Maple Capital Management

Economic Commentary

First Quarter 2014 January 13, 2014

Market Outlook

"It's Different This Time"
- The refrain of many just before history repeats itself.

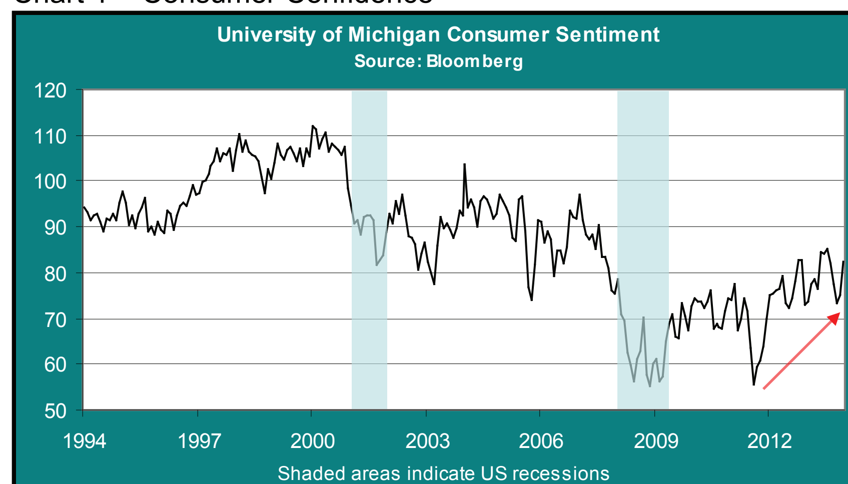
The Federal Reserve announced its long awaited reduction in monthly bond purchases at the December FOMC meeting. While the Fed's ultimate goal is to reduce quantitative easing (QE) purchases to zero, the message from the accompanying press release was the process would be gradual and highly dependent on economic activity. Following the meeting, Chairman Bernanke and the Fed governors went to great lengths to assure investors the underlying low interest rate policy would remain in place for a long, but unspecified, period of time.

After months of price drops at the slightest mention of "taper" consideration, the actual implementation of the concept was met with a stock market rally. The surge in the last two weeks of the month helped the S&P 500 rise 10.50% for the quarter and wrapped up a 32.44% gain for the year; the best annual showing since 1997. Unfortunately, bonds fell on the news and posted losses of 0.14% for the period and 1.02% for the year.

The Fed comments about continued low rates certainly helped investor confidence, as did the fact that virtually every other major central bank in the world is still flooding the globe with cheap money. However, the biggest catalyst behind the "post taper" rally was improving economic data. The Fed was able to begin reducing its bond purchases under the political cover of a strengthening economy. The data released in early December convinced even the most skeptical of investors the recovery is finally gaining momentum.

Payroll growth has been a particular bright spot in the data. The economy is adding jobs at an increased pace. Furthermore, virtually all of the growth is coming from the private sector, signaling real economic value is being created. Manufacturing has been surprisingly strong and the U-6 "underemployment" number is finally starting to come down. Purchasing manager data suggests these trends should continue in the near term. Importantly, this strength is now translating to rising consumer confidence numbers, as shown in Chart 1. While this measure remains at depressed levels, the rising trend suggests a consumer rebound might sustain growth in the quarters ahead.

Chart 1 – Consumer Confidence



Of course, sustained growth increases the likelihood of further reductions in Federal Reserve intervention. The FOMC would like to see quantitative easing activities cease by the end of 2014 and a reduction in accommodative monetary policy begin in 2015. This would be an endorsement of growth trends, but the transition from a stimulus driven recovery to a self-sustaining recovery is often tenuous. Past cycles have seen changes in monetary policy lead to disruptions in the economic landscape. Two oft cited examples are 1994, when tighter money led to a sharp summer correction and a flat year for stocks despite a surge in corporate profits, and 2007, when Fed tightening helped burst the real estate and debt bubbles.

Assuming "it's different this time" is often a recipe for disaster. This is why markets were so volatile when the concept of "taper" was initially discussed last summer. In our view, quantitative easing lost efficacy as an economic cure long ago. The past two or three rounds of QE have had a large impact on asset prices but only a marginal impact on the demand for goods and services in this country. The risk now is that taper actions create a 1994 scenario in which rising rates do not affect the underlying economy, but do impact asset prices significantly. If this comes to pass, 2014 will be a turbulent year for investors.

One key difference is tapering of QE will not affect traditional Fed policy (i.e. tapering is not tightening). Reductions in QE will remove an artificial asset price support, but taper is not being used as a tool to cool the economy and keep inflationary pressures at bay, as with past Fed tightening cycles. Rising rates may push asset prices back to market-based levels, but they will probably not affect the real economy. We note there was very little interest rate constrained economic activity that was freed up through quantitative easing. Most of the benefit of the programs resulted from financial activity such as refinancing and increased borrowing/leverage. As a result, taper-induced interest rate increases should have far less economic impact than prior periods of rising rates.

This suggests growth in the U.S. economy and corporate profits should stay on track despite the Fed pull back. The question now is whether profit growth will offset the negative impact of a steeper yield curve on security prices and market multiples. Stock prices rose in 2013 in anticipation of a positive answer to this question.

As the economy grows, revenues (sales) should also grow. Profit margins, long criticized as unsustainable, should hold up and may still have room to expand. Margins are being helped by higher productivity, low borrowing costs and a resurgent dollar. Inflation is low and should stay low or fall with a stronger dollar and global overcapacity. Technology and innovation have helped productivity gains offset higher input (labor, materials, etc.) costs. The U.S. is also bolstered by cheap energy that gives domestic producers a significant advantage over their foreign rivals.

This is setting the stage for another good year in America. The jobs picture continues to improve, and may accelerate as more Baby Boomers begin to retire (opening up jobs for younger workers). Household wealth is at record highs, profits are up and corporate balance sheets have never been stronger and low borrowing rates have been locked in place. The energy revolution (shale gas and oil) and pent up demand for automobiles and housing should keep industrial demand strong. While rising rates will likely cause some valuation pressures for stock and bond prices, we will probably see markets move higher during the year.

It usually takes several rounds of rate increases to affect asset prices. Initial shocks are then usually shaken off, setting the stage for further rallies. The 1980's and the late 1990's are great examples of early losses being followed by a bull market. History tells us it takes many steps for monetary policy to impact the economy and the initial steps rarely disrupt markets. Barring unforeseen events, we do not think it will be any different this time around.

Investment Strategy

It is difficult to pinpoint where we are in the economic cycle, but it is safe to say we are now solidly in recovery. Interest rates and inflation usually do not rise until an economy is expanding. This may be one of the few cases where rates will rise during the recovery as the Fed reduces bond purchases. Rising rates increase valuation risk, suggesting this is not a prudent time to blindly invest in stocks as an asset class.

Rising rates don't impact all stocks equally, though. Companies that have served as bond substitutes may be at risk if they cannot grow their dividends fast enough to maintain attractive yields. Conversely, companies that can raise dividends and/or post higher earnings growth may be more resilient as their strong growth should help to offset compressed valuation multiples. In general, we are increasing exposure to higher growth stocks and reducing exposure to defensive, lower growth stocks.

We are focused on sectors such as industrials and healthcare where revenue growth is increasing. Financials should also do well thanks to the steepening yield curve. We are maintaining exposure to the consumer as the employment picture continues to improve. Energy exposure continues to serve as a hedge to Mid-East turmoil, but surging domestic production and the liberalization of Mexican energy policies may flood the country with cheap oil (while good for consumers, the shale oil job growth engine will certainly slow if this happens).

In a broader sense, systematic risks are increasing. With five positive years in a row, this is a mature stock market cycle, even if the underlying economic cycle is still in the early phases of recovery. Furthermore, we have not seen a 10% correction in equity prices in nearly two years. This is the point when valuation risks start too build. This suggests the stock market is vulnerable to an exogenous shock, despite recent optimism.

Unfortunately, one factor that is truly different this time is the lack of tools in the Federal Reserve's kit. Interest rate policy is already at zero and a return to quantitative easing will not be enough to stem a slide. This keeps us nervous about the current investing environment, especially in light of growing geopolitical risks. With no safety net in place, staying conservative and having a sound strategy is more important than ever.

This continues to be a difficult environment for generating returns in fixed income portfolios. Strategically, we believe rates will rise modestly as "taper" continues and the economy improves. We believe chasing yield by extending duration remains a risky move. However, credit risk is becoming relatively more attractive as the economy improves and the Fed remains accommodating.

For new purchases, we continue to prefer shorter dated bonds with attractive yield. One example is our recent purchase of six year Potlatch bonds at a yield of 4.73%. Potlatch is a Baa3/BB+ rated forest products REIT (real estate investment trust). We believe the company should continue to benefit from the rebounding housing market. Its lower investment grade rating reflects management's decision to favor increased dividends over debt repayments, not a deterioration of the balance sheet.

We are comfortable with current holdings and do not anticipate making wholesale changes to portfolios. Interest rates should continue to go up modestly, yet this risk is somewhat mitigated by prevailing low inflation rates. We also believe the Fed will be quick to reverse the taper if data shows higher rates are hurting the recovery. Watching the Fed is still very important!

We continue to explore new ideas to generate returns and mitigate risk, and we are pursuing opportunities as investment guidelines allow. We have been discussing with yield oriented clients options to adjust asset class and sector weight guidelines to accommodate more attractive income opportunities. In some cases, this has included an increased exposure to low duration preferred stock and hybrid securities, and some stocks that act like bonds, which include higher dividend common stocks, real estate investment trusts (REITS), mortgage REITS (M-REITS), Business Development Corporations (BDC's), and Master Limited Partnerships (MLP's). We look forward to discussing these ideas in greater detail.

As always, we welcome your questions and comments.

Maple Capital Management, Inc.
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
www.maplecapital.com