Market Insights

Fall 2013

Whittier Trust

INVESTMENT & WEALTH MANAGEMENT

The third quarter was filled with headlines on Fed tapering, an impending government shutdown, and speculation of a new Federal Reserve Chairman, yet the S&P 500 Index managed to generate a 5.2% return, leaving the index up 19.8% year-to-date. Last year we shared our thesis that the **US economy would experience a self-sustaining recovery driven by key factors including the housing market and construction related job growth**. We expanded on that thesis by adding a renaissance in domestic energy production, pent-up demand for durable goods, and a prediction that the U.S. economic recovery would be slower but longer than typical recoveries. All of these themes continue to play out. Additional key developments include: improving consumer credit, significant changes at the Federal Reserve, the decoupling of the U.S. economy from other developed nations and the implications of that divergence.

The Consumer's Deleveraged Balance Sheet

The U.S. consumer is in a better position than the media has portrayed. Household net worth is at an all-time high driven by the recovery in the stock and housing markets. The average U.S. consumer's monthly cash flow is relatively healthy with credit card delinquency rates at the lowest level in over twenty years. Total credit card debt has declined by over $150 billion during the past five years as U.S. consumers have been more conscious about credit card spending. **With the exception of student debt, U.S. consumers are in a better position than they have been in for some time**. The relative health of the U.S. consumer will allow this economic cycle to last longer than historical cycles.

Tapering Not Tightening

2013 has been a year filled with speculation around when the Federal Reserve Board will "taper" their bond buying program. The Fed shocked markets on September 18th when it announced that it would not reduce the $85 billion per month bond buying program known as Quantitative Easing III (QEIII). In addition to the uncertainty around the timing and magnitude of the tapering program, Ben Bernanke will leave his post as Federal Reserve Chairman at the end of this year.

We expect that the Fed will taper asset purchases over the next six months. The Federal Reserve is on track to purchase over 80% of net Treasury issuance this year. The Fed is buying $45 billion of Treasury bonds per month, while the U.S. budget deficit is averaging $54 billion per month (down from over $90 billion last year). If the Federal Reserve does not taper asset purchases, then it will be purchasing close to all of the net Treasury issuance next year. The impact on interest rates from tapering will be mitigated by the declining budget deficit.

The new Fed Chairman will be incentivized to be late unwinding Bernanke's stimulus efforts. Monetary policy changes will occur as a new Federal Reserve Chairman is taking over for the most aggressive Chairman in the history of the institution. **Bernanke's successor will inherit a balance sheet that is nearly four times as large as when Bernanke took over as Chairman**. If the new Fed Chairman unwinds the Federal Reserve's balance sheet too early and causes deflationary pressures or a recession, then the new Fed Chairman will be blamed. The incentives for the new Fed Chairman are aligned

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with low interest rates in 2014. We view a new Fed Chairman as a driver of continued low interest rate policies. The Fed Funds Rate (often referred to as the "overnight rate") will remain near zero for the next twelve months. Additionally, inflation has been low and trending down, as measured by the Personal Consumption Expenditures Index (PCE). The Fed targets core PCE of 2%, but recent readings have been below 1.5%. The combination of a dovish new Fed Chairman, a commitment to keep overnight interest rates near zero through 2014, and low trending inflation will lead to relatively low interest rates in 2014.

Global Economic Malaise Gives Way to Opportunity

The U.S. stock market hit record highs in the third quarter, while European equities finished 23% below prior peak levels. Chinese equities are 40% off their peak, and emerging markets as a whole are back to 2009 levels. Global weakness has been highlighted by the European Sovereign Debt Crisis, which drove the EU into the longest recession since its formation in 1998. Emerging markets have struggled as exports to Europe declined and internal political and socio-economic challenges curtailed growth. However, the outlook for international markets is improving from this depressed base.

We see reasons for optimism as Merkel was re-elected in Germany, geo-political risk has been reduced in Syria and Iran, (with Syria surrendering chemical weapons), and a more moderate Rouhani replacing Ahmadinejad as President of Iran. Meanwhile, **Europe's 18-month-long recession looks to finally be over** and China has seen six straight months of improving manufacturing data. Greece and Italy are projected to post primary budget surpluses in 2014 allowing the largest economic union in the world to return to unremarkable growth. China's manufacturing data measured by the PMI index increased to 51.2 in September, which was the highest reading in six months. Beyond the improving macroeconomic landscape, valuations are compelling. While the S&P 500 Index trades at 2.4x book value, the EAFE (Europe, Australia, Far East) Index trades at 1.6x book value. Dividend yields offer a similar discrepancy with the S&P 500 Index yielding 2.1% and the EAFE Index yielding 3.2%. Further, we believe that corporate earnings in Europe are 20-30% below mid-cycle earnings. A lower multiple on depressed earnings allows for both multiple expansion and earnings growth. Much like the U.S. markets recovered after the "Great Recession," we believe that **international markets have the potential to recover from recent weakness** as improving economic growth and favorable valuations drive market returns.

We look at markets from two key perspectives; (1) the prospects for economic growth and/or recovery and (2) the assumptions embedded in the valuations of those markets. We are in a unique time period where emerging market stock indices have underperformed U.S. indices by over 50% during the last three years. While the S&P 500 Index returned 58% over the past three years, the MSCI Emerging Market Index was flat, returning 0%. Over that time, the U.S. economy has grown 2.1% on an annualized basis, while emerging economies have grown by 4.3% per year. Emerging markets are still "emerging," but with reset expectations. We have been positioned very well for this divergence with the core of our portfolios invested in U.S. large cap companies that sell into the faster growing emerging economies.

Looking Forward

We expect interest rates to remain low through 2014, but the direction of rates long-term is likely to be higher. We see opportunities in fixed income assets that offer long-term interest rate protection through floating rate structures. We continue to believe that companies with the accounting standards of the U.S. that derive a large portion of their revenues from faster growing nations will be good long-term investments. Finally, we are incrementally more positive on opportunities in non-U.S. markets due to depressed valuations and an improving economic outlook.

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