Fixed Income *Commentary*

February 5, 2015

Winter in Europe

FAST READ...

- Europe took center stage in January and the news and weather across the pond were both chilly.
- The ECB finally announced its quantitative easing program.
- The large scale purchases of public and private bonds should lower yields in Europe and, in turn, should help keep U.S. interest rates lower for longer.
- The newly elected Syriza led government in Greece could trigger another Euro crisis, which could trigger a "flight to safety" rally in U.S. bonds.
- Yields on U.S. Treasuries have already fallen as the chill of winter settles over Europe.

All eyes were on Europe in January. The announcement of the ECB's quantitative easing ("QE") program and the election in Greece were both watershed events that could lead to continued "lower for longer" rates in the United States.

The ECB's quantitative easing program is slated to purchase Euro 60 billion of public and private securities per month, beginning in March and continuing until September of 2016, or until inflation shows the potential of reaching their target of 2.0%. Purchasing sovereign and public debt will certainly depress interest rates, and even the announcement of the program already appears to be pushing rates lower.

From an economic standpoint, the efficacy of European QE seems questionable at this point in the cycle. Sovereign and public issuers currently borrow at negligible or even negative rates, so it is hard to see how lower rates will stimulate incremental demand. We have seen in the U.S. and Japan that low rates and liquidity support can only go so far, but QE is one of the few remaining tools available to the ECB, so it will be used aggressively.

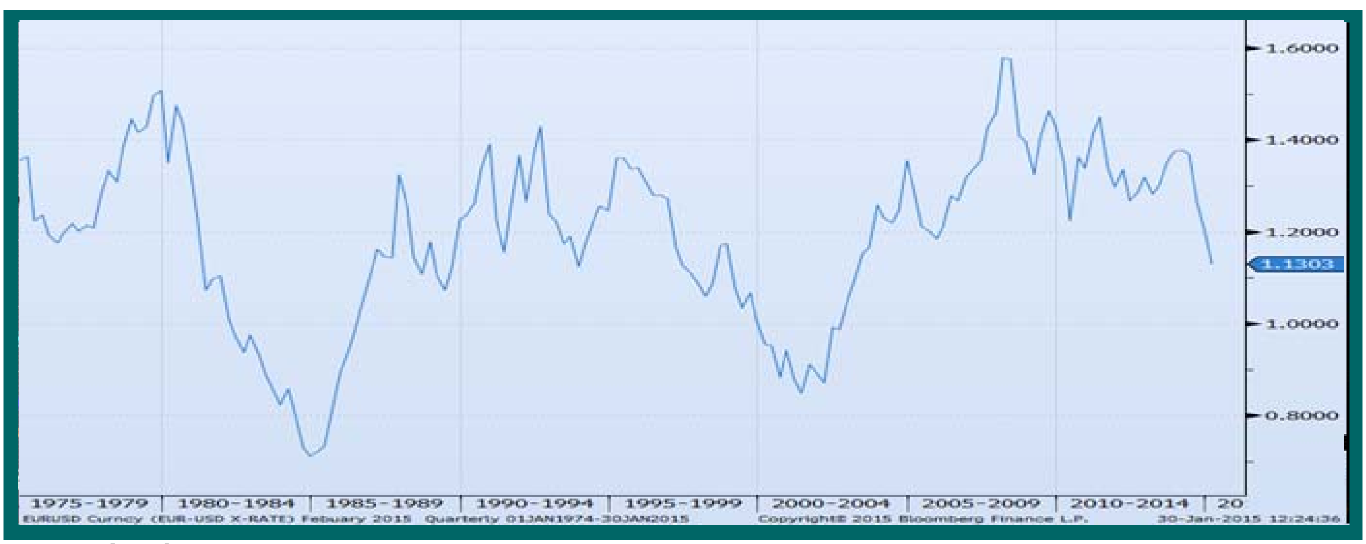
The ECB QE program will likely succeed at curbing deflationary pressures and making the Euro more competitive in global markets, both of which are big problems for the European economy. Inflation turned to deflation in the European Union during January, see Chart 1. While a portion of this decline can be attributed to lower oil prices, the decline in inflation is still persistent. With 11.4% unemployment and limited ability for increased deficit spending, it is not easy to generate demand and inflation in Europe.

Chart 1—European Union Consumer Price Inflation—Two Percent is in the Other Direction

Source: Bloomberg

The bright note to European QE is the steep fall in value of the Euro. The Euro is 17% cheaper vs. the U.S. dollar since June 30, 2014, which helps many European economies. While a cheaper Euro benefits European exporters and foreign tourists, it can hurt U.S. multinationals. Many U.S. companies with international sales reported lower revenue and earnings growth in the recent quarter due to the recent large and rapid U.S. dollar appreciation.

Chart 2—The EURO vs. the U.S. Dollar—A Steep Decline—Plan your Trip to Europe



Source: Bloomberg

In the second January watershed event, the Greek election on January 25th gave victory to the Syriza led coalition. The new Greek government won the election with the promise of renegotiating Greek sovereign debt and ending austerity for the Greek people. That focused message was popular with many Greek citizens, but the message is not good for the European Union. According to the new finance minister, Greece does not have the ability or willingness to repay its debts, but wants to remain in the Euro. This will be a difficult position to maintain at the negotiating table. A write-off of Greek debt is not life threatening to the EU or to the large northern European banks, but it will place a significant burden on an already stressed financial system. Europeans will be loath to accept this pain, especially since most feel it was caused by reckless patronage and social spending by the Greek government. An even greater risk is the reality that if Greece can write-off a portion of its debt burden, then other debtor nations will want to write-off their debt as well. Watch for the fireworks.

It is easy to see why there is increased demand for U.S. Treasuries and other financial assets. The U.S. economy is in decent shape, the dollar is appreciating, and the yield on the ten-year Treasury note is 550% greater than the yield on the ten-year German bund - 1.66% vs. 0.30%. Who wouldn't want to buy Treasuries?

Strategy

Fixed income security prices rose in January, as interest rates fell sharply. Yield on the ten-year Treasury note fell 53 basis points (bps) and the five-year Treasury fell 50 bps. Credit spreads widened somewhat last month, but this negative factor was swamped by the positive impact of falling rates. The best performing sectors had longer duration and higher credit quality, such as municipals and longer dated mortgage backed securities.

The Federal Reserve has stated its desire to raise short-term rates in 2015, but we believe it is becoming increasingly difficult to do as early as desired. We continue to believe interest rates will remain lower, and for longer, than the consensus view. Our view is supported by the established trends of continued lower inflation and weaker growth prospects around the world. Interest rate differentials also make U.S. bonds very attractive to foreign investors.

Credit spreads could continue to come under modest pressure in this "risk-off" environment, but corporate fundamentals remain strong, with the exception of the energy sector. We do not anticipate a major credit correction, absent a large systemic shock. Taking some credit risk continues as a strategy, primarily with higher quality and shorter duration issues. One example of this strategy is our January purchase of the Transocean 4.95% notes due 11/15/2015, at a yield of 4.12%. This investment grade oil services company possesses ample cash and cash flow to make its November bond payment.

Municipal bonds outperformed in 2014, and continued to do so, in January 2015. Prices are now back in line with recent historical valuation measures. Yet we still see decent value in this asset class supported by potential increases in income tax rates or further weakening in other credit related sectors. Taxable municipal bonds are also attractive on a yield basis, especially when compared to corporate bonds with similar attributes.

We remain optimistic about the risk/reward trade off in our fixed income portfolios. Our strategy uses sector and security selection in conjunction with an intermediate duration target to mitigate interest rate and credit risks. High quality callable preferred stocks are still employed to add yield at the front end of the curve. Unfortunately, many of these attractive preferreds are being called and not all can be replaced.

We continue to monitor these markets closely, and our strategies will continue to evolve with changes in fundamentals and market data.

As always, please contact us should you have questions.

Maple Capital

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