Market Insights

SPRING 2016

WhittierTrust
INVESTMENT & WEALTH MANAGEMENT

CLIMBING A WALL OF WORRY...

The first quarter of 2016 was virtually a tale of two halves as markets went on a roller-coaster ride.

The growth scare triggered by China's surprise currency devaluation last summer intensified at the beginning of the year. Commodity prices continued to tumble, oil went below $30 per barrel, credit spreads widened to recessionary levels and fears of widespread contagion began to dominate the markets. Growth expectations fell around the globe, stock prices declined by -12 to -18%, the 10-year U.S. Treasury bond yield dipped below 1.55%, the U.S. dollar climbed higher and oil hit a low of $26 per barrel in the midst of the market mayhem.

The headwinds pushing stocks lower appeared to originate from seemingly disparate sources. The one common theme, however, that tied China, commodities, credit and contagion together was currencies and central banks. A divergence in global central bank policies, where the Fed started to raise rates while other central banks were easing or even going to negative rates, produced the expected outcome of a stronger U.S. dollar. The Fed's stubborn adherence to its projections of four rate hikes in 2016 added more thrust to the continued rise in the U.S. dollar and escalated concerns about a serious policy misstep leading to an imminent U.S. recession.

As it turns out, strength in the U.S. dollar has an adverse effect on all of the other factors discussed above. The key, therefore, to any resolution of the market chaos was some policy action to halt the rise in the U.S. dollar.

The sudden reversal in all markets from mid-February can now be more easily understood because it coincided with signaling from the Fed that it was willing to back off from its more aggressive tightening stance. The new projections from the March Fed meeting now call for only 2 more rate hikes instead of 4 and market expectations are as low as just 1 rate hike in 2016.

The prospect of lower rates in the U.S. set off a chain reaction which caused the U.S. dollar to reverse its upward trend and, as a result, stabilized stocks, bonds, commodities and growth expectations. Global stock markets rebounded dramatically to finish almost even for the first quarter, oil prices climbed back to over $40 per barrel and fears of a global recession abated.

BUT WHAT ABOUT THE GROWTH SCARE?

Economic growth around the world remains admittedly weak. Growth in China seems to have stabilized for now but is still projected to head lower on a gradual downward trajectory. On a more troubling note, first quarter U.S. GDP growth was dangerously close to zero at an anemic 0.5%.

While we have averted a U.S. recession in the midst of this economic slowdown, investors have focused intensely on an even more worrisome earnings recession. Earnings growth in Q1 2016 was initially projected to be -8.6% which marks the fourth consecutive quarter of earnings declines. The earnings recession is, by far, the biggest driver of mediocre, and highly volatile, U.S. stock market returns over the last 18 months or so.

Lower interest rates in the meantime have supported stock valuations but persistent slow growth inevitably begs the question whether Price/Earnings multiples can be sustained at their current levels.

REASONS FOR OPTIMISM

We address the concerns over economic and earnings growth at a seasonal, cyclical and secular level.

We observe an interesting pattern in recent years where Q1 growth seems to be seasonally understated. As Figure 1 shows, first quarter GDP growth from 2010 to 2014 has been well below 1% and lower than average growth from Q2 to Q4 by almost 2.3%. This pattern of lower Q1 growth relative to the rest of the year has persisted for well over a decade now.

We defer a discussion of this discrepancy to perhaps a later date but the trend suggests that full year 2016 GDP growth may yet prove to be higher than 0.5–1.0% in light of reasonable strength in other economic indicators such as employment and housing and a more accommodative monetary stance.

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LOCATIONS

Southern California

LOS ANGELES
1600 Huntington Drive
South Pasadena, CA 91030
626.441.5111

ORANGE COUNTY
3200 Park Center Drive, Suite 980
Costa Mesa, CA 92626
949.216.2200

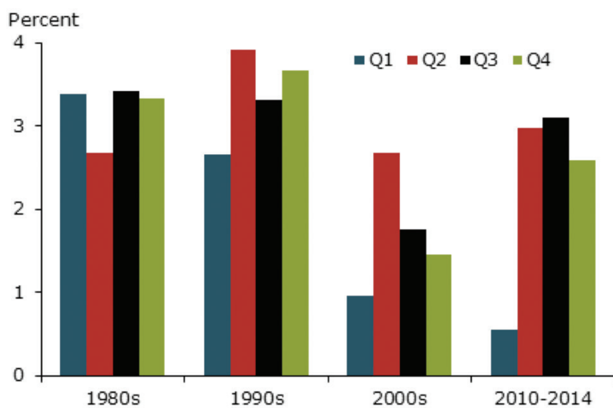
Northern California
505 Montgomery Street, Suite 620
San Francisco, CA 94111
415.283.1850

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

> "On a secular basis, real GDP growth in the U.S. has probably slowed down to around 2% from the historical average of 3% based on fundamental factors related to labor force growth and productivity trends."

Figure 1: U.S. Real GDP Growth



Source: Federal Reserve Bank of San Francisco

On a secular basis, real GDP growth in the U.S. has probably slowed down to around 2% from the historical average of 3% based on fundamental factors related to labor force growth and productivity trends. We have now observed slower-than-average growth for the last decade after the Global Financial Crisis.

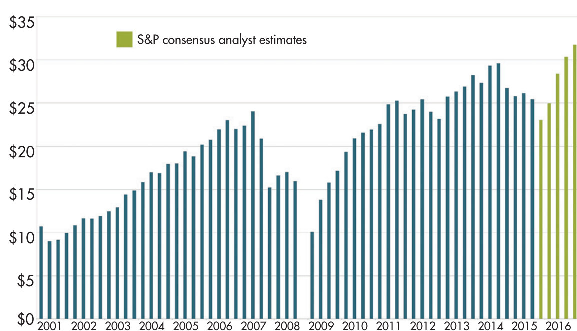
We focus next on the unfolding earnings recession—defined conventionally as two or more consecutive quarters of negative earnings growth. Earnings have now fallen year-over-year for 4 straight quarters. As discouraging as that trend appears, along with a projection for another decline next quarter, there now appears to be light at the end of this particular tunnel.

Figure 2 shows that earnings may have troughed in recent months and are now poised to register positive sequential and year-over-year growth in the second half of 2016 and beyond.

While this projected rise in estimated earnings is encouraging by itself, we find room for more optimism in the fundamental drivers of this expected reversal.

Profits for U.S. companies in the last year or so have been adversely affected by lower oil prices and a stronger dollar.

Figure 2: S&P 500 Quarterly Operating Earnings per Share



Source: S&P Dow Jones Indices

The steep decline in oil prices has devastated earnings in the Energy and Materials sectors where net income fell by -65% and -35% respectively in 2015. And a stronger dollar has forced many large U.S. multinationals to report lower revenues after currency translation of foreign sales.

Just as these twin headwinds contributed to the decline in 2015 earnings, they have now changed course to potentially become neutral or even positive factors in 2016. Oil is now up around +10% in calendar year 2016 and a stunning +60% from its February lows. The trade-weighted dollar peaked in late-January and is now almost -5% lower. A positive reversal in the outlook for Energy, Materials and multinational companies should boost overall corporate profits and lends greater credibility to the projected earnings recovery.

AND A FINAL COMMENT ON STOCK VALUATIONS…

With the S&P 500 index virtually unchanged for the year, is the forward P/E multiple of around 16.5x too high or within a fair range given current economic and market conditions?

The angst over stock valuations seems justified since we are not out of the woods by any means. Economic growth remains muted in the U.S. and around the globe. Other dangers continue to lurk in the form of political uncertainty in the U.S., Britain's potential exit from EU and the ultimate fallout from the distressed Energy sector.

There is reason, however, to believe that enough has changed from February where another steep decline in stock prices is less likely and that stock valuations are not at high risk.

1. The Fed is more dovish. Rates are, therefore, expected to remain lower for longer and provide support to risk assets.
2. We may have seen the worst of the cyclical dip in earnings as an earnings recovery is being forecasted for the second half of 2016 and all of 2017. These expectations of higher earnings seem to be supported by the recent bounce in oil prices and decline in the U.S. dollar.
3. Besides, as has been said repeatedly in this environment of low, zero and negative interest rates, **T**here **I**s **N**o **A**lternative (**TINA**). At current valuations, stocks offer higher earnings yields than current yields on government bonds and the potential for further growth.

We remain cautiously optimistic on the U.S. economy. We continue to believe that U.S. stocks are likely to ride out this volatility and eke out a modest return for the rest of the year. In this period of potentially lower returns for both stocks and bonds, we pursue our mandates of active security selection, tax efficiency and diversification from absolute return strategies with even greater vigilance.