

September 8, 2017

KEY TAKEAWAYS

Fixed income and equity markets remained complacent in the face of a number of different potential obstacles in August. The Treasury curve continued its flattening trend, with longer term rates down approximately 17 basis points, compared to shorter-term rates falling only 6-8 basis points. While the economy continues to improve, it is worth watching to see if the flight to quality trends continue.

Key Rates (%)

	Aug 31 2017	Jul 31 2017	Dec 31 2016
Treasury Yields			
2 Year	1.33	1.35	1.19
5 Year	1.70	1.84	1.93
10 Year	2.12	2.29	2.44
30 Year	2.73	2.90	3.07
Credit Yields			
BBB Industrial 10 Year	3.36	3.42	3.68
Muni Yields			
AAA 10 Year	1.84	1.90	2.35
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.83	2.98	3.13

AUGUST IN REVIEW

- Despite being a top performer on the year, High Yield was negative for only the second time this year.
- The yield on the 10 year U.S. Treasury fell 17 basis points, from 2.29% to 2.12%.
- Munis continue their strong performance, +.76 on the month and +5.20% on the year.

Complacency

The financial markets have been very complacent as of late, despite increased global tensions, a continued stalemate in Congress, and a Federal Reserve determined to unwind the securities held from its monetary easing activities early



in the decade. North Korea keeps pushing the tolerance of its neighbors, as it seeks a functional nuclear weapons delivery system, deflecting any attempt for a peaceful resolution to the crisis. China and Russia are doing little to help defuse the situation and seem to be using North Korea as a pawn to place the U.S. in a difficult position in which it must lose face. China in particular has stated that if the United States strikes first, they will defend North Korea and if North Korea strikes first, they will remain neutral (a deterrent to both).

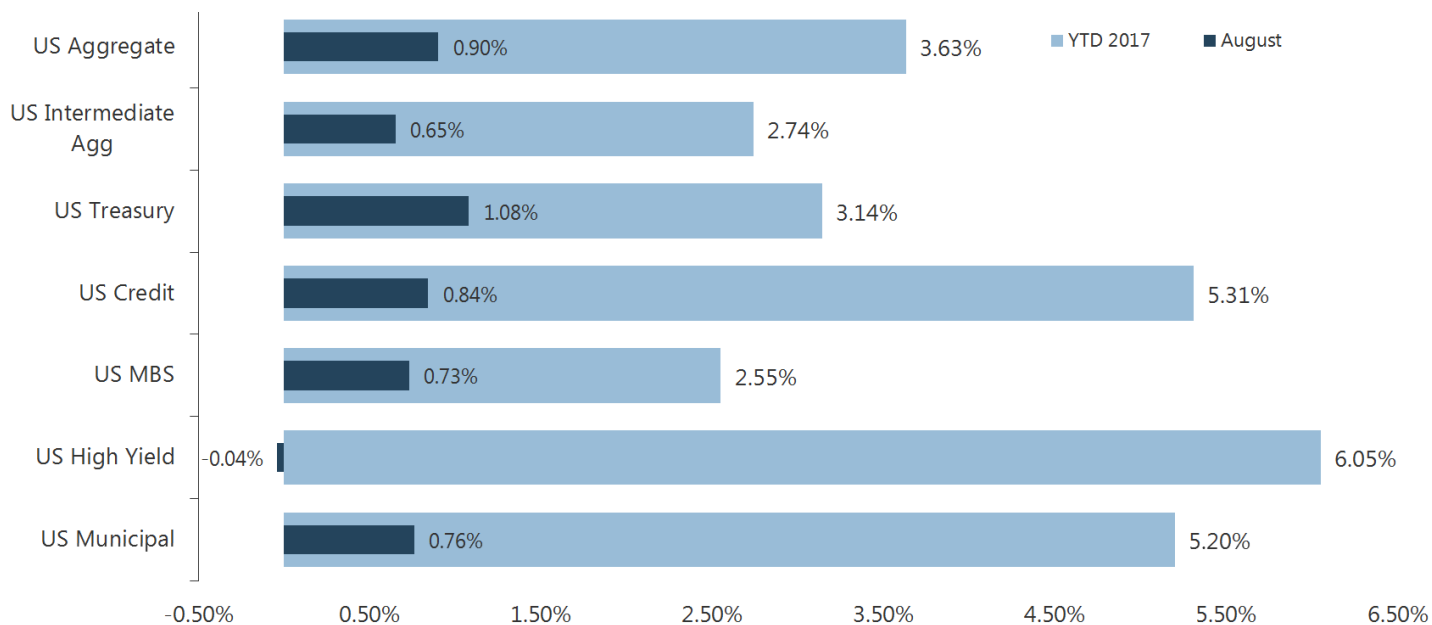
Against this backdrop, the financial markets remain essentially unfazed. It seems as though investors have either priced in the best possible outcome to the global crisis or have completely ignored the worst. Stocks continue to hover near all-time highs, while credit spreads in the fixed-income markets continue to hover near record low levels. There is little to suggest that fear is starting to take hold in the market psychology.

In many respects, this environment is filled with potential “Black Swan” events. Black Swan events are risks that are usually identified in advance, but are assumed to have such low probabilities of occurring that they are essentially dismissed by the marketplace. The risk of housing prices collapsing in 2008 is a good example of such an event unfolding.

Today, several “Swans” seem to be flocking. For example, the probability of a new Korean war - let alone a global war - breaking out seems minute, even as both sides increase their rhetoric. Investors are willing to discount such a possibility, despite the catastrophic consequences that such an outcome would precipitate. Similarly, years of passive action by the Federal Reserve have prompted many to discount the possibility of any move to normalize monetary policy, despite Fed officials using every opportunity to indicate balance sheet action is imminent.

In the near term, inflation remains tame and many central banks are still easing. Money is flowing here in search of higher returns. Markets seem to believe that rising geo-political risks and domestic political uncertainty will prevent the Fed from acting as quickly as they would like. Treasuries are benefiting from a “flight to quality” as those who want less risk move money to safer assets.

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

These factors have kept all rates low across most bond classes. Investors continue to defy a Federal Reserve intent on tightening monetary policy and shrinking their balance sheet.

In August, the Treasury yield curve continued to flatten, with long-term rates falling approximately 17 basis points, while short-term rates fell only 6-to-8 basis points. However, other recent trends, namely spread compression within the corporate bond market, reversed slightly in the month. **Exhibit 1** highlights the August and year-to-date performance by sector, as reported by the Bloomberg Barclays Indices for 2017.

As can be seen above, the High Yield Index posted only its second negative return this year, while Treasuries posted the strongest returns for August. There was a clear but slight flight to quality in August. Lower rated investment-grade corporate bonds finally underperformed higher quality issues for the first time in many months. Municipal bonds continued to post strong returns in August.

Consistent with our view that financial markets are basking in complacency, our strategy remains very cautious. We believe shorter duration Treasury securities (5-years and in) offer a good safe-haven. We are generally avoiding corporate bonds with credit spreads close to record low levels. Given geopolitical risks, the willful dismissal of the Fed's intent, and the growing unknowns surrounding the Trump Presidency, we are increasingly cautious on the financial markets. Risk reduction is prudent.

We conclude with the observation that further hikes to base reference rates (the Fed funds rate and the discount rate) are probably quite a ways off. We do not expect another move until the second half of next year, assuming there are no shocks to the system. We do expect the FOMC to follow through on its desire to normalize the Fed's balance sheet by letting some current holdings roll off. This should put pressure on longer term rates and lead to a steeper curve. While they do not pay much, shorter duration Treasury notes look like a pretty safe bet in this environment.

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