MAPLE CAPITAL MANAGEMENT

Economic Commentary

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"Let the Good Times Roll"

- The Cars

Global equity markets continued to surge ahead in the second quarter, with domestic and foreign stock indices hitting new record highs. While there has been a small (very small) increase in volatility, especially in the high flying technology sector, the bias of the market has been solidly to the upside. Domestic stocks, as measured by the S&P 500 Index, were up 3.09% in the second quarter and are up 9.34% since the beginning of the year. Foreign markets have fared even better, with the MSCI EAFE Index up 6.12% in the quarter and 13.81% since the end of December. Even bonds have been able to stay positive in this environment, with the Bloomberg Barclays US Intermediate Aggregate Index posting a 0.92% gain for the quarter. Year to date, bonds are up 1.61%; an impressive move since bonds are often inversely related to equities in a strong market.

Interestingly, the market moves have occurred against what many believe to be a dire political backdrop. In the U.S., new highs were repeatedly set in the face of numerous political concerns. In Europe, the DAX and other key indices set new highs despite the negatives of Brexit, a crisis in the European (specifically Italian) banking system and continued worries over the long term outlook for the Euro-Zone. In Asia, the KOSPI (Korean stocks) has been setting new highs and the Nikkei (Japanese stocks) remains strong despite the belief of many, at least in the U.S., that the Korean Peninsula is heading towards a nuclear confrontation.

While any of these events could spiral out of control and trigger a sharp correction - which is why we maintain proper asset diversification - the stock market remains a reliable proxy for economic conditions. The economy, both domestically and globally, continues to expand. The U.S. stock market is now in its ninth consecutive year of positive returns. Net S&P revenue growth, which had been posting negative numbers for several quarters, has once again turned positive. Earnings continue to increase and many companies have announced expansion plans.

Data points, especially economic data, rarely move in a straight line. Yet the trend is definitely up and we expect economic growth to remain on track, despite the occasional weak number. We are particularly encouraged by the forward-looking indicators such as confidence numbers (consumer and small business), housing data and the ISM data sets. Employment data continues to be surprisingly strong and we are beginning to see signs that the labor force participation rate and wages are both beginning to improve.

The strength of this data has been confirmed by the Federal Reserve, which has cited growth as it begins to normalize interest rates. This is a significant departure from the policy actions of the past eight years. The Fed raised base interest rates three times in six months, most recently at the June FOMC meeting. More importantly, the Fed used the June meeting press release to lay out a clear outline of how it expects to unwind the $4.5 trillion of securities held on its balance sheet from quantitative easing (QE) activities earlier in the decade. When it begins, the "Great Unwind" will represent the first sale of FOMC assets since quantitative easing began in late 2008.

The plan announced in June closely mirrors the approach used to purchase the securities in the first place. Principal received from maturing securities and monthly mortgage pay downs are currently reinvested into new holdings. When the Open Market Committee (FOMC) begins to unwind the System Open Market Account (SOMA), the payments will only be reinvested if the amount exceeds certain thresholds. The Fed referred to these thresholds as "caps" on the amount of money that will be allowed to roll off. Initially, the plan is to limit the roll off to $6 billion maximum per month for U.S. Treasury securities and $4 billion for mortgage-backed securities.

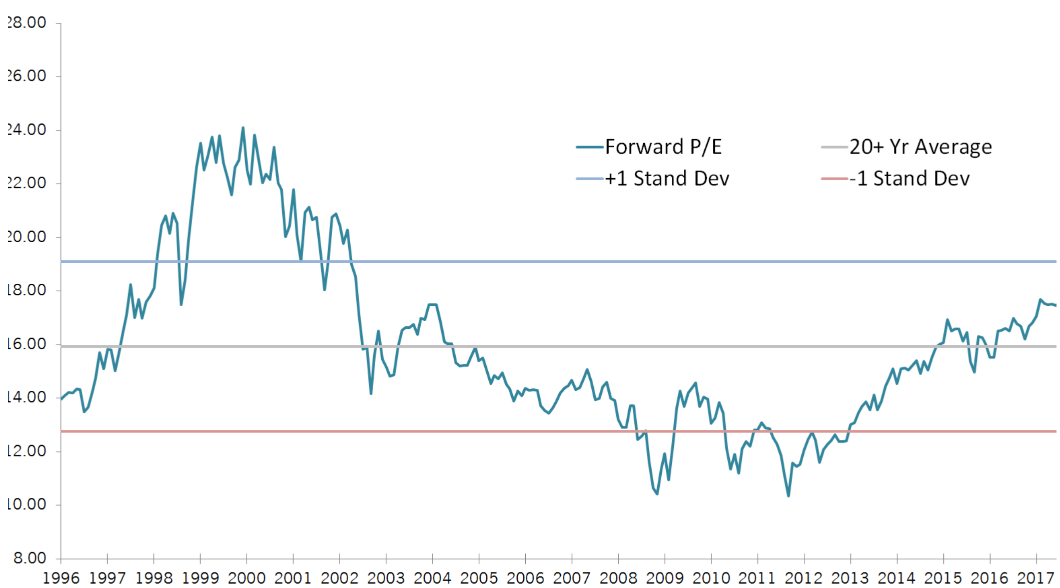
These "caps" will be increased over time, per a set schedule, as conditions improve and more of the portfolio runs off. The upper end of the caps, however, will be limited to $50 billion per month, at least as currently outlined. There is no mention of liquidation of securities if maturities do not reach the cap limit in a given month.

This process will take years to unfold. Assuming the "roll offs" happen according to plan, the process of normalizing the size of the Fed holdings will still take approximately eight years to unfold. Any delay from slowing economic conditions or the lack of necessary maturities in any given month will slow the process even further. For now, though, it is enough to recognize that the Fed's mindset has decidedly changed.

This shift towards a more hawkish monetary policy is a development to which markets will have to adapt. Market valuations reflect many considerations, including expected growth rates, the prevailing interest rate environment, and risk considerations of all types. As the balance sheet unwinds, investors will have to discount the impact of higher rates on market valuations. As shown in **Exhibit 1**, below, valuations are high at current levels, but not necessarily over-priced, by historical standards.

Valuation risk is a growing concern as interest rates rise. Asset valuation has not been a big

EXHIBIT 1: S&P 500 Forward P/E Historical Chart



Source: FactSet Research

issue in recent years due to the Fed's willingness to intercede in markets. As the Fed moves to normalize interest rates, it is likely this protectionist mindset will also be curbed. In recent years, investors have aggressively bought any market dip, knowing the Fed would act to prevent a sharper decline. This so-called "Fed Put" has dampened volatility and created confidence among investors. As the Fed pulls back, we look for market volatility to increase and market multiples to decrease over time.

Going forward, both the bond and stock markets seem complacent with regard to the Fed and global events. While the next rate hike isn't expected until December, at the earliest, the unwinding of the balance sheet is likely to begin much sooner. As always, the Fed will remain data dependent. However, we believe the bias has clearly shifted towards policy normalization and away from accommodation. The Fed will now need to see sustained weak data to consider stopping asset liquidations, rather than the previous view of needing to see months of sustained strong data before considering a tighter policy move. This is a major shift in what the Fed will be looking at going forward. Patience is required for these markets. We have not yet reached the point where meaningful repositioning is required, but increasing portfolio risk at this point seems like a strategy destined to fail. Things always feel great on the way up, and for now at least, the good times continue to roll.

Strategy and Market Outlook

Asset valuation is shaping up to be the biggest factor impacting equity prices. Economic data continues to improve and corporate earnings have been strong. With expanding growth rates and surging consumer confidence numbers, there is little reason to suspect a correction is imminent. However, valuations must reflect all risks, including the political and the policy risks, facing the markets.

The political risks are likely to be less severe than feared. Gridlock seems to be settling in over Washington and this has always been welcomed by the markets. Gridlock was a strong positive for asset prices in the 1990's, for example. International political issues, such as a trade war or a new crisis with North Korea, are potentially high severity events, but they should be relatively low probability outcomes given political realities.

The policy risks are more quantifiable. Monetary policy has already shifted to a rising rate bias and the impact of this change is already impacting prices. This will likely be a headwind going forward, although the policy shift has only occurred because economic growth has improved enough to allow Fed officials to make the change.

This appears to be a classic transition to a late stage market cycle. Growth stocks have been very strong for three years while value stocks have lagged. We expect the differential between the two camps to narrow, with value beginning to outperform. Banks have already moved, propelled by a combination of higher yields and an anticipated repeal of onerous regulations. Continued economic growth should also support cyclical areas of the market, such as industrials and materials. We believe small cap value, which has been particularly weak in recent quarters, should also see a reversion to the mean.

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.

The picture has also become more complex on the fixed income side. 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 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. 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.

As always, please contact us should you have questions.

For further information, please contact Steven Killoran, Vice President Business Development at 1-802-229-2838 or at skilloran@maplecapital.com. For further information about Maple Capital, including a copy of our informational brochure, please visit our website at www.maplecapital.com.

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