



ECONOMIC COMMENTARY

July 17, 2015

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As most readers are probably aware, the Grateful Dead drew their 50-year career to a close with a two city, five night concert tour. Careful listeners can often find sage investment advice in Grateful Dead lyrics, and the July Fourth concert in Chicago proved to be prescient in its timing. The band played “Deal” the night before Greek voters had to cast their votes for or against the bailout deal offered to the highly indebted nation by the European Union. As most readers are also aware, the Greeks voted to let the deal go down, causing markets to fluctuate wildly.

“Wait until that deal come round, Don’t you let that deal go down” - Grateful Dead—“Deal”

Volatility was prevalent throughout the second quarter. Financial markets began the period addicted to easy monetary policy, but then responded positively to strong economic data in May and June. The tug of war between rising interest rates and stronger economic data produced several sharp swings before the stronger data established supremacy. In a welcome change, good news was once again taken as good news rather than an omen of imminent Federal Reserve action that would derail markets with higher interest rates. Unfortunately, volatility spiked again as the Greek crisis unfolded and a crash in Chinese stock prices threw global financial markets into turmoil. Daily volatility surged, with the Dow Jones Industrials posting intraday swings of more than one hundred points for nine separate trading days in June.

Despite the increased volatility, the equity markets finished the second quarter virtually unchanged. Domestic equities, as measured by the S&P 500 Index gained 0.28% for the quarter and are up 1.23% on the year. International developed equities continued their recent outperformance, with the MSCI EAFE Index gaining 0.62% for the quarter and finishing the first six months of the year with a gain of 5.52%. Emerging markets did not fare as well, with the MSCI Emerging Markets Index falling 0.24% for the quarter. However, they are still positive on the year, showing a gain of 1.67%. Bonds, faced with the prospect of the first rate increase by the Federal Reserve in over eight years, fell during the quarter with the Barclay’s Intermediate Aggregate Bond Index declining 0.67%. Despite this decline, the index finished the first half of the year with a gain of 0.64%.

As summer progresses, it is likely increased volatility will be the new normal. Greece and other foreign crises continue to hang over markets. Higher interest rates are likely as the economy continues to expand, and the probability of a Fed funds rate hike this year continues to increase. The impact of one of the biggest variables facing markets in the months ahead, the strength of the U.S. dollar, has yet to fully be felt. Earnings, capital flows and economic data may

be subject to wide swings as the currency effect plays out. Any one of these factors is capable of keeping stock prices volatile in the months ahead.

To academics, volatility is synonymous with risk. In practice, it is not necessarily a bad thing. Volatility may reflect a series of positive news events that mark an inflection point in a prevailing trend. It may also be a necessary symptom of markets adapting to new realities. While it is still too early to forecast how this period will unfold, many potential positives are beginning to emerge. Domestic wage growth continues to pick up and U.S. GDP is forecast to expand by more than 3% in the second half of this year. Higher interest rates would confirm this strength and might suggest the Fed believes it is sustainable. Markets may be jumpy over the balance of the year, but we continue to see an upward bias for equity prices under current conditions. As a result, we continue to believe stocks are the best positioned asset class for the months ahead.

We expect volatility to be prevalent across many asset classes, but we do not believe all asset classes will have the same positive bias. On the fixed income side, prices should continue to move within wider ranges than we have seen in recent years. Rates are likely to continue moving higher, an effect that typically corresponds/coincides with economic growth and is consistent with the Fed's desire to normalize rates. However, we expect rate increases to be curbed by periodic "risk off" trades as investors flee to safe assets in the wake of the next

crisis. While we continue to believe rates will rise more slowly than many fear, the trend is toward higher rates. We continue to limit duration bets in client portfolios.

One of the most volatile areas over the past year has been the currency markets. The U.S. dollar has surged since last summer and remains a significant headwind for the economy. Currency translation effects are impacting corporate earnings and are placing U.S. made goods at a severe competitive disadvantage. We are looking to limit dollar exposure in portfolios. Currency trends do not reverse direction quickly and we expect dollar induced impacts to be a drag on our economy for several quarters.

While a stronger dollar is a negative in the long term, it does signal many positive signs for our markets. The dollar is strong and interest rates are rising because the U.S. is growing faster than many other economies. This strength is showing up in wage growth, housing data, and consumer confidence numbers. A strong dollar also keeps a lid on inflationary pressures. We do not foresee inflation taking hold for some time, avoiding the need for drastic changes to monetary policy. Despite the increased volatility, we believe economic conditions will allow U.S. markets to continue to grind higher in the second half of the year.

As always, please contact us should you have questions.

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