Market Insights

Summer 2016

Whittier Trust
INVESTMENT & WEALTH MANAGEMENT

We live in interesting, and it seems increasingly uncertain, times. The world seems less predictable these days as we grapple with geopolitical, social and economic tensions in the midst of a rising wave of populism against the establishment.

Quite paradoxically, markets appear to have stabilized in recent months. Investors are now adjusting to an uneasy equilibrium where lack of growth leads to low interest rates, which in turn supports high valuations—an outcome which then appears to be at odds with low growth!

Interest rates around the globe have now breached the previously sacred lower bound of zero and moved into negative territory. Relative to most historical norms, the low levels of yields today and the significantly lower premium for holding long duration bonds could even be interpreted as precursors to a recession.

The stock market, however, appears to have dismissed the possibility of a recession in a significant rally from its February lows. Relative to most historical norms, stocks appear fairly expensive at this time. While high stock valuations can be justified by low interest rates, they seem chronically vulnerable to the inevitable bouts of growth scares and recession fears.

"The conflicting valuations from the stock and bond markets present a number of challenges for investing and building portfolios. Are low and negative bond yields predicting a recession in the near term? Conversely, are stocks pricing in an economic or earnings recovery? Are investors being drawn to stocks only because cash and bonds can no longer maintain purchasing power over time? If not, are these stock valuations justifiable or are they at risk?"

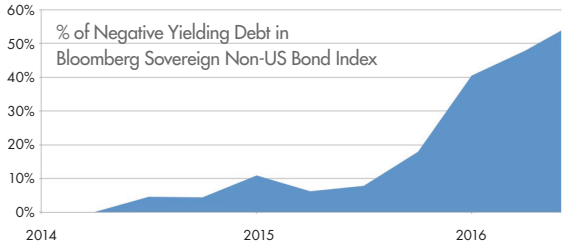
We address these questions in the following sections and offer evidence that a recovery is more likely than a recession.

NEGATIVE INTEREST RATES… PRECURSOR TO A RECESSION?

A drop in bond yields is usually triggered by a flight to safety. Investors typically flock into bonds as a safe haven when slow economic growth raises fears of a recession.

By most counts, over $10 trillion of global government debt, and 50% of the non-US sovereign debt index, is now trading at negative interest rates.

Figure 1—Record levels of negative interest rates



Source: Bloomberg

This has never happened before—we are in unchartered territory. And so how are we to interpret this unprecedented event?

On one hand, this may suggest that investors are so concerned about the economy that they are willing to forego preservation of purchasing power for 10 or more years. Or, on a more benign note, high bond prices and low yields may simply be driven by structural demand from government bond purchasing programs and natural buyers of long duration assets.

We believe that the real answer lies between the two scenarios. Yes, growth is slow and inflation is muted. Together, the combination provides an ideal backdrop for low interest rates. Negative rates, however, are probably more influenced by central bankers' new experiment with purchases of government bonds to lower borrowing costs even further and stimulate growth.

This policy of financial repression may even appear to be misguided as growth remains elusive, as banks become less profitable and less willing to lend and as investors and savers find it harder to grow wealth over time. The implications of the negative interest rate policy are profound and are worthy of a separate discussion.

Our more immediate take-away is that negative rates are more a policy outcome than a harbinger of an impending recession.

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LOCATIONS

Southern California

Los Angeles
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San Francisco, CA 94111
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Reno, NV 89501
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Seattle, WA 98101
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"Rising wages, a robust housing market and resilient consumer spending all bode well for economic activity in the near term."

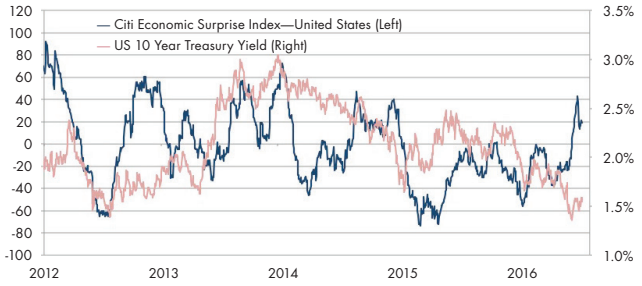
"Stocks may be pricing in normalized earnings as opposed to cyclical earnings in current valuations."

HOPES OF RECOVERY…RENEWED GROWTH?

While low interest rates are suggestive of prolonged economic malaise, the stock market has rallied strongly from February. The strength of the U.S. stock market and the leadership across its underlying sectors both hint at a revival of growth in the months ahead.

As you can see below, evidence of a recovery can be found within the economy and on the earnings front.

Figure 2—Citigroup Economic Surprise Index



Source: Citigroup, Factset

The Citi Economic Surprise Index has made an impressive swing into positive territory after two years of weakness as recent economic data has surprised to the upside. A key driver of improving economic fundamentals is the renewed strength in the job market. After a dismal showing in May, job creation in June and July has come in well above expectations.

Rising wages, a robust housing market and resilient consumer spending all bode well for economic activity in the near term.

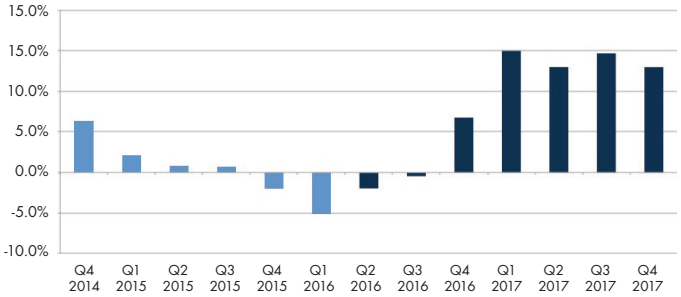
Corporate profits also seem poised for a turnaround. It now seems quite likely that earnings may have troughed in Q1 2016. Year-over-year earnings growth is projected to improve in subsequent quarters and be positive in all of 2017. The two biggest factors behind the earnings recession, steadily declining oil prices and a steadily rising dollar, seem to have halted and reversed their longer term trends.

The relative stability in both oil and the US dollar lends credence to the earnings recovery.

CAUTIOUS OPTIMISM

Renewed economic and earnings growth is not a *fait accompli* yet—it is still more about expectations than reality. A few recent signs warrant caution. A notable second quarter disappointment was the lower-than-expected 1.2% US GDP growth rate. While Q2 earnings growth remains negative as expected, year-over-year earnings growth for both Q3 and 2016 calendar year have now turned negative. And, finally, as has been the case for a while now, stock valuations remain high. U.S. stocks are now trading at a forward PE of over 17 times.

Figure 3—Rising earnings estimates



Source: Factset

We believe, however, that overall there is room for cautious optimism.

China seems to have stabilized despite a weaker currency. India has registered GDP growth in excess of 7% and is projected to do so in the coming quarters. The fallout from Brexit has been muted and localized. Central banks continue to ease and the next Fed hike has been pushed back. There is a greater emphasis around the globe on fiscal stimulus to augment monetary easing. Despite recent weakness, oil seems unlikely to test its February lows. Real-time indicators for Q3 US GDP growth are tracking at above 3.5%.

And finally, if earnings are indeed headed for a recovery, it casts stock valuations in a different light. If the earnings recession is drawing to an end, the trailing and forward PE may appear elevated by cyclically depressed earnings.

Stocks may be pricing in normalized earnings as opposed to cyclical earnings in current valuations.

As value stocks recover in this backdrop, we are even more focused on company valuations along with our emphasis on strong fundamentals and high quality. We favor stocks over bonds and are on the constant lookout for suitable alternative investments in client portfolios.