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Navigating A Complicated Financial Market

The U.S. and world economies continue with mixed signals and slow growth. The final estimate for the second quarter U.S. Real GDP showed economic growth at an annual rate of 1.4% up from 0.8% in the first quarter of 2016. At a global level, the growth benefits of the extraordinary monetary stimulus over the past years have been even more disappointing than in the U.S. China is struggling to grow over 5%, Europe 1%, and Japan 0%. The headline U.S. unemployment rate remained at 4.9% in August 2016, and a broader measure of unemployment, which includes discouraged and underemployed workers, also remained unchanged at 9.7%. Despite the anemic growth rates, the S&P 500 Index rose 3.85% on a total return basis and the MSCI EAFE USD Net Index increased 6.43% in the third quarter of 2016.

In the second quarter of 2016, U.S. productivity contracted by 0.5%, making this the third consecutive quarterly decline. According to the August 9, 2016 issue of the *Wall Street Journal*, during the eight years between 2007 and 2015, productivity growth averaged just 1.3% annually, which was less than half the pace that was seen in the seven-year period between 2000 and 2007. Productivity is still contracting in the Eurozone, Japan, and Canada. Global aging demographics, increased regulation, trade restrictions, and debt overhang are hurting productivity. Paul G. Mahoney, former Dean of the University of Virginia Law School, addresses the cost of securities regulation in *Wasting a Crisis: Why Securities Regulation Fails*, by the University of Chicago Press in 2015, in which he argues that financial regulation imposes millions of dollars in costs by hindering competition, with the largest impact on smaller firms. The outlook for growth seems to be more of the same, just strong enough to forestall recession, not strong enough to ease the market's reliance on an unnaturally accommodative monetary policy.

In its August 8, 2016 Weekly Report, BCA Research, Inc. outlined the two speed economy with consumption continuing to grow and non-consumption related GDP in recession. Consumers are benefiting from low fuel costs, historically cheap borrowing rates, and increasing capital availability. Balance sheets have been repaired with the personal savings rate higher than the average of the past 15 years. Financial wealth gains, led by the equity market, are creating a positive wealth effect. Wage growth is outpacing nominal GDP growth, consumer income expectations are climbing, underscoring that the barriers to increased consumption are gradually falling. The upshot is faster consumer spending especially if the U.S. dollar supports real purchasing power.

The slow speed economy is best expressed by the comments of the Economic Output Composite Index of Manufacturing Data and Services that the U.S. economy has remained in a rotation of inventory drawdowns since 2009, which leads to restocking cycles. This provides a temporary boost to economic activity but very quickly fades, and the economy softens once again. There have been fewer advances that propel innovation and productivity gains, and the more recent innovations lose their dynamic growth power as they turn from game changers into products with trivial value. The result is an intense search for investment opportunities, with businesses not making long-term capital investments in their businesses. Business spending for future expansion is difficult when the sales forecasts are so murky.

In its August of 2016 meeting in Jackson Hole, the Federal Open Market Committee (FOMC) left existing interest rates unchanged, but the members expressed their differences on when to implement another interest rate increase, and a December 2016 hike continues to be debated as long as some growth is evident. Both the low labor participation rates and the low productivity in the U.S. fuel the arguments of the proponents of the great stagnation hypothesis that rates should not rise presently. Opponents of keeping interest rates low believe that easy money operates by creating safe but low interest liquidity, and easy money can encourage speculation. Monetary policy appears largely exhausted. The Federal Reserve cannot address structural problems in the economy or ameliorate the various disequilibria, but it can buy time.

In "Bid Farewell to Buybacks," August 29, 2016, BCA Research comments that equity share buyback announcements have plunged. There is little financial incentive to issue debt to retire stock. The message is that companies are increasingly challenged to generate sufficient free cash flow to take on even more leverage to retire equity and/or engage in other shareholder friendly activities. It is entirely normal for net share repurchases to drop sharply when corporate debt is growing faster than profits, as has been the case for the last several quarters, except for the health care sector. FactSet's Buyback Quarterly reports for 137 companies in the S&P 500, or almost two fifths of those doing buybacks, that the amount spent buying back shares exceeded what the companies actually earned.

Note:

Overall spending on buybacks accounted for more than 70% of total S&P 500 earnings, which is not sustainable. Actual buybacks are down 7% year on year in 2016.

Although the U.S. equity markets have become much broader in 2016 than 2015, when Facebook, Amazon, Netflix, and Google (FANG) were up 50% while the equally weighted S&P 500 Index was down more than -0.7%, opportunities for quality investments appear to be declining. The result is an intense search for investment opportunities that create alpha. At this time, the U.S. earnings per share (EPS), excluding the energy sector, managed to rise by 1% in the second quarter of 2016. A weaker than expected growth rate is anticipated for 2017, given that present corporate profits and economic fundamentals are decelerating.

Inefficiencies are constantly changing the markets by their nature and challenging investment decisions, but there are some semi-reliable factors for patient investors. Martin Investment Management, LLC believes that wealth creation is primarily derived from the long-term compounding effects that result when a company makes investments in projects that have high returns on capital. In "A Five-Factor Asset Pricing Model" *Journal of Financial Economics*, 116 (2015), pp. 1-22, Nobel Laureate Eugene Fama and Kenneth French attempt to demonstrate that between 71% and 94% of investment variability of returns in their dataset is explained by adding profitability and investment factors to their traditional three-factor equity pricing model of market risk, size, and value. Another article, The *Financial Analysts Journal FAJ*, Volume 72, Number 4 July/August 2016, summarizes that the bulk of practicing investors find long-term investing impractical, as set forth by John Maynard Keynes 40 years ago: "most of these persons are in fact largely concerned not with the most superior long-term forecasts of the probable yield on an investment over its whole life, but with foreseeing changes in the conventional basis of evaluation a short time ahead of the general public. They are not concerned with what an investment is really worth to a man who buys it for keeps, but with what the market will evaluate it at under the influence of mass psychology three months or a year hence."

Martin Investment Management, LLC believes in the value of using a disciplined investment process in the equity markets and viewing the investments as partial ownership of businesses for the long-term. With an investment process combining factors of growth, including quality and profitability, with fair equity price valuation, the firm believes that it is able to find companies that have the ability to reinvest at a strong rate in the future and have the potential to create value for shareholders. The firm believes that there is a greater margin of safety in buying stocks at a discount to what they are worth. The discipline of patience is important to compound the wealth created by a company not in last year's or next year's earnings but in earnings over time. Martin Investment Management, LLC believes presently that equity returns compare favorably to most fixed income returns in this period and regards that most equity valuations are reasonable, except for a small percentage of stocks that are trading on market momentum.

An important tenet of the firm's investment process is viewing investment holdings from a long-term perspective of three to five years in order to identify and clarify the ideas that are ultimately included in the portfolios. Generating a comprehensive view of the investment environment represents one way to distinguish the investment process, which reviews structural trends such as debt and demographics as well as cyclical short-term variables to consider a more complete investment backdrop. For every idea, the portfolio team reviews the bottom-up fundamentals, understands the catalyst for growth, and assesses a company's valuation in the marketplace. The equity investments are intended to seek a compounded positive return over a three to five-year period.

Martin Investment Management, LLC is delighted that many of its holdings were recently featured in the September 2016 issue of *Fortune*, "How These 50 Companies Are Changing the World and Making Money Doing It." One of the longer-term holdings of Martin Investment Management LLC's strategies, is Nestle, the world's leading seller of bottled water. The company sources its water locally, helping the farmers of developing economies in more than 50 countries. Nestle has worked not only to purge slavery and child labor from its supply chain but to become a nutrition, health, and wellness company cutting fat, sugar, and sodium from thousands of products and fortifying many products with essential minerals and nutrients that are in especially short supply in low and middle income countries. Innovation can arise from highly liquid publicly traded companies, which have the potential to positively impact the world while delivering financial return to shareholders.

Wishing you a pleasant fall season!

Note: