MAPLE CAPITAL MANAGEMENT

Economic Commentary

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Just a Box of Rates

It is a sad fact of life that not all anniversaries are celebrated appropriately. March marked the seven-year anniversary of the U.S. stock market low during the 2008-2009 Debt Crisis. Propelled by record low interest rates and aggressive Federal Reserve monetary policy, the U.S. stock market has continued to grind higher since the bottom was established on March 9, 2009. The resilience of this rally has been as remarkable as it has been stealthy. Barring a sharp correction, this will be the second-longest bull market in U.S. history by the end of April.

This run to new highs has not been widely embraced by market participants. Surveys conducted over the past seven years have continually highlighted investor skepticism over the quality and sustainability of the rally. Much of this skepticism is rooted in the fact this has not felt or looked like a normal economic recovery on many levels. The current expansion has been tepid in comparison to previous recoveries. The steady improvement in GDP growth, for example lags prior recovery patterns. Employment gains have not inspired consumer confidence, as many of the new jobs created have been in lower wage service and retail positions. Many workers remain underemployed, as measured by the Department of Labor U-6 figures. Even the falling unemployment rate has had less impact than in normal cycles as much of the change is explained by discouraged workers dropping out of the workforce and not the creation of actual new jobs.

The slow but steady gains in the economy have contrasted with the generally hotter gains of the stock market. On the surface, this appears to be a disconnect. Corporate revenues have generally grown in line with GDP but earnings-per-share and stock prices have grown much faster. Companies have increased margins by aggressively cutting costs and streamlining operations. An additional catalyst for the market's move higher has been monetary policy, which has allowed companies to reduce borrowing costs and to fund acquisitions and massive share repurchase programs with cheap debt.

Many would argue the use of monetary policy has gone too far and bubbles are being created in many parts of the economy as a result. The Federal Reserve had to move aggressively during the financial crisis to prevent further damage to the system. The Fed became more creative in the years that followed, as traditional monetary tools failed to stimulate growth. The introduction of quantitative easing was a radical move intended to jump start economic growth in this country. Central banks around the world have since copied the American playbook and have moved aggressively to implement their own versions of the policies. The European Central Bank and the Bank of Japan, for example, have expanded the boundaries of quantitative easing. Many have taken additional steps, such as the introduction of negative interest rate policies, in an attempt to foster growth and influence the value of their currencies.

The Fed and its counterparts around the globe have been relentless in their efforts to add liquidity. In doing so, they have effectively distorted many of the market forces they were looking to influence. Many economies are now overleveraged. The current level of stock prices in many countries would be considered over-valued in a normal interest rate environment. Markets are now so dependent on easy money policies, any unilateral attempt to change the status quo is met with market, and sometimes economic, disruptions somewhere in the world.

This new construct was clearly demonstrated in the weeks following the December rate increase in the U.S. After the Fed announcement, currencies fluctuated, emerging market stocks and commodity prices fell and asset price volatility sharply increased. Fed officials used several high profile appearances during the first quarter to assure markets further rate hikes were not imminent, despite the FOMC's desire to continue down the path towards interest rate normalization.

The Fed has now found itself tightly squeezed into a box of its own making. By pushing the boundaries of monetary intervention, it has sent a signal to the marketplace that it is willing to do what is needed to stabilize markets. Other central bankers have happily followed suit, with some overseas actions making the Fed seem timid. These actions have collectively released a tidal wave of cash into the global economy. Markets are now addicted to this cash and any attempt to remove the stimulus will be highly disruptive to the new status quo. Yet by not acting, central banks are adding to the long term instability of the financial system they have been working so hard to save. We believe these conditions will keep the Fed on the sidelines for at least several more quarters. Even if domestic economic circumstances improve dramatically, there may be little room for a unilateral move. Recent FOMC meeting minutes specifically cite foreign market turmoil as a reason for not hiking rates in the first quarter. It appears we may be heading for a rare period in which U.S. growth rates may not be the primary driver of Fed policy, or even a primary force behind global market moves.

Strategy

Helped by a 6.80% surge during the month of March, domestic equities, as measured by the S&P 500 Index, overcame a first half decline of over 10% and ended the period with a gain of 1.35%. Foreign stocks did not experience the same rebound and again lagged domestic markets, posting a return of -3.01% during the period, as measured by the MSCI EAFE Index. Emerging market stocks returned 5.71%, as measured by the MSCI Emerging Markets Index, and were the clear winner during the quarter. This reversed a trend that had been in place for much of the past two years. Bonds were also positive, with the Barclay's Intermediate Aggregate Bond Index handing investors a gain of 2.31% through the end of March.

Having weathered sharp corrections in September and January, the seven-year market rally seems to be intact for now. There is little likelihood of a U.S. recession in the near-term and the risk of a significant slowdown in Chinese growth rates appears to be easing. With central bankers around the world taking whatever measures they can to support their economies, the short-term outlook seems stable.

The bull however, is beginning to show its age. Most indices remain close to all-time highs and valuations remain elevated. Modest gains are still possible, and even probable, under current conditions, but there is meaningful downside risk in the event of a slowdown, recession or unexpected event. The risk/reward profile is slowly beginning to shift in this slow-growth environment.

One of the clearest signs to watch will be the corporate earnings reports of publically traded companies, the flood of which will begin before this letter is even mailed. Corporate earnings growth, specifically from non-energy related companies, is widely expected to be negative for the first quarter of 2016. This would be a significant development for investors to consider. Corporate profits have grown steadily despite flat revenue growth and the negative effects of foreign currencies. Rising productivity, debt-fueled acquisitions and share repurchase programs, and falling commodity prices have helped to keep margins and earnings per share high. In today's slow growth world, any change to these factors will lead to earnings disappointments and falling prices.

This backdrop suggests pressure will increase on both stock multiples and bond yields, potentially pushing both lower. It is prudent to be risk averse in this setting. We continue to move toward higher-yielding, value-focused equity portfolios. This search for value includes companies overseas, since many foreign stock markets now trade at values well below those found in our domestic markets. This has led us to modestly increase international holdings during the quarter, although we continue to remain under-weighted in international markets.

Our fixed income strategy remains unchanged. As discussed above, we believe the Fed remains constrained in a box of its own making. FOMC minutes show the governors would like to raise rates at a steady pace. However, their options are severely limited by the global macro-economic environment. We foresee just one rate hike in 2016 and even this is not likely until later in the year. We have lengthened portfolio durations slightly during the quarter and continue to find values in several segments of the bond market.

Corporate bonds have rebounded with the stock market and bond spreads have tightened over the past two months. There are still values to be found in this sector. We also remain very constructive on municipal bonds. Taxable municipal bonds are particularly attractive in this sector. We expect some dislocation due to the situation in Puerto Rico and legislative initiatives to allow for the Commonwealth to restructure its debts. The continued budget problems in states like Illinois and New Jersey are also giving investors pause. These issues should not be enough to derail the strong relative performance of municipal bonds given the increasing probability of higher income 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.

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