Economic Commentary

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**"Don't you let that deal go down, no, no
Don't you let that deal go down"** **- Grateful Dead - "*Deal*"**

While it would be hard to glean from the newspaper headlines, we are in one of the stronger bull markets in history. Stock prices, as measured by the S&P 500 Index, were up 6.06% in the first quarter of 2017 and are now up 11.31% since the elections last November. More telling, markets have gained 19.89% since the "Brexit" vote last June and are up 32.03% since the recent cycle low set on February 11, 2016.

The stock market is now in its ninth consecutive year of positive returns, making this the second longest bull market on record. Although there have been some hiccups along the way– usually Federal Reserve or Federal government policy induced—this has been a remarkable run, by historical standards. To put this in perspective, the average life of a bull market in the U.S. is only 61 months, or just over five years.

The move in equity prices has been supported by nearly eight straight years of positive economic growth; including 85 straight months of private sector job growth. Admittedly, the economic growth we have seen during this period has been weaker than that of previous expansions. However, this may have prevented irrational behavior from taking hold and asset bubbles from forming.

As the market continues to climb, speculation is inevitably building as to when the "up cycle" will end. Since this is already an aging bull market, many believe it might end soon. However, bull markets do not die of old age; they die when future economic growth rates can no longer support aggregate equity valuations. If valuations are high, even a modest slowdown in the economy can precipitate a correction. However, if valuations remain reasonable, expectations for future economic growth must narrow sharply or even contract before equity prices fall.

For now, the economy seems to be rising at a steady pace. There is little sign of a looming slowdown in growth, although several economic data measures, such as the labor force participation rate and the under-employment rate, point to a weaker economic picture than that painted by headline unemployment numbers. Furthermore, interest rates are artificially low and must eventually rise, potentially weighing on future growth. While we are not in a bubble, valuations are not cheap. Factors such as the CAPE (cyclically-adjusted Price-to-Earnings) ratio, trailing price-to -sales ratios and earnings yield, are high when viewed as stand-alone items. This suggests a short term pull back may be in order, even if the longer term bull market remains intact.

The bullish camp, including many strategists from major financial firms, is more positive on the outlook for future growth. Accelerating global growth rates, strong corporate earnings, and the prevailing low interest rate environment are common data points used in their arguments. Even domestic growth looks to be improving and consumer confidence continues to climb. The proposed legislative initiatives of the Administration – deregulation, tax cuts, infrastructure spending and the negotiation of better trade terms – have also boosted the optimism underlying the bullish view. The big variable is whether or not these come to pass.

We will opine that both sides are correct in their arguments. The financial markets remain attractive under current conditions. There is little risk to security prices as long as factors such as interest rates, government policy and economic growth rates remain relatively unchanged. However, economic conditions are never static. If any of these factors experience material change, security prices will be impacted. We note interest rate trends are shaping up to be a strong negative factor, given recent developments. However, economic growth rates can certainly accelerate from the muted levels we have seen over the past eight years. Positive economic policy developments would certainly help this acceleration.

We see two longer term risks to the status quo. Foremost, interest rates have been held artificially low for most of this century. We know the Fed would like rates to normalize. Most economists expect to see regular increases in the Fed funds rate and the discount rate well into the future. However, there has been little discussion of the Federal Reserve's balance sheet. Any effort to normalize rates will have to include a plan to deal with these holdings. When the Fed begins to unwind its securities portfolio, even with the simple step of halting reinvestments, the market will react. The Fed holds approximately $4.5 trillion of government bonds and mortgage-backed securities. Placing even a portion of these securities back in the market will impact market rates.

The second risk is the rising level of geo-political tensions. It is foolish to predict if or when conflicts will break out into open hostilities, yet global tensions are rising as nations seek to move their own agendas forward. We cannot model how such developments will play out, but there is a rising risk that something will happen to disrupt the status quo. This is normal. The Cold War ended approximately twenty-five years ago and the relative peace we have experienced since then is the exception, not the norm. Investors will have to learn to incorporate these risks into security prices when putting money to work.

If the trend of rising interest rates and increased geo-political tensions continues to evolve, it will become an environment we have not seen for decades. We have to go back to the late 1970's to find such a combination of events. Market multiples were much lower during that time period. If we revert to those metrics, stock prices will likely fall. For now, this appears to be a worst case scenario and we remain optimistic that the necessary policy deals will be negotiated. If the deals get done, the bull market still has room to run.

Strategy and Market Outlook

Equity prices have continued to rally in 2017, as the post-election market surge carried over into the first quarter. Economic data continues to improve and corporate earnings have been strong. With expanding growth rates (real GDP may come in over 4% for first time in over 10 years) and surging consumer confidence numbers, there is little reason to suspect a correction is imminent.

The optimism lifting the markets was evident for most of the quarter. The Dow Jones Industrial Average set a new record for consecutive up days (12) during the quarter and new all-time high records were set multiple times. The Dow broke the 20,000 level in January and the 21,000 mark in March. Markets seemed to be off to a rousing start. And then the health care reform bill failed to pass in Congress.

While the bill would have had little direct impact on the financial markets, its failure exposed the difficulties facing the Administration's legislative initiatives. Investors had assumed these bills would be whisked through Congress in the months ahead. Many economic models and earnings forecasts have been updated to incorporate the pro-growth policies of the Trump Administration. If these policies do not pass, expectations will have to be revised. Markets have begun to digest this risk and expectations are being dialed back accordingly.

The bulk of the post-election gains remain intact, despite the weakness of the past few weeks. We do not believe these gains will be severely eroded by the failure of any single policy vote. The rally started long before the elections and is based on fundamental improvements in the economy. There is no doubt the Trump economic proposals have helped reinforce investor sentiment. The failure of any one vote should not have a material impact on market prices.

Despite the market being in the ninth year of expansion, it is not clear that we are in the "late market" stage yet. This phase of a market cycle is usually characterized by tight monetary policy, slowing economic growth and the relative outperformance of defensive stocks. We note growth is picking up and monetary policy remains accommodative (the Fed funds rate still remains below the rate of inflation). Growth oriented names have been out-performing. These items are consistent with a "mid-market" stage of the cycle. This suggests the market, barring a shock to the system, still has room to run.

The picture for fixed income is not as clear. As mentioned above, interest rates will be the wild card. Multiple Fed governors have publicly voiced the opinion that up to three additional rate hikes will be coming later this year. The balance sheet issue, which has rarely been discussed since the advent of QE activities, is now mentioned regularly whenever FOMC members speak.

These hawkish comments suggest higher rates will be forthcoming in the not too distant future. This view is consistent with the view that equities are still in the mid-market phase of the cycle.

Interest rate increases will continue to reflect the expected strength of the economy. The bond market staged a rather significant recovery at the end of the quarter, bouncing solidly off the March lows. The low (in price terms) was set following the March rate hike by the FOMC. The bond recovery began after the failure of the healthcare reform bill raised questions about the Administration's ability to get pro-growth bills through Congress. This focus on growth and policy suggests the Fed's ability to unilaterally direct rates is beginning to erode. This is the sign of a healthy economy, one in which credit analysis and security selection may trump (no pun intended) central bank actions.

In terms of sector performance, corporate bonds, both investment-grade and high yield, continue their multi-quarter dominance in terms of relative performance. Despite a slight widening in March, spreads in the corporate bond market remain near five-year narrows, both in terms of quality spreads within the sector and relative to other fixed-income sectors. Treasuries essentially earned their coupon in the quarter, while mortgage-backed securities lagged on a relative basis due to fears of extension risk with rising interest rates.

Municipal bonds performed well in the quarter, after posting weak returns in 2016. Municipal bond prices are sensitive to changes in the tax code. Higher marginal rates make the bonds more appealing, causing their prices to rise. Conversely, lower marginal rates make the bonds less attractive, causing prices to fall. Municipal bond prices have been under pressure since the election due to President Trump's pledge to slash Federal tax rates. The legislative difficulties encountered with the health care reform effort suggest a drastic overhaul of the country's tax code might face more hurdles than previously expected. While we think it is too early to suggest tax reform is dead, we have used recent strength to reposition portfolios and lock in gains where appropriate.

Without better clarity on the interest rate cycle, maturing securities will be reinvested according to portfolio needs, but we anticipate a slower rate of active repositioning of portfolio holdings. We are looking at increasing the credit quality of portfolios due to concerns the credit cycle may be showing signs of age. Spreads are now quite tight across all sectors of the corporate bond market and even a modest widening might wipe out the excess income earned in the sector.

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

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