Maple Capital Management

Fixed Income Commentary

August 4, 2017

KEY TAKEAWAYS

The major trends of the fixed income market over the last couple of years remained intact in July, namely low interest rates, a flattening of the U.S. Treasury yield curve, narrowing of credit spreads and the slowing of prepayment speeds in the MBS sector. While employment data was strong in July, there is a growing sense of increased risks in the market.

Key Rates (%)	Jul 31 2017	Jun 30 2017	Dec 31 2016
Treasury Yields			
2 Year	1.35	1.38	1.19
5 Year	1.84	1.89	1.93
10 Year	2.29	2.30	2.44
30 Year	2.90	2.83	3.07
Credit Yields			
BBB Industrial 10 Year	3.42	3.52	3.68
Muni Yields			
AAA 10 Year	1.90	1.96	2.35
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.98	3.03	3.13

JULY IN REVIEW

- High yield continues to be the outperformer, up 1.11% on the month and 6.09% on the year.
- The yield on the 10 year U.S. Treasury fell 1 basis point, from 2.30% to 2.29%.
- July FOMC confirmed the unwinding of assets on the Federal Reserve's balance sheet will begin in the near term.

The Dog Days of Summer

The major trends of the fixed-income market over the last couple of years, namely relatively low interest rates, a flattening of the U.S. Treasury yield curve, a narrowing of credit spreads, and the slowing of prepayment speeds in the MBS sector, remained intact during July. Equity markets continued to grind higher, with most U.S. indices achieving new record highs. Interest rates barely budged in July, with the 10-year Treasury note falling just 1 basis point to 2.29%. The bond market struggled to digest a variety of conflicting data points in July. Items like a weaker U.S. dollar and stronger employment data were offset by subdued inflation data and a growing sense of increased risks in the market, namely stretched valuations in equities, uncertainty over U.S. fiscal policy, and geo-political tensions.

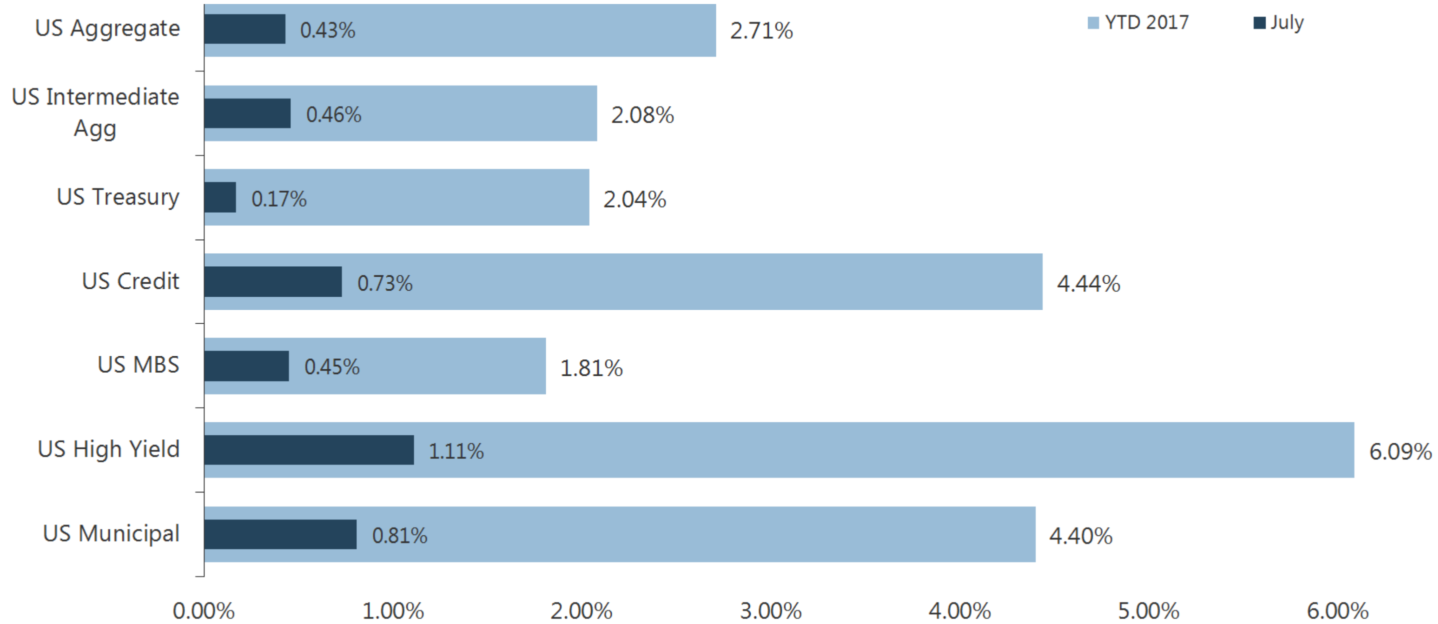
The Federal Reserve helped maintain calm by not moving rates at the July FOMC meeting. However, the FOMC used the meeting to confirm they will begin unwinding the assets held on the Federal Reserve balance sheet in the very near term. We believe this "balance sheet normalization" process will be a mechanical, non-subjective implementation with future monetary policy (Fed funds and discount rate changes) adjustments remaining dependent on economic activity. Bond investors seem to view these announcements as a positive, with the implication being balance sheet liquidation will keep base rate hikes on hold for the foreseeable future. Whether this view holds, once the liquidation begins, remains to be seen.

Against this backdrop, bonds posted another month of good returns. The chart on the following page highlights the performance of the various sectors of the fixed-income market according to the Bloomberg Barclays Indices.

This does not suggest smooth sailing ahead. Rising interest rates will remove some of the safeguards in the market. Higher levels of volatility will likely be seen going forward. The S&P 500, for example, has only had four days in 2017 in which it has had price movements greater than one percent. Rising rates increase volatility for several reasons, not least of which is the potential impact on corporate earnings. It would not surprise us to see a pullback in the near term as markets digest the new realities.

Longer term, bond prices may be particularly susceptible to higher volatility. The quantitative easing activities earlier this decade resulted in the Fed buying approximately half of the public debt issued during those years. In addition, the Federal government continues to run large budget deficits. Markets may not be able

EXHIBIT 2: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

to absorb both the liquidation of the Fed's balance sheet and future debt issuance without disruption.

The complacency of the market suggests this might be an underappreciated risk. We look for absolute yields to rise and spreads to widen in the months ahead. Corporate bonds in particular continue to trade at very tight spreads over Treasuries. This will have to change at some point, even though credit quality remains high. If spreads on high grade bonds widen by 25 basis points (going from +50 to +75), Treasuries will outperform.

Municipal bonds are one segment of the bond market that we believe will have less correlation to rate moves in the near term. This segment will be more influenced by tax rates and credit changes. It now appears that tax cuts at the Federal level may not be as generous as hoped. Furthermore, several states are raising taxes. Higher tax rates make tax free bonds more attractive. As credit issues on the municipal level grow, several troubled issuers are taking steps to solve their problems. The State of Illinois, for example, raised taxes over 30% to fund a severe budget shortfall. The bonds issued by the state rallied on the news, despite the fact interest rates were rising that week.

As the market repositions on risk, we look to add higher grade assets to client portfolios. We believe shorter duration profiles are also in order. We do not expect to make any wholesale shifts to current holdings, but maturing securities will be reinvested accordingly.

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