

Market Outlook

“The times they are-a-changin’”

- Bob Dylan

This is our first spring in MCM’s new offices on the ground floor overlooking the river. We have spent the last few weeks keenly watching the water level, even though we are above the flood plain. The ice was wicked thick and the snowpack deep after a long, bitter winter. With a sudden spring rain, we could have easily seen an ice jam resulting in flooding in Montpelier. The last big flood was in 1992 – long enough ago to have been pushed to the back of our collective minds. Floods are hard to predict and nobody wants to go out on a limb and say this will be the year, even if visible factors point to a much higher probability. In 1992 it took only four hours for the ice to break, jam and flood the town.

Global stock markets seemed to be heading for the financial equivalent of a flood in January, as most indices experienced their largest monthly declines in nearly two years. However, the dark clouds parted as improved economic data and a rebound in investor optimism lifted markets higher. Stock prices managed to end the first quarter with a gain of 1.84%, as measured by the S&P 500 Index, while international stocks were up 0.66%. Bonds defied end of year predictions and rose 1.20%.

These gains came despite numerous signs that storm clouds are building over the markets. Like residents of flood prone areas, investors are quick to dismiss the looming clouds as nothing to worry about. Most have forgotten that risk sometimes does result in negative outcomes, even if the chances of such an event are small. Very few storms result in floods, yet it is wise to take precautions to mitigate the risk. This is a basic rule all investors should remember.

Systemic risk is a fact of life in financial markets. These risks have been increasing in recent years. There is compelling data and wide agreement to support this observation, yet it is likely market participants will not change behavior before the next crisis. Even those with the best data sometimes turn their eyes away from growing risks.

A classic example of this observation can be found in the recently released records of the Federal Reserve policy meetings prior to the 2008 correction. Despite having access to the best data available, the Federal Reserve failed to anticipate the severity of the 2008 financial crisis. The Fed’s economic predictions from the summer of 2008 were stunningly off the mark. These projections called for sustained growth rates through 2011; an outlook that was not revised until December, well after the market had collapsed. In hindsight, we wonder how the Fed could have missed the glaring signals.

Of course, the Fed is only human, and humans, by nature, tend to overemphasize recent events and memories. The Fed economists were focused on extrapolating the prior strong global growth and missed the reckless behavior of millions of borrowers who added debt without the ability to pay. After all, they had their forecasting models and, until then, people lent and borrowed rationally under these forecasts.

Investors today seem to be falling into a similar trap as the Fed did in 2008. The past two decades have seen a near continuous decline in interest rates, the end of runaway inflation, the advent of world peace as the Soviet Union collapsed, a blossoming of world trade and the unprecedented formation of capital as taxes were cut around the world. The downturns during this period were largely the result of too much of a good thing. The “Dot Com” bubble in 1999 and the real estate/debt bubble in 2008 were the result of speculative excesses fueled by cheap money. These bubbles did not burst due to global economic turmoil or conflict. In historical terms, the risk levels of the past two decades were extraordinarily low.

There are still many reasons to be optimistic about the current state of affairs, at least from a market perspective. This is especially true for U.S. investors. Corporate and household balance sheets are improving, corporate earnings are surging, and financial markets are riding a two-year wave of upward momentum. The domestic energy sector has been booming and many employers are struggling to find enough qualified workers. It is easy to understand the prevailing optimism. The potential returns are attractive and this is certainly not a time to be selling equities across the board.

However, investing is a two-sided equation. Analysts study stocks to identify opportunities and quantify the potential returns. Markets are supposed to weigh these returns against the potential risks and set prices accordingly. This risk/reward relationship is where we are seeing a potential disconnect.

We believe systemic risks in financial markets are rising. In the event of a crisis, Central bankers have few options available. Many, including the Federal Reserve, are nearing the limits of quantitative easing and may soon need to curb bond buying to protect their balance sheets. Interest rates cannot go much lower, even with another crisis. Steady or accelerating growth will cause rates to rise as easy monetary policies are curbed. Higher rates will be dangerous in a world where debt is at record high levels around the globe.

Government debt levels in the US, Europe, and Japan now exceed the annual GDP's of these countries; a risk expertly documented by Reinhart and Rogoff in their groundbreaking book “This Time is Different.” High debt levels usually lead to slow growth and can result in either deflation or inflation, depending on the policy response. Deflation is clearly the risk the Federal Reserve wants to avoid. It is showing up in European data already. Inflation remains below target in the US, and Japan can only generate a modicum of inflation by running the monetary printing presses.

More concerning, we cannot turn a blind eye to the increased chance of armed conflict as geopolitical risks are increasing sharply. A resurgent Russia seems intent on squaring off with the West over Ukraine, China and Japan are deeply enmeshed in territorial disputes, and armed conflicts are rife across the Middle East. Adding to the uncertainty, the U.S. and other Western powers are pulling back their military umbrellas just when stability is most needed.

Of course, Americans tend to focus on domestic problems and often miss events overseas. China's banking system is riddled with bad loans. The country is trying to reign in its rapid debt growth and its shadow banking system. We see early evidence of financial distress in the bankruptcy of some wealth management firms, and in the volatility of Chinese short-term lending rates.

Chart 1: Chinese Overnight Repo Rate – Trailing 12 months



Source: Bloomberg

To say any one of these factors will lead to the next major crisis would be presumptuous. There is not even a reasonable basis to suggest a major crisis is imminent. However, we do seem to be entering a new period of increasing turmoil and growing risks. With these changing times, security prices will eventually reset accordingly. Elevated risks imply lower normalized valuation multiples (price-to-earnings, price-to-cash flow) and increased risk premiums which weigh on security prices. The world is beginning to look more like the 1970's than the 1990's.

Markets are still healthy and the prospects for continued gains are still intact. However, the storm clouds are building on the horizon. Whether turbulence will come to pass has yet to be seen, but it is prudent to take some precautionary moves. Foremost, pay attention to valuations. Many stocks are trading well above any semblance of reasonable value. Avoid paying too much for optimistic growth projections, as many are doing with recent "hot" initial public offerings. Most importantly, investors need to stay diversified. This includes owning bonds and reducing high concentrations of risky assets.

These strategy thoughts may be viewed as quaint by many in the investment industry. However, these are simple ways to reduce portfolio risk with little impact on investment returns. Few risks become reality, but it does not hurt to think about the "what if" scenarios. A little forethought can prevent a great loss. After all, we thoroughly enjoy our river views, but in case of an emergency, we have taken a moment to plot a route to higher grounds.

Investment Strategy

We continue to believe we are well into an economic recovery. While it may be a shallow recovery, it's a recovery nonetheless. Interest rates are subdued, unemployment is drifting lower, industrial production is relatively steady, and consumer confidence is rising. There is more economic and political instability around the globe right now, so the US economy is attractive on a relative basis as well.

US equity markets had a huge run in 2013 and many stocks are near their 52-week highs. We are selectively taking advantage of the run up in stocks by selling or paring back certain positions that we believe are fully valued or are at risk of price declines. We are always looking for stocks which we believe have much greater upside potential and risk/reward profiles than the ones we are selling. In the past, we have held fully priced stocks with less downside price risk until a replacement could be found. We have been much more aggressive this year about selling stocks that have hit our price targets, even if we do not have ready replacements. IBM, McKesson and Becton Dickinson were all sold this past quarter.

IBM is a good case study. We sold IBM for several reasons, but chief among them was it hit our price target and the risk/reward profile was no longer compelling enough to meet our strict criteria. Our analysis indicated that revenue growth was slowing and the company now had more downside risk than upside potential. Management was stretching ever harder to meet their sales and earnings guidance and we suspect the company may reduce guidance in the near future, something not reflected in current valuations.

The equity market run in 2013 capped a massive rise from the lows of 2009. After nearly five years of gains, we believe this is a mature bull market with the potential for sharp, short term pull backs. This is a good opportunity to reduce exposures and to make prudent adjustments to client holdings. Cash may be trash to many, but it is a good place to be in a volatile market with a narrowing number of attractive investment options.

Volatile equity markets and international crises are generally good for bonds. Investors flee risky assets and seek to buy stable outcomes in times of turmoil. This flight to safety has been helping bond prices in 2014. Defying year end forecasts about the demise of bonds, fixed income returns have been positive this year. While interest rates must eventually go higher, the short term offers many attractive incentives to hold debt.

Our bond strategy continues to avoid long duration bets. We have been seeking to add value through yield curve placement and security selection. Given market conditions, we typically forgo incremental yield gain opportunities in favor of bonds with more favorable risk/reward profiles. When we choose to take credit risk, our research indicates the front end of the yield curve currently provides excellent investment opportunities. We continue to see higher quality municipal bonds providing compelling investment opportunities.

While we do not have the ability to predict the next flood, we do have the ability to prepare for it by investing in bonds that are well positioned on higher ground!

As always, we welcome your questions and comments.

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