Economic Commentary

October 14, 2016

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"You take it on faith, you take it to heart
The waiting is the hardest part " **- Tom Petty—"The Waiting"**

Global equity markets continued the post-Brexit rally during the third quarter, as investors savored the low rate environment prompted by the British vote to leave the EU. The ECB, the Bank of England, and the Bank of Japan all announced either outright actions or plans for bold moves during the quarter. Despite a backup in rates in September, the government bonds of most major countries continued to trade near record low yields. Shaking off a volatile September, domestic stocks, as measured by the S&P 500, managed to post a gain of 3.85% for the quarter and are now up 7.84% for the year. International stocks were up strongly with the MSCI EAFE International index gaining 6.43% during the quarter. This puts the index back into positive territory for the year with the index now up 1.73%. Bonds were up slightly with the Barclays Intermediate Aggregate Index gaining 0.31% for the quarter and up 4.10% on the year.

The financial markets spent much of the third quarter, and indeed, much of the past year, trying to forecast when the Federal Reserve would choose to raise base interest rates for the second time. Many observers had long viewed September as the earliest month for the next move and any prediction of a prior move was quickly dashed by market volatility and international events; namely the "Brexit" vote in Great Britain. Steady domestic growth and speeches by several high profile Fed officials led many to believe a September hike might become reality. When the decision time came, however, the economy just wasn't strong enough to provide the necessary political cover for such a move. Despite strength in the labor market and improving economic growth, the Fed Governors chose not to act, citing soft business fixed investment and an inflation level well below its 2% target.

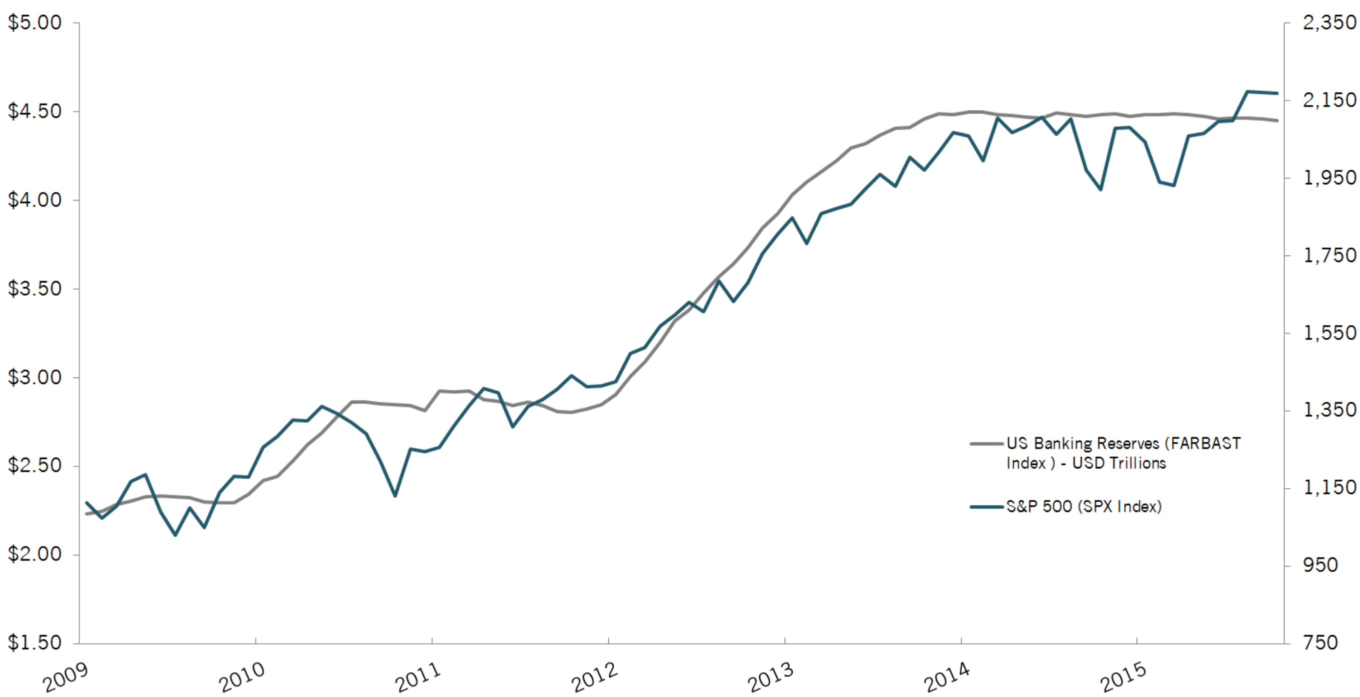
With the decision not to hike, the Federal Reserve has once again forced the financial markets into a state of data-driven limbo. Market participants are back to a wait-and-see mode of sifting through future economic data to discern clues of when the Fed might move next. Unfortunately, little additional insight was given as to what data needs to be seen before a policy change is triggered. There is little indication economic growth is about to accelerate in the near-term, so we believe the next move will be more a matter of time passing than reaching certain economic metrics. The Fed desperately wants to reign in its emergency rate policy (now that we have no emergency) and has stated that moving a little bit each year is preferable to deferring now and having to move multiple times in one year in the future. This suggests the Fed will act in 2016, barring a serious setback in economic conditions. Investors seem to agree with this thesis and the futures market implies a 59% probability of a December hike, as of this writing.

The markets care about Fed policy for one very simple reason: it matters. It is hard to overstate how much influence monetary policy has had on the U.S. economy over the past seven years. The chart in **Exhibit 1**, below, shows the high correlation between the growth in banking system reserves and the growth in the S&P 500 Index. The expansion of banking system reserves was almost entirely driven by the rapid inflation of the Fed's balance sheet due to QE activities. The correlation between the two lines suggests the increase in asset values over the past five years is closely linked to Federal Reserve bond purchasing activities.

Most of the market corrections during this time period have coincided with discussions surrounding the end of quantitative easing phases or by the "tapering down" of security purchases by the Fed. The end of QE activities coincided with the topping of the market during 2014-2015. Markets were only able to reach new highs in 2016 after the Brexit vote suggested that central bank support would need to remain in place longer than had been previously expected. With the Fed seemingly ready to act on rates, many believe action on the balance sheet issue cannot be far behind.

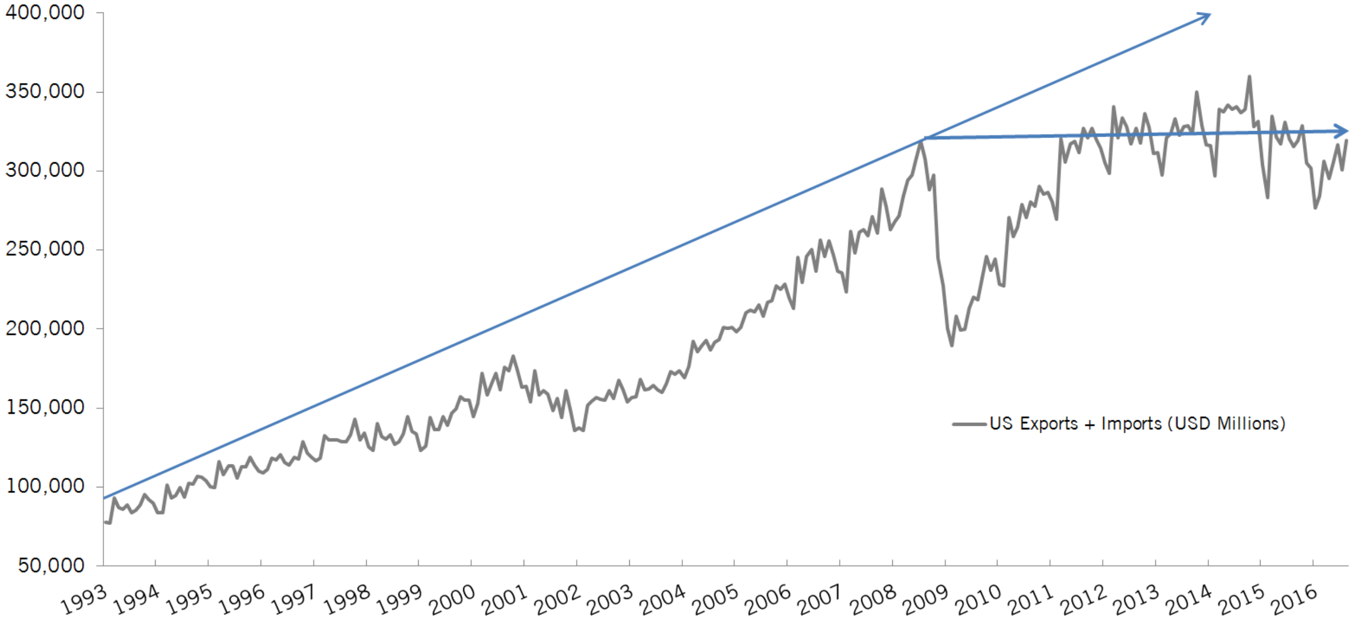
Interest rate policy has been a meaningful crutch for asset prices in recent years. Any weakening of this support will have an impact. Asset prices, notably bond prices, remain high. While volatility has increased, markets have remained in a tight range thanks to low rates. Investors have been in this situation before, only to see the Fed sit tight. With the Fed unlikely to act until well after the elections, investors will have to wait until December to glean any direct information about the scope and pace of future policy actions. They will also have to wait to see if economic growth will accelerate enough to offset the impact of a rate move. Given the stakes, it will not be an easy wait.

EXHIBIT 1: US Banking System Reserves vs. S&P 500



Source: Bloomberg Financial LP

EXHIBIT 2: US Exports + Imports



Source: Bloomberg Financial LP

Strategy and Market Outlook

Our strategy embraces the belief the Federal Reserve will probably raise rates in December, but will not be aggressive on further moves, barring a meaningful acceleration of economic data. This is still consistent with the "lower for longer" view that we have long held. This perspective suggests a stable equity market in the months ahead, absent an economic disappointment or an exogenous event. We do not believe economic conditions will create an upside surprise, so we view an interest rate shock as a low probability scenario.

We believe economic growth will remain sluggish in the quarters ahead. This suggests cyclical and deep value stocks may have issues, at least in the large cap segment of the market. Mergers and acquisitions are once again becoming commonplace. Established value and small cap stocks are likely to be continued beneficiaries of this trend. Mergers may actually increase along with interest rates as companies look to buy growth in a slowing economy.

Risks remain elevated and the chance of an unintended event occurring is high. Risks include geo-political events, interest rate hikes, a surging dollar (if U.S. rates go up while the rest of the world remains in easing mode) and political dysfunction in the U.S.

We are particularly focused on the rapid rise in geo-political tensions. Global growth took off with the end of the Cold War in the early 1990's. New markets were opened, defense spending was redirected and trade barriers fell. International trade and national GDP numbers soared. Trade and access to new markets were key factors driving global growth through the 1990's and early 2000's. Although the Debt Crisis in 2008-09 derailed trade in general, geo-political tensions have since curbed any sort of resumption of this trend, as shown in the chart in **Exhibit 2**.

Between embargos, boycotts and government mandates, trade is slowly being curtailed. The risk of a new Cold War is growing and could reverse many of the gains that have been made in the past twenty years. Even without tensions, a strong dollar is curbing U.S. sourced trade. These trends have us looking more towards companies with strong domestic sales and less international exposure.

Our fixed income strategy remains relatively unchanged from last quarter. Central bank action remains the biggest single force in the bond market. Rates can only rise as fast as these banks permit and will drop quickly if they so desire. We expect the Fed to raise rates slowly and foreign banks to remain passive for the balance of this year and most of next. While interest rates should trend higher in the months ahead, we expect bond markets to remain relatively calm over the next few quarters. We are structuring portfolios with this view in mind.

The yield curve remains quite flat. For example, the spread between the 2-yr and the 10-yr Treasury remains near the lows of the cycle. This has made duration a significant asset from a total return perspective, but further additions to longer term securities will have an expanded risk profile. Despite this, the intermediate duration segment of the curve generally remains attractive.

Lower rated bonds have been the stars of 2016. We are seeing several signs a change may be afoot. We have been seeing BBB-rated securities offered at wider spreads to Treasuries than just a month ago and there are indications investors are beginning to lock in gains on high yield bonds. Bond investors have historically sniffed out economic trends long before they materialize. They tend to sell in anticipation of a slowing economy since that is a negative for credit sensitive bonds. We will be watching these trends for signs that systematic risks are building.

As always, please contact us should you have questions.

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