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Equity Investing Ten Years after the Great Financial Crisis

The total return for the S&P 500 Index was 7.71% for the third quarter of 2018 and 10.56% year to date. Real gross domestic product (GDP) increased at an annual rate of 4.2% in the second quarter of 2018 compared to 2.2% in the first quarter of 2018, according to the third estimate released by the Bureau of Economic Analysis. Consumer and business confidence continue to be crucial for the longevity of the bull market. The combination of strong U.S. equities, a lower U.S. dollar, higher bond yields, and rising oil prices help explain the U.S. expansion. While U.S. economic momentum remains strong, acceleration in the rest of the world has been more muted. U.S. capital expenditures are presently low compared to the size of the economy as the risk premia have increased. Excess cash accumulations and equity buybacks exemplify the shortage of attractive investment opportunities producing an adequate return on investment. There has been a lack of investment in any particular sector for over a decade since the Great Financial Crisis without any massive buildup in leverage. These factors suggest that the business cycle expansion could last longer than anticipated.[1]

The domestic economic picture in the U.S. is simply too strong right now for the Federal Reserve to slow down in front of trade concerns that may or may not act as a hindrance to growth.[2] The Federal Reserve's balance sheet ballooned from less than a trillion dollars in 2008 to $4.5 trillion by 2018. The Federal Reserve is beginning to reduce its balance sheet in what we see as an untested experiment. The Federal Open Market Committee (FOMC) raised the benchmark fed funds rate by .25% on September 26, 2018 to a range of 2% to 2.25%, suggesting three more rate increases by June 2019. The two-year Treasury yield climbed to 2.82%, up from 2.63% at the beginning of September. The 10-year yield has risen a bit further, reaching 3.085% from 2.84%. This is the eighth rate increase since December 2015 and the third rate hike this year.

Although the Federal Reserve has been raising rates, the Trump administration is easing fiscal policy rather aggressively. Fiscal stimulus during a period of low interest rates is very potent. The impact from the Tax Cut and Jobs Bill in 2017 is offsetting the Federal Reserve's interest rate hikes. The Trump administration is also deregulating the economy.[3] Although Trump's economic policies are highly stimulative for the U.S. economy, the long-term consequences will depend on multiple factors, including the resolution of trade agreements, deficits, aging populations, and geopolitical risks.

President Trump's trade wars with China, Japan, and Europe will eventually be felt in the marketplace over time. Trump's actions may be correct, especially in regard to China in assuming unfair play, but his actions change the rules, and everyone else needs to react.[4] The EU, Japan, and the U.S. are continuing to meet at the Ministerial level to tackle World Trade Organization (WTO) reform and distortive trade practices.[5] Tensions, however, are escalating with China as President Trump accuses China of interfering in U.S. midterm elections. Concurrently, China blasted the "Protectionist" U.S. in a lengthy white paper, and new tariffs are in place to take effect. A U.S. trade war with China introduces too many variables into an already difficult situation. China will continue to promote increased trade within its Asian region and with the EU. With its "One Belt, One Road" initiative, China is putting itself at the center of the global trade.[6] China's recent slow growth, especially in the private funds industry over the last three years, suggests the Chinese have less money to invest. People's Daily noted record-low growth rates for bank deposits in yuan. China, presently with overcapacity and excessive leverage, may hesitate to prevent a possible slowdown due to a U.S. trade war with another major fiscal stimulus.

Japan's real gross domestic product (GDP) is expanding approximately 0.2% per year. The Bank of Japan has tried repeatedly to bring rates above zero over the last two decades, with each attempt leading to worsening deflation or an economic slump. Japan's equity markets are recovering and, in our view, are presently attractive.[7] Europe's prospects are slowly improving. Although the European Central Bank (ECB) will likely finish its asset purchase program in 2018, its monetary policy will remain stimulative. Government leadership, world trade, Italy's budget, and Brexit are major challenges facing the Eurozone, but these issues are already reflected in depressed equity valuations and an inexpensive euro. The economic dynamics between the U.S. and China are more important for Japan and the EU than the actions of their central banks.[8] The MSCI EAFE (USD) Net Index returned 1.35% for the third quarter of 2018. The MSCI World (USD) Net Index increased 4.98% for the third quarter in 2018.

The U.S. equity bull market may last longer, especially if the current business cycle expansion stretches out further. The forward price/earnings (P/E) of the S&P 500 Index is much lower than in the 1990s. Although the equity risk premium has fallen steadily as the economy improves, it remains high and far above the 1990s levels. There is no sign of investor euphoria or excessive risk-taking. The U.S. corporate sector has increased its leverage due to debt-equity swaps as firms maximize their earning per share growth. Companies are flush with cash and their balance sheets are reasonable. U.S. earnings growth has been outpacing the rest of the world on the back of the tax cuts, favorable foreign currency translation, and buybacks. Global companies outside the U.S. have also been producing solid revenue and earnings. The Financial Sector is the only one whose performance continues to struggle on a global basis with subdued interest rates around the world and increased government regulations.[9] Although global economies have slowed significantly in 2018, the U.S. economic growth may spill over to global markets. Global economies are more robust than in 2015, when the U.S. GDP growth weakened to less than 3%, with contracting corporate profits, falling commodity prices, U.S. Treasury bonds rallied, and China's nominal growth plunged to 6.4%.[10] Recent equity market actions are consistent with an improving global growth, while inflation expectations have stayed largely stable at 2.1%.

The S&P 500 Index may have challenges from trade tensions, political uncertainty, higher short-term interest rates, and the prospect of a slowdown in U.S. economic growth. Trying to do bilateral trade agreements with each country is time-consuming, if not impossible. Interest rate increases are already feeding through to higher borrowing costs for households and businesses. When the Federal Reserve began raising interest rates in December 2015, interest rates on credit card debt, vehicle purchases and mortgages started to trend modestly higher. But in the past year or so, they have surged. Consumption and investment growth may continue to slow in 2019 due to these increased costs of borrowing. Because the U.S. consumer has been the engine of the U.S. economy, sector rotations may intensify and market leadership will change.[11] The growth classification landscape shifted in September 2018 when the Global Industry Classification Standard (GICS) was reorganized. Three of the five mega-cap FAANG stocks, (Facebook, Netflix, and Alphabet), were moved from the Technology Sector and Consumer Discretionary Sector to the new Communication-Services segment. This reclassification has occurred just as it appears the market has shifted away from some of the mega-cap FAANG leadership.

Martin Investment Management, LLC realizes that uncertainty is always part of investing with a variety of possible outcomes, each with different market implications. A major focus of our firm is to preserve capital in down markets. We believe that our investments in liquid quality companies, with low leverage, strong fundamentals, and reasonable equity valuations will help protect a portfolio over investments in illiquid companies with high betas, high debt levels, weak fundamentals, and extreme equity valuations. Our current view is that the U.S. economy has momentum, and the expansion may continue, reflected in positive earnings. We also believe that well-constructed, straightforward, cost appropriate strategies are an attractive alternative compared to indexes, which hold the whole market, regardless of the underlying businesses or valuations.

Our best wishes for a festive fall season!

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5. *Strategas Global Economic Update*, September 28, 2018.
6. "Daily Memo: Italy's Capitulation, China's Economy, NAFTA's 9 Lives", *Geopolitical Futures*, September 28, 2018.
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