Economic Commentary

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Days of Future Past

Great Britain stunned global financial markets on June 23rd by voting to leave the European Union (EU) triggering a massive global equity market sell-off. Chinese, U.S., and British markets were down 3-to-4%, German, French, and Japanese markets lost 7-to-8%, while Italian, Spanish, and Greek markets lost in excess of 12%! Originally given a low probability of success, the "NO" (i.e. Leave) vote clearly caught many by surprise. Most European markets and the British Pound had rallied in the days just prior to the vote. The final results forced investors to re-evaluate their investment theses and macro-views of the global economy.

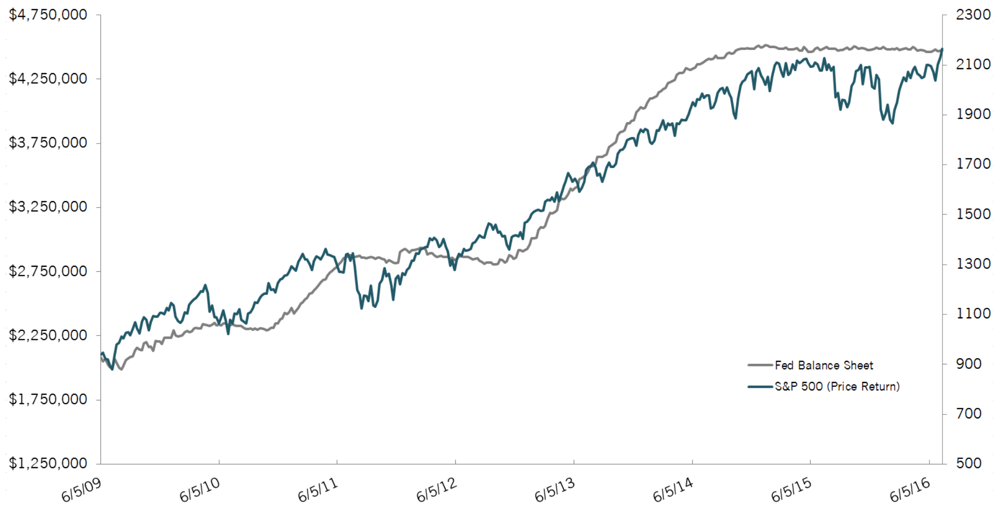
While the shock of Brexit sparked a global equity sell-off, it also ignited a sharp rally in "safe" assets such as bonds, gold, the U.S. dollar and the Japanese Yen. Yields on government bonds plunged as investors sought safety in sovereign debt. The German 10-year Bund yield, for example, turned negative – falling to -0.19% as of the time of this writing - while the U.S. Treasury 10-year note hit a record low at 1.318%. Nearly $13 trillion worth of bonds – virtually all of which were issued by national governments – now trade at negative yield levels.

The sell-off in global equity prices quickly reversed and has since turned into one of the strongest stock market rallies in years. The rebound in stock prices was not sparked by the sudden realization that the "Brexit" vote was somehow of great benefit to the global economy. To the contrary, as it became clear that the vote was a potentially systematically destabilizing event, investors quickly recognized that easy monetary policies would have to be maintained far longer than commonly expected just one month ago. Even the minutes of the June Federal Reserve Open Market Committee (FOMC) meeting showed the Fed was concerned about the impact of a "No" vote on the financial system. Central bankers around the world used every opportunity to assure markets they were prepared to do whatever was needed to prevent the vote from sparking a crisis.

Easy money has been the lifeblood of the financial markets for the last seven years. Since the Fed began its use of quantitative easing activities at the end of 2008, the rise of the S&P 500 has mirrored the growth of the Federal Reserve's balance sheet. The role of monetary policy cannot be understated. Quantitative easing has more than offset the effects of what has been, at least by historical standards, a relatively tepid recovery. Chart 1 shows the tight correlation between the growth of the Fed balance sheet, in trillions of dollars, and the recovery of the stock market since the start of q/e activities.

The correlation of the lines illustrates just how significant the effect of monetary policy has been for the recovery and on asset values. This lesson is not lost on investors. This is why every serious discussion of the Fed ending quantitative easing over the past four years has been met with a sharp increase in volatility. Looking at the chart above, it is easy to understand why investors have regularly looked past weak employment and growth data and supported what is now one of the longest bull markets in history.

EXHIBIT 1: Fed Balance Sheet vs. S&P 500 Since June 2009



Source: Bloomberg Financial L.P., Federal Reserve

This chart also explains why many investors are looking past the uncertainties created by the "Brexit" vote and are viewing the increased risks as a reason to buy rather than a reason to be concerned. The uncertainty created by the vote will not blow over quickly. The referendum is not legally binding, as it takes an act of Parliament to commence the process and even this first step will probably be highly contentious. The whole departure process will literally take years to unfold, keeping the global financial markets hostage through the negotiations. Amidst all the variables and unknowns, one thing seems to be certain: the Federal Reserve, the ECB, the Bank of England, and other major central banks will likely remain highly accommodative during the lengthy transition period, at least if bankers are to be taken at their word. It this siren song of easy monetary policy remaining in place for years to come that is prompting money to flood into stocks.

As oceans of essentially free cash wash over markets, it should be remembered this will not be a period without risks. A British departure from the EU will most likely leave both the UK and the EU worse off than they are today. Britain sends about half of its exports to Europe and may face tariffs going forward. Many banking functions will have to leave Britain. London real estate is some of the most expensive in the world and the fear of soaring vacancy rates as financial firms relocate to the Continent has forced at least six property-linked mutual funds to halt redemptions.

There will also be pain in other countries. The EU is losing its second-largest member, which will clearly have an economic impact. Britain sends about 350 million Euros a week to Brussels and, if suspended, it puts a far greater onus on the stronger northern members of the EU who have been subsidizing the weaker southern members for years. Currency fluctuations and a recession in Europe may also have far reaching impacts on other countries.

Despite these risks, investors will continue to stick with what has been working. They have seen how low rates have supported markets by lowering borrowing costs and allowing corporate stock buybacks and acquisitions to be completed with very cheap funding. This has been a winning formula for seven years. It also appears this will also be the pattern of the future, as well. However, the risks are clear – asset bubbles will build along the way and when easy money finally ends or the bubbles pop, there will be volatility in the equity markets.

Strategy & Market Outlook

Global equity markets shook off the turmoil caused by the June 23rd vote in Great Britain and ended the second quarter with a gain. The S&P 500, for example, posted a gain of 2.46% for the quarter, virtually all of which was realized in the last week of the month. The seven-year stock market rally seems to be intact for now.

With the Fed on the sidelines and economic data showing signs of acceleration, there seems to be little likelihood of a U.S. recession in the near-term. Valuations are not stretched, especially when compared to the alternatives available to investors. The dividend yields on the common stock of a large number of high quality companies now surpass the yields on the 10-year bonds of these companies. Johnson and Johnson, for example, pays a 2.60% dividend on its common stock while its 10-year maturity debt only yields just under 2%. J&J has raised its dividend for the past ten years and will probably do so for the next ten years. A J&J bond, by comparison, can only pay the same flat rate for the entire time. Stocks have always been a great source of rising incomes. This will probably be even more true in the future and this is the best argument to putting more money into equities.

Our fixed income strategy has been adjusted to reflect recent events. As discussed previously, we believe the Fed remains constrained by past decisions. There is certainly a case to be made for raising base interest rates sooner rather than later and many Fed governors have stated their desire to see this process begin. Such a move, however, would be sure to cause market disruptions. Given the pattern of slowing global growth rates and the impact of the British vote, we believe the Fed will be very hesitant to act pre-emptively; its options are just too severely limited by the global macro-economic framework. We do not believe we will see a rate hike in 2016 and may not see the Fed act until the second half of next year.

We continued to modestly extend portfolio durations during the quarter and continue to find values in several segments of the bond market, including municipal bonds and "cross-over" corporate bonds. We are, however, resisting the rush toward sovereign debt, including U.S. Treasuries. Despite the uncertainties surrounding Britain and the EU, it is difficult to understand the purchase of government securities at these yield levels. It would only take a mere 17 basis point interest rate rise to wipe out the twelve-month return of the U.S. Treasury bond. And U.S. Treasury securities have positive yields! The downside is even worse for sovereign bonds with negative yields.

The risk/reward profiles of government securities are skewed toward high risk with minimal chances for positive return. The trade-off only makes sense if investors expect broader use of quantitative easing if the global economy remains weak or if the U.S. economy slips into recession. We do not believe either of these events will come to pass, at least on the scale needed to make the purchase of a negative yield a profitable trade.

Puerto Rico Update: On July 1, Puerto Rico missed nearly $1 billion in bond payments, including $780 million in general obligation debt. The move came just one day after Federal legislation providing a legal pathway for debt restructuring was signed into law. The new legislation, called Promesa, creates a Federal oversight commission and allows for the Commonwealth to restructure its debts in similar fashion to a bankruptcy proceeding. While the law does not extend to states, it does pry a crack in the long held position that state-level governments cannot seek to relief from their debt. It is feared that debt-laden states like Illinois and New Jersey will seek similar legislation. There is little near-term risk of such extension and we believe this sector is one of the few segments of the bond market to still offer capital appreciation potential. However, this is a significant disruption of what had been a sacrosanct promise. We will be watching developments closely.

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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