Market Insights

Third Quarter 2017

WhittierTrust
INVESTMENT & WEALTH MANAGEMENT

THE CONUNDRUM OF LOW INTEREST RATES

The current economic expansion in the U.S. is beginning to approach longevity that has rarely been seen in prior cycles. This economic cycle, which began in July 2009, is already the second-longest expansion on record at 96 months. It has been a remarkable recovery … in many different ways beyond its sheer chronological age. One of its most striking traits has been the prevailing conundrum of low interest rates – at such a late stage of the economic cycle.

Set in the aftermath of a severe financial crisis and the Great Recession, this global recovery has been deeply rooted in ultra-easy monetary policy from day one. Interest rates were cut, gradually at first and eventually all the way down to zero and even into negative territory, to stabilize economic activity. In addition to zero and negative interest rates, central banks all over the world have engaged in multiple rounds of quantitative easing to keep long-term rates low and spur growth.

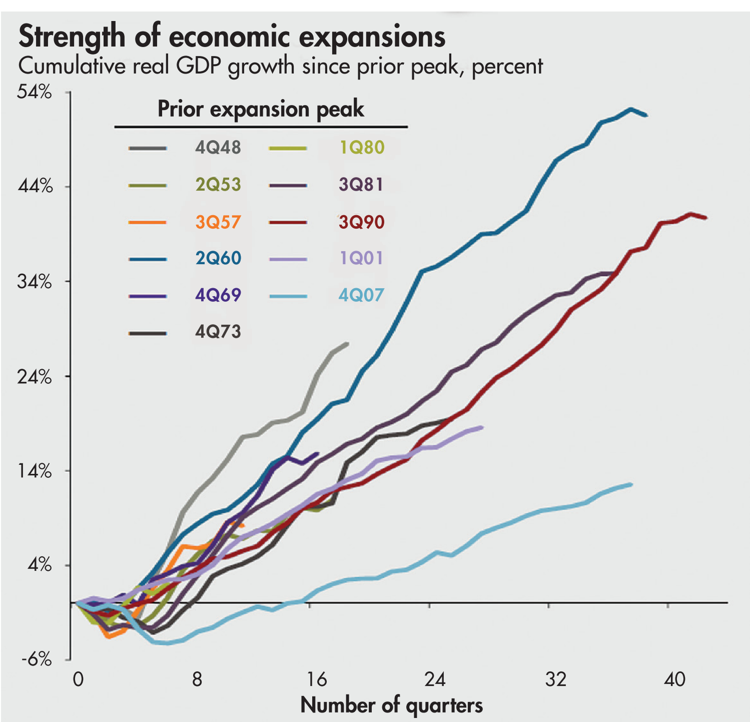
The Federal Reserve Board has become the first major central bank to reverse this trend and increase interest rates in recent months. The Fed has raised rates four times since December 2015 by 1%, or 100 basis points. Even in the midst of this tightening cycle, long-term interest rates remain low by historical standards in the 2.3 – 3.0% range for the 10- and 30-year Treasury bonds.

Why are these rates so low? How high can they go? And what does it mean for your investment portfolio? We examine the forces behind current interest rates, the outlook for future possibilities and the implications for asset prices.

We begin our discussion with a closer look at the two main drivers of interest rates – varying levels of economic activity and changes in inflation expectations.

A NEW NORMAL FOR GROWTH, INFLATION AND … RATES?

Just as this economic cycle has been remarkably elongated, economic growth during the recovery has been even more remarkably muted. The chart below compares the current expansion to prior ones.



Source: J. P. Morgan Asset Management

"We take a closer look at the two main drivers of interest rates – varying levels of economic activity and changes in inflation expectations."

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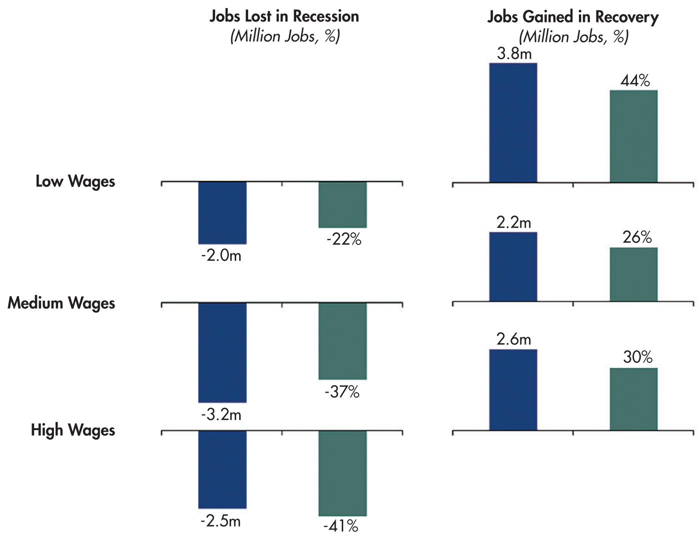
> “Low inflation is compatible with slow growth but distinctly at odds with remarkably strong employment. We can think of at least three key themes that have kept a lid on inflation – quality of job growth, ceiling on oil prices and Amazonification.”

While prior cycles have seen occasional spikes of real GDP growth well in excess of 3%, they have been conspicuous by their absence this time around. First quarter growth has been chronically weak in this recovery and the cycle-long real GDP growth rate has barely averaged 2%.



Source: Bureau of Labor Statistics, National Employment Law Project

While the lack of robust growth is a departure from prior recoveries, there may be a number of fundamental factors that contribute to low growth. History has shown that severe financial crises can be debilitating. It takes a long time to heal from such a shock – some academic studies have suggested that it takes as long as a decade to recover sufficiently from a major financial crisis. We also know that labor force growth drives economic growth. The U.S. labor force has been shrinking both from an ageing population and a lower participation rate. Productivity growth is low, the propensity to save has increased after the scars of the last recession and credit growth has been below trend in the face of secular deleveraging.

Experts have debated whether this now defines a “New Normal” in the U.S. economy. The less optimistic forecasts of future growth range from the sinister prospect of secular stagnation to one of sub-par, below-3% equilibrium growth. As prospects of a big impetus from policy initiatives erode, we subscribe to a “New Modest” view of the U.S. economy with real growth of around 2.5% and no imminent recession.

Inflation has also been remarkably quiescent so far. On one hand, low inflation is compatible with slow growth but distinctly at odds with remarkably strong employment. The U.S. unemployment rate stands at a scarcely believable 4.4%, well below the normal 5% threshold level of full employment, and yet, wage growth is steady at 2.5%, headline inflation is a mere 1.6% and core CPI is equally low at 1.7%!

As we reflect on these observations, we can think of at least three key themes that have kept a lid on inflation.

a. Quality of job growth

Private sector employment growth in this recovery has kept pace with or even exceeded trends from prior cycles. The good news is that the quantity of jobs created in this cycle has been stellar – the private sector has so far added well over 10 million jobs from its employment low in early 2010. The bad news relates to the quality of jobs created – job growth has been stronger in lower-wage industries and a number of higher-wage jobs have been permanently lost. We illustrate this with a simple example in the chart to the left. It is estimated that around 8.8 million jobs were lost from the employment peak to its trough around the Great Recession. It took 4 years from the low point in employment to recover the same number of jobs. Unfortunately, the employment growth during the early recovery was unbalanced and adverse – twice as many jobs were added in lower-wage industries as were lost in the recession (44% vs. 22%). By the same token, only 56% of new jobs were created in the mid to high wage industries – not nearly enough to offset the 78% of recession-related job losses from the same industries. This trend has persisted into the later stages of the cycle. The downward shift in the wage composition of new jobs, in large part, explains the absence of significant wage inflation.

b. Ceiling on oil prices

The recovery in oil prices from their low of $26 per barrel in early 2016 has been modest. Demand for oil has remained relatively strong and does not explain why oil remains under pressure. The continued relative weakness in oil is still

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all about a global supply glut – one that persists even after OPEC's commitment to two consecutive rounds of production cuts. In the meantime, U.S. shale production has proven to be surprisingly resilient. Secular trends in better technology and lower break-even points are likely to make U.S. shale the swing producer in oil and keep a ceiling on prices at between $50 and $60. While the global markets are gradually rebalancing to equilibrium between supply and demand, limited upside in oil prices contains overall inflation.

c. Amazonification

Amazon's leadership position in e-commerce is well-established. The company continues to grow revenues, cash flow and market share in traditional retailing with devastating impact on competitors. Even as Amazon's stock price has surged to above $1,000 and its market capitalization to above $450 billion, we estimate that its retail competitors have lost around $70 billion in market value in the last year alone. The Amazon juggernaut shows no sign of slowing down as it now sets its sights on the grocery food industry with the Whole Foods acquisition. Amazon has been disruptive in creating price deflation through its innovative use of technology. Amazon's technology edge in the areas of cloud computing, robotics and automated delivery give it a strong competitive advantage not only through lower prices but a more compelling overall value proposition. The Amazon effect is now wide-spread enough to be systemic in dampening inflation and even job growth itself. It is also a trend that is likely to continue as the world focuses more and more on automation and artificial intelligence applications – autonomous driving is one simple example.

We have so far discussed some of the drivers within the U.S. that may have contributed to lower growth, lower inflation and, therefore, lower rates. We next look at some influences from overseas that could also be holding rates down.

INTERNATIONAL INFLUENCES

Interest rates were cut even more aggressively outside the U.S. in response to the Global Financial Crisis of 2008-09. In the U.S., short term interest rates fell to zero and stayed there for a long time; outside the U.S., both short term and long term rates dropped below zero and stayed negative for a while. I wonder how many of us saw that coming – I certainly didn't expect to see the 10-year German bund at a negative yield in my lifetime! At its low point, an astounding 30% of international sovereign debt was estimated to be trading at negative interest rates. Even as international bond yields have risen above zero in recent months, they still remain very low. In many ways, the U.S. recovery today is stronger and closer to a self-sustaining trajectory than the ones in Europe or Japan. As a result, monetary stimulus is stronger internationally than in the U.S. Given that global bond markets are all inter-connected through equilibrium interest rate differentials, low international rates are also keeping U.S. rates lower than just based on domestic considerations.

2017 has also brought about the first instance of a synchronized revival of global growth in nearly a decade. Even though global economies have been healing since 2009, we haven't seen all regions of the world firing on multiple cylinders at the same time until now. We can best describe the disjointed nature of this global recovery through an analogy that hits close to our home here in California. Imagine the Global Financial Crisis to be a monumental earthquake. As is common with such a seismic event, we have since encountered a number of "aftershocks" on the heels of the Big One. The European sovereign debt crisis (2011), Grexit (2013-14), prospects of currency wars (2015), collapse of crude oil (2016), China hard landing (2016) and Brexit (2016) are just a partial list of these economic aftershocks. We contend that they have all combined and conspired to interrupt the global recovery. With each instance of an after-shock, markets have retreated and bond yields have collapsed. We believe that this fitful, stop-and-go nature of the global recovery has also held U.S. interest rates down in this cycle.

INVESTING… IN A GOLDILOCKS ECONOMY

We have highlighted a number of factors that shed light on the conundrum of low interest rates. Most of these themes suggest that both growth and inflation are likely to be muted and

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modest. As an extension of these observations, we believe that the destination and the path for normalized interest rates will be lower and shallower than in the past.

The 10-year U.S. Treasury yield has historically been 5 to 5.5%, in line with average nominal GDP growth rates which have also been in the same 5 to 5.5% range. We believe that real growth and inflation are likely to be lower than in prior cycles. As a result, U.S. interest rates may not rise to historical levels during this cycle and could well normalize at a percentage point or two below prior norms.

Such a possibility could have a meaningful impact on investment choices and portfolio considerations.

1. A gradual rise in bond yields may make bonds less risky to own in a well-diversified portfolio.
2. The need or urgency to be “short” duration may be less compelling than generally believed.
3. The demand and price for inflation hedges may be overstated.
4. A longer, and more muted, cycle pushes back the timing of the next recession.
5. Lower-than-historical interest rates can support higher stock valuations.

We are vigilant of the transition in the economic and monetary cycle. We remain committed to a broad, yet customized, level of diversification across stocks, bonds and alternatives and emphasize high quality companies to invest in at the security level.

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