



# ECONOMIC COMMENTARY

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**“To everything (turn, turn, turn), there is a season (turn, turn, turn) ”  
- Pete Seeger—“Turn, Turn, Turn”**

The financial markets were dominated by two factors in the third quarter: the Federal Reserve and the Chinese economy. While the question of when the Fed will finally begin the move to normalize interest rates remains a point of intense speculation, it is now widely accepted that a rate increase will not occur until 2016 due to a slowing U.S. economy. China, which was widely expected to post rapid growth for years to come, has shown a sharp fall-off in economic activity. These two factors collided in early August when the Chinese central planners finally had to acknowledge their domestic growth would not meet official projections. A series of drastic moves, including a sharp devaluation of the yuan, signaled just how dire the situation in China had become. Viewed as one of the few sources of growth in a stagnant world, the “China syndrome” caused stock markets around the globe to fluctuate wildly.

The Chinese data and ensuing market turmoil removed any chance of a Fed rate hike during the quarter. The press release issued following the September FOMC meeting specifically made eleven references to troubles overseas when discussing why no action was taken. The statement was initially welcomed as the best of both worlds: strength in the U.S. combined with continued low rates due to weaker economic conditions globally. This optimism quickly turned to pessimism as investors realized low rates without growth cannot support current prices. Market participants quickly digested this new reality, sparking a sell off that lasted through the end of September.

While the press has focused on China as the cause of the recent volatility, we believe it was just a catalyst for the selling. Milton Friedman famously opined “too much money chasing too few goods is always inflationary.” While the word “goods” is typically taken literally, Dr. Friedman’s mantra seems to apply to financial assets, as well. Economists assume markets are efficient and cannot be irrational. However, central banks have been injecting biblical amounts of reserves into the monetary system and this cash has distorted valuations around the world. Prices have been inflated beyond the ability of earnings growth to support them. Markets needed an excuse to correct the excesses and China was the spark.

For now, the volatility reflects a valuation issue, not a structural issue. Security prices are a function of growth rates and the interest rate by which this growth is discounted. Prices may rise in a slow growth environment if interest rates are falling. Likewise, growth can more than offset rising interest

rates in an expanding economy. Unfortunately, growth has been hard to find in recent years and interest rates cannot go meaningfully lower.

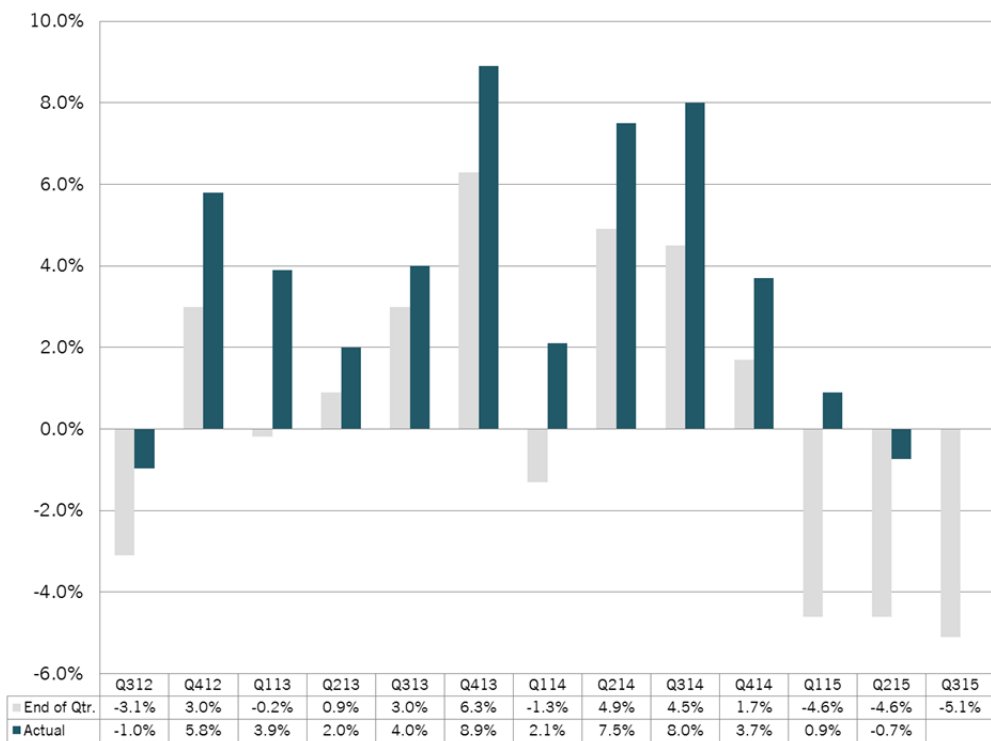
A slowdown overseas can have far reaching implications for domestic markets. Emerging markets in general, and China in particular, have been viewed as a source of growth in an otherwise tepid global economy. Much of the marginal consumption growth in this century has had its genesis in these countries

and there is little growth elsewhere in the world. Developed markets are stagnant at best. The U.S. has posted the strongest GDP growth among the G7 nations over the past few years, but even this growth has been weak relative to prior post-recession recoveries.

Global economies are more entwined than ever and the U.S. economy will not be fully immune to the global contagion. We are already seeing signs of foreign troubles reaching our shores. Many emerging markets are already in recession and cannot afford to import our goods, even before factoring the effects of a strong dollar. Domestically, dollar strength – the result of strength here and weakness overseas – is hurting corporate profits, boosting the competitiveness of imports and is weighing on exports and domestic job growth. The number of firms missing earnings targets or lowering guidance is increasing. It may be too early to suggest a recession is imminent, but it would be foolish to suggest the risks of a slowdown are not increasing.

These trends are not lost on the investment community. Earnings expectations, often led by

**EXHIBIT 1: S&P 500: Estimated Earnings Growth at End of Qtr. vs. Actual Growth**

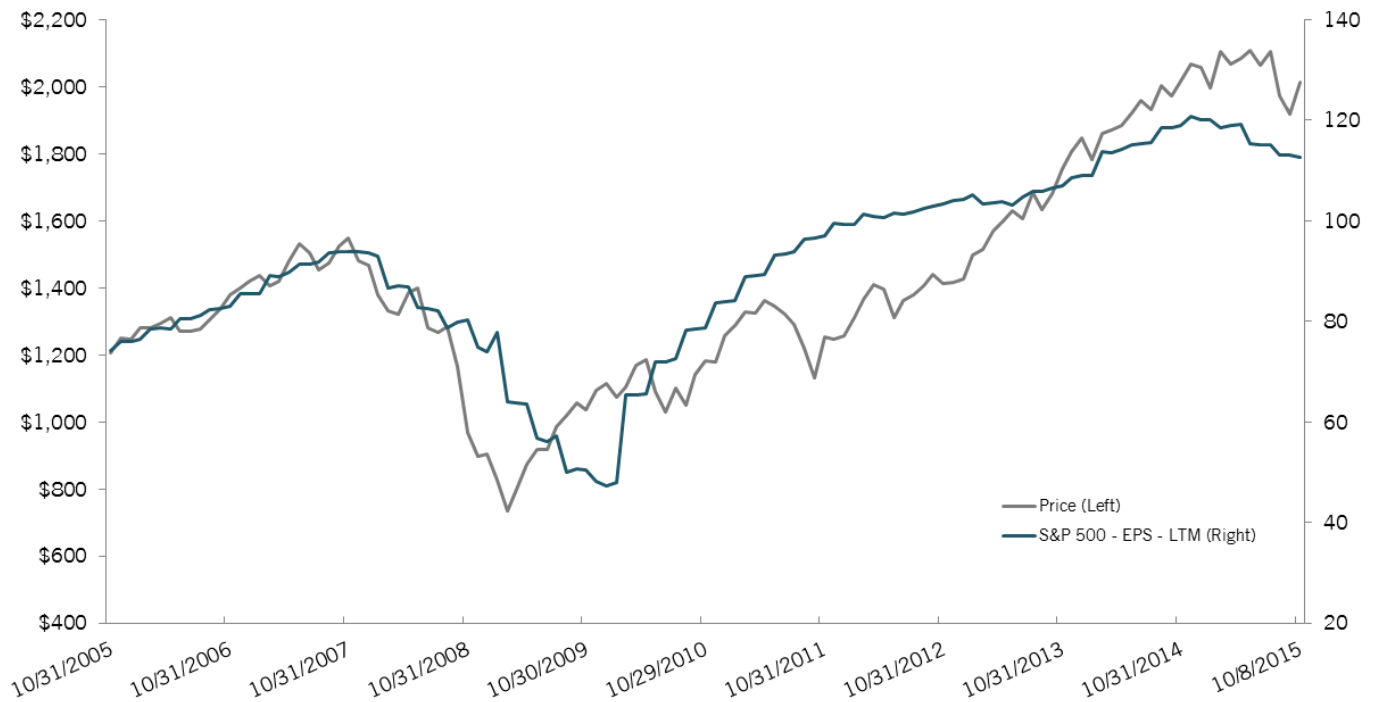


Source: Factset

company guidance, have been falling for five straight quarters. Actual earnings growth for the S&P 500 was negative (i.e. earnings fell relative to the prior quarter) in the second quarter and is projected to be negative in the third quarter as well. If this drop does materialize, it would be the first back-to-back quarterly decline in earnings since the Great Recession.

The economic cycle, like the season of the year, must turn. These turns generally take place gradually and it is not unusual for warm weather to stay well into autumn or snow to remain on the ground well into spring. To be sure, there are still many positive factors supporting the financial markets. There is certainly no reason to make wholesale shifts to investment portfolios. However, the investment seasons are beginning to turn and investor sentiments should as well. As noted in Exhibit 2, the price level of the S&P 500 has been rising faster than earnings growth for most of the past two years. The last time this occurred in normal conditions was in early 2008; shortly before the start of the last crisis. Investors chasing growth at any cost might be ignoring signs

**EXHIBIT 2: Change in Trailing 12-Month EPS vs. Change in Price: 10 Years**



Source: Factset

that segments of the markets are looking overextended.

### Strategy

Equity markets finished the quarter less than 3% off the lows of the year. Domestic equities, as measured by the S&P 500 Index, lost 6.44% for the quarter and are down 5.29% on a year-to-date basis. International developed equities reversed their recent outperformance, with the MSCI EAFE Index declining 10.23% for the quarter. On a year to date basis, international stocks have performed in line with U.S. markets, posting a loss of 5.28%. Emerging markets fared far worse, as the rout in commodity prices continued. The MSCI Emerging Markets Index fell by 17.90% for the quarter and is now down 15.47% on the year. Bonds, helped by a flight to quality, rose during the quarter with the Barclay's Intermediate Aggregate Bond Index rising by 1.08%. The index finished the first nine months of the year with a gain of 1.73%.

Of particular note, growth stocks outperformed value stocks by 2.66% during the quarter. For the year, growth stocks are 7.20% ahead of value; a negative for the value bias of the MCM

discipline. Small cap stocks lagged larger stocks on both a quarterly and year-to-date basis.

We believe there is only a minimal increase in the chance for a recession due to market action this year. By and large, economic fundamentals are still sound and should be able to weather a shallow valuation correction. However, it is prudent to start taking risk off.

To this end, we have sold some higher beta names and replaced them with lower risk companies. We continue to under-weight international markets – both developed and emerging markets – in favor of U.S. exposure. We have been increasing our exposure to smaller capitalization companies as we expect this group to begin to outperform in the quarters ahead. Smaller companies should benefit from the continuing merger and acquisition wave and generally higher exposures to domestic sales.

Great companies should keep performing well in this setting, especially if they have less foreign exchange exposure. We look to add to these positions as prices continue to improve. We also expect continued low interest rates to bode well for dividend paying companies.

The fixed income market is being driven by many of the same factors. Many government bond markets, including the U.S. T-bill market, now trade at negative yields on front end maturities. This reflects the fact investors are willing to pay governments to hold their money because they are too scared to invest their funds elsewhere. It is hard to believe a 2015 rate hike is possible given circumstances, but the Fed does seem determined to act. A December move is still on the table, but market trading implies the odds of this are falling rapidly.

Continued lower rates should be a positive for bond markets. Securities in higher quality segments, such as government bonds, should appreciate as rates fall. Economically sensitive bonds, such as corporate and some municipal bonds, may not fare as well. Lower corporate earnings mean companies have fewer funds available to meet debt service requirements. Lower rates also mean investors will likely reposition portfolios in search of higher yields. We expect continued volatility and flatter returns in the months ahead.

We have been adjusting to these new conditions by using higher grade investments for new bond purchases. We have been favoring Agency mortgage-backed securities and higher quality municipal bonds when constructing portfolios. We have been letting our corporate bonds mature and have been avoiding new purchases in this sector for all but the most appealing securities. We continue to limit duration exposure in client portfolios. The low, flat yield curve does not reward investors for extending maturities in this environment.

As always, please contact us should you have questions.

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