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**With Or Without Central Bank Intervention**

The terrible beginning of global equity markets in 2016 changed in mid February as the market began to rally due to a more positive perspective of future oil prices. The price decline of commodities, particularly oil, had driven the market down to new lows in the first quarter of 2016. There tends to be an inverse relationship between the U.S. dollar and oil. The current equity markets are a response to the volatility in the commodity markets. On March 16, 2016, the Federal Open Market Committee (FOMC) ruled against its projected rate hike trajectory of one point with four interest rate hikes in 2016 and maintained its benchmark short-term interest rate in the range of ¼ to ½ percent with only two rate increases planned for 2016. Later Janet Yellen reiterated the need for the Federal Reserve to "proceed cautiously" in lifting interest rates given weak corporate earnings, unfavorable market conditions, and weaker than expected overseas growth. In addition, an increase in interest rates would further strengthen the dollar against the currencies of the U.S.'s major trading partners. In the first quarter of 2016, the S&P 500 Index fell to 1829 before rising to 2060 for a 1.35% increase on a total return basis. The utility sector in the first quarter of 2016 performed very well as investors sought income yield. The rate on the ten-year U.S. Treasury Note surprisingly was equally as volatile for the first quarter of 2016 as it dropped from 2.3% to 1.6%.

One of the key themes for investors in 2016 is the divergence between monetary policy in the United States and the rest of the world. The Federal Reserve is in a difficult position regarding normalizing rates, since the economic cycle may be moderating just as the central bank seeks to raise rates. Europe, Japan, and even China, are pursuing accommodative policies while the United States is moving slowly to a tighter policy. Global growth is reflecting broad based weakness in both purchasing and lending. Credit markets are still fundamentally challenged. Recently, the European Central Bank (ECB) boosted stock prices with its latest easing, but the implications for corporate earnings are much less certain. The U.K. growth forecasts may be at risk due to the Brexit referendum this June as the U.K. makes a decision on remaining in the European Union (EU). Japan's Abenomics lacks reflationary traction as personal consumption expenditures, and nominal and real wages are flat. The Chinese stimulus policy has been wide but is not rekindling final demand. Emerging market equities and cur-

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rencies are still fundamentally vulnerable. Global growth or the lack of growth will continue to influence monetary policy.

Although the Federal Reserve prefers that future tightening in monetary conditions results from their interest rate increases, this tightening will likely occur through the change in the value of the dollar. Since 2014, the U.S. dollar has appreciated substantially against other major currencies, primarily caused by weaker global growth and better growth in the U.S. Since the Federal Reserve initiated a rate increase last year, the dollar has increased despite dismal U.S. corporate earnings and a mixed economy. The Japanese yen, the Swiss franc, and gold also have appreciated due to their perceived safety. However, many countries such as Sweden, Switzerland, Denmark, the Eurozone, and Japan have adopted a negative interest rate policy (NIRP). Even though many countries have depreciated their currency, these moves failed to improve corporate profitability and these countries' exports relative to the U.S. The recent decision by the Bank of Japan (BOJ) to lower its interest on excess reserves to negative 10 bps (basis points) and the ECB's decisions to be more accommodative make it even more difficult for the Federal Reserve to tighten, because any dollar increase is sensitive to even marginal changes in short rates, and magnifies the effects of tightening.

China had made a series of policy missteps in the summer and fall of 2015 with its currency and equity markets. For China, the key uncertainty is the size of the capital outflows by Chinese companies, hedging their U.S. dollar liabilities, and households, due to Chinese investors seeking international diversification in their portfolios since the liberalization of capital. China's reflationary efforts have stepped up a notch with fiscal spending increasing, particularly with infrastructure projects. However, the authorities continue to struggle with controlling the surge in leverage without letting growth slow much further. Monetary growth and fiscal spending are already at or above government targets. The pick up in government funding for real estate and infrastructure projects is offset by the drawdown from private sector economic activity. Loan demand remains weak as deflation remains pervasive throughout the country's manufacturing sector. Recently, Chinese authorities have become more constructive, soothing markets with lower targets for economic growth in 2016. The government is also addressing the property price bubble, bad loans in its banking system, lack of transparency, and the lack of new growth drivers to replace employment in manufacturing.

Although world oil consumption has continued to grow, it has not grown fast enough to meet the oil supply glut. Until the summer of 2014, the world had the highest inflation adjusted oil prices in its history for the previous seven years

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of approximately $132 a barrel of oil. As a result, billions of dollars were borrowed to finance speculative and expensive experimental technologies like fracking, which are now proven to obtain more oil from the ground. Production greatly exceeded demand, and oil prices fell. The factors in global oil production and drilling operations are complex, and therefore, forecasting is problematic. Many E&P oil companies are over-leveraged and may default on their financing. While the energy sector is not a huge part of the economy, the previous explosive growth in the sector coupled with anemic economic recovery has meant the recent weakness in this sector is a drag on GDP. Large oil producing countries such as Russia and Saudi Arabia now have huge debts and deficits, which is very problematic. Eventually oil supply will be rebalanced, but the oil market is just beginning to find a price where the surplus starts to get cleared at an accelerated rate. The second half of 2016 may prove to be more constructive, but presently most commodities have been on a volatile downward trend.

Central banks of the world have been very active over the last several years in reflating their economies. Their view has been that monetary accommodation pushes up financial asset prices, and lowers the cost of capital, thereby leading corporations to increase capital expenditures, and consumers to feel wealthier and to spend a little more. The problem is that relying only on monetary policy provided the impetus for financial rather than economic risk taking. Corporations preferred using the advantage of lower cost of capital to buy back shares rather than invest in capital projects. The central banks have influenced the equity markets, which have become particularly pronounced since the onset of the unconventional policies. The benefits of the central banks' policy interventions have come with heightened risks of collateral damage and unintended consequences. A continued focus on monetary policy has placed more pressure on the financial system. In Europe and Japan, negative interest rates are forcing investors to save more or take greater risk with capital in order to earn any return. The Federal Reserve needs to make a decision whether to be "data dependent" on U.S. employment and inflation or dependent on global economic weakness. When the Federal Reserve announced a series of rate hikes in 2015, it created a surge in the U.S. dollar, which hurt U.S. corporate profits and oil prices, thereby, straining economic growth. So if the Federal Reserve chooses to be accommodative, asset prices will continue to expand faster than the economy, and if the Federal Reserve chooses to increase rates too quickly, it risks the reversion in asset prices, loss of consumer confidence, and a possible recession. The Federal Reserve continues to hedge both positions with its actions and language, but the continuation of this policy is not sustainable in the long term.

The future of China, oil, and central bank policies remain the most important variables facing the world in 2016 as they could potentially cause signifi-

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cant downside risks to economies and risky assets. They will continue to be a source of volatility this year. Complicating these issues are the additional headwinds emanating from rising political uncertainty in multiple constituencies: populism in Europe, the U.K., and the United States; the refugee crisis; terrorism; and unstable governments. While political risks are difficult to quantify, there is the potential to impact consumer confidence and corporate expenditures. While many investors are optimistic, the market seems to be planning for the worst as there is a struggle between risk on and risk off. Investors are demanding a clear margin of safety. This is understandable given the uncertainty in the capital markets. The world is seeking stronger economies and more effectively coordinated global security.

Many investors select traditional passive indices, such as the S&P 500 Index or the MSCI EAFE Index, perceiving the capitalization weighted investments as an efficient way to gain broad market exposure. Smart beta is an alternative to the traditional index investing, where factors other than market capitalization based indices are used. Smart beta has become very popular, used by one of every five exchange traded funds (ETF) globally. Many of the alternative factors or rules of smart beta are founded in academic studies. One alternative weighting scheme is the emphasis on the measure of low volatility. In the *Financial Analysts Journal* FAJ, Volume 72, Number 1, January/February 2016 a third study appeared about low volatility. "The Low-Volatility Anomaly: Market Evidence on Systematic Risk vs. Mispricing" by Xi Li, Rodney N. Sullivan, CFA, and Luis Garcia-Feijoo, CFA, CIPM, furthered a study of how a strategy of buying low-volatility stocks and selling previously high-volatility stocks has historically generated substantial abnormal returns in U.S. and international markets. On March 21, 2016 in *Bloomberg News*, Rob Arnott, the Chief Executive Officer of PIMCO's Research Affiliates, LLC and one of the first proponents of smart beta using the low volatility anomaly, concluded that this factor tilt will perform poorly as a consequence of its soaring popularity. He comments that "It's easy to dismiss relative valuation and to chase performance, to chase fads…'Valuation does matter'."

Martin Investment Management, LLC has noted the relevance of the academic studies on the low-volatility anomaly in previous newsletters. The low-volatility anomaly is an important academic finding, but Martin Investment Management, LLC believes for itself, that low volatility is a byproduct of the firm's stock selection process rather than a deliberate intent, such as the use of low-volatility with smart beta strategies. The firm recognizes that equity investments represent a very long-term stream of cash flows given to shareholders over time. Many companies that grow at a consistent pace tend to be under investors' radar because they do not attract the most attention relative to fast grow-

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ing stocks. Many of these companies have a long track record of growth with consistent earnings and stock price increases. Consistency of returns and valuation are very important factors to the decision process of the firm. The investment process looks for reasonable returns without compromising longer term results. In an exuberant market, the firm may underperform, yet over longer time periods, more stable growth may be achieved.

Martin Investment Management, LLC realizes that the market is very challenging presently. On the positive side, the return on capital is still well above the cost of capital for the broad market although the spread between return on capital and cost of capital is narrowing. Companies on average are underinvesting for the future so the firm's stock selection continues to be extremely important. The firm is particularly evaluating companies that efficiently deploy capital and invest in future productivity. The firm remains committed in its disciplined investment process for its domestic, international, and global equity strategies.

Warm wishes for a bright spring season!

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