

MARKET INSIGHTS

WINTER

2015



WhittierTrust

INVESTMENT & WEALTH MANAGEMENT

THE S&P 500 INDEX ROSE for the sixth year in a row, returning 13.7% in 2014 while international markets finished with negative returns. U.S. stocks appreciated as investors around the world sought higher economic growth in the United States. Developed non-U.S. markets fell -4.2% and emerging market stocks lost -4.6%. International stocks lost ground in 2014 as concerns of deflation in Europe, a stronger U.S. dollar and the precipitous decline in oil prices all disproportionately affected equities outside of the United States. Oil prices slid over 50%, while the U.S. dollar strengthened and interest rates fell around the world. Falling interest rates abroad stoked demand for existing U.S. bonds allowing the aggregate bond market to return 6% in 2014. Falling oil prices, a stronger U.S. dollar, **and low interest rates will contribute to a strong U.S. consumer and growing U.S. economy in 2015.**

Oil fell drastically from a high of \$105/bbl in June to the mid-\$40 range at the start of 2015. OPEC opted to maintain its production quota, U.S. oil production surged, and global demand for fossil fuels fell. The stronger U.S. dollar compounded the decline in the commodity price. The current oil price collapse occurred in half of the time of the average decline over the past thirty years and roughly equals the 57% average decline. The recovery in oil prices will take a different shape this time. New technology, known as 'fracking,' generates large production initially, but is quickly followed by a substantial decline in production. The production profile of new drilling techniques will lead to swifter changes in oil supply than conventional oil drilling has historically. **The current oil price decline may be more short lived than history suggests as oil supply will**

shrink from steep decline curves in the second half of 2015. In the meantime, oil importing nations will benefit at the expense of oil exporting nations and consumers broadly will have improved cash flow.

Extremely low interest rates overseas forced global investors to seek higher relative yields in the United States. To the surprise of all 67 economists polled by Bloomberg in April, interest rates fell in 2014 despite the Federal Reserve tapering its bond buying program from over \$1 Trillion to zero. The decline in U.S. interest rates occurred because the disparity in interest rates between U.S. bonds and European bonds widened to multi-decade levels. The European Central Bank (ECB) pushed the bank deposit rate into negative territory to combat deflation. Speculation that the ECB would engage in a bond buying program drove yields even lower. Bond yields are *negative* in ten developed nations including: Japan, Germany, France, Sweden, and Switzerland. The U.S. ten year bond yields less than 1.85%, while the German ten year bond yields less than 0.5%. The two year Swiss bond has a negative yield of -0.94%. Capital moved to the United States from overseas as investors sought higher relative interest rates, which drove the U.S. dollar higher. The combination of lower interest rates, a strengthening U.S. dollar and a slide in oil prices sets up for a stronger U.S. Consumer in the coming year.

The U.S. consumer is healthier than at any time in the past fifteen years. Household net worth is at an all-time high of \$82 trillion, job openings are the highest in thirty years, claims for unemployment insurance are at the lowest level in this century, and median income is at an all-time high. For every cent

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Locations

Southern California

1600 Huntington Drive
South Pasadena, CA 91030
626.441.5111

Northern California

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

Nevada

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

Northwest

520 Pike Street, Suite 1415
Seattle, WA 98101
206.332.0836

“For every cent that gasoline becomes cheaper, U.S. consumers have more than \$1 billion per year for spending on other goods and services.”

that gasoline becomes cheaper, U.S. consumers have more than \$1 billion per year for spending on other goods and services. This equates to over \$150 billion of disposable cash for the U.S. consumer. We acknowledge that there is plenty of data refuting the claim that the consumer fully healed from the financial crisis including: high underemployment levels, record student debt, and low labor force participation, but still maintain that the consumer is in a relatively healthy position. The average consumer reduced debt following the Great Recession of 2008 and record low interest rates allowed for cheaper financing opportunities. As the dollar strengthens, the benefits of lower commodity prices, import prices, and increased purchasing power will inure to the benefit of the consumer as well. The strength in the U.S. consumer will allow for this economic cycle to last longer than typical cycles.


Looking forward

2015 will be a year of monetary policy divergence. The U.S. Federal Reserve is projected to raise overnight interest rates for the first time in six years, while the next two largest central banks will keep rates close to zero and engage in significant balance sheet expansion. Interest rates should rise modestly in 2015 from very low levels. Rates fell dramatically in anticipation of each quantitative easing program enacted by the Federal Reserve over the past six years; however, rates actually rose during each of the bond buying programs. 2015 will be the first year since 2007 that the Federal Reserve will not expand its balance sheet, but the European

Central Bank and the Bank of Japan will engage in roughly \$1.5 trillion of stimulus (nearly double the \$850bn annual expansion during the last round of quantitative easing enacted by the Fed). We expect that interest rates will track a similar pattern globally, where rates fall ahead of the announcement of quantitative easing in Europe and will actually rise modestly during the bond buying program in 2015.

Implied long-term inflation expectations are too low. The yield on the 30 year U.S. Treasury bond is 2.4%, which is below the historic lows of 2.55% and 2.46% in 2008 and 2012 respectively. These prior levels were reached during the height of the global financial crisis and the European sovereign debt crisis. The current 2.4%, in contrast, comes during a period of healthy economic growth and implies that inflation over the next 30 years will be negligible. It is unlikely that interest rates will increase significantly in 2015, but investors should heed caution believing that interest rates will remain this low indefinitely.

U.S. equity valuations are slightly above fair value, but are not yet approaching lofty valuations that preceded significant bear markets in the past. The asynchronous strength in global equity markets that began in 2009 has further to run. The U.S. consumer will be aided by falling oil prices, a stronger U.S. dollar, and a favorable commodity price decline. The combination of a strong U.S. consumer along with accommodative central banks set up a favorable backdrop for global equity investors in 2015.



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