Market Insights

SUMMER 2014

Whittier Trust
INVESTMENT & WEALTH MANAGEMENT

Stock Market Hits All Time High

The stock market marched steadily higher in the second quarter of 2014 to reach a historic high. This marks the 7th quarter in a row that the S&P 500 Index ended at a new record level. The S&P 500 Index returned 5.2% in the second quarter, with the index up 7.1% year-to-date. Bonds performed well for the second straight quarter with the Barclay's Aggregate Bond Index up 3.9% for the first half of the year. The 10 year Treasury bond ended the quarter yielding 2.5%, which is down from the 3% yield at the beginning of the year. **Interest rates have come down despite over 95% of economists projecting an interest rate increase in 2014**. The European Central Bank became the first central bank to have a negative deposit rate driving down sovereign yields around the world. We are entering the third quarter with improving economic data, near record low market volatility, and increased corporate mergers and acquisitions.

Erratic Economic Data

Investors generally brushed off the -2.9% decline in first quarter U.S. GDP, as the economy bounced back quickly in the second quarter. **Inclement weather kept consumers indoors during the first quarter, but pent up demand drove sales in the second quarter**. Auto sales bottomed at a 15.3 million annual pace in February and rebounded to a 16.9 million annual pace in June, which is the highest in eight years. The second quarter ended with the U.S. economy adding 288k jobs in June, leading to the highest five month job gain since before the financial crisis. U.S. GDP is set to improve in the second half of 2014, building on the strength of the second quarter.

Low Volatility Increases Risk Appetite

The CBOE Volatility Index (VIX) is near a ten year low, U.S. high grade corporate bonds are trading with lower volatility than at any point in the past ten years, and currency volatility is near an all-time low. **Low volatility is a sign of stability, which in turn gives investors comfort to take on additional risk**. Thus, we have seen risk assets move higher and higher. The longer that volatility stays low, the more these asset classes will rise and ultimately become vulnerable to a correction. **The longer the market enjoys a sustained period of low interest rates and calm economic fundamentals, the more important it becomes to own high quality equities.** History offers countless arguments against taking excessive risk in what feels like a benign market environment. Specifically, lower credit quality bonds and small cap stocks with valuations based on rosy future earnings projections warrant caution. While the U.S. stock market is not currently in a bubble, moderate increases in market volatility may be healthy for the market and allow the market to grow in line with earnings growth rather than rising faster than the intrinsic value.

Tax Inversions Are The Flavor Of The Year

The U.S. has the highest corporate tax rate in the developed world at 35% (Japan lowered its corporate tax rate to 30% in Q2 2014), which is **incentivizing companies to domicile outside of U.S. borders through a 'tax inversion.'** Under U.S. tax law, domicile depends on where the majority of the operations are based, not where the company is controlled and managed. Thus, re-domiciling from the US to another country to save taxes is difficult to achieve without taking over or merging with a foreign company and utilizing a tax inversion structure. **Near record mergers and acquisitions will continue and include more overseas transactions**. This is partly due to U.S. corporations holding more cash than at any time in the past forty years with the

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Locations

South Pasadena
1600 Huntington Drive
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626.441.5111

San Francisco
505 Montgomery Street, Suite 620
San Francisco, CA 94111
415.283.1850

Reno
100 W. Liberty Street, Suite 890
Reno, NV 89501
775.686.5400

Seattle
520 Pike Street, Suite 1415
Seattle, WA 98101
206.332.0836

"The Fed was buying $85 billion per month of Treasury and mortgage bonds in 2013 and has steadily reduced the program by $10 billion per month in 2014."

preponderance of that cash held outside of the U.S. Despite efforts in Washington to prevent the loss of tax revenue from U.S. companies moving overseas, there is very little talk of a repatriation tax holiday leaving tax inversions as a major theme of 2014 and beyond.

Tapering Was Not Tightening

The Federal Reserve has been "tapering," or reducing its bond buying program throughout 2014. The Fed was buying $85 billion per month of Treasury and mortgage bonds last year and has steadily reduced the program by $10 billion per month in 2014. By the end of this year, the Fed will not be buying additional bonds through balance sheet expansion. **This should not be confused with restrictive monetary policy merely less accommodative. The Federal Reserve will have a $4.5 trillion balance sheet at the end of the 2014, more than quadruple the pre-crisis level**. With the employment-to-population ratio hovering around twenty year lows, the Fed will likely be slow to exit its stimulus program and will not raise overnight interest rates until next year. The argument has been made that the U.S. Federal Reserve will have to keep rates low because debt levels remain high and the economy (particularly the real estate market) will be sensitive to increases in interest rates.

The U.S. is becoming addicted to low interest rates. While former Federal Reserve Chairman Alan Greenspan was heralded as the guru of monetary policy during his time as Chairman, he was later criticized during the financial crisis as being overly stimulative and responsible for the real estate bubble and subsequent bust. **The average Fed Funds rate during Greenspan's term was 4.78%, well above the 1.62% average rate during Bernanke's 8 year term**, and Yellen's roughly 0% average rate. As long as the Fed keeps overnight interest rates near zero and reinvests the proceeds from bond principal and interest payments, the Fed will be stimulative albeit less so.

Outlook

The market has shrugged off instability in Russia and Syria and the second half will test the resiliency of the market with the civil war in Iraq. Iraq produces roughly three million barrels of oil per day (4% of global production) and is projected to produce six million by the end of the decade. **Oil prices have increased with the threat of reduced production,** but the majority of that production is in the Basra province (over 350 miles from Baghdad). Baghdad itself is only six million people and is not large enough to be a major disruption to global markets without the threat of external warfare. The conflict in Iraq is more likely to have a minor impact on global markets akin to Egypt in 2012. Furthermore, political instability in the Middle East becomes less detrimental to the U.S. economy as the U.S. is increasingly energy independent.

Economic data will bounce back in the second half of 2014, market volatility is likely to increase from near record low levels, corporate acquisitions will approach record high levels with an emphasis on overseas transactions, and the Federal Reserve will be late to exit their stimulative policies.

Increased tax inversions will benefit companies with accretive acquisitions, reduced tax rates and their accompanying overseas targets.

Investors will be rewarded by focusing on long-term opportunities, seeking quality companies at reasonable valuations, and resetting return expectations to preserve the gains made over the past several years.

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