Maple Capital Management

Economic Commentary

First Quarter 2015 January 20, 2015

Market Outlook

"This is like déjà vu, all over again"
-Yogi Berra

The volatility of summer and fall did not abate in the fourth quarter. After dropping nearly ten percent in early October, markets seesawed back and forth, setting new all-time highs and staging sharp declines. The year ended with a strong rally, allowing the broader markets, as measured by the S&P 500, to post a 4.93% gain for the quarter and finish the year up 13.69%. Domestic small cap stocks were also positive although to a lesser degree with the Russell 2000 gaining 4.89% for the year. International stocks were even more volatile, with MSCI EAFE and MSCI Emerging Markets Indices declining 4.90% and 2.11% respectively. Bonds, by comparison, rallied during the quarter and finished the year up 4.12%.

As we kick off 2015, we can't help but sense we have seen this setting before. In many ways, our view of the year ahead is similar to this point last year. The positives are in place for another good year, although once again there is a sense of foreboding hanging over the market.

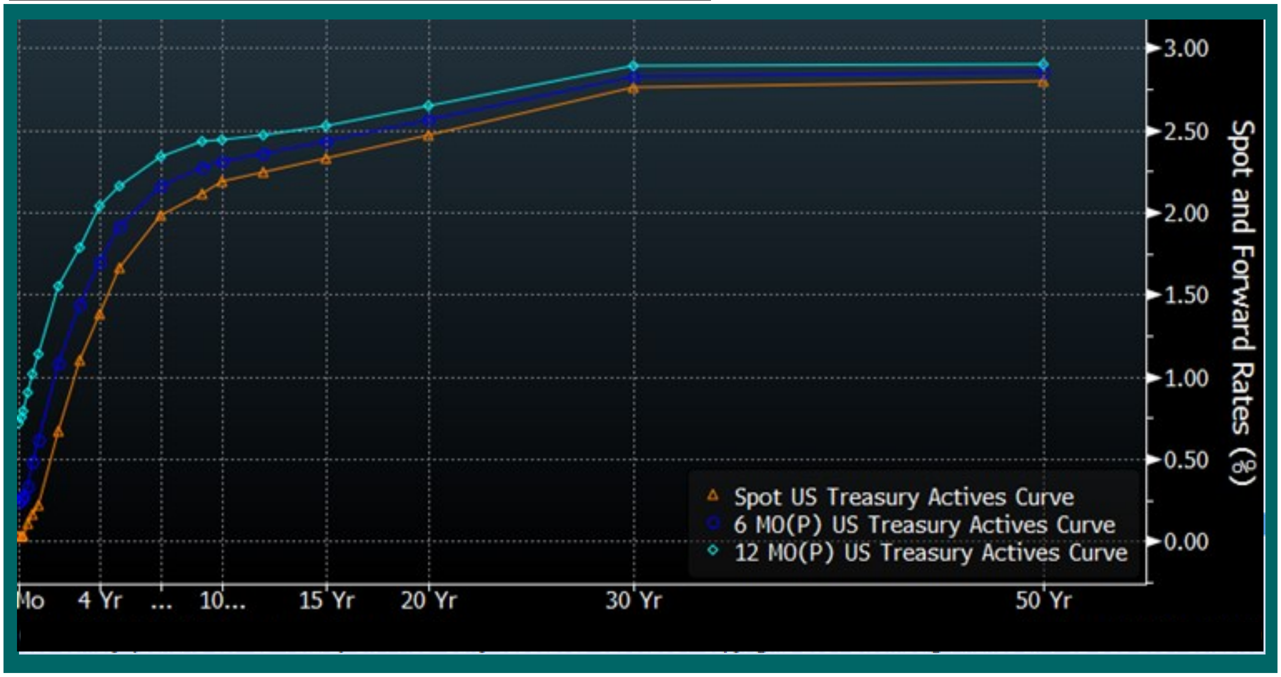
Many of the positives from last January are still intact. Economic data trends point to continued improvement. Corporate earnings are on an upswing and low interest rates continue to suggest the long awaited rotation out of cash and bonds into stocks may be coming in the months ahead. Household balance sheets have mostly been repaired and local governments are spending again. The Federal deficit is once again manageable. The nation's capital equipment stock and automobile fleet are far older than average cycles, suggesting a sustained spending spree in the months and years ahead.

New factors, such as low inflation and falling oil prices (a $350 billion economic subsidy at $50/bbl oil versus this point last year) should help the economy, although not without some consequences. The new political landscape will ideally lead to gridlock (good) or new growth efforts (better), although the status quo (bad) or worse is a real risk given the intractable partisanship on both the left and the right. Perhaps most importantly, central banks around the world are engaged in new rounds of monetary easing, even as the Federal Reserve moves to normalize rates. It is easy to see why so many folks are optimistic.

Unfortunately, increased volatility is once again central to our outlook for the year ahead. The risk of higher interest rates, while lower than last year, is still present. Deflationary pressures and rising geo-political risks are also factors of concern. Equity valuations, in particular, are elevated by many measures and may be at risk with any significant change to the status quo.

While interest rates have fallen over the past year, the clarity surrounding a Federal Reserve rate hike has increased. The Fed has made it clear it would like to begin normalizing interest rate levels in 2015. The market believes the Fed will be good to its word and this faith is reflected in the forward interest rate curve. On December 31st, the one-year Treasury traded at a yield of 0.22%, while the forward interest rate curve implied a rise to 0.62% in six months and 1.13% in one year. See Chart 1.

CHART 1: Spot and Forward Interest Rate Curves



Source: Bloomberg

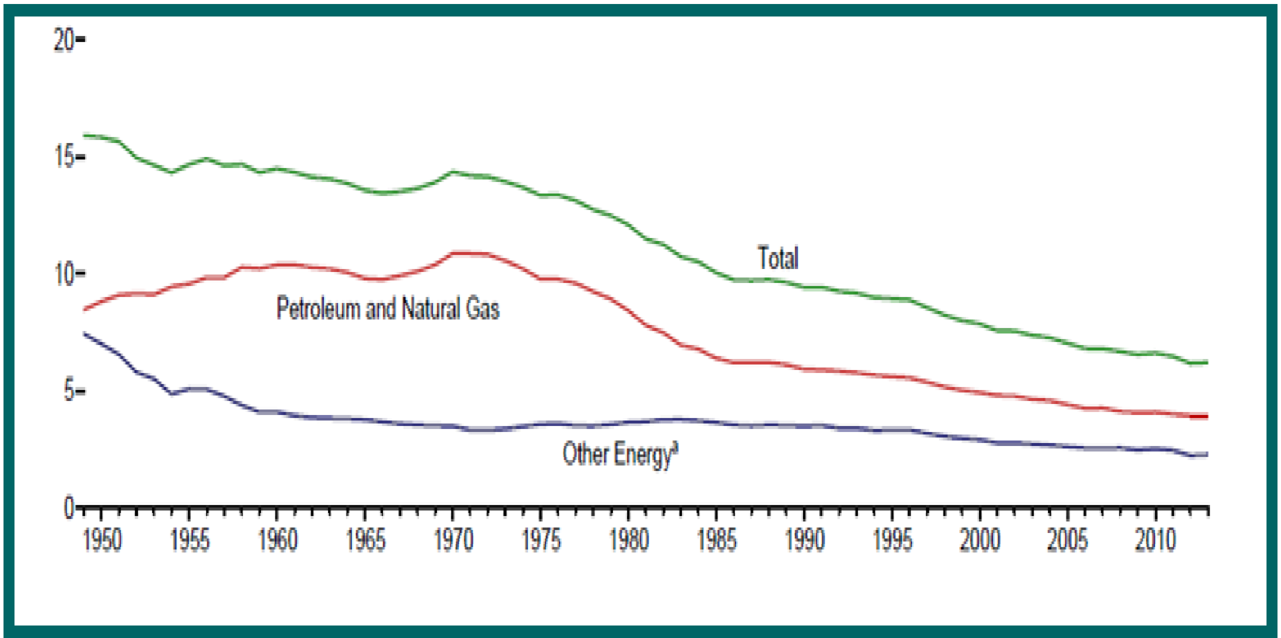
The increased risk of a deflationary spiral despite years of quantitative easing reflects how little influence the Fed can now exert over price trends. We believe the market continues to overestimate central bank ability to achieve stated inflation targets. For example, inflation expectations in the U.S. took a steep downward slide in 2014, reflecting slower worldwide growth, the recent fall in oil prices and the continued strength of the U.S. dollar.

CHART 2: Ten Year Inflation Expectations

Source: Bloomberg

The recent collapse in the price of oil is a great study in deflation. Lower energy prices contribute to lower inflation expectations in several ways. As a primary input to industrial production and consumer purchases, lower prices show up immediately in lower headline data. The price collapse may also slow employment growth as the oil and gas industry reduces capital expenditures and payrolls over the next few years. The industry has been a significant source of new jobs over the past five years and oil and gas equipment is a major export category for the U.S. While the energy industry has become an increasingly important driver of U.S. economic growth, the cost of energy as a percentage of GDP consumption has been steadily shrinking (see Chart 3).

CHART 3: Energy Consumption as a Percent of GDP



Source: EIA.gov

This suggests the added dollars in consumer wallets from lower energy costs, an input many economists are factoring in to their forecasts for stronger demand in 2015, may have less of a net impact on the economy than in prior periods of falling energy prices.

Finally, we believe one of the more certain sources of market volatility this year is likely to be uncertainty. The world is full of wildcards as we go into 2015 and uncertainty often results in a flight to quality. Oil was a wildcard in 2014 and should be just as unpredictable in 2015. Chinese economic growth is slowing and even the most knowledgeable China watchers are uncertain about the rate of decline. Japan continues to muddle through while Europe (and the Euro) could be thrown into another crisis by any number of events. Throw in a wounded Russian bear and continued fighting in the Middle East and it is easy to envision a flight to the safety of U.S. Treasury bonds and out of riskier assets.

Most investment strategists are calling for another strong year in the stock market. While we cannot argue with these forecasts, we are fairly certain it will be a bumpy ride.

Investment Strategy

Our last commentary noted how U.S. growth has been positive, but economic data pointed towards weakening international conditions. We received further confirmation of this thesis during the fourth quarter. U.S. conditions have continued to improve while European economies have indeed weakened, Chinese growth has slowed, and many foreign currencies have plummeted versus the dollar. Our prior commentary still holds; it will be difficult for U.S. growth to accelerate against the backdrop of slowing international economies and a rising dollar. Adding to the headwinds in the fourth quarter was the collapse of energy prices, which may lead to future layoffs in the oil patch, one of the few bright spots in the American economy over the past five years.

The effect of weakening global growth is amplified by increasing geopolitical risks and terror threat levels, as highlighted by the recent terrorist attacks in France. We believe these economic and geopolitical factors are likely to result in rising risk premiums, higher volatility and an increased focus on valuations. Put another way, investors require greater return potential to make an investment during periods of higher risk. An investor requiring a 10% return is willing to pay up to $10.00 for a stock with a one year target price of $11.00. An investor with a 15% required rate of return would not pay more than $9.56 for the same stock.

While we have already increased our return hurdles, we continue to stick with our proven, long term investment process. As we evaluate investments on their long-term prospects, we will look to take advantage of market panic during volatile periods. We look to purchase new positions at significant discounts to their intrinsic value. We also look to buy companies that we believe have outstanding products and services, have strong balance sheets and are led by management teams that have demonstrated an ability to successfully navigate the turbulent waters of the global economy. Also, we have been taking profits on stocks that have reached our price targets and selectively redeploying the proceeds into stocks that meet our criteria. Clients should expect to see increased activity in their accounts as we adjust to these changing market conditions.

Bonds continue to surprise the market. Interest rates have been plunging since last summer, confounding virtually every interest rate forecaster. At this point last year, it was a universal conclusion that interest rates would be higher by now. While markets did not cooperate with the pundits, it is still widely held that Federal Reserve interest rate hikes will move the 10-year Treasury yield above 2.5% by year end. While we believe the Fed will raise short-term rates in 2015, we expect rates to remain lower, and for a longer period, than the consensus view. Our view is supported by the established trends of continued lower inflation and weaker growth prospects around the world. In this environment, proper positioning on the yield curve remains vital.

Credit spreads could continue to come under modest pressure in this “risk-off” environment, but corporate fundamentals remain strong outside of the energy sector. We do not anticipate a major credit correction unless there is a large systemic shock. Taking some credit risk continues as a strategy, although primarily with higher quality and shorter duration issues. In recognition of increasing credit risks, we are directing money into government securities, seasoned mortgage-backed securities, and higher rated municipal bonds.

Municipal bonds outperformed in 2014 and prices are now back in line with historical valuation measures. We see support for this asset class driven by potential increases in income tax rates or further weakening in other credit related sectors. We are particularly attracted to “kicker” bonds in this environment. Kicker bonds are callable bonds with longer maturities. These bonds trade as if they will be called, creating prices that produce very attractive yield to maturity levels if the bonds are not called. We are finding structures with lower call risk and are purchasing these bonds with the assumption they will be held to maturity. These holdings are very attractive relative to comparable maturity bonds without call features.

We remain optimistic about the risk/reward trade off in our fixed income portfolios. We are using sector selection, security selection, and yield curve management to help mitigate interest rate and credit risks. We continue to monitor markets closely, and our strategies will evolve with changes in fundamentals and market data.

As always, please contact us should you have questions.

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