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A World of Hype and Hope
The Importance of Wages, Income, and Corporate Earnings

The U.S. economy continues to muddle through with an increase of 1.1% in Gross Domestic Product (GDP) for the first quarter of 2016 and with the rate of job growth and corporate earnings remaining lackluster. However, the consumer sector has exhibited encouraging strength in the second quarter of this year. The U.S. consumer, who continues to benefit from current low energy costs, is driving more than two thirds of the U.S. economy's growth with a May increase of 0.3% in consumer spending and a revised April increase of 0.8% adjusted for inflation. The April increase in consumer spending, propelled in part by automobile purchases, was the largest increase since August, 2009. Consumer expenditures will be three to four times greater than first quarter of 2016. Given recent economic data released by the Bureau of Economic Analysis, consumer spending in the second quarter of 2016 appears to have increased by 4.0% over the same quarterly period one year ago, supporting overall economic growth this year. The U.S. Manufacturing Purchasing Managers Index (PMI) continued to rise in June with the new orders component up to 57.0, the sixth monthly increase. The present inflation rate is up slightly but well below the Federal Reserve's target of 2.0%. Economic growth periods tend to last longer when inflation is low. Because inflation is at a relatively low rate, this suggests that the business cycle expansion period may last longer than usual. The S&P 500 Index had a total return of 2.46%, and the World Index (USD) Net increased by 1.01% in the second quarter of 2016, while the EAFE Index (USD) Net declined -1.46% during this same period.

Because real U.S. GDP has been growing slightly less than 2.0%, corporations, which need about 2.0% U.S. GDP to generate profits, have significant headwinds. The U.S. economy becomes unstable when there are no profits, so risk is skewed to the downside. The Federal Reserve, moving at a glacial pace, will not likely increase interest rates until 2017, mainly because of demographics and debt issues, and the balance between controlled inflation and slow GDP growth. Investors will continue to gravitate to stocks that look like bonds and corporations with free cash flow growth and solid revenue profiles. Currently about two-thirds of the stocks in the S&P 500 Index have a dividend yield greater than that of the U.S. 10-year bond. Yield seeking speculation has increased significantly in financial markets. At present, investors can expect a conventional portfolio mix of 60% S&P 500 (5.0%), 30% Treasury bonds (1.45%), and 10% Treasury bills (0.25%) to return less than 4.0% annually over the coming years according to figures cited in the *Wall Street Journal*. This situation is likely to provoke a broadening pension crisis in the years ahead, due to underfunding and capital losses over the complete market cycle, as many pensions assume a much higher required rate of return. According to Strategas Research Partners, there is a slight chance of a U.S. recession in 2016, which increases to 40% in 2017 as economic indicators point to slower growth going forward. There is some cushion in 2016, thanks in part to the U.S. consumer, but the election may determine how the economy looks going forward.

Globally, the world is economically absorbing the Brexit shock, the failing Japanese policy of Zero Interest Rate Policy (ZIRP), and the weakening Chinese Yuan. The U.S. dollar and Japanese Yen are strengthening, which will eventually hurt exports of these countries. The U.S. Treasury rates have declined with a flight to safety. The yield on the U.S. 10-Year Treasury, a benchmark rate for many consumer and corporate loans, is currently at 1.45%, almost declining to the low of 1.38% in 2012 when worries about Spanish solvency rose. Most world countries have falling Leading Economic Indicators (LEIs) rather than increasing LEIs, which means most of the U.S. monetary tightening is occurring through the exchange rate rather than interest rates. The tightening of the financial conditions, spurred by the Brexit vote, is probably sufficient to tip U.S. GDP below 2.0% in the coming quarters. Because British trade has little impact on the U.S. economy, the Brexit vote will likely be less relevant to domestic corporate earnings.

According to BCA Research, the growing gap between rich and poor is the key driver for the populist backlash that empowered the Brexit leave side. The supply of low skilled workers is no longer falling in tandem with declining demand for such workers. Open border immigration policies have enlarged the potential supply of low skilled workers, while increased trade, technological improvements, and rampant outsourcing have reduced the number of well-paying blue collar jobs. Not only has increasing globalization led to a shift of income from low skilled workers to high skilled workers, it also resulted in an overall decrease in the share of national income flowing to labor. The flipside of this has been a rising share of income flowing to capital. Corporate executives and other captains of capital have benefited the most from globalization. This explains why the big surge in incomes has not come at the 95th percentile of the income distribution or even at the 99th percentile. Globalization has particularly benefited the 99.9th percentile and above.

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In the U.S., weaker payrolls likely reflected the lagged effects of the soft patch in real GDP in the fourth quarter of 2015 and the first quarter of 2016. Although unemployment claims continue to fall, the participation of labor is starting to fall again after a brief bounce earlier this year. The current dynamics of the labor market have created a situation where wage inflation has been subdued even though the unemployment rate is below 5%. Because of the large number of people in part-time jobs wishing they could be full-time and the retirement pace of baby boomers at the top end of the pay scale, wage inflation is only 65% of what would be expected at this point in an economic cycle.

A recent article in the *Financial Analyst Journal*: Volume 72, Number 1, 2016, Ilia Dichev, John Graham, Campbell R. Harvey, and Shiva Rajgopal conclude in "The Misrepresentation of Earnings" that the characteristics of earnings quality include sustainability, predictability, few one-time items, and backing of actual cash flows. Their research was conducted by interviews with 12 Chief Financial Officers (CFOs) and a large scale survey of 400 CFOs, who represent the intersection of business operations and accounting rules. In any timeframe, as many as 20% of public companies use discretion within Generally Accepted Accounting Principles (GAAP) and distort earnings. These companies misrepresent as much as 10% of reported earnings. The CFOs identified several red flags that investors should be mindful of to identify poor earnings quality. These include the lack of correlations between earnings and cash flows, misreporting accruals, unsubstantiated deviations from industry norms, lack of controls, and poor governance. The most common reason for misrepresenting earnings was to affect the stock price.

Because accounting rules are increasingly complex, it is often difficult to discern management decisions versus reported earnings. For investors less attuned to accounting practices, there is concern that the increased use of non-GAAP earnings is a worrisome trend. The concerns are a growing problem as industry standards are falling as a result. These aggressive non-GAAP practices evidence a failure of transparency from the managers to the owners of these companies. Non-GAAP references in proxy statements for S&P 500 companies are presently 58% versus 27% five years ago. Based on calculations from Thompson-Reuters, the divergence between GAAP and non-GAAP earnings per share for the S&P 500 Index companies increased from $2.57 per share out of $27.47 in the third quarter of 2014 to $10.82 per share out of $18.70 in the fourth quarter of 2015. Companies that use non-GAAP are by definition more prone to beat estimates employing these dubious practices. Companies guidance is almost always presented in non–GAAP terms, thus giving the company wiggle room, to meet or exceed earnings expectations. Gaming GAAP whether to increase the stock price, boost executive compensation, or some combination of the two is unethical to corporate culture committed to transparency and responsibility. The SEC's recent review of Regulation G will result in greater adherence to GAAP going forward.

Martin Investment Management, LLC continues to look for companies that can achieve high returns on invested capital without excessive leverage and unconventional accounting. We want to evaluate the intrinsic value of a company, rather than the book value, which is a nominal accounting value. Accounting numbers are the beginning and not the end to business valuation. Companies, which consistently practice transparent and conservative accounting, typically run their businesses in a similarly open and ethical fashion. Quality companies have relatively stable earnings streams. Although cash flow is important, over a five to ten-year period, a company must make investments to continue to grow their businesses. The economic goodwill from their investments is very important, as it tends to rise in nominal value proportionally with inflation. Martin Investments also believes in the importance of employing a long term investment horizon to the equity markets.

Wishing you a safe and relaxing summer season!

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