Maple Capital Management

Economic Commentary

Third Quarter 2014 July, 18, 2014

Market Outlook

"Sign, sign everywhere a sign"

- The Five Man Electrical Band "Signs"

It is safe to say new record highs in the stock market have rarely been so uncomfortable for investors. Improving economic data, especially in the U.S., and a new round of intervention by the European Central Bank (ECB) have helped stocks overcome the tepid earnings releases of April. The Dow Jones Industrial Average broke the 17,000 level for the first time and the S&P 500 index, which came within a few points of breaking the psychologically important 2000 level, ended the second quarter with a gain of 5.18% and is up 7.12% for the first half of the year. International stocks, as measured by the MSCI EAFE index gained 4.09% during the June quarter and are now up 4.78% on a year to date basis.

Despite these gains, few are celebrating the strength of the market. Trading volumes are light and there is little rotation into stocks from other asset classes. Funds are being committed to equities only grudgingly. Anxiety about the permanence of the recovery and the growing expectation that at least one of the expanding list of regional crises will flare up into a full-fledged war has kept cash on the sidelines. The current market environment is more reminiscent of 1970's than of the 1990's.

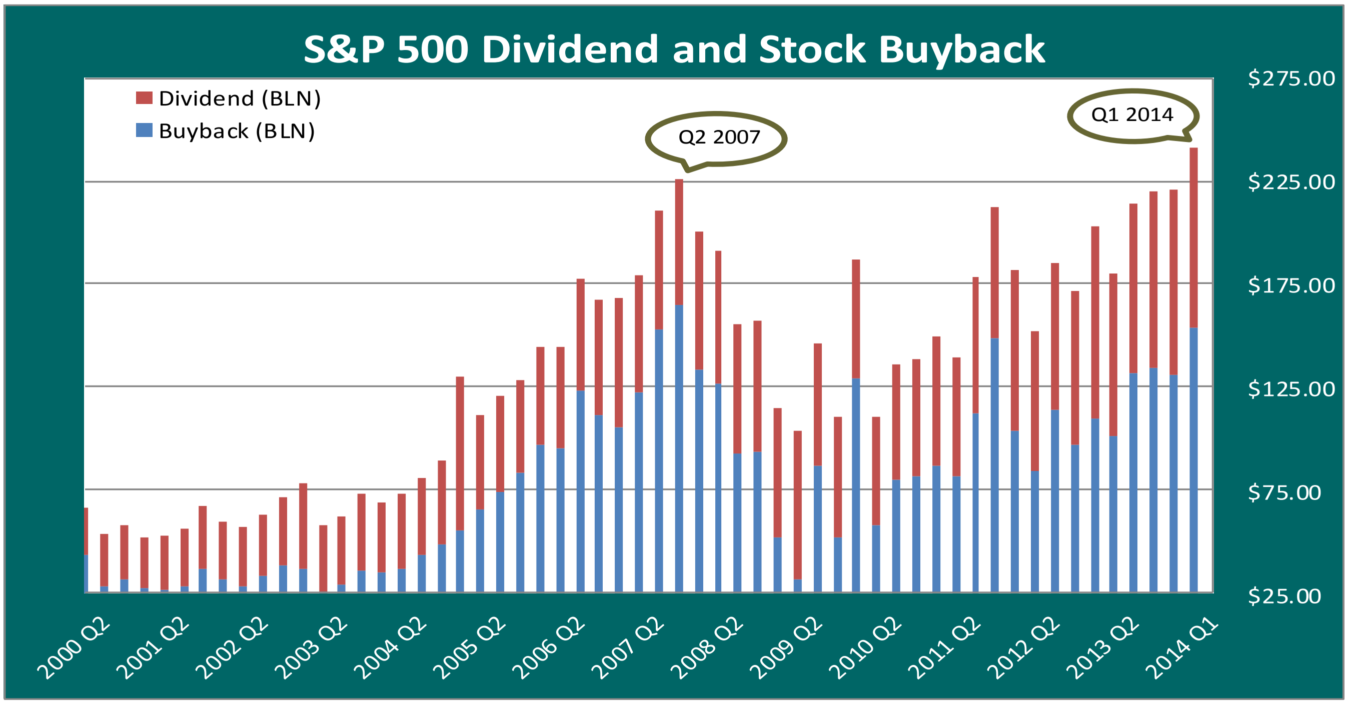
While systemic risks are increasing, equity prices continue to grind higher as they climb a proverbial wall of worry. The market correction that many have been predicting has not materialized. Many retail investors concerned about having too much cash are choosing to invest now. Institutional investors have even less flexibility as they are forced to invest their cash within a certain period of time or risk running afoul of investment guidelines.

A snapshot of current economic conditions appears supportive of stock prices. Recent economic data, while lukewarm historically for this point in the business cycle, have been stronger than expected and seem to be gaining strength. Leading indicators, especially the data provided by the Institute for Supply-chain Management (ISM), have been even stronger, suggesting growth rates will continue to accelerate.

While interest rates may be moving higher in the future, they are still near historic lows, which provides support for both economic growth and stock prices.

The impact of low interest rates on stock prices cannot be overstated. Low rates have led to a boom in mergers and acquisitions activities which tend to occur at premium valuation multiples and can further bolster investor confidence. More importantly, companies borrowing at such low rates have been able to fund share repurchases and increase dividends. The extent of this activity can be seen below in Chart 1.

CHART 1



Source: Bloomberg

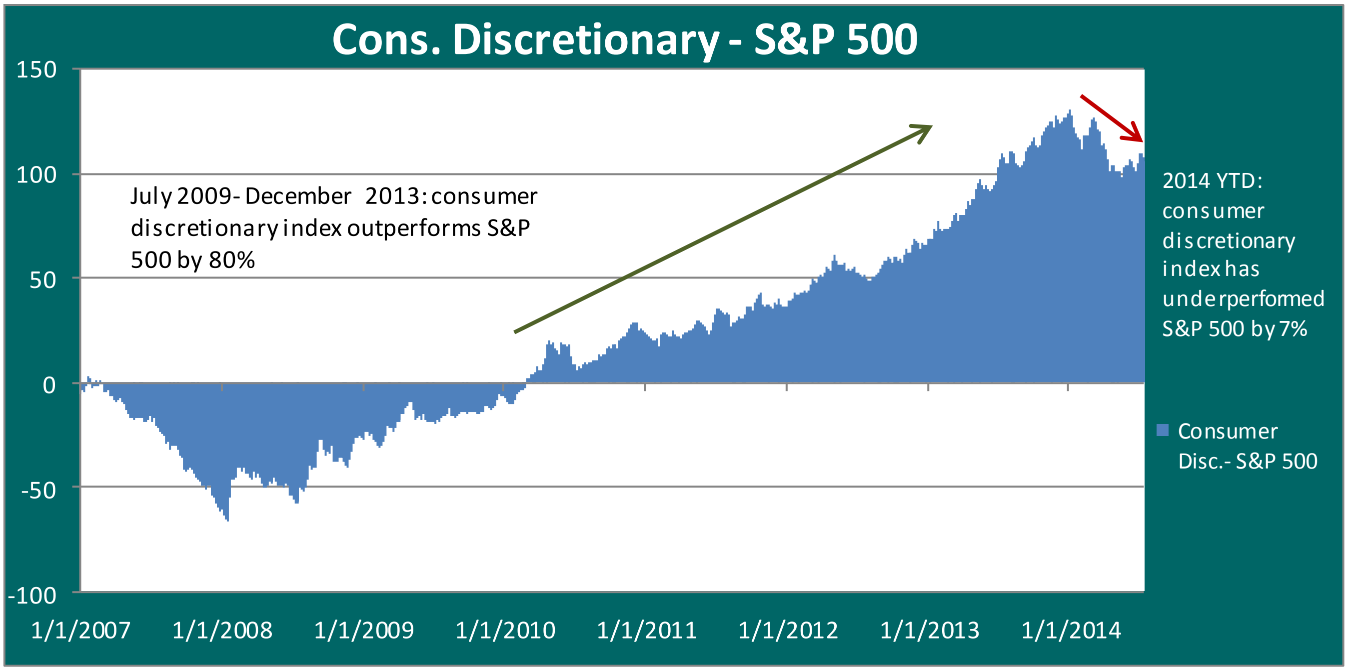
So why aren't stock prices even higher? Prices incorporate both the potential returns of the market and the risks involved with making an investment. While much of the anticipated returns have already been priced into current markets, systemic risks are growing and many are only now becoming apparent to observers. As risks increase, investors become choosier about the prices they are willing to pay for riskier assets.

Interest rate risk is one of the more tangible risks being incorporated into investment decisions. The minutes of the June FOMC meeting point to an end of quantitative easing by October of this year, and an increase in the fed funds rate in the first half of 2015. Markets are forward looking and tend to discount news six to nine months in advance. This suggests higher rates will become a much stronger headwind to price levels in the near future unless offset by faster economic growth.

We are increasingly concerned about the trajectory of interest rates. The Federal Reserve governors have made it clear they will proceed with plans to move rates towards a market driven level sometime next year. In addition to the direct impact on security valuations, consumer discretionary spending may be more vulnerable to rising rates than many investors currently expect. This is of great concern since consumer spending accounts for approximately 70% of the US economy.

We are already seeing signs that consumer spending may be weakening, even without higher borrowing costs. Household borrowing remains weak (except for student loan debt, which is surging) and several major retail chains have posted earnings warnings, some for the second quarter in a row. Consumer spending may not drive the stock market, but it certainly is a coincident indicator of overall market health. Chart 2 shows the outperformance of the consumer discretionary sector relative to the S&P 500 index. The consumer discretionary sector has been a leading sector during the recovery from the most recent recession and has outperformed the S&P 500 by 80% , from July 2009 to December 2013. However, this leadership position has recently broken down with the sector underperforming the broader index by 7% since the beginning of this year - a trend we are watching closely.

CHART 2



Source: Bloomberg

These consumer spending warning signs could be temporary. They could also reflect changing trends due to demographics. An aging population generally spends less. Consumers in general are trending more toward “experiential” spending on things such as trips and vacations and moving away from buying more material goods. The younger generation, but clearly not limited to them, has also gravitated toward more on-line shopping while expecting everything for free or at least what they perceive as a great deal. Many see nothing wrong with using the inventory and knowledge of a local store to determine the correct size and brand before making their purchase on-line.

Coincident indicators do sometimes appear just by coincidence. However, given the importance of consumer spending to the U.S. economy, this chart merits attention. After all, as goes consumer, often goes the economy and it is the health of the economy that will drive the health of the markets.

Investment Strategy

U.S. economic data continues to point to a recovery. While it may be shallow, it is still a recovery and we are headed in the right direction. Interest rates remain subdued, unemployment is drifting lower, industrial production is relatively steady and consumer confidence is rising. We are also seeing improvements in wage and workweek data.

Stronger economic growth should lead to broadly higher stock prices, assuming this growth is sustainable. We remain concerned, however, that growth expectations are too high. We believe the U.S. economy will be hard pressed to see a 3% growth rate in the third quarter, let alone for the year, as many have been predicting. This disappointment could lead to flat prices in spite of the positive news.

We are further concerned that geopolitical risks are increasing faster than the economy is growing. The traditional risk/reward analysis underpinning stock prices could make additional price gains harder to come by over the next few months. It will be hard to maintain valuation multiples without a resolution of the multiple tensions flaring overseas. We remain cautious with new purchase decisions and are holding higher than normal cash positions as a result.

One area where we are finding some value again is the emerging market sector. The valuations of emerging market stocks have improved significantly in the past few years. While some of the regional conflicts are taking place in emerging market countries, many remain free from strife.

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, not least of which is the preservation of capital.

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.

As always, we welcome your questions and comments.