Maple Capital Management

Economic Commentary

Second Quarter 2015 April 14, 2015

Market Outlook

"I want a new drug,
One that won't make me sick"
-Huey Lewis from "I Want a New Drug"

The financial markets are still addicted to easy monetary policy, as trading during the first quarter confirmed. Strong economic data was met with selling rather than buying and weak data sparked rallies. Investors fretted the strong numbers would allow the Federal Reserve to begin the process of pulling back on easy money. It is still an environment in which good economic news is seen as bad for the markets, while bad news is viewed as a positive.

The first three months of the year ended with a gain in stock prices only after the minutes of the March meeting of the Federal Reserve Open Market Committee (FOMC), the rate setting body of the Federal Reserve, showed the Fed was very concerned by the headwinds facing the economy. The late March rally helped the S&P 500 post a gain of just 0.95% for the quarter. Foreign central banks, which are only now catching up to the aggressive easing actions of the Fed, helped push international stocks higher by 4.88%, as measured by the MSCI EAFE Index. Bonds, which benefit from the prospect of globally low interest rates, rose 1.32% during the quarter, as measured by the Barclay's Intermediate Aggregate Bond Index.

No one really knows when an addiction begins. The financial markets became addicted to easy money sometime towards the end of the Greenspan Fed and the dependence has been growing ever since. Increasing doses of monetary stimulus have invariably led to a system wide over-dependence on cheap money. Ironically, this policy of constant intervention has fostered a cycle in which cheap money encourages reckless behavior and in turn fuels the next crisis (i.e. the "tech bubble" in the late 1990's and the "borrowing bubble" of the mid-2000's), thereby creating a need for more monetary support.

Any hint the dosage might be reduced has led to withdrawal symptoms for the markets. This has been repeatedly confirmed over the past few years. As the end of every phase of quantitative easing (QE) drew near stock prices fell. Just last month, we saw markets sell off in advance of the March FOMC meeting, which was supposed to lay the groundwork for tighter monetary policy.

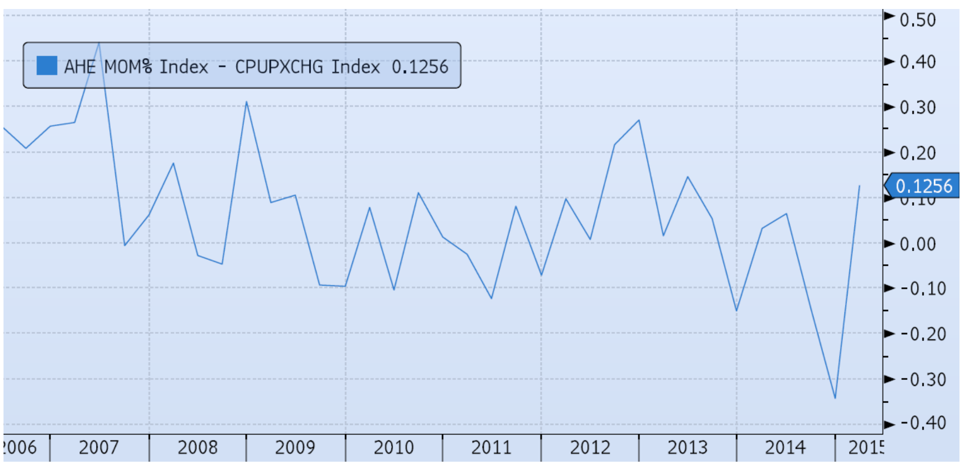
This negative reaction to the prospect of rate increases and tighter monetary policy is understandable. The economy has struggled to generate sustained job and wage growth over the past ten years without the help of "trickle down" interest rate policy. Investors remain concerned about weak growth, despite the fact most equity indices are at all-time highs. Many students of the market argue stock prices are only at current levels because low rates have distorted normal market dynamics.

Changing investor psychology to focus on positive economic data rather than monetary policy is not an easy task. Low rates have supported asset prices in many ways, including the ease at which companies can issue low cost debt to finance acquisitions, fund share repurchases and increase dividend payments. The steadiness of monetary policy is more reassuring to investors than the ups and downs of data reports, especially since the positive economic data of the past few years has generally been weaker and more uncertain than during prior recoveries. This has led to the perception that the costs of tightening will more than offset the benefits of positive data.

To really break the Fed habit, future economic reports need to show sustainable job creation and real wage growth. While current unemployment numbers appear strong on the surface, the plunging labor force participation rate and high number of part-time and temporary jobs, as measured by the U-6 employment number, may indicate underlying weakness. For good news to be seen as a signal to buy, rather than to sell in anticipation of rising rates, it must be seen as sustainable. Rising real wages and increased participation rates are two key metrics to measure the sustainability of growth. Higher quality jobs are important, as well, given that much of the recent job growth has occurred in the food service and retail sectors; traditionally low wage industries. Historically, data and stock prices continue to rise long after rate hikes begin, showing growth can trump rate increases.

We believe markets are already giving more weight to economic data. As we saw in the reaction to the January employment data, markets are already beginning to look at jobs and wages for direction. January showed strong job growth but wage weakness moved markets lower. Real wage growth is one of the better measures of future economic growth. Rising wages reflect future spending power and a rising demand for labor as employers expand. Wage growth and inflation have continued to be soft for this stage of the economic cycle. However, we are starting to see signs of improvement and this could be a key support for sustained growth in the quarters ahead.

CHART 1: Real Wage Growth is Now Positive



Source: Bloomberg

We have long argued the Fed is holding rates too low, running the risk of sparking negative long-term consequences. It seems like a foregone conclusion that any sign of growth will set the stage for higher rates. However, we believe the Fed will err on the side of caution and will keep rates low as long as possible. We see an ideal combination of positive data and little risk of higher rates in the months ahead.

While markets begin to look for strength, the Fed remains focused on signs of weakness. It is concerned the economy is still too fragile to raise interest rates any time soon. One of the bigger surprises from the March FOMC meeting was the level of anxiety among its members over the state of the economy. Data points such as stubbornly low inflation rates and rising inventory balances suggest the state of the recovery remains tenuous. The surging U.S. dollar and large layoffs in the oil and gas industry also point to additional weakness in the months ahead. The Fed is clearly less optimistic after an analysis of the new data, mitigating any concern that rates would be raised this summer.

This might be the best of both worlds for financial markets. Economic activity finally appears to be strong enough to drive activity regardless of the impact on Fed policy. The Fed, on the other hand, appears to be on the sidelines for now, so we see little risk that markets will experience a "cold turkey" withdrawal of easy money. To be sure, there are many economic headwinds facing the markets, but changes to Fed policy should not be viewed as the biggest risk facing investors.

Investment Strategy

The Federal Reserve has stated its desire to begin raising short-term rates in 2015. Ongoing weak economic data has made it increasing difficult to do so in the near term. We continue to believe the Fed will be unable to act as aggressively as it would like, keeping interest rates lower and for longer than the consensus view. Economic growth has been stronger than expected in the past few months, but there are several recent data points that suggest this trend may be vulnerable in the months ahead. In the meantime, interest rate differentials across borders continue to attract foreign capital, holding domestic rates lower than many had forecast.

Barring a drop in economic activity or a geo-political shock, this may bode well for equity prices. The status quo is often good for market psychology and continued low rates provide a floor for stocks. This explains why market valuation metrics, such as price-to-earnings ratios, have been expanding despite increased systematic risks. It also explains why so many large cap stocks are trading above their 50-day moving averages, a positive technical signal.

Interestingly, stock prices continue to rise as earnings estimates are slashed by analysts. Rising costs, including wage pressures and a lack of pricing power are weighing on corporate earnings. Foreign exchange issues are of particular concern, as the dollar surges higher. This reduces the earnings of U.S. multinational firms and increases the competitiveness of imported goods for domestically focused companies.

CHART 2: Changes to Earnings Estimates Since Dec.

Name	31 Dec '14E Q2 '15	2 Apr '15E Q2 '15	31 Dec '14E CY 2015	2 Apr '15E CY 2015
S&P 500	**5.42**	**-2.29**	**8.31**	**1.93**
Consumer Discretionary	14.47	9.70	15.22	12.84
Consumer Staples	3.90	-0.71	5.88	1.38
Energy	-20.88	-63.05	-18.52	-57.04
Financials	7.16	5.11	17.11	14.60
Health Care	9.21	8.25	12.19	10.52
Industrials	6.59	4.71	9.69	8.44
Information Technology	10.27	4.39	10.22	8.30
Materials	12.33	1.56	10.83	0.91
Telecommunication Services	4.43	3.27	6.70	4.87
Utilities	6.92	5.64	3.16	1.49

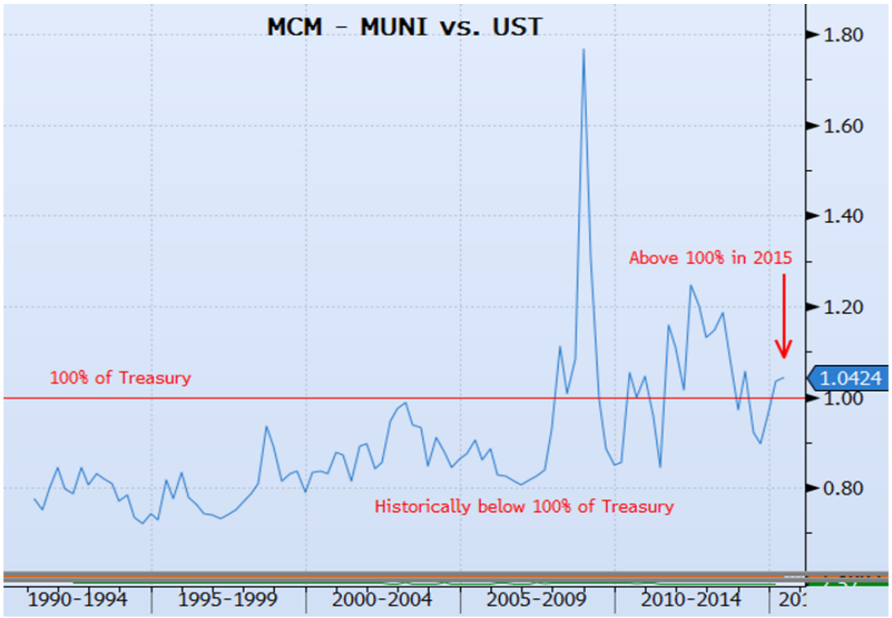
Source: FactSet

One of the more pronounced reactions to the FOMC's March meeting was the reversal of the US dollar. The dollar had been rising dramatically since last summer, as stronger growth prospects and higher interest rates in the U.S. attracted funds from overseas. The prospect of slower growth and correspondingly lower rates signaled the dollar's rise may have been over-done and it subsequently fell from its recent highs. Despite this slight pull back, the dollar remains strong and U.S. based multinationals are likely to experience earnings headwinds in the quarters ahead. This has led us to focus on companies with lower exposures to foreign exchange related earnings problems.

We continue to believe stocks are the best positioned asset class. We remain over-weight equities, although we are being far more selective on where we are taking our exposure. We have been increasing our investment in international stocks as part of this process.

On the fixed income side, markets have been volatile this year. Prices rose and the yield on the benchmark ten-year Treasury note fell by 25 basis points (bps) during the quarter, although not without dramatic moves. The strength in Treasury prices is not just a function of slow growth and falling inflation. Investors are faced with a growing list of geopolitical and economic risks so there is a "flight to safety" component in the current move in Treasury prices. We continue to limit duration bets.

CHART 3: Widening Trends in Tax-free Municipal Bonds



Source: Bloomberg

Segments of the market without a Federal backstop, such as corporate and municipal bonds, have seen yield spreads versus Treasuries widen since the start of the year. In particular, municipal bond yields have not fallen in sync with Treasury yields, as heavy new issuance and renewed pension liability concerns have weighed on the sector. Tax-free municipals have yielded more than Treasuries for most of this year; a significant move from historic norms. The nominal yields of this asset class are now higher than comparable maturities in other segments of the bond market. Tax-free bonds will also rise in value if tax rates increase, providing investors with the potential for capital gains.

As always, please contact us should you have questions.

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