Market Insights

WINTER 2014

WhittierTrust
INVESTMENT & WEALTH MANAGEMENT

The stock market had its strongest year since 1997, as measured by the S&P 500 Index. The market rallied despite a Government shutdown and continued to move higher when the Federal Reserve announced the highly feared tapering process. The Fed appeased the market by committing to continued accommodative monetary policy in conjunction with reducing the bond buying stimulus program. ***The strength in the U.S. equity market came as corporate profits grew and investors shifted their allocations from bonds to stocks.*** Interest rates rose in 2013, which led to losses for the aggregate bond market. The 10 year Treasury bond finished the year yielding 3%, almost doubling the near record low 1.6% yield in April. The U.S. economy will expand at a faster rate in 2014 as the Federal Reserve will continue to be accommodative, depressed economies in Europe will turn to positive growth, and corporate acquisitions in the U.S. will increase.

The Federal Reserve's loose monetary policies have had many positive effects, but are not without consequence. Low interest rates have helped the housing market recover, the flood of new money has fueled a stock market rally, and the Federal budget deficit has been reduced by the Fed's low interest rate policies. ***The more time the Fed takes to exit its stimulus programs, the more the U.S. economy will be dependent on low interest rates and investors will price assets with the expectation of continued low interest rates.*** This policy can lead broadly to low prospective returns and an increased appetite for risk taking. The S&P 500 Index generated a return of 32% in 2013, while earnings are expected to grow by a mere 6%.

This discrepancy is unsustainable. For six years, bond indices generated returns higher than the yield at the beginning of the year. This pattern abruptly ended in 2013 as bonds suffered losses—the Barclay's Aggregate Bond Index finished down—2.7%. ***Just as a bond cannot out earn its yield forever, the stock market cannot grow faster than earnings forever.***

The Fed's policies have essentially "pulled forward" returns. The stock market increase of 2013 took gains from the next few years and pulled those gains into 2013. Looking forward, it will be important for investors to temper their return expectations after a strong run in the market in 2013. Investors will be well served to make investment decisions based on fundamentals rather than chasing the best performers of 2013. The S&P 500 Index will begin 2014 trading at a multiple of 15.5 times forward earnings estimates, higher than the 13x multiple at the beginning of 2013 and slightly higher than historical averages. ***It is important for the Fed to continue to reduce its impact on the market and do so in a measured way.*** We believe equities will be good long-term investments and are fairly valued; however, we would prefer that the market appreciate in line with earnings growth rather than see an imbalance created by mispricing from sustained low interest rates.

In early 2012, we highlighted that the U.S. economy was on the verge of a self-sustaining recovery. We stated that the real estate recovery, the energy renaissance, and pent-up demand for autos and other capital goods would drive growth. Also in 2012, we called for

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Locations

South Pasadena
1600 Huntington Drive
South Pasadena, CA 91030
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

"Economic growth will pick up in 2014, but strong equity returns were pulled forward into 2013 through the Federal Reserve's stimulus program."

the end of the bull market in bonds. Both of these early predictions proved to be correct. While those predictions were neutral at best in 2012, by 2013 our clients benefitted significantly. Our clients generally held a core position in U.S. equities, which outperformed non-U.S. peers and held creative bond portfolios that generated gains despite the worst year for the aggregate bond market in almost twenty years.

Outlook for 2014

As we enter 2014, the consensus view is that U.S. equities will continue to generate double digit returns. We too have a positive view for U.S. stocks heading into 2014, but recognize valuations around the world offer opportunities outside of U.S. borders. Low valuations in non-U.S. equities compensate for the recent recession in Europe and the structural imbalances in the emerging markets. The U.S. stock market, as measured by the S&P 500 Index, trades at a forward multiple of 15.5 times record high earnings, while the European stock market trades at 13 times depressed earnings. A lower multiple on earnings that have the ability to rebound is more compelling. **U.S. GDP will grow more than the Euro area, however, there will be greater *acceleration* of growth in Europe.** The European Union's GDP shrank in 2013 by 0.5%, but is poised to grow in 2014 by over 1%. While GDP growth will be tepid, a change from negative growth to positive growth is more impactful on market returns. We cannot overstate the importance of valuation in determining risk. The perception of risk in the U.S. is declining, but actual risk is increasing as asset prices in some cases are above underlying intrinsic values. Meanwhile, the perception of risk in emerging markets is increasing, while actual risk is declining as cheaper valuations provide an increasing margin of safety.

The U.S. economy will be buoyed by an ***increase in mergers and acquisitions in 2014***. Corporations are flush with cash and have access to cheap capital through low interest rates. Sluggish economic growth will force companies to be acquisitive to grow earnings. Companies that otherwise would build factories or hire staff to meet market demand, will seek growth through buying competitors. We saw a record number of IPOs in 2013 with venture capital returning a record amount of cash to investors. That cash will find its way back into the hands of private equity firms, who will add leverage and acquire companies in 2014.

Unprecedented monetary policy has raised fears ranging from runaway inflation due to newly printed dollars all the way to deflation when the Federal Reserve withdraws the liquidity. We see an outcome that falls in between with **inflationary pressures increasing but relatively low inflation continuing in 2014** as wage growth will be modest and labor market slack remains above average.

The Bottom line

1. ***Equities are still more attractive than bonds****, but the more equities rally and interest rates rise, the more narrow that relative value becomes.*
2. ***For 2014, we expect the U.S. stock market to generate positive returns for the sixth straight year as valuations are full but not frothy****.*
3. *Markets outside of the U.S. have more compelling valuations long-term, however, market performance in the short-run will be driven by investor psychology and a positive feedback loop in the U.S. more than valuation.*
4. *The Fed has been instrumental in fueling the market rally and will have to be disciplined in reducing stimulus.*
5. ***Interest rates will rise modestly in 2014 as the Fed slowly unwinds the bond buying program****.*