Market Insights

WINTER 2015

WhittierTrust
INVESTMENT & WEALTH MANAGEMENT

The swift retracement in stocks prices in 2016 has stoked fears of an economic slowdown after an unabated six-year bull market. The forces behind the current sell-off are similar to the ones from last August but more intense in magnitude. The strong U.S. dollar has led to a further decline in commodity prices, a rise in bond yields for commodity producers and a continued slowdown in China's export-driven economy. Global central bank policies have diverged further as the Federal Reserve has increased interest rates, while the European Central Bank has promised more monetary easing.

On the other hand, it is useful to note that the strong dollar, and its related effects, can be directly attributed to U.S. economic strength relative to the rest of the world. The positives for the U.S. economy remain the same. Employment is growing steadily, the U.S. consumer is healthy with higher disposable income and housing is fairly strong. The yield curve is still positive which normally precludes recessions and low oil prices and low inflation should eventually help consumers and businesses.

In addition, U.S. stock valuations have improved in 2016 and are now below long-term averages.

We take a closer look at the factors behind the sell-off and offer our perspectives.

COMMODITIES

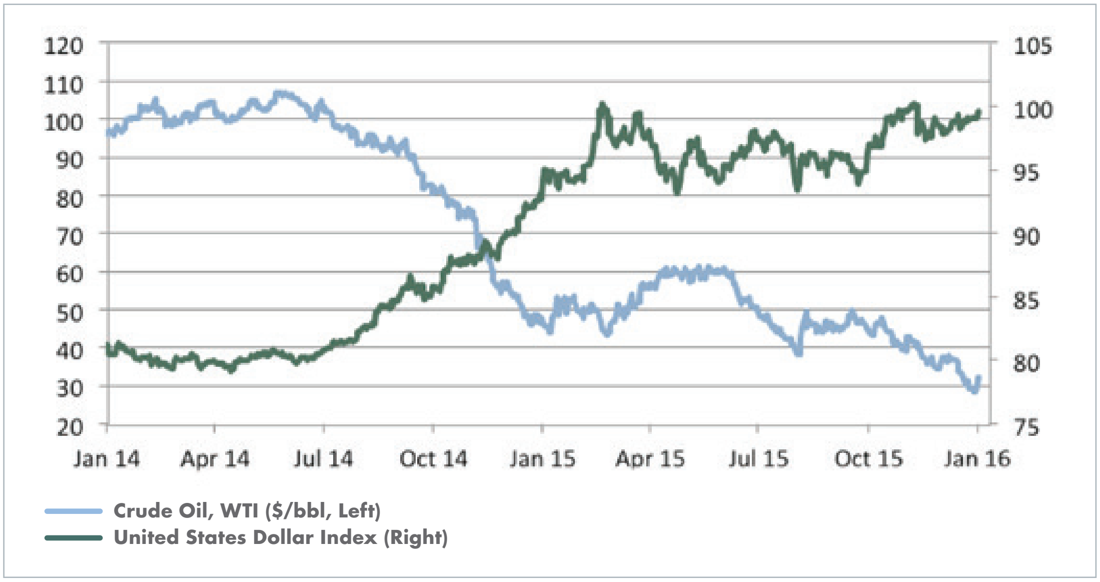
2000 was the year of the Technology bust and 2008 brought the Housing bust. While 2016 could well be the year of the Energy bust, it is likely to remain a localized crisis. U.S. oil has fallen below $30 per barrel which magnifies the risk of bankruptcies and defaults within the Energy sector. *See Figure A.*

The distress in the Energy sector is affecting related sectors like Metals, Mining and Industrials. Stocks and bonds in these sectors have fallen precipitously as a result.

With OPEC holding firm in its December meeting, Iran getting ready to add production, the dollar staying strong and demand remaining muted from a global slowdown, the downward pressure on oil is likely to continue in the near term.

- The decline in rig count from around 2,000 to below 650 will reduce U.S. production. Steady demand will lead to a rebalancing of the oil market at higher prices close to the marginal cost of production.

Figure A



"Employment is growing steadily, the U.S. consumer is healthy with higher disposable income and housing is fairly strong."

LOCATIONS

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"While junk bond spreads become elevated in every recession, not all periods of higher junk bond spreads lead to a recession."

We believe that current oil prices are not sustainable and will be higher by the end of 2016.

- While continued weakness in Energy and Materials stocks (and bonds) is a source of additional downside risk, a lot of the bad news may already be reflected in prices. At around 6%, Energy is now a smaller component of the broad equity market.

CREDIT

High yield credit (or junk bond) spreads are now approaching 10%. These levels normally reflect a reasonably high probability of a recession. There are also growing liquidity problems in the high yield credit market. The inability to hedge losses in the illiquid credit markets is causing selling in liquid U.S. equities.

- We attribute the wide spreads in junk bonds to a disproportionately high issuance from the Energy and Material sectors where risk of default is extremely high.
- While junk bond spreads become elevated in every recession, not all periods of higher junk bond spreads lead to a recession. Recent examples of the latter phenomenon include 2002, 2005 and 2011. We assign a relatively low probability to a U.S. recession in 2016.
- However, the lack of liquidity is a genuine concern and represents a potential source of contagion from the Energy sector to the rest of the market. We continue to closely monitor spillover and contagion risks.

CHINA

China appeared to have stabilized during the fourth quarter of 2015 through a combination of both monetary (interest rate cuts) and fiscal (spending) stimulus. Renewed concerns over the slowdown in China emerged in the first week of January as the People's Bank of China fixed the yuan lower relative to the dollar for 9 straight days. The desire to weaken the yuan was interpreted as a sign of more trouble in the Chinese economy.

- We believe that China has enough policy tools at its disposal to engineer a soft landing in which growth will glide down to a more realistic 4-5% range but still remain above the worst case scenario of 1-2%.
- While manufacturing is in a recession in China, the service sector is growing steadily. Although official economic data out of China is not always seen as reliable, the 4th quarter GDP growth rate of 6.8% and full-year growth rate of 6.9% may be close enough to the 7% 2015 target to allay fears of a hard landing.

The Chinese economy is clearly slowing down and GDP growth is now being targeted at 6.5% for 2016. We expect China to experience unusual volatility as it transitions from a manufacturing to a service-sector economy.

CENTRAL BANK DIVERGENCE

The Fed is in the rare minority of central banks to have embarked on a tightening cycle. The Fed lift-off in December set the stage for removing an important source of monetary stimulus in support of asset prices. Markets were further concerned about the Fed's projections of 4 more rate hikes in 2016.

- We do not believe that the Fed will increase rates 4 times in 2016. With the U.S. economy slowing down in the 4th quarter of 2015 and mounting evidence of further global weakness, the Fed will be hard pressed to raise rates even once or twice.
- Lower than projected interest rates should dispel fears of a policy misstep and help support equity and bond prices.

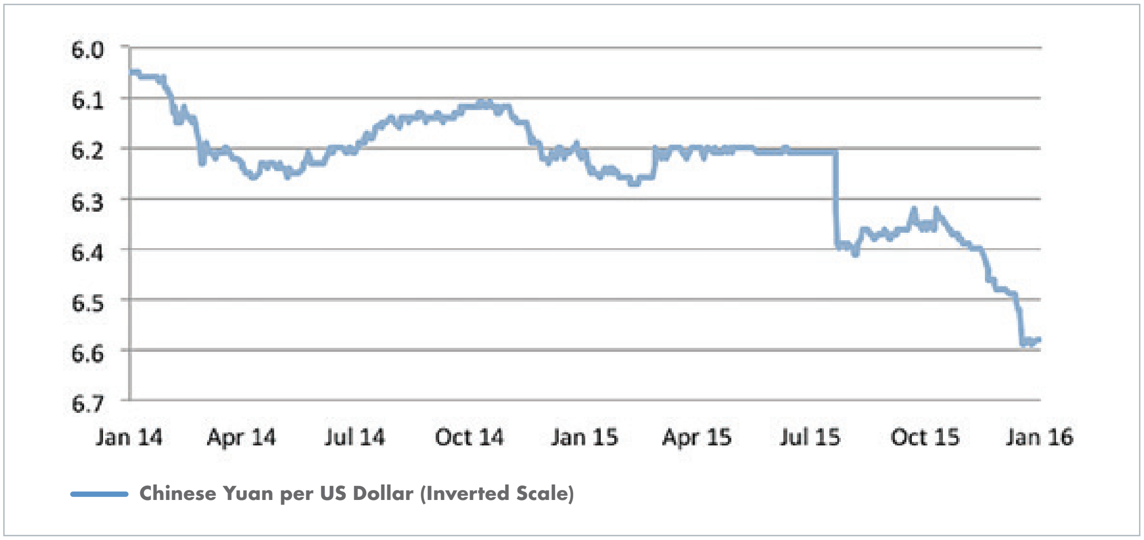
CURRENCIES

The combination of a relatively strong U.S. economy and Fed tightening has led to a stronger dollar. A rising dollar creates several adverse outcomes. Oil prices decline, foreign earnings of U.S. companies fall and the Chinese yuan is more likely to devalue to alleviate the upward pressure from its dollar peg.

The most damaging of these effects is the prospect of additional Chinese devaluation. Further depreciation in the yuan can lead to similar matching moves from other Emerging Economies to maintain competitiveness in Exports and lead to currency wars. *See figure B.*

"With the U.S. economy slowing down in the 4th quarter of 2015 and mounting evidence of further global weakness, the Fed will be hard pressed to raise rates even once or twice."

Figure B



Currency wars can lead to a fall in global prices and result in global deflation. Deflation, in turn, can inhibit spending and lead to recessions.

- While cognizant of the possibilities, we do not believe that currency wars will export deflation from the Emerging Markets to the rest of the world in a meaningful way.
- Based on our earlier discussion of Fed policy, we expect that a more gradual pace of rate hikes will moderate U.S. dollar strength.
- China will likely create stimulus through both interest rate cuts and spending rather than through currency devaluation alone.

SUMMARY

Commodities, Credit and Contagion: Continued weakness in Energy and Materials is a source of more downside risk, but much of the bad news may already be priced in. Lower oil and commodity prices should help other sectors and mitigate contagion across the economy and markets. The lack of liquidity in high yield credit is a source of concern and may trigger spillover risks across other asset classes.

China has enough policy tools to achieve a soft landing with GDP growth of 4-5% and avoid a worst-case scenario of 1-2% growth.

Central Banks and Currencies: The Fed is unlikely to raise interest rates 4 times in 2016 as signaled. Lower rates should dispel fears of a policy misstep, help support equity and bond prices and moderate U.S. dollar strength.

Consumer: Strong employment and steady wage growth have increased real disposable income. Low oil prices and low inflation may act as a synthetic tax cut and spur discretionary spending. Gains in household formation and housing starts reflect a healthy housing market.

We observe in closing that protracted bear markets are more commonly observed during recessions. Recessions, in turn, are more commonly preceded by rising inflation and higher interest rates.

With the Fed unlikely to fulfill its projection to increase interest rates in 2016, we believe that a recession will be deferred. We remain cautious about the cross-currents from multiple headwinds, continue to stress diversification and own high quality U.S. companies within our equity portfolios.