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

PATRICK A. MARTIN, CFA **(847) 424-9124**
SANDRA STASKON MARTIN **FAX (847) 424-9182**
MARY ELLEN MARTIN ZELLERBACH

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Focused Thoughts on Investing

The U.S. economy is growing robustly despite rising interest rates, market volatility, and tariffs. The last nine years have been extraordinarily profitable for the equity markets. The U.S. consumer remains the engine of the U.S. economy. Consumer confidence continues to hover near historical highs despite trade noise and market volatility. The Atlanta Federal Reserve revised the Gross Domestic Product (GDP) estimate for the Second Quarter of 2018 above 4%. The Dallas Federal Reserve's Manufacturing Outlook Survey shows that U.S. manufacturers are risk-on and capital expenditure plans remain steadfast despite trade uncertainties. The U.S fiscal stimulus of tax cuts and repatriation, easy financial conditions, and relative economic insularity are expected to contribute to sustained U.S. growth. For the second quarter of 2018, the total return for S&P 500 Index was 3.43%. The S&P 500 Index rose 2.65% for the first half of 2018 on a total return basis.[1,2]

The softer economic data in Europe continues to signal that the weakness in the first quarter of 2018 will continue into the second quarter of 2018. While UK equity valuations have become slightly inexpensive at mid-year 2018, the uncertainties surrounding Brexit continue.[3] Although Japan's leading economic indicators (LEI) are up, retail sales have notably weakened in the second quarter of 2018. Part of the rise in Japanese profit margins appears to be structural rather than cyclical. Presently, over 59% of Japanese companies are now debt free.[4] The MSCI EAFE Index (USD Net) returned -1.24% for the second quarter of 2018. The MSCI World Index (USD Net) increased 1.73% for the second quarter in 2018

The Chinese economy continues to decelerate with broader implications for markets, recalling the global earnings recession of 2015.[5] China has worries about highly elevated debt levels, overcapacity, and pollution making the bar for a Chinese stimulus higher than in the past. The worries surrounding mounting protectionism are increasing with the possibility of an outright trade war developing. All of the data from May 2018 on industrial production, retail sales, and fixed asset investment disappointed in China. In addition, property prices in tier 1 cities are down year-over-year.

The main global data trend has been the growing gap between the economic performance of the U.S. and the rest of the world. U.S. growth leadership is one reason the U.S. equity market returns have outpaced those in

Europe and Japan. U.S. corporate profits are forecast to be up over 20% for the second quarter of 2018, in line with the 23.2% advance in the first quarter of 2018. This growth is occurring despite the compression of multiples from monetary tightening. Corporate sales and EBITDA growth are up 6.4% year over year and 7.9% year over year respectively emphasizing the stronger upward trend in real business activity. The Purchasing Managers Index (PMI) for the U.S. has trended higher in 2018, while Europe and Japan reversed some of their 2017 gains.[6] The growth is due to the U.S. fiscal policy of tax cuts, repatriation, and spending on infrastructure. U.S. companies repatriated $296 billion in corporate profits in the first quarter of 2018, about 17.6% of the estimated total $1.7 trillion of un-repatriated corporate profits of U.S. companies.[7]

The Federal Reserve voted to increase the benchmark federal funds rate (FFR) by a quarter percentage point to a range between 1.75% to 2.00% with the possibility of two further quarter point rate increases in 2018. As a point of reference, the FFR was virtually zero from 2008 through 2016. With the U.S. unemployment rate at a seasonally adjusted 3.8% in May of 2018, the Federal Reserve has been raising interest rates to prevent the economy from overheating.[8] One of the biggest fears is an inversion in the yield curve where Federal Funds rate is higher than the 10 Year Treasury rate, often a precursor of a recession.

The European Central Bank (ECB) has expected to end a program of bond purchases known as quantitative easing in December of 2018 but not increase interest rates, which are below zero, until the end of summer 2019.[9] The Eurozone's economic outlook is uncertain. ECB President Mario Draghi may not intervene in the present Italian banking crisis, the third largest economy of Europe. Italy's recent shift to populism is arriving at the same time that the ECB is looking to wind down its asset purchase program. This means that a key buyer of Italian debt is stepping back just when it may be needed the most.[10]

The People's Bank of China's (PBOC) policy response has been fairly muted. Reserve requirements have been cut and some administrative controls loosened, but the combined credit and fiscal impulse has plunged. The bar for a fresh round of stimulus is higher today than it was in the past. The economy needs to feel more pain before policy makers come to its aid.[11]

The first section 301 tariffs are scheduled to be imposed on July 6, 2018 for the intermediate (52%) and capital goods (43%) imports from China, but not the final goods.[12] The 25% duty on $34 billion worth of products falling under these tariff lines equates to approximately $8.5 billion, a fraction of the $800 billion in fiscal policy stimulus expected for this year from tax cuts, spending, and repatriations.[13] Stiff retaliatory trade barriers are set by China, Canada, and other countries. President Trump appears to dismiss the effects of trade wars, which is estimated to have increased to $450 billion worth of products.[14] The Mnuchin/Kudlow "trade truce" episode has illustrated that the U.S.

establishment favors tough action against China. The U.S. Senate passed a resolution against the Chinese company ZTE. The Sino-U.S. confrontation is based on structural factors, which began in 2014.[15] The U.S. is adopting a more confrontational stance in the South China Sea as Chinese assertiveness has continued despite President Xi Jinping's vague pledge in 2015 to refrain from militarizing the artificial islands in the disputed Spratly archipelago.[16]

China and Germany as the second and fourth largest economies have seen each other as alternative options as they are both increasingly at odds with the U.S. Trade between the two export dominated economies is growing: China became Germany's top trade partner in 2016, when trade between the two countries reached €170 billion. China appreciates German complex technologies as part of the Made in China 2025 strategy. Germany serves as the hub for Chinese goods destined for the European markets. Germany has more than 5,000 German companies operating in China today, primarily for Germany's high value exports.

U.S. inflation is almost back to target, and the Federal Open Market Committee (FOMC) is expected to normalize policy to target slower economic growth once long-term inflation expectations return to the 2.3% to 2.5% range.[17] The price index for U.S. personal consumption expenditures, including food and energy costs, rose 2.3% in May of 2018 from a year earlier, the largest increase since April 2012. Outside of housing, service sector inflation is about 2.4% in 2018 and is likely to increase further this coming year.[18] Eurozone inflation has increased slightly from 1.9% annually to 2.0% in June of 2018. The recent pickup in inflation is largely due to a rise in energy prices, which were 8% higher in 2018 than a year earlier.

Global oil prices have been on the rise in recent months as demand has picked up and supply has tightened from U.S. actions on Iran, disruptions in Canada, Libya, Venezuela, and a sharp decline of U.S. crude inventory. Crude oil prices are up 70% from the same time last year, which contributed to inflationary pressure that pushed up consumer price growth. Bank of America's Hootan Yazhari forecasts $90 oil.[19] Oil prices have not yet increased enough to derail the expansion in the developed economies. The U.S. consumer spends about 4% on energy as a share of disposable income.[20] The U.S. daily consumption plus inventories costs close to $600 billion annualized compared to a $388 billion trade deficit with China. This is one reason why energy prices and inventories are so important when assessing the U.S. dollar (USD).[21]

"Accurately predicting price inflation is one of the most important prerequisites for predicting the outlook for the stock and bond markets. A bad inflation forecast almost certainly will result in bad investment choices in all the major financial markets."[22] Ed Yardeni continues to comment how inflation now remains subdued, and much liquidity has gone into the financial markets of stocks, real estate, and bonds. Globalization and technological innovations may account for low wage inflation despite low unemployment, a reverse of the traditional Phillips curve. Corporations appear to be focusing on increasing their profit margins.

Corporate earnings remain upbeat in the major countries. Corporate profitability is just one important aspect of the financial backdrop. In the next economic downturn, corporations that have a heavy accumulation of debt likely will be most affected. European corporations are still well behind the U.S. in the leveraging cycle. European equities, however, are structurally handicapped by their substantial underexposure to technology, over exposure to financials, and the undervalued currency.[23] Sectors with vastly different structural growth prospects, such as financials and technology, need to trade on very different valuations. The sector or market with the lower headline valuation is not necessarily the cheaper sector or market.[24]

At the end of September 2018, the Global Industry Classification Standard ("GICS") will be reclassifying the Sectors. The existing Telecommunications Services Sector will be expanded into a new Communication Services Sector. The Media Industry Group including Entertainment will be moved from the Consumer Discretionary Sector to the newly expanded Communication Services Sector along with certain internet companies that currently are classified as members of the Information Technology Sector. The Communication Services Sector will have a market capitalization weighting of about 10% of S&P 500 Index compared with an approximate weighting of 2% for the current Telecommunication Services Sector. Companies such as Alphabet, Facebook, Netflix, Comcast, and Disney will be joining the new Communication Services Sector. There are two major impacts stemming from these changes. Amazon's weight in the Consumer Discretionary Sector will probably increase by 35% with its new weight being over 20% of the Sector. The characteristics of the new Communication Services Sector will change substantially with the addition of several high multiple, growth companies.

Martin Investment Management, LLC believes that growth will remain above trend in the advanced economies but the economic data will be less supportive of global risk assets than in 2017. We continue to look for companies with durable competitive advantages, run by solid management teams, trading at attractive valuations. We seek companies that generate significant cash flow, have high-returns on reinvestment opportunities, and a sound capital structure. This approach tries to generate capital appreciation for all the firm's strategies. As the firm has a long-term investment horizon, we aim to be prepared for a market correction during this long holding period. Investing in companies with strong balance sheets and cash flow with durable business models is important to minimize risk in a period of economic weakness.

We see changes in the global marketplace that are very investable. Millennials consume differently than Baby Boomers on social media, online shopping, and smart phones. Millennials have also shown a preference for card payment systems, including debit and credit-based. They respect Environmental, Social, and Governance (ESG) criteria. These products/services are heavily weighted to the Technology (smart phones and cards), the new Communication Services (social media), Energy (clean energy), and Consumer Discretionary Sectors (online shopping and home ownership). The European female labor participation rate has been in a major structural uptrend, which should bode well for global consumer products and services. The Technology Sector continues to bring products and services to the global marketplace that increase the standards of living worldwide. Technological innovations are driven by profits. We believe that free markets provide the profit incentive to innovators, and market participants can benefit from investing in great technological companies.

Warm wishes for a great summer!

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