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Expecting the Unexpected

The January 2016 newsletter of Martin Investment Management, LLC stated: "the world was besieged by increased geopolitical risk and more deflationary headwinds. An endless list of factors, including an Emerging Market slowdown, particularly in China, oil and commodity price routs, domestic terror, Middle Eastern conflicts, and mass migration into Europe has eclipsed global stability." The 2016 U.S. elections were expected to bring four more years of the same direction. If one based investments on early 2016 news, future expectations might not have anticipated a large equity rally after the election and in the first quarter of 2017. The U.S. dollar and domestic equities have experienced strong gains, benefiting from post-election optimism with the promise of regulatory reform, tax reduction, and infrastructure investments by the new administration. Despite the price correction in many Sectors such as Financials since the initial "Trump Rally," for the first quarter of 2017, the S&P 500 Index rose 6.07%. In addition, deflationary worries around the world appear to have diminished as the MSCI EAFE Index rose 7.25%, and the MSCI World Index rose 6.38% in the first quarter of 2017.

Martin Investment Management, LLC believes that U.S. equities are no longer in a profit recession but are waiting for economic and financial data to confirm that earnings will grow into the latest valuation expansion. The pro-business Trump administration, China's present outlook, and improved oil prices are helping to lead a nominal recovery in 2017, which in turn is helping boost confidence in the soft economic data. The hard data of corporate earnings and other economic indicators is just beginning to be reported and may or may not support the present sentiments. The upturn in CEO confidence is a very encouraging sign for a capital expenditure ("capex") rebound. We believe a capex recovery is crucial to boost both productivity and real GDP. Consumers are preferring experiences over goods and online shopping rather than in store purchases, but they are spending. Recent data on retail sales and personal expenditures continue to exhibit an uptrend. Wage growth is accelerating as labor is continuing to take a greater share of national income.

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The Federal Open Market Committee (FOMC) wants to raise interest rates two more times in 2017 after the March 2017 increase of 25 basis points as the Federal Reserve officials believe that the U.S. economy looks to be near full employment. The Federal Reserve now sees inflation as having finally reached 2%. The Federal Reserve is very data dependent and may react quickly as the economy heats up. The U.S. federal government has benefited from its extraordinarily low interest rates. The Federal Reserve has locked up $2 trillion in reserve accounts paying 0.5% in interest. Selling from the Federal Reserve's bond portfolio would likely make the debt supply exceed present demand, especially as Chinese ($1.05 trillion) and Japanese ($1.10 trillion) investors reduce their exposure to U.S. Treasuries.

According to BCA Research's report from April 3, 2017, the global leading economic indicators remain in a solid uptrend. The lagged effects of easing in financial conditions over the last twelve months and the end to fiscal austerity continue to support growth. Global trade is now at a seven-year high. The economic data remains constructive for profits in the major countries. It appears that monetary policy in Japan and Europe is at a turning point. For the first time in almost four years none of the economies of the Eurozone's 19 members were in deflation. The European Central Bank (ECB) believes its long struggle to lift inflation is abating, but the ECB will not raise short-term interest rates before it starts the tapering process in 2018. Export driven European companies are benefiting from present economic conditions. In Japan, the Bank of Japan (BoJ) continues to remain accommodative with its 0% yield cap on the 10-year JCB for the remainder of this year. Japan can only keep interest rates depressed to the rest of the world by making the yen weak. Like Europe, Japan has export driven companies, which will benefit from increased global trade. These companies are closer to the Asia Pacific region, with 60% of the world's population and the fastest growing middle class presenting new opportunities for European and Japanese multinationals. Additionally, the equity valuations of European and Japanese companies appear reasonable.

Martin Investment Management, LLC believes that the Federal Reserve bond buying and easing since 2008 have distorted the economy with more debt investors. Our firm welcomes reasonable interest rate increases. Lacy Hunt, an economist with Hoisington Investment, estimated at a recent conference held by Grant's Interest Rate Observer that debt of all kinds in the U.S. now totals more than $69 trillion. That is more than double the $30 trillion recorded by Federal Reserve's statisticians as recently as 2000. If true, the debt is now about 370% of GDP up from 294% in 2000. Strategas Partners suggests in its March 16, 2017 commentary that persistently low yields have pushed many investors to use bond funds as a proxy for money market mutual funds. Unfortunately, many

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investors, given the outflows from domestic equity mutual funds and the inflows into ETFs, have not participated in an equity bull market that started in 2009.

The main culprits since the great recession in the lack of capital expenditures for companies were bank lending issues, the high cost of capital, and elevated hurdle rates. Companies preferred not to invest in more productive capital projects over the last several years but instead placed their excess cash in less productive share buybacks, dividends, or cash equivalents. Market pressure, together with macro uncertainty among Chief Executive Officers (CEOs) kept the hurdle rate applied to new investment projects high despite the major drop in market interest rates. The gap between the required rate of return on new projects and the risk-free rate or corporate borrowing rates surged according to J.P. Morgan's "Bridging the gap between interest rates and investments", which concluded that the median hurdle rate of the S&P 100 companies is around 18%. The study blamed uncertainty over the cash flow outlook (macro risk) and the fact that CEOs believed that low borrowing rates are temporary. It is rational for a firm to hold cash and buy back stock if perceptions of downside tail risk remain lofty. The financial market pressure for short-term returns to shareholders has been an obstacle to investment. Short-termism makes sense if investors feared that the recovery could turn badly at any moment as well. However, the analysis in the J.P. Morgan report suggests that firms have significant room to lower their hurdle rates and will create value by doing so. As business leaders come to believe that deflation risk has finally been vanquished, they are more likely to focus on long-term revenue generation through capital expenditures.

Martin Investment Management, LLC believes that real GDP growth and earnings growth are constructive for stocks. We try to understand businesses that we are buying with a long-term mind set. We believe that investors are rewarded over time by the compounding of wealth. Through our process, excess returns do not necessarily come in one month or a quarter but over five and ten-year periods, highlighting the importance of taking a patient, long-term approach to equity investing. We understand the importance of present returns, and how they contribute to future ones. In March 2017 FactSet, Inc. reported that with the first quarter of 2017 ending, companies are reporting earnings increases of 9.1% from the same period one year ago, which would be the best performance since 2011 and the third quarter of continuous growth. However, our firm believes that the most important advice for an investor presently is to take the approach of a long-term, patient, and disciplined investor, investing in well managed companies with growing needs, strong consumer demand ahead, and steady, growing income over time. These companies may or may not be performing in the present quarter.

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In the recent article from *Financial Analysts Journal*[1], "Are Cash Flows Better Stock Return Predictors Than Profits?" Stephen Foerster, CFA, John Tsagarelis, CFA, and Grant Wang, CFA, ask whether or not cash flows are better stock return predictors than profits. The researchers transformed the indirect method of cash flow statements into more direct estimates of cash flows from operations and other sources. They formed portfolios on the basis of these measures. The authors concluded that stocks in the highest cash flow decile outperformed those in the lowest by over ten percent annually. Investors may obtain better information about investment prospects and thus future stock returns by relying on cash flows that disaggregate operating cash flows from financing, tax, investing, non-operating, and nonrecurring activities. The results were robust to investment horizons and across risk factors and sector controls. The results of the study suggest that cash flows are preferable to income statement profitability measures for investment decisions. The authors also demonstrated that, in addition to operating cash flow information, cash taxes and capital expenditures provide incremental predictive powers.

Martin Investment Management, LLC always considers cash flow as an important metric in its equity selection. We are pleased that both the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) are compelling companies to break cash flows down into individual characteristics that can be analyzed by investors in the Primary Financial Statements Project. Investors can potentially achieve superior risk adjusted returns by replacing commonly used profitability ratios including return on equity and P/E multiples with those using cash flow. Prior research suggests that earnings targets influence accounting decisions, which creates an incentive to bias accruals. Our firm aims to avoid investing in companies with accruals that cannot be understood or measured.

Martin Investment Management, LLC's investment philosophy offers an opportunity for wealth creation over time by selecting a focused portfolio of individual securities using a fundamental bottom-up investment process. As we discussed in our January 2017 newsletter, the Clarke, de Silva, and Thorley paper, "Fundamentals of Efficient Factor Investing",[2] confirms the importance of individual security selection in a portfolio and reaffirms our philosophy. Over time, we believe our discipline sets Martin Investment Management, LLC apart as a successful active manager over the long-term.

Wishing you a warm spring season!

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[1] *Financial Analysts Journal*[1] (FAJ) Volume 73 Number 1 2017

[2] *Financial Analysts Journal* (FAJ) Volume 72 Number 6 2016

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