Market Insights

FALL 2015

WhittierTrust
INVESTMENT & WEALTH MANAGEMENT

Now A Correction…What Next?

The mid-cycle global economic slowdown became more pronounced in the third quarter of 2015 as growth decelerated discernibly. The weakness was most pronounced in the global manufacturing sector as industrial production dipped, exports dropped dramatically and leading indicators such as the Purchasing Managers Index (PMI) declined significantly. As a result, stocks sold off sharply to create the first correction since 2011, volatility spiked, bond yields plunged and commodities continued their spectacular rout.

Investors have now fretted for several weeks whether this current slowdown will remain just that…or deteriorate further into a full-blown recession. The two economic scenarios produce significantly different outcomes in the U.S. and global stock markets. Stock prices typically decline by about -15% during corrections but spiral much lower by over -30% during recessions.

We analyze the forces behind the current economic malaise to guide us going forward on the most likely outcome for the U.S. and global economy and financial markets.

Transition in China's Economy

China has engineered a remarkable run of outsized economic growth for well over 25 years. Driven by powerful contributions from Investments and Exports, the Chinese economy has grown at an annual compound rate of 9% from 1981 onwards. In recent years, growth has slowed down from double digits and it now appears that even the 2015 target of 7% will be hard to achieve.

In many ways, the somewhat painful transition of the Chinese economy away from Investments and Exports towards domestic Consumption is inevitable. Continued Investments in infrastructure become redundant once you reach over-capacity and Exports are always vulnerable to any global slowdown. It serves China well to grow domestic Consumption as a more dominant driver of growth and create a better-balanced economy. The reality of this transition is that growth will continue to moderate from unrealistic levels created by autocratic Investment policies to a lower, but more reliable, level which is supported by organic domestic demand.

As evidence that this transition is underway, a number of economic reports began to show a more dramatic slowdown in China during the third quarter. Exports fell by -6% in August, imports by -14% and industrial production and GDP growth dropped to their lowest levels since 2009. However, the one event which crystallized the growth problem in China was the surprise devaluation of its currency on August 11. The move was designed to spur exports by making Chinese products more competitive in the global market and viewed as the first clear admission that growth was faltering.

The key question in minds of investors now was not whether China could achieve 7% growth, but rather how far below 7% its growth would fall. The debate gathered momentum throughout the third quarter—would China crash into a "hard landing" which we define to be 0-3% growth or would it somehow maneuver a "soft landing" with growth in the range of 3-6%?

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"We believe that concerted global stimulus will avert a global recession."

Investors also began to worry about two related concerns. Commodities accelerated their already sharp losses on this evidence of slowing Chinese demand and fears of future extrapolated weakness. As other emerging market currencies went through their own painful downward adjustments, investors also began to focus on the specter of currency wars and their potentially devastating effect on deflation.

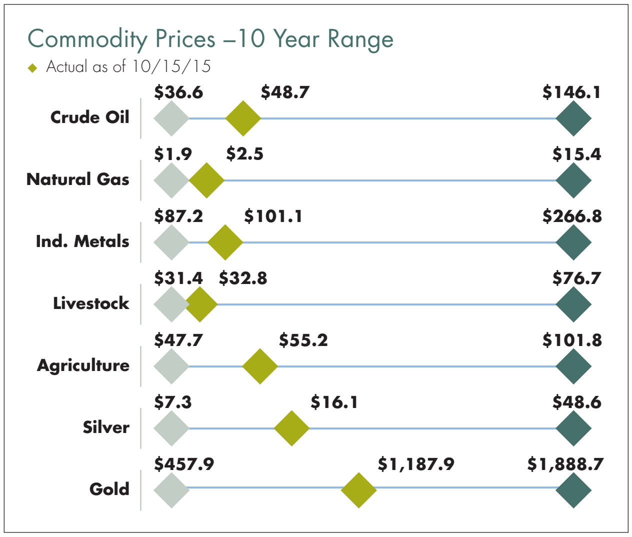

Figure 1

Deflation from Commodities and Currencies

The commodities sell-off in 2015 picked up steam in the third quarter as evidence about slower China and global demand mounted. As WTI crude oil reached its lowest level of 2015 below $40 per barrel in a broad-based commodities rout, headline Consumer Price Indexes began to approach or fall into negative deflationary territory *(Figures 1 and 2)*.

The Chinese devaluation and its ripple effects across other emerging currencies also began to export deflation across the globe. As nations compete with each other to make their goods cheaper, the resulting deflation and downward spiral in prices actually has the potential to trigger a recession. The progressively self-fulfilling prophecy can unfold as follows—consumers observe deflation or falling prices, then hold off on making a purchase until prices fall further, and wait again in the future anticipating even more weakness and thus set off a pattern of deferred spending which can tip a slowdown into a recession. These fears resulted in a sharp decline in Chinese equities of more than -40%, a fall in U.S. equities of -12 to -18% and a correction in virtually all risky assets by late August.

Volatility remained high as markets whipsawed between

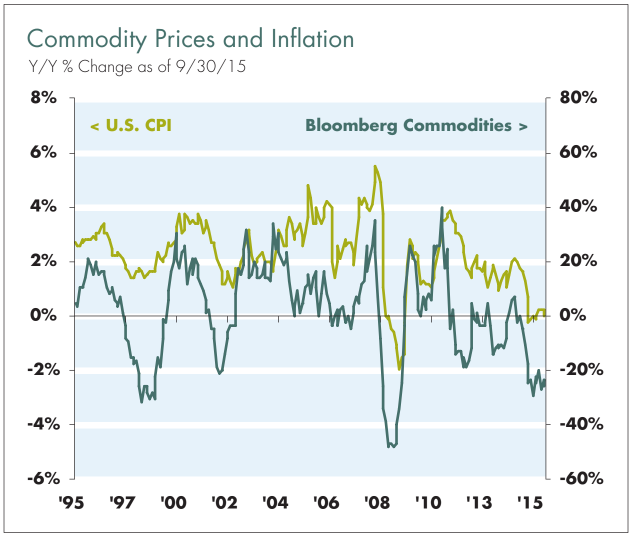

Figure 2

hopes of a benign slowdown and fears of a more malignant recession. Prices recovered during September on optimism that the worst economic scenario could yet be avoided.

We present our own economic and market outlook in the following sections.

Global Stimulus Key to Avoiding Recession

We believe that concerted global stimulus will avert a global recession. Our analysis begins in China which finds itself at the epicenter of the current economic storm. We observe that China has already undertaken over 60 measures of stimulus ranging from outright cuts in interest rates and bank reserve requirement ratios to tax cuts on car sales and increased funding for railroad projects *(Figure 3)*.

Through its perennial trade imbalance where exports exceed

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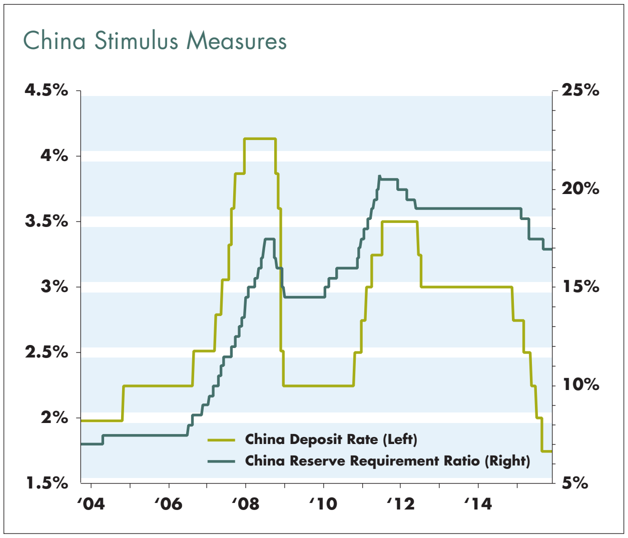

FIGURE 3

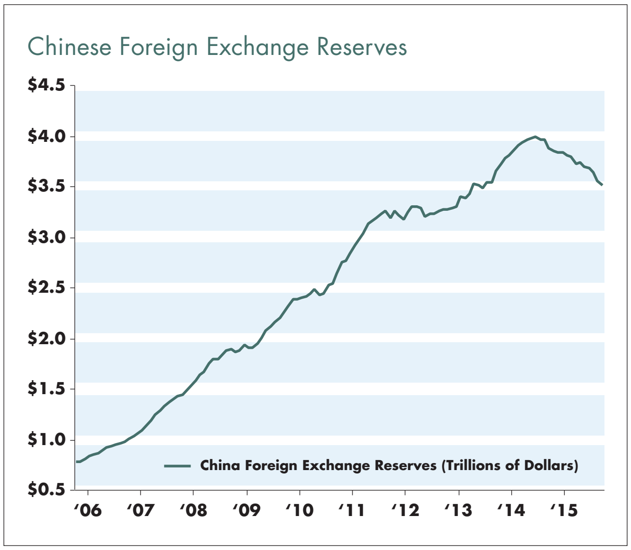

FIGURE 4

imports, China has also built up an impressive "current account surplus" and foreign exchange reserves. China has the ability to draw on these reserves to support its currency at any level it deems necessary and to also support additional stimulative policies. At $3.5 trillion, we believe this weapon of foreign exchange reserves will provide China enough ammunition to fight off the economic slowdown *(Figure 4)*.

The European Central Bank, Bank of Japan and central banks in India, Taiwan and Norway, to list just a small sample from all central banks globally, have all reiterated monetary stimulus in the form of lower interest rates and continued "quantitative easing". Even the Federal Reserve Board, which was virtually the lone central bank contemplating a rate hike, backed off from the lift-off in September and could yet remain on the sidelines until 2016. We acknowledge that monetary policy is beginning to lose effectiveness after such prolonged use but believe there is still just enough potency left on the monetary front, along with additional tools of fiscal stimulus, to stabilize the global economy.

More timely measures of economic activity in China such as airline passenger miles, electricity consumption, car sales and company surveys already seem to indicate that the slowdown has bottomed out over the last several weeks. With our thesis of a "soft landing" in China, we believe global economic growth will remain muted and modest in 2015 and 2016 but high enough at 2.5-3.0% to avert a global recession.

U.S. Economy More Robust

We have reason to be even more optimistic in our U.S. economic outlook. As we discussed in a prior paper, the direct transmission mechanisms for contagion from China are limited—both exports and revenues of U.S. companies in China are less than 10% of the total. We recognize that there are other indirect channels of contagion through our trade exposure to Europe and Japan to still catch pneumonia from China's flu but view this to be a less likely possibility.

It is important to note that the U.S. economy is driven largely by the U.S. consumer—domestic Consumption is almost 70% of the U.S. economy. The U.S. consumer is relatively healthy as a result of strong employment gains *(Figure 5)*, a robust housing market and increasing household formation. We believe that the decline in commodities, oil and gasoline prices will eventually produce the effects of a synthetic tax

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cut to spur additional consumer spending. As a result, we expect that U.S. economic growth will be high enough at 1.5–2.25% in 2015 and 2016 to avoid a U.S. recession.

Rates Lower for Longer… and Equities Higher for Longer

We believe that the current economic expansion will become more elongated and stretched as the result of a secular decline in the natural growth rates of many economies. Such growth, also referred to as the "potential" growth of an economy, is likely to be lower because of aging demographics and related downward shifts in the size and productivity of the labor force.

Within this secular transition into a "slower for longer" economic trend, we believe that interest rates will remain "lower for longer" and stocks can remain "higher for longer."

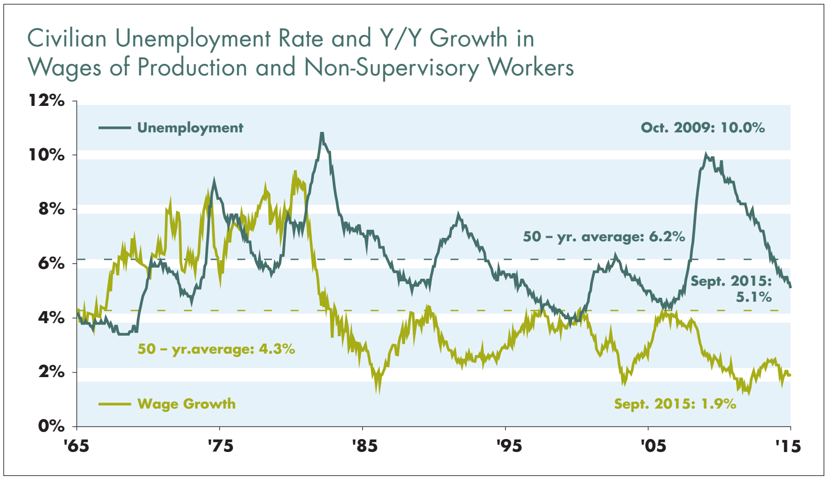

Figure 5

While a December rate hike is possible, we may yet see the Fed on the sidelines until 2016 as growth moderates in the second half of 2015. We believe the Fed has assessed the risk of a potential policy misstep to be a lot lower from waiting longer than it would be from acting sooner. Consistent with our theme of a relatively healthy consumer on the heels of strong employment gains, we expect some wage inflation to build up in the coming months and provide the Fed with the appropriate trigger to lift off.

We believe that the current Fed stance carries several implications for financial assets.

- Interest rates across the yield curve could stay lower than most expectations
- The dollar may begin to plateau at, or at least stop rising significantly from, these levels
- Zero and low rates are likely to be more supportive of equity valuations

We are not surprised to see that equities have been tested and challenged in 2015. With no further room for P/E multiple expansion, the lackluster equity market performance for the year is easily explained by what has happened to earnings. Earnings growth for 2015 is projected to stall out at almost zero in the face of the following headwinds.

- Slower economic growth
- Cratering profits in the Energy sector from lower oil prices
- Currency translation losses for multinationals from a strong dollar

However, as we look ahead to 2016, we believe that a resumption of profit growth is quite likely. As oil prices and the dollar stabilize, they will no longer represent headwinds in 2016 when year-over-year comparisons become easier. We expect modest gains for the stock market in the next 12 months from:

- a healthy U.S. consumer,
- fair valuation in a low rate, low inflation environment of around 16x forward P/E and
- at least mid-single-digit, and possibly higher, earnings growth.