MAPLE CAPITAL MANAGEMENT

FIXED INCOME COMMENTARY

October 4, 2017

KEY TAKEAWAYS

Fixed income markets saw the continuing of several established trends during the third quarter and in September. Trends that remained intact were the outperformance of lower quality bonds, the slowing of prepayment speeds, and the narrowing of quality spreads within credit and municipal markets.

Key Rates (%)	Sep 30 2017	Aug 31 2017	Dec 31 2016
Treasury Yields			
2 Year	1.48	1.33	1.19
5 Year	1.94	1.70	1.93
10 Year	2.33	2.12	2.44
30 Year	2.86	2.73	3.07
Credit Yields			
BBB Industrial 10 Year	3.52	3.36	3.68
Muni Yields			
AAA 10 Year	2.00	1.84	2.35
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.97	2.83	3.13

SEPTEMBER IN REVIEW

- High yield was the only positive US fixed income sector in September, +.9% on the month.
- The yield on the 5-year Note rose 24 basis points to 1.94%, while the 10-year Note rose 21 basis points to 2.33%.
- Federal Funds futures show a 70% probability of an interest rate hike in December.

Trick-or-Treat

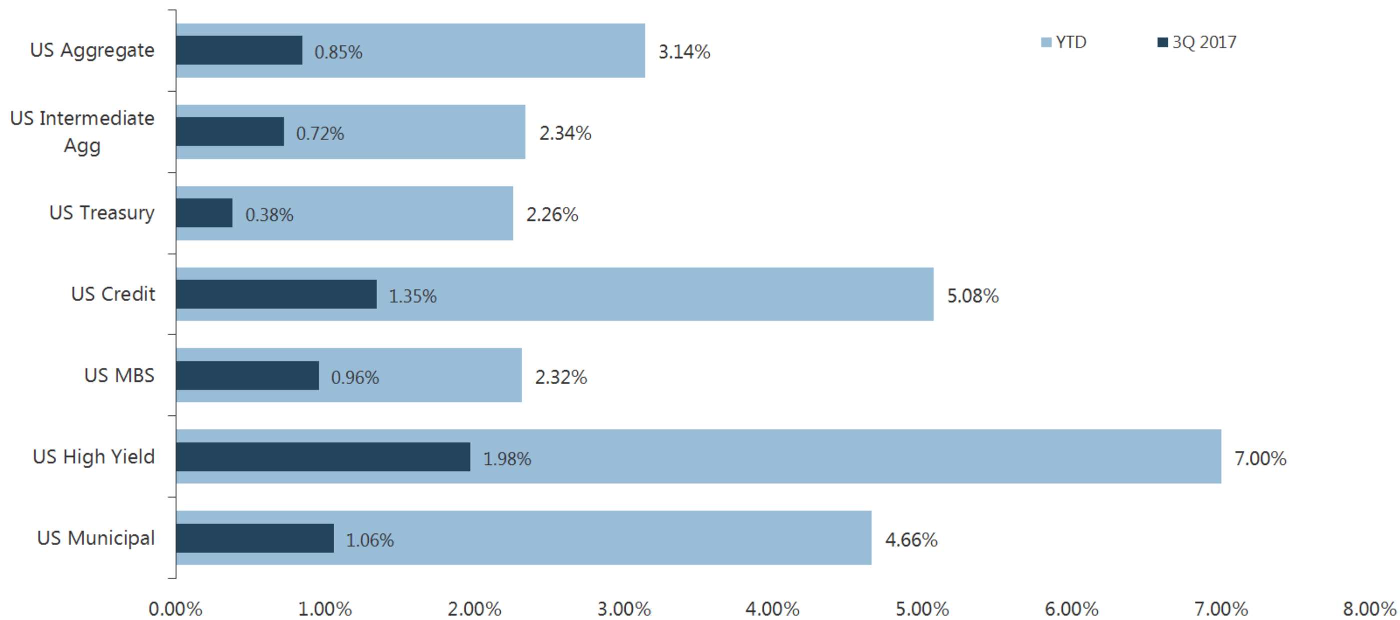
Will October be a trick-or-treat month for the global financial markets? With U.S. equity markets at all-time highs and interest rates still relatively low, the financial markets remain in a blissful state as we enter October, a notoriously volatile month for the equity markets. This market complacency is eerily reminiscent of the old horror movies often released around this time of year: things look fine and serene until the guy in the hockey mask pulls out the chainsaw. We do not mean to suggest a surprise is coming, but we do see risks increasing.

On the bond side, September provided some warning that the status quo may be about to change. For much of the past eight years, there was little fear the Fed would tighten monetary policy in any form. Standard policy for many firms has been to disregard official comments about monetary policy changes because of a widely held view the Fed will not act. The Fed, therefore, caught markets off guard with the September announcement that they will commence downsizing their balance sheet, beginning this month. Interest rates rose following the meeting and the market-derived probability of a December rate hike surged from zero before the September FOMC meeting to 70% at month end.

As if to drive the point home, Fed Chairwoman Janet Yellen made some very direct, but contradictory, comments to the National Association for Business Economics (NABE) on September 26. First, she warned the Fed should be "wary of moving too gradually." Yet, she also said the Fed must adjust its outlook when warranted by new data; suggesting that data dependent pauses may still be possible. She commented the Fed is perplexed by chronically low inflation and that downward inflation pressures may "unexpectedly" persist for some time. However, she also stated that it would be imprudent to stay on hold until inflation is at 2% and that inflation overshooting 2% wouldn't be a "tragedy." She concluded her comments by noting the need to keep tightening gradually, regardless of short-term weakness in economic data points.

Interest rates rose modestly during the month, although the move was not uniform across the curve. The yield curve steepened, with the 10-year Treasury note rising by 21 basis points to 2.33%, and the 2-year note up 15 to close at 1.48%. Credit spreads continued to narrow with the Bloomberg U.S. Credit Index tightening by 8 basis points during the month. Generally,

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

lower grade issues outperformed higher quality issues during the month. The outperformance of lower quality bonds was helped by strong spread compression in the automotive, telecommunications and energy sectors. The MBS sector also outperformed Treasuries as slowing prepayment speeds helped boost returns.

If there was a surprise in the month, it was in the municipal bond sector. Munis posted negative returns as the resurgence of tax reform plans weighed on the sector. Lower taxes reduce the demand for tax-free bonds. However, recoveries in the prices of bonds issued by financially stressed issuers, such as New Jersey and Illinois, helped total returns.

Exhibit 1 illustrates the performance of the various sectors of the fixed-income market as reported by the Bloomberg Barclays Indices.

With equity markets putting in record highs on a daily basis, credit spreads hovering near historically low levels and the elongation of duration within the MBS sector, we continue to adjust client portfolios. Our strategy remains cautious. Given rising geopolitical risks and the complacency of the financial markets, we see higher quality securities as more appealing than higher yielding alternatives. There is simply not enough spread to make spread products attractive. We have been reducing interest rate exposure (at the margin) and prefer shorter duration securities over longer. Risk reduction is prudent.

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