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MAPLE CAPITAL MANAGEMENT, INC.

Quarterly Economic Commentary



Economic & Financial Market Outlook

It is the custom of many investment managers to use the January letter to grade their comments from the previous year and tout their successful calls. While we are typically not avid self promoters, we note that we were accurate with our prediction last January that the nearly uniform Wall Street forecasts for 15% to 20% gains for 2007 were too optimistic. Indeed, even our modest prediction of an 8% to 10% gain for stocks proved to be a bit high when the stock market, as measured by the S&P 500, produced a total return of only 5.48% for the year. Bonds posted a rare outperformance relative to stocks as the Lehman bond index rose 7.02% for the year.

As this letter goes to press, we find ourselves with a sense of déjà vu. December has once again produced a wave of forecasts from the Street calling for double digit gains in the year ahead. Most of these forecasts are predicated on the belief that further Federal Reserve rate cuts will keep the U.S. out of recession, although almost every firm predicts a slowdown in the first half of the year. Once again, we believe this outlook is too rosy and fear the slowdown has the potential to be severe.

Our skepticism is rooted in the warning we made in our October commentary – “If the FOMC (Federal Reserve Open Market Committee) plans more cuts, investors should be very nervous about why.” As events transpired, the Fed cut rates by 75 basis points since our last letter, mostly in reaction to the continued fallout from the Borrowing Bubble. Investors grew increasingly nervous about the economy as they watched these same events unfold. In effect, the Fed actions were seen as a symptom of the deterioration rather than a cure for the ailment. Over the past six months, the primary question being asked by investors has changed from “will we have a slowdown?” to “will we enter a recession and how long will it last?”

To the first part of the question, we fear the odds favor a recession. Most pundits are underestimating the impact of the debt hangover. Loan delinquencies now stand at levels that we have not seen since early 2001 and defaults are spreading beyond sub-prime loans into home equity loans, a favored option for middle class borrowers. The job losses related to real estate, both directly and indirectly, are large. Furthermore, incomes will drop for a large group of people, such as realtors, mortgage bankers, and developers, even though they will still have jobs. More importantly, we think forecasters miss the fact that we have been in a “consumption” bubble, not just a “debt” bubble.

In recent years, American consumers ran up huge debts to buy cars, electronics, and homes, with many borrowing to live beyond their means - “aspirational spending” in the words of economists. Americans as a whole now spend a record 14.3% of their household income just to service their debt load. This means we now have less money available for consumption and savings just as credit standards are being tightened by lenders, shutting off another big source of discretionary spending. While the U.S. economy remains strong, it may not be robust enough to stave off a contraction in the face of these income and debt pressures.

We hesitate to forecast how long a slowdown might last. Rarely have global factors been so closely tied with domestic events. According to the latest World Bank data, the United States was the only industrialized nation to increase its share of global GDP over the past 10 years, so any domestic slowdown will impact the rest of the world. If the slowdown is global in nature, it is unlikely Federal Reserve rate cuts alone will be enough to halt the slide in growth. We will need to see some form of coordinated central bank action as well as the discipline among our foreign trade partners to resist calls for protectionist measures as their own economies start to slow.

However long the downturn lasts, we will

seek to take advantage of any slide in the markets. As the old saying goes, the best time to buy is when everyone else is selling. We will prudently do so as conditions allow.

Investment Strategy

As you may have noticed from your account statements, we have been steadily increasing cash holdings in client portfolios. This is not a market timing move. We are simply locking in gains on stocks that are close to our price targets and exiting those whose business models are at risk. We have been increasing bond holdings for balanced accounts - those that hold both stocks and bonds - as our inflation outlook moderates. We are using this opportunity to rebalance back to the midpoints of the ranges permitted under client investment policies.

The big risk that we see to stocks in this environment is the irrationality of investors. We note that good stocks are often sold without regard for their underlying fundamentals during periods of turmoil. While the recent sell off has brought some stocks back to realistic levels, sell-offs can go too far. Numerous stocks already appear to be pricing in a deeper slowdown than we forecast as holders choose to sell first and analyze later. We expect to see this pattern repeated over the course of the year.

The fact that this is an election year may not help matters. Historically, presidential election years have been very good for the stock market. Since 1984, however, the mean returns during election years have been below average and many were positive only with the help of strong fourth quarter rallies. The predicted economic weakness in the first half of the year and the closeness of the Presidential race (markets hate uncertainty) may not help us break this pattern in 2008.

The silver lining here is that corporate balance sheets have rarely been stronger. Corporate debt and inventory levels are low and cash balances are high. There are many good firms that can be owned with confidence. These firms will be able to ride out any short term disruptions in the economy and take advantage of the market shakeout. Furthermore, a weak dollar has put the United States on sale. Firms that are unduly sold off may find themselves the target of foreign buyers.

The outlook for bonds varies by security type. While we are even with or overweight fixed income relative to client benchmarks, we are not randomly buying bonds. For example, with a 2.65% yield on the 2-year note, U.S. Treasuries look very rich relative to the opportunities in stocks. However, they are safe and that is what some investors want in this environment. Still, for those willing to take a bit more risk, other sectors of the fixed income markets offer great values. We are placing new money in U.S. Government agency bonds, mortgage backed securities, and corporate bonds. For tax free investors, we are seeing select municipal bond yields that are very cheap. Housing and student loan authorities offer particularly good opportunities for our clients.

In an interesting turn of events, some insured municipal bonds are yielding more than comparable Treasury notes, even when the underlying issuers are sound. This is due to the fact that many bond insurers are facing downgrades in the face of sub-prime debt exposures. However, an AAA-rated municipal bond with an A-rated underlying credit will still be A-rated if the bond insurer goes out of business. These bonds will not become junk, although that is how they are trading. This is yet another symptom of how irrational the markets have become in the debt crisis and, hopefully, another sign that we are getting closer to the bottom.

As always, we welcome your questions and comments.