MARTIN INVESTMENT MANAGEMENT, LLC
1560 SHERMAN AVENUE SUITE 1250
EVANSTON, ILLINOIS 60201

(847) 424-9124
FAX (847) 424-9182

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Investing In Quality Holdings Still Matters

In the fourth quarter of 2023, the S&P 500 Index had a total return of 11.69% and a total return of 26.29% for the year. The MSCI EAFE Index (USD) Net had a total return of 10.42% for the fourth quarter of 2023 and a total return of 18.24% for the year while the MSCI World Index (USD) Net had a total return of 11.42% for the fourth quarter and a total return of 23.79% for the year. After a surprisingly strong 2023, equity investors seem to temper expectations for 2024 as earnings estimates and valuations look high, volatility is unusually low, and global economic growth is likely to slow.[1] Equities have rallied to a degree in the past 12 months on relief that at least in that the U.S. recession has not arrived. The disparity between stock prices and global growth indicators suggests that either stocks need to fall, or global growth will need to rebound in the coming year.[2]

Government policy has been a big driver of U.S. equities performance in 2023. Treasury debt decisions have driven stocks and bonds in the second half of 2023.[3] This past year was a massive year for spending with large increases in defense, Health Care, Social Security Tax, Tax Refunds, and interest costs. As Janet Yellen stated "While some forecasters predicted a 100% chance of recession this year, that didn't happen. During the first three quarters of 2023, annualized growth averaged around 3%... The Infrastructure Investment and Jobs Act, the Chips and Science Act, and the Inflation Reduction Act all serve to incentive private sector investments".[4] Dan Clifton of Strategas Research believes there will be a "trifecta of infrastructure money" that will be realized from these three Acts in 2024. Investors are starting to price this spending into impacted stocks.[5] The uneven application of fiscal policy throughout 2023 coupled with the injection of emergency monetary support has been generally supportive of risk albeit at a narrower subset.[6] In the summer of 2023, the U.S. Treasury was $250bn short of debt due to less expected capital gains tax revenue and higher than expected spending. Yellen and Powell added $300bn of liquidity in six weeks from November 2, 2023's refunding announcement, borrowing more on the short end of the Treasury curve to pump more liquidity into the financial markets.[7]

Although not sustainable, Treasury accomplished this change by ballooning government debt. Since the March 2021 rule change, money market funds (MMFs) have been allowed to place deposits at the Federal Reserve and have flooded into the Federal Reverse Repo (RRP) as investors placed money in the MMFs in search of yield. Starting in June 2023, after the debt ceiling was raised, almost $-1.3tn switched out of RRP and into short term T-bills (+$1.46tn), which has accounted for 89% of the +$1.64tn of net Treasury borrowing. At 5% interest rates and lower underlying inflation, only the government has become a borrower. The present economy is growing dependent on deficit spending, which appears to be entirely dependent on MMF funds in the RRP. Using the RRP for funding the U.S. deficit is merely a "stop-gap measure" for Treasury, good for only part of 2024.[8] If the U.S. deficit is the major driver of the economy now as the private sector slows, additional means may be needed to avert a major recession.

In 2024 a reversal of interest rate hikes and quantitative tightening by the Federal Reserve could move more quickly than initially planned. Policy makers are also proposing additional fiscal stimulus before the presidential election. The income driven re-payment programs will provide relief. As student loan collections restart, only half of the millions of borrowers are paying their loans back, just as the new Income Driven Repayment Program is planned to take effect on July 1, 2024. A renewal of the Employee Retention Tax Credit program could be one of the most important options for the Biden administration to increase real per capita disposable income growth into the economy. Congress is considering more consumer stimulus through SNAP, Medicaid, Student Loans, and Tax refunds because the COVID aid programs are rolling off at $200bn annualized rate. The risk of the policy makers is that they do too much in 2024, which sets up more inflation for 2025 as too much money chases too few goods.[9] Larry Summers believes that excess federal deficits and a need to fund areas such as the green transition create more risk to the economy. Summers believes that the primary cause of higher inflation over the last few years was the Fed-induced liquidity. He also cautions that "when inflation comes down, historically, a significant economic downturn follows."[10]

If globalization previously reduced underlying inflationary pressure for a long time, making it easier for the central banks to reach their inflation targets at relatively low interest rates, then it is reasonable to assume that deglobalization will have the opposite impact. As the global economy undergoes several transitions, technological, demographic, geopolitical, and climate-related, there will be expected changes in the risks to growth. The frequency and size of shocks, alongside proactive fiscal and monetary policy, mean growth is likely to see great fluctuations.[11] According to El-Erian, central banks' once predictable impact on asset prices is being overshadowed by economic growth prospects, the final stages of inflation control, and the capacity to manage increased debt issuance due to substantial deficits and rising borrowing costs.[12]

From a wider global perspective, the unintended consequence of the unsustainable fiscal expansion from the U.S. Treasury and the restrictive policy from the Federal Reserve has been a major rise in the U.S. dollar. The implication is that global excess U.S. dollar liquidity, a proxy for the availability of U.S. dollars funding offshore, has fallen into the deflationary zone restricting the availability of commodity finance, trade finance, and emerging market credit finance.[13] Debt has begun rising relative to world GDP. International trade, impacted by a high USD, is slowing. Higher interest rates, geopolitical tensions, and regulatory challenges have prompted global dealmaking below $3tn for the first time since 2015.[14] To avert a major global slowdown, the Federal Reserve may need to lower the price of the USD by reducing the Fed Funds rate or expanding base money supply.[15] Against this background, most central banks have decided to pause raising interest rates, following the Federal reserve's lead, even though not all developed countries are in the similar circumstances.[16]

YTD equity returns were driven by outsized performance from the "Magnificent 7" from the start of 2023. Returns have diverged since Q3 of 2023, but the seven stocks still dominate YTD results.[17] The S&P 500 Index is the fourth best performing developed country index YTD. Globally, the top ten stocks are all U.S. based and constitute about 18% of the overall MSCI ACWI Index. It is comprised of approximately 2,360 total stocks, 27% of them being U.S. based, indicating that from an equal-weighted standpoint, a substantial majority of 73% represents non-U.S. stocks.[18] Individual international equities may continue exhibiting solid and diversified returns next year driven by present valuations, positive earnings growth, and improving return of capital to shareholders. However, the present divergence with the eurozone, U.K., Canada, and China disappointing while the U.S., Japan, and emerging markets ex-China ended up surprisingly positively may change as inflation falls and economic support turns more positive in other regions.[19]

In 2023 we believe that conservative investors have flocked to the tech giants for their capital, safety, and dominance in the AI revolution, and these stocks now dominate a great slice of the performance of global equity markets.[20] When the profits cycle decelerates, investors gravitate to the fewer and fewer companies that can maintain growth and have access to capital during an increasingly adverse backdrop. Leadership narrows as fundamentals deteriorate, and growth becomes scarce. We believe the fundamentals of the Magnificent-7 are not uniquely superior, and the breadth and depth of other ignored growth opportunities seem historically attractive. Growth opportunities exist in Sectors other than Technology.[21] We believe that economic booms and growing industries are not always synonymous with higher equity returns as investors get paid by profits, not innovations or patents.[22] We also believe that investors do not benefit from countries which experienced economic miracles over the past 26 years like China, where poor returns on investments were due to extreme rates of equity issuance. Share buybacks, limiting outstanding shares, tend to be an underestimated driver of shareholders' returns.[23]

Martin Investment Management, LLC has been cautious on the outlook for the economy and the markets for the better part of a year and remains so. The only reason the U.S. economy is growing and not yet officially in recession has been the record peacetime, non-emergency deficit.[24] Given the degree of asset inflation built into the system after nearly 15 years of profligate policy decisions, it may be that the bull market will need to be built on the footing of solid fundamentals.[25] Michael Cemblast of JP Morgan believes that the most significant influence on stock performance is corporate earnings as stock prices move up or down based on investors' perceptions of the current value of future company profits.[26] Most importantly, it seems intellectually inconsistent to discount the importance of earnings and interest rates as the keystone building blocks for stock prices in an environment seemingly devoid of recent historical equivalent.[27]

The market is expecting the beginning of a quick monetary policy loosening cycle in early 2024. As economies diverge around the globe, this may present opportunities for investors. In 2024 our focus will continue to be investing a small group of high quality companies above $2bn market capitalization with solid fundamentals, great products and services, ability to grow over time, and self-fund their expansion. The advantages of relatively high quality exist within many Sectors, industries, and stocks and may present a better opportunity for potential equity returns with lower risk. Quality factors may limit downside risk without sacrificing upside potential. More important than picking Sectors is identifying companies with the right mix of reasonable valuations and quality factor exposure.

Warm wishes for a bright 2024!

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