Maple Capital Management

Economic Commentary

Fourth Quarter 2014 | October 16, 2014

Market Outlook

"Patience is power"
- Fulton J. Sheen

Volatility has returned to the financial markets. After setting new all-time highs in the first half of the year, the third quarter of 2014 saw several broad market indexes stall and break down. More importantly, the returns on various market segments are starting to diverge. Small-cap stocks, tracked by the Russell 2000 Index, declined 7.60% during the quarter while large-cap stocks, as measured by the S&P 500 Index, posted a small 1.15% gain. International stocks were even more volatile. Stock prices in developed economies, as measured by the EAFE Index, were down 5.88% during the quarter while emerging markets lost 4.33% during the period. On a year-to-date basis, The Russell 2000 and EAFE Indexes are now negative, while the S&P 500 Index remains in positive territory with an 8.35% gain. Bonds, by comparison, were essentially unchanged during the quarter and are up 2.88% for the year.

The pullback from the September highs is not entirely unexpected. Despite the recent strength in U.S. economic data, global growth, especially in Europe and China, has been slowing. Slower growth abroad tempers U.S. exports and depresses the earnings of domestic companies with large operations overseas. Consensus forecasts have called for steadily increasing earnings, so any weakness may cause corporate earnings to fall short of expectations in the quarters ahead.

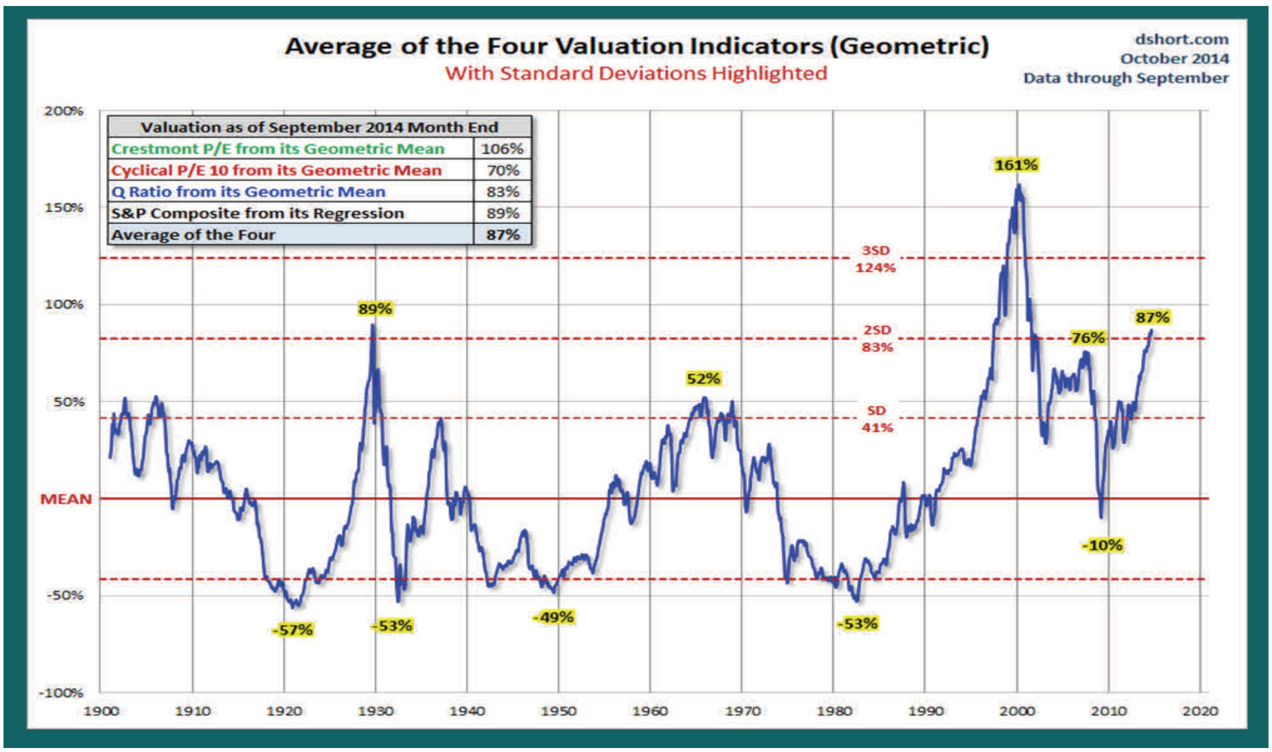
Earnings slowdowns are a normal part of the business cycle. The risk with this cycle is that many investors are not properly positioned for a surprise. Our past letters have warned the prevailing conditions of relative stability and artificially low interest rates have induced many investors to accept higher levels of additional risk for very low incremental returns. This is not a sustainable condition over the long term. The actions of U.S. and global central bankers have stabilized financial markets, but have also discouraged saving, promoted debt-financed consumption, and influenced the flow of capital towards financial speculation and away from investment in factories, machinery and technology.

When used wisely, central bank actions can be effective tools to ease specific constraints and help the economy grow at its full potential. Monetary policy can stoke the economic fire to where it will subsequently thrive on its own. Unfortunately, the magnitude of central bank interventions over the past seven years has created an environment where stimulus is no longer seen as the kindling to reignite the fire, but is now seen as the primary fuel sustaining the fire. This is why markets often fluctuate so sharply around Fed announcements and rally on weak economic data.

Monetary policy, like many medicines, may have unintended side effects. Most notably, cheap money distorts efficient market behavior, often leading to inflated asset prices somewhere in the economy. In the mid-2000's, easy money led to ballooning real estate values and a binge of reckless borrowing. Today, we fear a bubble is building in several segments of the securities markets.

There are many valuation metrics to use when discussing whether security prices are over or undervalued. Guest commentators use many different measures when discussing market valuations on business news channels. These range from rational benchmarks to "fad of the moment" metrics. Many of them have very low correlation to subsequent market returns. We do not have allegiance to any one indicator, but we monitor four with high correlations to future market returns. Averaging these four measures into one line, in Chart 1, we see equity prices are more extended now than in 2008. Such simple charts are never a catch all reason for investment action, but the chart does warrant attention.

CHART 1



Source: Advisor Perspectives

The valuation risks are noticeable in this chart. Any move above two standard deviations from mean valuations has always preceded a major correction. However, a catalyst is generally needed to drive valuations lower, either in the form of higher interest rates or slower global growth. The peaks in 1929, 2000 and 2008 were fueled by accommodative monetary policy and the belief that markets would only go higher. All three ended when growth could no longer meet the expectations built into stock prices. The one-standard deviation peak in 1937 ended with a four year bear market when global tensions overwhelmed government stimulus efforts and growth stalled.

All four of these peaks have similarities to today's environment. Investors should recognize the lessons of the past, but also notice the differences. While monetary policy has never been as accommodative as it is today, we believe rates will stay lower than many expect and will do so longer than expected, even after the Federal Reserve ends quantitative easing actions. This should support market valuations longer than expected. Finally, while it is easy to envision a scenario where events accidentally spin out of control, such happenings are quite rare in history, especially when global economies are as entwined as they are today.

Fortunately, most corrections tend to be relatively short. They may also take many forms. A quick correction of 10% or more is viewed as healthy, but sometimes more time is needed. We would not be surprised to see several quarters of low returns and sideways price movements as the economy and earnings grow enough to support higher valuations. A pause in the rally is inevitable after the gains of the past few years, although we cannot predict how it will ultimately unfold.

Predicting short term changes in market direction is a guessing game, at best. There is little evidence anyone can do it well. Rather than timing the market, investors should continue to seek undervalued investments with meaningful upside potential. This may seem foolish given the current backdrop, but there is no certainty a severe correction will come to pass. It has rarely been a wise idea to move entirely out of stocks, mainly because most fail to get back in as conditions improve. There will be pain if a correction develops but it is even more costly to miss the subsequent recovery. With patience, good companies will emerge stronger and reward shareholders accordingly.

Investment Strategy

Recent US economic data have been relatively stable and would be indicative of steady growth under normal circumstances. Other large economies, however, have been exhibiting weaker growth, extremely low inflation, and falling currencies. With international economies weakening and the dollar rising, it will be difficult for the US economy to break out of this modest growth range.

In addition to a weak global economy, geopolitical risks continue to increase around the globe. The list has an almost 1970's tone: Russia and China are increasingly bellicose towards their neighbors, the Middle East is in turmoil, and terrorist groups threaten to strike in Western countries. Adding a new twist, the largest Ebola outbreak in decades could weigh on market psychology (our collective anxiety levels are raised) and earnings as discretionary activities such as travel are curbed.

These factors point to increased risk premiums as investors become more cautious when valuing stocks. In the face of an already extended bull market, it is hard to enthusiastically call current price levels cheap. The valuation question explains much of why trading volumes have been so light this year. It also points to why volume increases so much on big sell-off days, but does not rebound on strong up days.

While we have allowed cash holdings in client portfolios to build to the highest level since 2008, we haven't become complacent. We seek to navigate these markets by sticking to our core philosophy of finding companies with superior growth, operating models and balance sheets. We have also been taking profits on stocks that have reached our price targets and selectively redeploying the proceeds into stocks that meet our criteria. This is a deliberate process. Being out of the market for protracted periods of time is a significant bet against history.

With patience, high quality companies trading at attractive prices should outperform other investments over the long-term, even in the event of a periodic market downturn.

Bonds, on the other hand, will likely benefit from the stock market turmoil as investors seek safety. We anticipate interest rates to remain low and stable for several quarters before increasing in the second half of next year. We are maintaining our current duration exposure, reflecting our belief the ongoing sell-off in equity markets, continued low inflation prospects and our below consensus view of weaker global growth will keep interest rates near current levels. Positioning on the yield curve remains important in this environment, as we seek to balance safe yield with the risks of longer duration.

Corporate bonds could come under pressure in this "risk-off" environment, but fundamentals remain strong and we do not anticipate a major credit correction absent a large systemic shock. However, we are avoiding more corporate bond exposure, except for higher quality and shorter duration issues. We are increasingly directing money into government securities, mortgage-backed securities, and higher rated municipal bonds.

Municipal bonds are now back in line with historical valuation measures but may see additional gains with any increase in income tax rates. We believe it is more prudent to hold longer duration exposure in muni's than in corporate bonds, especially since the average credit risk in municipals is lower than corporates.

We remain optimistic about the risk/reward trade off in our bond portfolios, despite the late summer downdraft. We are using sector selection, security selection, and yield curve management to help mitigate interest rate and credit risks. We are still using high quality callable preferred stocks to add yield at the front end of the curve. Many of these securities are currently being called and not all will be replaced.

We will, of course, continue to monitor these volatile markets closely, and our strategies will evolve with changes in fundamentals, global events and market data.

As always, we welcome your questions and comments. We are also available if you would like to discuss the attached chart in greater detail.