Fixed Income Commentary

January 5, 2018

KEY TAKEAWAYS

The major themes that have persisted in the fixed-income markets over the last few years continued to close out 2017, namely a sharp flattening of the U.S. Treasury yield curve, a significant contraction of quality spreads within both the corporate and municipal bond markets, and a significant slowdown of prepayment speeds within the MBS market. Looking ahead, the bond market will be looking to the Fed's cadence of rate increases in 2018, as well as geopolitical events.

Key Rates (%)	Dec 31 2017	Nov 30 2017	Dec 31 2016
Treasury Yields			
2 Year	1.88	1.79	1.19
5 Year	2.21	2.14	1.93
10 Year	2.41	2.41	2.44
30 Year	2.74	2.83	3.07
Credit Yields			
BBB Industrial 10 Year	3.61	3.61	3.68
Muni Yields			
AAA 10 Year	2.01	2.21	2.35
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.00	3.05	3.13

DECEMBER IN REVIEW

- The Fed raised rates for the third time and raised its GDP estimate from 2.1% to 2.5%.
- High Yield was up .30% in December, and finished up the year up 7.5%.
- Municipals finished the year as the strongest performing sector on the month, up 1.05% in December, and finished the year up 5.45%.

Ring Out The Old

It is said nothing personifies change more than the turnover of the calendar year. For the financial markets, this was not the case in 2017. The market moves of November and December 2016 continued into the New Year and 2017 turned out to be an excellent year for equities and a decent year for the fixed-income markets. The S&P 500 Index was up 21.8% (with dividends reinvested), while the Bloomberg Barclays Aggregate Bond Index posted a 3.54% total return for the year and the Bloomberg Barclays Intermediate Aggregate Index came in at 2.27%. Exhibit 1 on the next page highlights the sector performance within the bond market as reported by the Bloomberg Barclays Indices.

The major themes that have persisted in the fixed-income markets over the past few years continued in 2017. We saw a sharp flattening of the U.S. Treasury yield curve, a significant contraction of quality spreads within both the corporate and municipal bond markets, and a significant slowdown of prepayment speeds within the MBS market. All of these fixed-income measures are hovering near 5-year lows. In addition, the Federal Reserve continued its slow, but steady pace towards the goal of normalizing monetary policy.

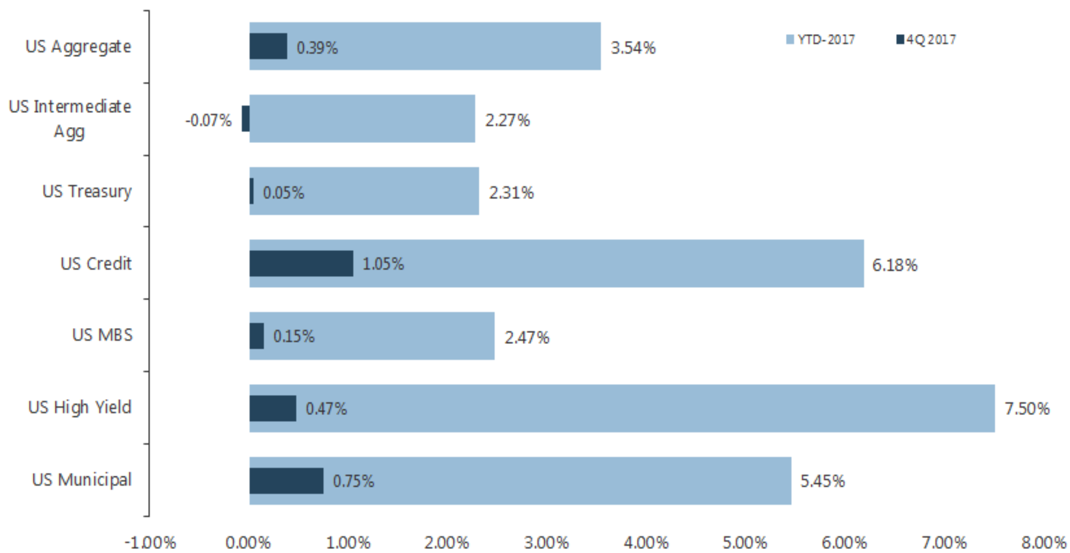
The interest rate moves we have seen this year reflect Federal Reserve policy actions. The front end of the yield curve rose, while longer term rates fell. The front end of the curve, in particular, was pressured by the FOMC decision to raise rates at the December meeting. Given the magnitude of the stock market rally during the year and consistently strong corporate earnings reports, this rate hike had been widely expected. However, the statement released after the meeting contained an explicit statement on the strength of the economy and an affirmation of the need for three additional moves in 2018; catching many by surprise.

Despite the rise in the front end of the curve, long-term rates fell. The 30-year Treasury bond, for example, was one of the best performing securities in the bond market in 2017. Ironically, this move in long-duration assets is also consistent with Fed tightening. Rising rates will theoretically act as a brake on economic activity, leading to the belief that inflation will remain lower than expected in the years ahead. Investors are also pricing in the deflationary impact that technology is having on the economy.

Longer-term bonds are also catching a bid from another aspect of monetary policy. The Federal Reserve has purchased so many bonds under its quantitative easing operations that there is actually a bond shortage in the longer duration segment of the bond market. Demand for these securities remains high and the Treasury has even considered issuing 100-year bonds to take advantage of the situation.

With the rise in short rates and the fall in longer rates, the yield spread between the 2-year Treasury and the 10-year Treasury is now hovering around 50 basis points. This measure is a closely watched indicator of future economic direction and stability. A wide spread typically indicates a robust economy and an increased demand for money. A stronger economy also implies a greater risk of increased inflation volatility, leading to wider spreads. A tight or negative spread (when the 2-year yields more than the 10-year) is viewed as a sign that either the Fed is moving too aggressively or the economy is slowing; potentially increasing capacity utilization slack over the long term.

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

We now see the bond market much like a coiled spring. We believe, at some point soon, the spring will have to uncoil. Spread widening can result from short rates falling, long rates rising or a combination of both. However, with the front end of the curve held in place by a tightening Federal Reserve policy, any unwinding will likely have to come entirely from the long end moving higher.

The risks to interest rate stability, especially at the long end, are numerous. The perennially large Federal budget deficit is poised to swell, even before taking into account the impact of the new tax plan. Treasury debt issuance is expected to double to $1.3 trillion, according to J.P. Morgan Chase & Co. estimates; the highest level since 2010. Adding to the pressure, the Federal Reserve, the largest buyer of Treasury debt in recent years, is now stepping back and shrinking its bond holdings. The Fed will allow over $300 billion of bonds to roll off its balance sheet next year and these securities will have to be purchased by the public. Monetary policy will also continue to normalize in the years ahead, leading to more rate increases and higher yields across the board.

Policy decisions aside, the world is generally experiencing robust economic growth. Foreign central banks, already behind the curve on normalizing monetary policy, will be under even greater pressure to act soon. Domestically, the U.S. economy is experiencing the strongest growth in several years and forecasts suggest this will be a multi-year phase of the economic cycle. Unemployment is low, wages are rising (although not as fast as some would like) and companies are expanding. The banking system - the primary driver of the velocity of money - is solidly in recovery and loan growth is beginning to accelerate. If this expansion phase was not strong enough, the recent tax legislation will add a significant amount of stimulus to the system. Economic strength leads to a greater demand for money and, generally, higher interest rates. If the New Year will ring in change somewhere, it will be in the bond market. Barring a severe crisis, all signs point to higher financing costs in 2018.

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

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