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IdahoTrust

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Market Insights

A periodic newsletter from Idaho Trust

The Bank of Japan has lowered its benchmark interest rate into negative territory. Japan's move reflects an effort to stimulate its economy as a globally slower economic environment has restrained growth in that region. More broadly speaking, corporate profits, as measured by the S&P 500, have begun to decline, which has caused many to wonder is this a temporary slowdown caused by lower oil prices or the beginning of a more dramatic economic recession?

Japan

The Bank of Japan (BoJ) surprised financial markets by moving its official interest rate into negative territory at the end of January. The bank announced that it cut its benchmark interest rate to -0.1%, essentially a charge for excess reserves parked at the bank by financial institutions. The move is an attempt to counteract the negative effects of falling oil prices and a slowdown in the Chinese economy. The BoJ is following the lead of several central banks, including the European Central Bank (ECB), which first resorted to negative rates in 2014.

The move by the BoJ is not as dramatic as it sounds: the negative rate will apply only to new reserves that banks place with the central bank. Existing reserves, which now total a record ¥220 trillion ($1.8 trillion), will continue to earn 0.1%. Generally speaking, these new reserves will come from the Japanese central bank's ongoing quantitative easing program. The Prime Mister of Japan, Shinzo

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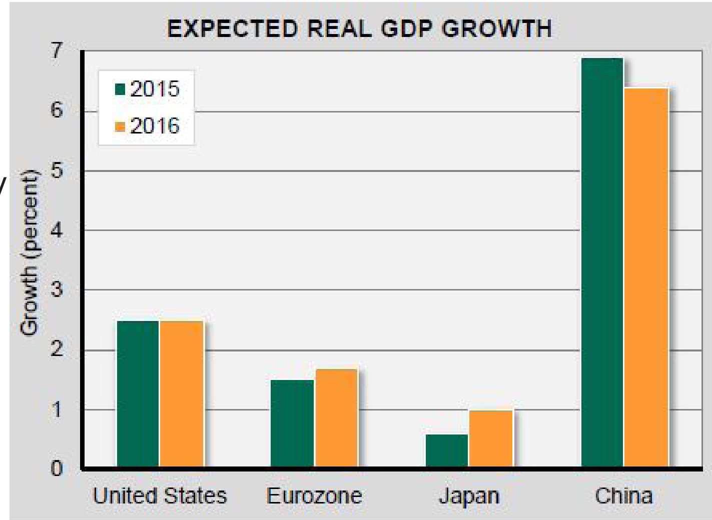
Abe, has pledged to banish deflation and revive economic growth with aggressive monetary policy. The BoJ kept its Quantitative Easing (QE) program unchanged, maintaining an annual expansion in the nation's monetary base at around 80 trillion yen.



The BoJ cited recent volatility in financial markets, particularly the outlook for the Chinese economy, as one of the catalysts behind its decision. The monetary authority lowered its median core Consumer Price Index (CPI) forecast to 0.8%, down from its prior expectation of 1.4%. The BoJ expects that inflation levels will reach their 2% target between 2017-2018. In response to the expected positive impact that ultra-easy monetary policy will deliver, the BoJ increased its 2016-2017 median GDP forecast from 1.4% to 1.5%, which would represent a healthy gain from the current level and above current forecasts.

The Bank of Japan (BoJ) is not the first central bank to pursue a negative interest rate strategy. Many interest rates in Europe have been below zero for quite a while and may well continue into the future. Mario Draghi, president of the European Central Bank (ECB), recently hinted that monetary conditions in the Eurozone would be eased further as inflation remains stubbornly below the 2% target and unsettling news from Asia could diminish growth prospects.

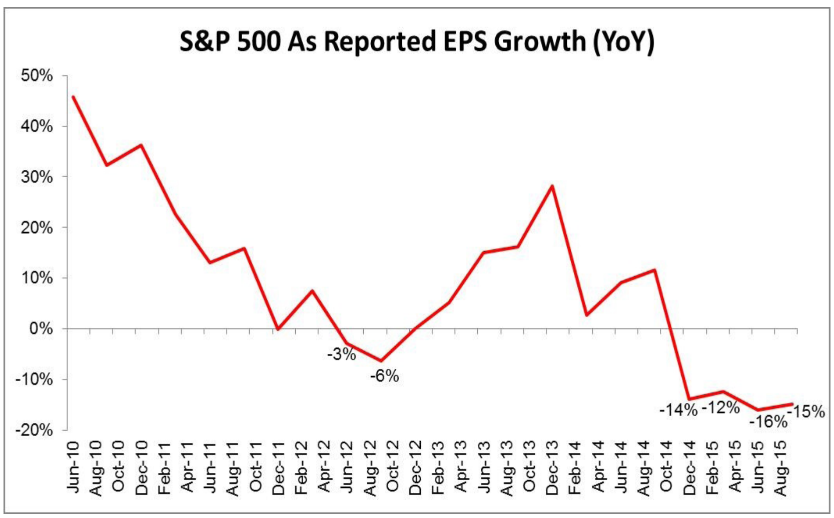
Profit Recession

By many measures, operating earnings for the S&P 500 reached an all-time high in third-quarter 2014, but have since declined at a mid-double digit rate on a year-over-year basis. Over the same period, the U.S. Department of Commerce Bureau of Economic Analysis NIPA (National Income and Product Accounts) measure of corporate profits, fell by 8%. The major difference between these two measures of corporate profits is that the NIPA measures both private and public companies. The NIPA is considered a much broader measure of the economy. Moreover, since the S&P 500 Index contains many larger corporations, they typically have much higher exposure to sales generated in foreign markets.

The current earnings decline represents a significant change from the relatively steady corporate profit environment experienced since the credit crisis. Many investors are concerned with the recent profit drop since in the past similar profit drops have coincided with major price declines in the U.S. equity market. The sharp profit decline (see chart) has led many to refer to this period as a corporate "profit recession", since the U.S. employment data and consumer spending have held up relatively well in comparison to corporate earnings.

The primary driver behind falling corporate profits in the S&P 500 is the sharp decline in oil prices and its impact on the energy sector. Oil prices have declined due to a combination of rising supply in the United States as well as a slowdown in demand from many emerging economies, especially China. A stronger U.S. dollar has contributed to the profit squeeze as it has helped reduce demand for U.S. exports and has hurt U.S. multinationals when they convert foreign-earned revenues back into dollars. The materials sector has not benefited from the cost savings of cheap oil as the sector's profit margins have declined as well. Chemical companies have led the decline. U.S. chemical producers' margins suffered as European manufacturers gained a cost advantage.

In contrast, profit margins in the industrials sector have increased slightly year over year. Lower oil prices have reduced input costs, thus allowing industrial companies to expand their operating margins. However, this improvement in operating margins has been more than offset by a drop in sales.



On a positive note, the consumer and financials sectors have made positive contributions to the profit outlook. Low energy prices have benefited consumers by allowing them to spend a larger portion of disposable income on non-energy consumption. Consumer sector earnings have improved in response.

Conclusion

Earnings for the S&P 500 Index struggled to generate positive momentum in 2015. In fact, EPS (earning per share) peaked in the third quarter of 2014. As we have mentioned in previous Market Insight papers, the dramatic plunge in the price of oil and a slowdown in demand overseas has devastated energy and materials companies' profits. In the years ahead, oil production should decline which will help to remove excess capacity and boost prices for commodities, allowing energy company margins to recover to more normal levels. This should help corporate earnings to return to more normal levels. The current commodity-induced "profits recession" may be short lived, but the overall secular trend in profit growth will likely be at slower rates than in the past quarter-century.

S&P 500 Index

3 Month	-6.19%
Year-to-Date	-4.96%
1 Year	-0.67%
3 Year	10.95%
5 Year	10.54%

MSCI EAFE Net Index

3 Month	-9.91%
Year-to-Date	-7.23%
1 Year	-8.43%
3 Year	0.48%
5 Year	1.24%

Barclays Aggregate Bond Index

3 Month	0.78%
Year-to-Date	1.38%
1 Year	0.16%
3 Year	2.18%
5 Year	3.56%

As of 1.29.2016

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