Market Insights

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Whittier Trust
INVESTMENT & WEALTH MANAGEMENT

Connecting the dots …

Over the past 18 months, the S&P 500 Index has gone sideways but with renewed bouts of volatility. From 2012 through 2014, the S&P 500 Index rose over 50% without experiencing a -10% correction. Yet from the beginning of 2015 through the first part of 2016, the S&P 500 Index has returned only its dividend and gyrated through two -10% declines. The media has highlighted a number of reasons for the market volatility: the threat of China's economy experiencing a hard landing, the collapse in the price of oil, the Federal Reserve raising interest rates, a global manufacturing recession, an emerging market crisis, credit spreads indicating a recession, and the list goes on. The purpose of this piece is to help connect the dots and dispel some of the mystery as the market climbs the most recent "wall of worry."

Quite ironically, the market weakness can largely be traced to the U.S. economy performing better than the rest of the world. As the U.S. economy expands, the expectation is that the Federal Reserve will raise interest rates. Meanwhile, Europe and Japan are engaging in *negative* interest rates to stimulate economic growth. The divergence in interest rate policy is putting pressure on global currencies, which in turn is causing nearly all of the aforementioned problems. **With negative and falling interest rates around the world and increasing U.S. interest rates, money has flowed into the U.S. dollar and the dollar has strengthened.**

A strong dollar is both good and bad. A strong dollar is good for U.S. citizens who are spending money abroad or importing cheaper goods, but is bad for U.S. exporters, emerging markets whose currency and/or debt is tied to the USD, and the oil sector. The stronger USD makes it difficult for exporters in the U.S. and in China to compete against cheaper currencies. Oil prices fall when the USD appreciates, which has created a default scare for oil producers. **These seemingly unrelated market concerns are all ultimately tied to currency markets.**

The disparity in interest rate policy is weighing on the banking system as well as currency markets. Banks in Europe are required to hold reserves in sovereign bonds that pay zero interest and actually have a *negative* yield. While central bankers are trying to stimulate borrowing by offering zero or negative interest rates, this policy is perversely crippling the banking system.

Central banks have recently stepped in to alleviate several of the concerns. The Fed has communicated that interest rates will remain historically low, which has led to stabilization in oil prices and alleviated concerns around China for now. The European Central Bank moved to ease the pressure of negative interest rates on banks by buying bonds issued by financial institutions.

There are a number of moving parts, but they are all tied to currencies and interest rates. **The Fed is delicately balancing interest rate policy along with currency markets and the spillover effects on China, the oil sector, and credit markets.** If the Fed navigates interest rate policy well, by keeping rates relatively low and placing a ceiling on the USD, the recent market rally is justified.

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