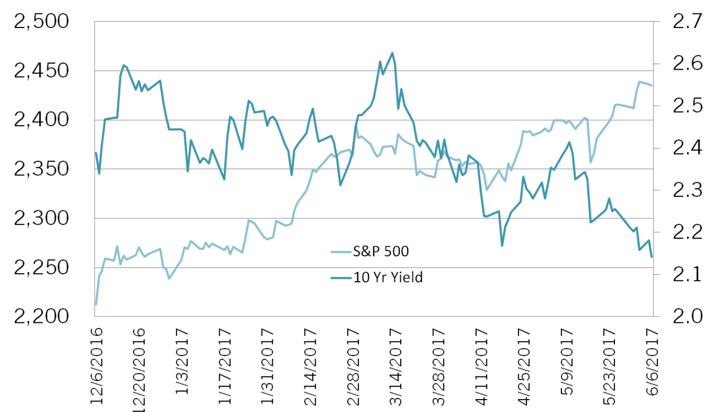
Source: Bloomberg Financial L.P. and Barclays Securities

As can be seen from above, municipal bonds had a very strong month and are second to only high yield on a year-to-date basis. Credit indices continue to produce superior returns, which is getting to be an old story. MBS, generally a shorter duration index, continued to lag on a relative basis. The bond market continues to produce good returns this year, as low interest rates increasingly look like they have more staying power than many thought likely.

Going forward, we are somewhat puzzled regarding the performance of the bond and stock markets. Both continue to move together when many observers think they should be moving apart. The chart in **Exhibit 2** illustrates this point.

Stocks are rising in anticipation of stronger global economic growth, infrastructure spending, and deregulation. These factors should be bad for bond prices. Conversely, bond investors seem to expect a slow economy to keep the Fed on the sidelines, a resurgence of deflation, and political impasse in Washington, all factors that should be bad for equity prices. Both markets are nearing inflection points. This might be a perfect "Goldilocks" environment that is neither too hot nor too cold. However, we continue to exercise caution with our bond portfolios.

EXHIBIT 2: STOCKS VERSUS BONDS



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