MAPLE CAPITAL MANAGEMENT

ECONOMIC COMMENTARY

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"Ch-ch-ch-ch-Changes"- David Bowie —"Changes"

In a widely expected decision, the Federal Reserve finally moved to begin normalizing interest rates in December. With the decision to finally take action, two long standing trends came to an end. The hike marked the first increase in reference interest rates since 2006, thereby ending the longest period of easy monetary policy since World War II. The move also ended what is probably the longest period of globally synchronized monetary policy in history. The Fed and the ECB, for example, have moved in the same direction, albeit with varying degrees of magnitude, since the late 1990's. The expected pace of rate hikes suggests it will take nearly two years to reach a market equilibrium level. At this pace, interest rates will still be quite low by historical standards for quite some time. However, the process has started and the end of the status quo will inevitably lead to some fallout.

Low interest rates have come to be viewed as an unshakable truth by investors, CFO's and politicians alike. Many have come to believe low rates will remain in place for the foreseeable future and have made decisions accordingly. Bond issuers, including the Federal government, have floated mountains of debt, while investors searching for yield have willingly purchased bonds with little regard for credit or interest rate risk. Many have argued the stock market has been pushed higher by low interest rates, which in turn lowers the discount rates used in valuation models, resulting in higher "intrinsic value" numbers. Dividend yields in excess of bond yields have also attracted massive amounts of money to equities. Markets around the world are clearly dependent on central banks to maintain prices. At some point, rising rates will cause these trends to reverse.

The divergence of central bank policy stands to be even more disruptive to market stability. For years, central banks have all been guiding rates lower. While the Fed has begun raising rates, other central banks continue holding rates steady or easing further. These divergences in interest rates - the U.S. 2 year treasury currently yields 0.85% while the German Bund yields -0.40%, for example – may have significant impacts on many segments of the world economy. Exchange rates, commodity prices and global trade paradigms may all be impacted. The capital flight that occurs with such shifts can wreak havoc with weaker economies and hurt the U.S. by causing our trade gap to widen. U.S. goods will be less competitive, hurting our economy and our workforce. These risks make it unlikely the Fed can continue to raise rates at the pace desired.

A third trend may also be about to change, regardless of the Fed's ability to raise rates. Unlike the pattern held for most of the past seven years, 2015 saw stock and bond markets begin to de-link. Much of the past decade has been characterized by a stock market that valued lower interest rates more than rising earnings. Stock and bond prices often moved in the same direction when economic data was released. In the coming year, this may no longer be true. All things equal, the bias in interest rates is to move higher – we calculate the equilibrium level of rates to be about 200 basis points higher than the current Fed funds rate. Even if rates can remain unchanged, there would likely be little impact on share prices. At current prices, earnings matter far more than rates. Economic strength will help equity prices rally, but will also lead to higher interest rates and therefore lower bond prices. We expect an inverse relationship between stock and bond prices to dominate market activity in 2016 and both asset classes should see increased volatility in the coming year.

We are already seeing signs investors are being shaken out of their complacency. Credit spreads are widening and both bond and equity price volatility is increasing sharply. Corporate earnings warnings are met with sharp price declines rather than minor dips. Weak economic data is now met with selling rather than buying in anticipation of even lower rates. It is dawning on markets that the old metrics may no longer work and the touchstone beliefs that have guided investor decisions for the past eight years are being slowly reconsidered.

Strategy

Equity markets finished the year with a strong fourth quarter rally. Domestic equities, as measured by the S&P 500 Index, gained 7.04% for the quarter, helped by an 8.44% gain in October alone. For the year, however, stocks rose a paltry 1.38%, as the late rebound merely took back some of the losses from August and September. International developed market stocks, as measured by the MSCI EAFE Index, rallied during the quarter posting a gain of 4.71%. Unfortunately the gain was not enough to offset losses incurred earlier in the year leaving international stocks in negative territory for 2015 with a return of -0.81%. Emerging markets, as measured by the MSCI Emerging Markets Index, had a flat quarter returning 0.66% and ending the year down 14.92%. Bonds, reacting to the Fed's rate hike, declined during the quarter with the Barclay's Intermediate Aggregate Bond Index off 0.51%. The index finished the year with a gain of 1.21%.

As noted above, earnings growth will be increasingly important in 2016. Valuation multiples cannot expand against a background of increasing global tensions, weakening economic fundamentals and the threat of Fed rate increases. Stock prices can only rise in such an environment if earnings increase and earnings cannot rise if the global economy does not expand. As growth overseas continues to sag and the commodity collapse threatens many emerging market economies, the risk of a contagion effect increases. We believe the chances of a recession are increasing, but still remain low. However, it is prudent to continue taking risk off the table.

We continue to lighten up on economically sensitive sectors and look to increase holdings of lower risk companies. We have also been increasing exposures to higher quality bonds. We continue to under-weight international markets and have been trimming the small emerging market holdings we have for clients. We have a value bias in our stock selection process and this hurt performance last year as growth names surged. We believe this trend will reverse in 2016 and have been increasing our exposure higher quality companies. We continue to add to smaller capitalization companies for the same reasons. Smaller companies underperformed in 2015 but should experience some mean reversion as larger companies seek future growth through mergers and acquisitions.

Our fixed income strategy remains unchanged. We expect the Fed to continue to raise rates at a steady pace, although we expect fewer increases than the consensus call of four 25-basis point hikes in 2016. We believe the front end of the U.S. Treasury yield curve will bear the brunt of these moves, but eventually the longer end will have pay the catch up. The big unknown is whether the catch up will take place this year or whether the curve will continue to flatten in 2016. We continue to keep portfolio durations on the shorter side and look to exploit bond market inefficiencies throughout 2016.

We expect corporate spreads to continue to widen, with lower-quality issues underperforming those of higher credit ratings. We expect mortgage-backed securities (MBS) to hold steady as originations and prepayments abate, at least until the Fed stops re-investing their MBS portfolio repayments. Finally, we are very constructive on municipal bonds. We expect this sector to continue its strong relative performance and we expect municipal yields to once again trade solidly through comparable U.S. Treasury securities due to improving municipal finances and the increasing probability of higher taxes in the years ahead. As a result, we believe this sector is one of the few segments of the bond market to offer capital appreciation potential.

As always, please contact us should you have questions.

For further information, please contact Steven Killoran, Vice President Business Development at 1-802-229-2838 or at skilloran@maplecapital.com. For further information about Maple Capital, including a copy of our informational brochure, please visit our website at www.maplecapital.com.

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