Fixed Income Commentary

November 6, 2017

KEY TAKEAWAYS

Fixed income markets experienced modest losses in October. The Fed reinforced their position that a rate hike in December is likely. Strong economic data helped to remove many of the remaining doubts about such a move. As the Yellen era draws to a close, the Fed is on track to normalize monetary policy, regardless of inflation and growth rates.

Key Rates (%)	Oct 31 2017	Sep 30 2017	Dec 31 2016
Treasury Yields			
2 Year	1.60	1.48	1.19
5 Year	2.02	1.94	1.93
10 Year	2.38	2.33	2.44
30 Year	2.88	2.86	3.07
Credit Yields			
BBB Industrial 10 Year	3.52	3.52	3.68
Muni Yields			
AAA 10 Year	2.03	2.00	2.35
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.00	2.97	3.13

OCTOBER IN REVIEW

- High yield continued to post positive returns in October, rising .42% on the month.
- The yield on the 5-year Note rose 8 basis points to 2.02%, while the 10-year Note rose 5 basis points to 2.38%.
- Federal Funds futures now suggest a 98.8% probability of an interest rate hike in December.

Tug of War

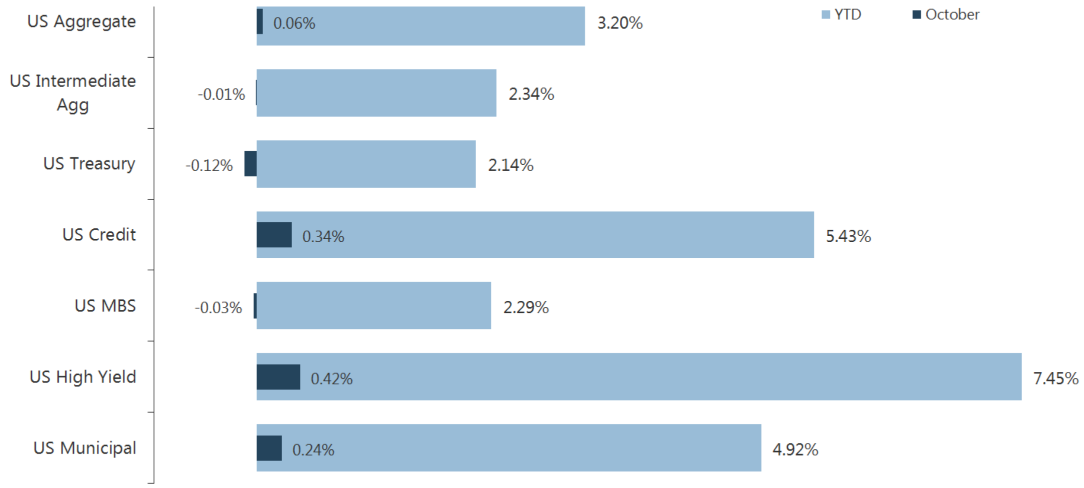
The bond market is experiencing a tug of war between fundamentals and fear. On the fundamental side, all signs point toward the beginning of the end of the Great Bond Bull Market; a trend that has been intact since the early 1980s. The economy is on a roll and business is booming. The Federal Reserve has stated its intention to normalize interest rates and remove the excess liquidity injected into the system during the Financial Crisis. The federal budget deficit, which should be falling rapidly at this point in the cycle, seems poised to balloon even wider, as tax cuts and a lack of spending discipline highlight the recent budget discussions in Congress. Interest rates should be moving higher against this backdrop.

On the fear side, the belief that geopolitical risks will overwhelm economic fundamentals has kept money in bonds, despite better opportunities in other asset classes. Many bond market participants also remain skeptical about the durability of the current expansion. Any pause might prompt the Fed to slow, or even reverse the pace of policy normalization. This was their reaction during previous attempts to change the direction of monetary policy in recent years. The fear of losing money has also supported domestic bond prices with foreign capital flowing to our shores as investors abroad seek to avoid the negative interest rates prevalent in Europe and Japan. There is also a widespread belief that inflation will remain low far longer than the Fed models project, prompting many to maintain duration exposure.

The economic data is clearly on the Fed's side. Initial jobless claims are hovering near all-time lows, the unemployment rate is the lowest since early 2001, and manufacturing activity and GDP statistics continue to improve. The Fed has affirmed that data continues to show both the domestic and global economies are growing at a solid pace. While rates remained unchanged following the November FOMC meeting, the Fed said it expects the U.S. economy "to evolve in a way warranting gradual hikes in rates."

In the near term, the bigger issue for the fixed income markets may be the pending replacement of Janet Yellen as Fed Chairperson and the appointment of Jerome Powell as the new head of the Fed. Powell has been on the Fed's board since 2012 and is viewed as neither a hawk nor a dove. As a pragmatist, Powell is against much of the aggressive regulation imposed on the financial system over the past eight years. He also understands the limits of monetary policy. Never one to rock the boat, Powell was against QE3, even though he voted in favor of it, and is expected to continue Janet Yellen's rate-hike policy. This is a highly valued trait in the eyes of investors, given the financial markets hate uncertainty. It is widely expected Powell will stay the course, even as he acts to unwind the vestiges of the Yellen years. However, change is never certain.

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

The trends we have seen throughout the year remained intact in October: a narrowing of credit spreads, a flattening of the US Treasury yield curve, and rising equity prices. Higher grade bonds barely earned their coupon, while lower quality bonds tracked the equity markets and performed well. **Exhibit 1** illustrates the performance of the various sectors of the fixed income market, as measured by the Bloomberg Barclays indices, for the month of October and on a year-to-date basis.

The bond market has experienced an unusually wide distribution of returns in 2017. Short term bonds have fallen sharply while longer term bonds have risen. The return variances by credit rating are equally as diverse. As we move into the new year, we expect volatility to remain elevated, even without a shock to the system.

The high yield bond rally, for example, has been intact since 2008 and will most likely reverse as higher rates begin to take hold. Longer duration bonds and low quality credits both offer poor risk/reward profiles in a rising rate environment. While the yield on the 2-year Treasury note would have to rise 166 basis points to achieve a 0% return over a 1-year investment horizon, the yield on the 30-year Treasury bond only has to rise 15 basis points to produce the same result. Corporate bonds are even more sensitive since their yields can rise due to credit spreads widening, as well as from increases in base interest rates. With credit spreads at 10-year narrows relative to Treasuries, even a modest widening of spreads might produce a 0% return for longer duration corporate bonds, without any change to base risk-free (Treasury) rates. We continue to position our fixed income holdings defensively, with lower duration and higher quality being emphasized in new purchases.

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