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MAPLE CAPITAL MANAGEMENT, INC.

### Quarterly Economic Commentary

Shaking off the dramatic sell off in late February, the first quarter ended in the black with the help of a solid March rally. After dropping nearly 5% from its mid-quarter high, stocks bounced back in the final weeks of the period to end the quarter up 0.70% as measured by the S&P 500 index. Bonds fared a little better with the Lehman Index up 1.57% for the first three months of the year.

While these are hardly awe inspiring numbers, one must remember that this was a quarter that saw more than an average number of market moving events. Surging commodity prices, the collapse in sub-prime mortgages, and the stand off between Britain and Iran over the 15 British service personnel all contributed to market jitters. Most notable, and most overlooked by the popular media, was that virtually every major central bank, with the exception of our own Federal Reserve, tightened credit in some form during the quarter. In fact, it was the Chinese central bank raising margin requirements that sparked the 416 point decline in the Dow Jones Industrial Average on February 27<sup>th</sup>. When the Japanese Central Bank raised its base lending rate by 25 basis points to 0.50% or ½ of 1% (the comparable US rate is 5.25%), the financial news was rife with speculation about the end of easy money.

The market's resilience in the face of the events of the past year is a testament to the continued strength of the economy, both here and abroad. The growth in GDP and corporate earnings continues and the unemployment rate stands at 4.4%, the 18th consecutive month below 5%. The stock market is currently in one of the longest periods of growth ever and we have not seen a 10% correction in over four years.

It is this background that is causing us concern. There are numerous examples of markets shaking off rising rates as the cost of growth. Valuations today are reasonable and even seem cheap to those whose

memory only extends to the 1990's. If the fundamentals are so strong, why would the market sell off on fears that the era of cheap money is coming to an end? Even the wave of defaults on sub-prime loans is being viewed as more damaging to the economy as a catalyst for tighter credit standards rather than for the actual losses inflicted to lenders. These signs indicate an underlying economy that is far more sensitive to credit than to real demand for earnings growth. Cheap capital has allowed consumers to spend at an unsustainable pace while corporations and hedge funds have used cheap money for activities that would have been punished by the financial markets in the past.

This is distinctly different than market bubbles where stock prices get disconnected from earnings power. Real economic growth in the late 1990's was average but stock prices ballooned due to a colossal expansion of valuation multiples, for example. Today, however, market multiples are at or just above historical averages despite the underlying growth of earnings. The "bubble" in the '90's was in stock prices. In this decade, we may be seeing "bubbles" in real estate values (already a widely accepted view), corporate earnings and consumer spending. Unfortunately, things are rarely seen as unsustainable until after the fact.

Cheap foreign money has supported stock prices (as seen in record levels of margin debt, leveraged buyouts, and debt financed repurchase programs) and fueled economic growth. The influx of foreign capital has provided a supply of money to offset this demand so rates have remained stable. It has kept the dollar strong, inflation low, and has helped home owners of all stripes since mortgage related securities, even those of the sub-prime variety, are a favored destination for much of this capital.

This brings us back to the quandary facing

the Federal Reserve. As foreign rates rise, there is less incentive to send funds here. Furthermore, cheap money, from any source, has always lead to higher inflation, the seeds of which are readily apparent today. If the economy slows, inflationary pressures may limit rate cuts. Even if the Fed cuts its overnight rate, market pressures will likely keep longer term rates high, if just to keep attracting foreign money. If the Fed Funds rate remains unchanged or is raised, longer term rates will also rise to maintain a normalized yield curve. Any increase in the cost of capital will have an impact on the economy, although we cannot say when it will materialize. However, higher rates and rising geopolitical tensions are not a good combination. We suspect that, after a long absence, volatility has finally returned to the financial markets.

## Investment Strategy

Like a storm building in the Atlantic, the economic clouds that we see must be watched. Not every storm makes land fall and not every storm becomes a hurricane. Few storms actually follow the path that forecasters predict. What is important is that people are prepared if a storm comes ashore.

The financial equivalent of stocking up on milk, bread, and firewood (who needs electricity when you have your wood stove?) is to make sure that client portfolios do not have exposure to the affected sectors of the economy. When we wrote about the problems in mortgages last summer, we also reviewed all of our holdings to quantify how much risk we had to that sector. The mortgage foreclosures have made landfall and the impact on our portfolios has been minimal. The inflationary storm and the interest rate storms are still at sea and may not even come ashore. However, we are looking to hedge against that possibility.

The silver lining to these clouds is that good companies often get thrown out with the bad due to headline risk. We have always tried to take advantage of these situations to buy high quality companies when others doubt their ability to navigate a challenge. We have done that in the past with names like Hospira and United Health and we recently started nibbling on TJX Corp.

In general, stable growth companies and those with international exposure should provide protection

against a weaker US economy and hedge against inflation. These also afford continued exposure to a rising market if the US economy remains on track. Consistent with our worry that the cost of funds may start to rise, we believe is more important than ever to avoid capital market risk. This entails avoiding companies with weak balance sheets and heavy borrowing needs that will be hard to finance in a nervous market. Capital market risk may also make it harder for companies to be bailed out by private equity funds paying high prices for acquisitions.

On the bond side of the ledger, we believe that the Federal Reserve will cave to political pressure to ease in the face of mounting mortgage foreclosures. This should cause the front end of the yield curve to remain flat or even come down, although we still expect longer term rates to stay flat to modestly up from current levels. We have been taking a barbell approach with portfolios by buying a mix of both short term and long term securities. This is consistent with our actions since last summer when we started to extend the maturity dates of our bond purchases to hedge against the possibility of a rate cut.

Commodities, of course, remain the big wild card. Both Iran and Venezuela need oil prices to remain above \$60 per barrel to meet their budgetary needs. Iran, for one, appears desperate to do what it can to keep prices up. Rising global demand and the actions of speculators are inadvertently helping these countries reach this goal. Higher prices are here to stay, but they would be far lower without the risk premium caused by the constant threats from the leaders of these two countries. While energy stocks remain a core component of any portfolio, earnings growth from price increases will not be as pronounced as it was during previous four years. With lots of cash and slowing growth, we believe that mergers in the energy field will increase in the years ahead.

As always, we welcome your questions and comments.