Market Insights

Spring 2015

Whittier Trust
INVESTMENT & WEALTH MANAGEMENT

Too much of a good thing—Some is good, more is better, too much can be a disaster.

Financial engineering has been a source of economic and market strength over the past five years for the United States. Japan and Europe are aggressively trying to emulate the success in the U.S. with outsized monetary stimulus programs known as Quantitative Easing. In the first quarter, the European Central Bank (ECB) announced €1.2 Trillion of Quantitative Easing, similar to the programs that the U.S. Federal Reserve engaged in over the past five years. **Global equity and bond markets reacted sharply to the ECB's announcement. The Euro collapsed and interest rates in developed Europe turned negative. The Euro fell from $1.40 to $1.05 before the ECB bought 5% of the €1.2 Trillion** stimulus with many forecasters predicting a further fall below parity. Meanwhile, interest rates moved into negative territory. The German ten-year bond yield fell to less than 0.20%. Switzerland became the first nation in history to issue ten-year bonds at negative interest rates, which begs the question of why they did not issue more debt. The ECB has already accomplished its goals of lower borrowing costs, a more competitive (weaker) currency, and increased growth expectations. Has the ECB done too much too fast?

Given the dramatic market impact of the initial moves, the ECB will be forced to consider reducing its policy measures over the course of the year. While a weaker Euro is one of the desired effects of Quantitative Easing, there is a point where the currency falls too far. As the Euro continues to weaken, wealth is being eroded in Europe. The European Union wants to be competitive from an export standpoint, repay debt in cheaper currency, and encourage tourism with cheaper vacations for foreigners. For these reasons, a slightly weaker currency is a desired effect of aggressive Monetary Policy. However, negative interest rates and a collapsing currency are not healthy, sustainable monetary objectives for a developed central bank.

While driving interest rates down can help an economy emerge from a recession, prolonged low interest rates can cause problems for the economy and markets over longer time periods. Extremely low interest rates are punishing savers and rewarding debtors. One homeowner in Spain received a credit on his mortgage statement for the negative interest due on his mortgage. Over time this 'disincentive to save' will reduce the pent up spending that accrues during periods of saving. With 25% of European government bonds trading with negative interest rates, there is virtually no incentive for fiscal responsibility. After years of austerity in Europe, several countries can borrow at negative interest rates. The Eurozone was facing a government debt crisis a few years ago and now many countries are being paid to take on additional debt. At a minimum, this reduces the motivation to implement balanced budgets and could create perverse incentives that cause structural problems when interest rates increase.

As the EU is aggressively trying to lower interest rates, the Federal Reserve is facing a relatively mature economic recovery in the United States that would typically warrant interest rate policy normalization. The U.S. unemployment rate hit the 5.5% threshold associated with historically tighter labor markets. The Fed views the 5.5% unemployment rate as a target rate to begin raising interest rates. **While the data suggests that the Fed should raise rates, the recent strength of the U.S. Dollar is clouding that**

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decision. If the Fed elects to raise interest rates meaningfully, then the U.S. Dollar will appreciate further (as foreign money is attracted to a higher rate of return). The Federal Reserve will raise interest rates very slowly, balancing the concerns of a mature economic cycle and a strengthening Dollar.

Reflating the Bubble?

After fifteen years, the NASDAQ Index is approaching an all-time high while select housing markets are hitting fresh highs in the same year. Tech stocks and the housing market were the cause of the last two bubbles in the U.S. economy. It is fitting that both markets are hitting fresh highs during the same year. While both markets are approaching record high levels, each market looks very different today after years of profit and rental growth.

The previous peak for the NASDAQ Index, comprised mostly of technology companies, was reached at the height of the dot-com bubble (March 2000) when the NASDAQ Index hit 5049. In February 2015, the index surpassed 5000 for the first time in 15 years. While the index is approaching the same price level, the earnings power of the underlying companies is significantly higher today. **Apple, for example, earns more today ($39.5 billion in 2014) than the entire index of over 100 companies earned in the year 2000 ($34.5 billion). All of the NASDAQ Index companies combined earned $386 billion in 2014, approximately 1,000% more than the $34.5 billion earned in the year 2000, yet the price index is at the same level.** Cisco provides an example of how the index has changed over the past fifteen years. In the year 2000, Cisco earned $2.7 billion with a market cap (equity value) of $448 billion. Today, Cisco's earnings have grown to $8.7 billion with a market cap of $132 billion. The market cap has fallen 75%, while earnings have grown more than threefold. **While stock market valuations have become more expensive than at the depths of the Great Financial Crisis (March 2009), the broad market (especially technology companies) are far from the peak valuations of the dot-com bubble.**

Similarly, the housing market is once again approaching all-time highs in select markets around the country supported by improved fundamentals. Some will worry about those housing markets that have reached new highs with a fresh memory of the last housing collapse, but fundamentals are more supportive of those same prices. For example, rents have increased 16.3% nationwide since the peak of the housing bubble in 2006. Borrower quality has improved as well, with the average FICO score of borrowers increasing to 749 from under 700 in 2006. Homeowners have shifted towards 15 year mortgages, higher down payments, and fixed rate terms. Meanwhile, housing supply has not kept pace with population growth. Home construction has been limited, with housing starts below 1 million for most of the past five years. As rents continue to rise, the housing market will continue to recover across the country.

Outlook

The improving fundamentals of the stock and housing markets demonstrate the importance of having time on your side as an investor. Long-term value creation is often clouded by the short-term fluctuations of the market. With each passing day, the next cash flow receipt, rent increase, or dividend increase is one day closer. Strong, cash flow generating assets will prove to be accretive long-term investments with the passage of time.

The U.S. economy will once again experience a transitory slowdown in the first half of the year due to a harsh winter on the East Coast exacerbated by port shutdowns; however, the economy should grow in the second half of 2015 aided by strength in the labor market and prolonged low interest rates. **For these reasons, we continue to favor equities over fixed income and prefer quality companies over speculative stocks. The low hanging fruit of cheap valuations from the financial crisis is behind us, but we are not yet in bubble territory for core equity holdings.**

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