Market Insights

Summer 2015

Whittier Trust
INVESTMENT & WEALTH MANAGEMENT

Despite Drama and Crisis, Markets Remain Resilient

The U.S. stock market has been remarkably resilient to a myriad of potential disruptions in the first half of 2015. The year began with commodity markets falling sharply, West Coast port shutdowns and a contraction in the U.S. economy in the first quarter. The second quarter ended with fireworks as the 4th of July holiday neared, with Puerto Rico and Greece offering the specter of a dual default on the final day of the quarter. Greece failed to make a €1.6bn payment due to the IMF on June 30th, while Puerto Rico announced that its debt will not be payable.

At the same time, volatility in the Chinese stock market spiked in the midst of a virtual roller-coaster ride. The Shanghai Index rose almost 150% in the twelve months through June 12, 2015 as the government loosened capital and borrowing constraints. The run-up in Chinese equities was followed by a swift 30% retracement including a dramatic 5% fall in one hour of trading on July 1st. Despite these uncertainties, the S&P 500 index was essentially unchanged in the first half of the year.

Drachma Queen Takes Center Stage

Greece is a nation with too much debt relative to its ability to repay its obligations. If Greece were a company, this would be a simple case of bankruptcy. Greece would pay claims to its creditors and reorganize as a new company. Greece, as a developed country tied to the world's largest monetary union, faces a more complex default scenario. More than 80% of Greek debt is held by public sector and quasi-sovereign entities while only 17% is held in the private sector where the conventional risk of contagion is likely to be higher. Thus, the owners of Greek debt are driven more by political motives than economic factors.

The troika of the IMF, ECB and the Eurozone Commission need to balance conflicting interests including the political preferences of EU member countries, the sustainability of Greek debt, the stability of the European economy and the return of taxpayer money. These competing interests have led to perhaps the most prolonged and telegraphed default in history. Most EU voters believe that debt relief is unfair given Greece's inability to collect taxes and its overly generous pensions. In contrast, Greek voters find reform and austerity without debt relief unacceptable. The obvious solution of debt relief in exchange for fiscal reform has been unreasonably difficult to achieve due to political complications and the precedent such a deal would set for the rest of the European periphery.

> *"Now I have the feeling we've reached the demarked line. From here on there is a minefield."*
> ~Alexis Tsipras

Greece and the European Union may have reached a deal, but it is quite likely that both Greece and Puerto Rico will ultimately default on outstanding debt obligations. While Greece garnered most of the media attention, prospects of a Puerto Rico default and a stunning stock market decline in China also posed systemic risks on a different scale. Puerto Rican debt is held by approximately half of the municipal bond funds in the United States as a result of the dual tax exemption of Puerto Rican bonds. This favorable tax status helped Puerto Rico amass nearly $15,000 of debt per capita, almost 15 times the median U.S. state debt, at unusually low yields which, at times, were close to those on U.S. Treasuries!

> *"The U.S. economic expansion remains intact despite the risks from Greece, China and Puerto Rico."*

LOCATIONS

Southern California

Los Angeles
1600 Huntington Drive
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Orange County
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Costa Mesa, CA 92626
714.888.5547

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

Greece and Puerto Rico also share the commonality of tourism-based economies with a currency tied to a stronger economic union. This common currency allowed both countries to amass more debt than was reasonable to repay. The day of reckoning for both countries to face the consequences of bloated balance sheets coincidentally arrived on June 30th as the two economies now reach for lifelines after years of fiscal mismanagement.

The meltdown in the Chinese stock market eventually required significant intervention policies from the government including trading halts and selling restrictions. The need to control market activity raised the disturbing prospect that mechanisms to control the economy may be dwindling or even failing. The simultaneous challenges of managing both a debt and equity market bubble along with a secular economic transformation towards more domestic consumption could meaningfully slow Chinese growth in the coming months.

Closer to home

The U.S. economic expansion remains intact despite the risks from Greece, China and Puerto Rico. Total exports comprise only 12% of the U.S. economy and less than 2% of those go to Europe. The U.S. economy is projected to grow at a 2-3% annual rate as lower energy-related capital investment is offset by gains in consumer spending from stronger employment and lower commodity prices. The housing market continues to strengthen and wage growth ticked up in the second quarter. Unemployment is now down to 5.3% and within reach of the Federal Reserve's target rate of unemployment of 5.0-5.2%.

While the markets fret about the timing of the first interest rate increase, it is important to focus instead on the pace and trajectory of subsequent tightening. On one hand, unemployment data suggests that the Fed should begin to normalize interest rate policy. On the other hand, the recent strength of the U.S. dollar coupled with commodity weakness will dampen inflation and lead to a slower glide path for interest rate hikes. Any Federal Reserve action is also likely to diverge from other central banks which are in the early stages of quantitative easing or continued easing through lower rates.

We believe that the Federal Reserve's approach of "looser tightening" and "lower for longer" will appropriately balance the dynamics of a stable economic cycle at home, political uncertainty abroad and a strong U.S. Dollar.

A Pause … Or a correction or even an end to the US equity bull market?

While U.S. equity market valuations are higher than recent averages, they are not excessive. The S&P 500 index is priced at around 17x forward earnings estimates, while most markets outside of the U.S. are cheaper. With the headwinds of a strong dollar and weak commodity revenues, earnings growth in 2015 is projected to slow down to around 2% but then rebound to over 10% in 2016. Disruptions in China, Greece, and Puerto Rico pose threats to the U.S. economy, but are unlikely to weigh down the tailwinds of global liquidity and a durable US economic recovery. The long duration and steady pace of this economic cycle, low inflation and limited valuation risk suggest that the US equity bull market may have longer to run but at a more modest pace.

Our constructive outlook on U.S. equities renders them more attractive than bonds and also relative to other regional equity markets. We believe that an emphasis on quality investments is even more important today since valuations are not cheap in most asset classes. In addition to finding value in direct real estate investments and opportunistic energy investments, we continue to favor equities with core holdings in the U.S. and incremental allocations to regions with accommodative monetary policy. At Whittier Trust, we have been able to mitigate and, to some extent, even avoid pitfalls such as Greece, Puerto Rico, and China.

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