July 14, 2006

MAPLE CAPITAL MANAGEMENT, INC.

Quarterly Economic Commentary

Economic & Financial Market Outlook

As we noted in our last letter, we believe that the rapid growth in corporate earnings is starting to slow. The price action of the past two months implies that other investors are also coming around to this point of view. Since reaching a six year high on May 8th, stock market indices have pulled back across the board. As measured by the S&P 500, U.S. stocks have lost 4.1% of their value since hitting the May peak, while international stocks fell 6.8% and emerging markets dropped approximately 15%. For the full quarter, the S&P 500 fell 1.46%, although it was up 2.76% on a year-to-date basis through June 30th.

The media has placed much of the blame for the recent correction on rising interest rates. Indeed, the spectre of higher rates is a very real threat to the markets. Even as our own Federal Reserve appears to be one or two more hikes from the end of its tightening cycle (no, they are not done yet), other central banks around the world are just getting started. Even Japan, which has long maintained what is an essentially zero interest policy, appears to be on the cusp of meaningful rate increases.

The pain caused by these rate hikes is being felt by many. Millions of homeowners who took out adjustable rate mortgages in the past few years are now seeing their monthly payments increase dramatically. Especially hard hit will be real estate speculators and people who bought more home than they could otherwise afford by using aggressive versions of floating rate mortgage products. Companies are being hurt too, since most commercial bank loans float with market rates.

It is important to remember that interest rates have been raised for a reason. Central bankers understand that the costs of runaway inflation to the world economy as a whole would far surpass the pain suffered by those who have overextended themselves in a period of artificially cheap money. As an additional benefit, savers, who have suffered with low rates while borrowers benefited, are finally seeing a return to realistic payment levels on their funds.

By moving to cap inflation now, the Federal Reserve is attempting to prevent the rampant inflation that the nation experienced during the surge in commodity prices in the 1970's. We believe that the Fed is making the appropriate moves and that both the U.S and the global economies will continue to expand, although at a slower pace than most market pundits have projected.

The difference between sustaining the current rate of growth and simply having slower growth may seem to be a minor distinction, yet it can mean a world of difference to markets if stock prices reflect unwarranted optimism. The case can be made that stocks do look cheap when compared to forecasted earnings. Our concern is that investor dollars have gravitated towards growth stories with little regard for valuation and risk. The prices of many of these securities leave little room for error. Without making any forecasts on the direction of the economy, we note that the world today is much different than it was just a few years ago. One only has to open a newspaper to see that multiple issues exist that could impact the global economy. Certainly, high quality stocks with consistent earnings and strong balance sheets - the kind that we look for at Maple Capital - should ride out any near term turmoil with minimal damage. In the short run, however, the ten-year Treasury note has rarely looked better.

Q2 key market data	06/30/06	Q2 % change
S&P 500 Index	1,270.20	-1.90%
DJ Industrial Avg.	11,150.22	+0.37%
Nasdaq	2,172.09	-7.17%
Oil	$ 74.17	+11.23%
Gold	$615.85	+5.52%
$/Euro	$1.2788	+5.63%
10 Year Treasury Note	5.13%	-

Investment Strategy

While we have used quite a bit of space here and in our prior letters talking about rising interest rates, the recent pull back in the stock market was not caused by rising rates alone. The continued upward creep in energy prices and interest rates is beginning to take a toll on discretionary spending. Inflationary pressures are beginning to erode corporate profits. Average hourly wages, for example, are up 3.9% over the past twelve months.

Many of these pressures are starting to show up in corporate earnings releases. Companies such as 3M, Advanced Micro Devices, Alcoa and Lucent are just a few of the well known companies that have warned of earnings shortfalls in the past few weeks. Earnings risks and rising international tensions are weighing on investor psychology, keeping many on the sidelines. This new found respect for risk is refreshing and a sign that rationality may soon be returning to market prices.

The silver lining to this sudden risk aversion is that many quality companies are being sold off along with the more speculative issues. The markets have gone through these phases before. Using the weakness to buy high quality companies has been a good strategy for the long run, although it has not always provided immediate gratification. However, a company like Adobe Systems will provide its own floor for its stock price. With almost $2 billion in cash, no debt on its balance sheet, and over $800 million per year in operating cash flow, Adobe can and will step in and buy its own stock as the price slips. At a historic low of 20 times next year's earnings, the stock price does not reflect Adobe's strong growth prospects from a pipeline of new products. The products are designed to capitalize on technology trends, such as mobile and wireless devices and the transition towards digital rather than paper documents.

Our fixed income outlook continues to call for a range bound market, with the benchmark ten-year Treasury note trading between a 5% and a 5.50% yield, although our strategy to address this outlook has shifted somewhat. We have held very short duration portfolios for our clients over the past few years. We are now extending maturities across most of our portfolios and will look to buy long term bonds as rates hit the upper end of the range. These purchases will concentrate on Treasury securities and non-callable agency notes since these instruments will allow us to both minimize our call risk and avoid the accelerating erosion of corporate bond quality.

It is our belief that inflationary pressures will dissipate, probably sooner than expected by many in the industry. Central bank action, a global abundance of mobile money supplies, and the recent weakening of commodity prices all point to a slow down in inflation sometime in the not too distant future. Even some energy costs are starting to moderate, with prices for natural gas down over 60% from the highs set last December. Even the price of oil may moderate somewhat should tensions in the Middle East ever be resolved.

We are also starting to see stock prices and bond prices delink from each other. Should the economy slow at a faster rate than expected, earnings growth will taper off and stock prices will be impacted accordingly. But a slower economy should cause interest rates to come down and bond prices to rise. In addition, bond prices tend to hold value or even rise in periods of turmoil while stock prices tend to be weak. We suspect that few people would suggest that the level of turmoil is falling. Fixed income securities may not return 20%, but owning some bonds is a good way to hedge risk in this environment.

Addendum to Commentary

We completed this quarter's commentary just as tensions in the Middle East escalated with the outbreak of fighting over the Lebanon/Israel border. Wars in the Middle East are rarely good for markets. Obviously, we cannot predict how the current conflict will unfold, but we do know that markets often act irrationally during times of crisis.

Given the near impossibility of quantifying how these events will unfold, we have decided to mail the commentary in its prepared form to reflect our current thoughts without war. This is not to say that we will ignore the fighting when we make our portfolio decisions, but rather that the fighting will hopefully be temporary while the underlying economic trends will remain in place after the crisis is concluded. We further note that our investment process is based on finding companies that trade at prices below where their cash flows suggest they should be trading. This focus on cash flow and quality should continue to serve our clients well in what could be a volatile market environment.

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