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The Sustainability of a Global Upswing

Martin Investment Management, LLC believes that the S&P 500 Index continued to move higher in the third quarter of 2017, increasing 4.48% on a total return basis, because domestic and global growth are reaccelerating. Profits from corporate earnings and GDP growth are intertwined, and the U.S. economic output grew at a 3.1% annual rate in the second quarter of 2017, the best quarterly rate of growth in two years. The U.S. economy remains stable with steady job growth, a rising stock market, and little inflation. According to survey data from the Purchasing Managers' Index (PMI), which provides a useful indication of GDP's direction, growth in the third quarter should also be strong. Based on market exchange rates, the global GDP growth rate for the third quarter of 2017 is estimated by J.P. Morgan to have been around 3.8%, which might be higher than the U.S. third quarter GDP estimates. This is the highest growth rate recorded since mid-2010.[1] The MSCI World Index (USD Net) increased 4.84% and the MSCI EAFE Index (USD Net) increased 5.4% for the third quarter of 2017.

Core inflation has been undershooting the Phillips Curve, which assumes the inverse relationship between inflation and unemployment, giving the Federal Reserve some hesitancy in raising interest rates by 0.25% in December of 2017. The U.S. Federal Reserve policy acknowledges some downside risks to its goal of price stability and may be undershooting inflation. Although the Federal Reserve has raised rates four times since 2015, the consensus opinion is that more tightening is warranted as bond yields appear too complacent about growth. The Federal Reserve will also start to reduce its balance sheet this October, a quantitative easing (QE) in reverse. While the process will begin slowly, once begun it will accelerate on autopilot between 2022 and 2023. The Federal Reserve has detailed a pace of mortgage backed securities (MBS) runoff of $4 billion a month rising to $20 billion a month by the end of next year and $6 billion a month of Treasuries (TSY), rising to $30 billion by next year. The Federal Reserve is taking great precautions to send a smooth message to investors. To put the Federal Reserve policy in perspective, the $6 billion per month of initial unwinding is approximately one fifth of the average monthly maturities over the next year.[2]

In Europe, growth has not been hampered by the euro's strength. Unemployment across the Eurozone is at eight-year lows, while manufacturing leading indicators are at six-year highs. There is now widespread acceptance that real activity growth in the Eurozone and Japan has been much firmer than originally expected this year. Traditionally, when inflation does tick up in Europe, earnings start coming back at a faster rate than in other parts of the world due to the large proportion of financials and commodity companies in the region. The European Central Bank (ECB) is beginning to discuss tapering for 2018 while the Bank of England (BOE) is considering an interest rate hike. Presently, the U.K. is suffering from stagflation, a weak currency and increased inflation. According to BOE Governor Mark Carney, Brexit could lead to persistently higher U.K. inflation. European corporate earnings are in the early stages of recovery. Japan's recovery continues as the weak yen has helped exports. China appears stable although the yuan strength softens Chinese demand for foreign currency, including U.S. Treasuries.[3]

The G7 economies are finally reaccelerating from a 1.8% average annual growth rate over the 2010-2017 post crisis-period, even when the combined central banks afforded the markets about $6.2 trillion of excess liquidity with their accommodative policy bias. The strategy that helped the crisis in 2008 has not worked for a cyclical rebound in the real economy. The current equity price/earnings multiple of 21.3x is remarkably close to the average of the last quarter century, approximately a price/earnings multiple of 20x, even though easy monetary policy was believed to prop up equity prices. Most equity valuations are not extreme at this time. The central banks' policies will begin to remove monetary accommodations of zero bound interest and asset purchases, but their policies are well advertised and still quite accommodative. Long-term interest rates and volatility risk may increase as the cost of capital increases, but the risks are to the bond market and weak companies only supported by the low cost of money.[4]

Given the robust corporate earnings, fiscal policy changes (tax cuts), deregulation of the financial and energy sectors, the cash excess of large corporations, and infrastructure spending, Strategas expects that U.S. monetary policy will be somewhat overshadowed going forward. The most recent phase of the equity bull market has fundamental support, as consumer confidence continues to support earnings gains. There is still pent-up capex demand in the economy, particularly in defense and infrastructure. Manufacturing has expanded at a torrid pace in the third quarter of 2017. Corporate earnings are projected to grow by roughly 4% and 9% in 2017 and 2018 respectively. The rally continues despite no major legislative accomplishments. Equity markets remain solid investment choices given these assumptions. The U.S. economy has never had a recession with corporate profits rising.[5]

Inflation will not move higher without wage increases, which remain stable. The present inflation backdrop is significant as it will likely sustain the corporate sector's pricing power gains, suggesting that the market has a long way to rise. BCA Research's analysis shows that 75% of their covered industries are able to increase selling prices, and 45% are doing so at a faster pace than the overall inflation. Only twelve industries are experiencing a downtrend in selling price inflation, a decrease of seven since late June of 2017, of which nine industries are deep cyclical/commodity related industries. Their analysis suggests that corporate sector pricing power is recovering and is positively influencing sales growth, operating leverage, profit margins, and earnings per share (EPS) growth as well as modest wage inflation for the second half of 2017.[6]

The interest rates on the U.S. 10-Year Treasury have not risen significantly since bottoming during the 2008-2009 recession and financial crisis. The last stretch of rising rates was just after June 2016 Brexit vote, when the yield of the 10-Year Treasury Note hit an all-time low of 1.37%. It subsequently hit a two-year high after the November 2016 presidential election of 2.60% and has ranged between 2.2% and 2.5% throughout most of 2017. The current 10-Year Treasury rate is 2.3%. In the 1990s, a 10-Year Treasury note returned close to 6.7% per year versus a 2.3% yield now, about a 440 basis points drop in income for 10-Year Treasury holders. Bond investors now face two challenges. The first is relying on bonds for cash flow presents challenges to generating a robust income. Secondly, if rates rise, the prices of existing bonds will fall. While the risk of rising interest rates is important, the risk of rates remaining low for an extended period of time is more significant.[7]

Since the 1980s, many public corporations have increasingly used share buybacks instead of dividends to reward shareholders. Across the U.S. stock market, buybacks have surpassed dividends in eight of the last ten years. The impact of buybacks on stock return has been overlooked or misinterpreted by investors according to Philip U. Straehl and Roger G. Ibbotson. Buy-and-hold investors, who exercise their right to hold on to their shares during a buyback offer, wind up owning a larger proportion of a company, given that the total shares in issue are reduced after the buyback. The authors' models show that long-term equity returns are almost completely driven by total payouts–dividends and buybacks. The total payout model is found to more accurately attribute long-term returns than models based on dividends only. Total payouts per share grow in tandem with economic productivity, implying that total payouts contribute to the long-term growth of the economy. Between 1980 and 2014, approximately 32% of the economic growth measured is attributable to buybacks, not to the growth of the underlying cash flows of the business. Buybacks have a fundamentally different impact on the return generation process than dividends do. According to this study, although payouts via dividends increase the income return, buybacks increase the price return per share because a buy-and-hold investor's share in a company is increased.[8]

In the Grant Interest Rate Observer of 2016, Steve Bregman suggests that many strategies are reliant on a moderate Federal Reserve. He believes that weakness in some passive strategies might be exposed as investors assess the challenge of the potential volatility created by a quantitative easing exit. He believes that the growth of exchange-traded funds (ETFs) is the world's biggest potential bubble. "It has distorted clearing prices in every sort of financial asset in every corner of the globe."[9] The real push to index funds began in 2013. Inflows to U.S. Equity ETFs have reached record levels in 2017, over $300 billion. Stocks added to indices may experience an anomaly of exceptional short-lived gains with increased demand for shares, unrelated to specific company news. As the fees of ETFs have decreased, product differentiation has increased. There has been a proliferation of subsets of the market, for which a higher fee could be charged: country funds, industry sector funds, style funds, etc. Many specialized index trackers can be expensive and do not have long track records established for return, volatility, or correlation. Devising subsets of the index accentuates a structural flaw of the market-capitalization weighting system: the top heaviness problem. Over time an index of stocks tends to get concentrated in a few names, which may increase systemic market risk or specific risk in certain securities. Since investors in ETFs do not buy shares individually they cannot sell them individually with price discovery. Passive investors cannot be dismissed for underperformance but carry unrecognized concentration and liquidity risk if the market declines.[10]

Martin Investment Management, LLC believes that the analyses of the two mentioned studies reinforce our view on investing in large, financially sound companies traded on recognized exchanges with strong liquidity. These companies have been able to participate in buybacks, increasing shareholder ownership over time. They also have the ability to pay a dividend. These companies have growing revenues and earnings, positive free cash flow, a low level of debt to equity, a current price close to or less than fair value, and very importantly, trading liquidity.

Wishing you a great fall season!

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