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January 2017

Investment Thoughts as 2017 Commences

The total return for the S&P 500 Index was 11.96% for 2016 and 3.82% for the fourth quarter. A substantial list of sentiment measures indicates a recent positive change in the global economy. The global sentiment is also improving in Japan and the U.K., and bourses have generally moved higher in Europe. The U.S. real GDP growth was revised to 3.5% annually for the third quarter of 2016. With the improved outlook, expectations are high for the Trump administration to boost U.S. economic growth in 2017. Less regulation and strong growth are bullish for U.S. corporate profits. Trump's proposal for a major corporate tax cut is another positive for equities. On the negative side, the recent dollar appreciation hurts U.S. corporate profits as a third of the S&P 500 corporations' earnings are sourced from abroad. Although a stronger U.S. economy will have a spillover effect to other countries, the U.S. will likely benefit the most from Trump's fiscal stimulus plan. Another potential downside is the risk of trade wars resulting from anti-globalization policies aimed to boost the U.S. domestic economy.

The U.S. economy will likely grow above 2% in 2017, and the labor market should continue to tighten, pushing wage inflation higher. Full employment has only recently been attained and in order to pose a long-term inflation worry, it would have to stay near 5% for another three years according to BCA Research Inc., Special Report, December 5, 2016. Long-term inflation expectations have also increased since the election reflecting expected higher import tariffs. Inflation may increase but should not be significantly higher if the new administration succeeds in boosting demand and expanding the supply capacity of the economy. If businesses respond to increased demand with a significant increase in capital spending, the result will be faster productivity growth and less inflation. A stronger household sector leads to the robustness of the expected final demand anticipated by corporations.

The Federal Reserve will likely become more orthodox in its monetary policy if it is not the only option to stimulate the economy, as an easier fiscal stimulus policy is implemented. Although sizable tax cuts, increased infrastructure and defense spending, protectionism and a tougher stance on immigration

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are inherently inflationary policies, the Consumer Price Index (CPI) will most likely renormalize rather than surge. The Federal Reserve will likely not rush to abruptly tighten monetary policy with a resurgence of inflation in 2017 and a corresponding strong dollar. Although the output gap is almost closed, industrial production has diverged negatively from the output gap recently, suggesting that excess capacity still remains. The upshot is that inflationary pressures may stay contained for some time, especially if the U.S. dollar continues to firm. Inflation actually decelerates when the dollar is in a strong bull market.

The dollar had been relatively weak against most of the world's major currencies over the past decade, which improved U.S. exports worldwide. Since 2014 the U.S. dollar has begun to appreciate and surged to a 14-year high in the wake of the Trump election and the Federal Reserve's decision to raise interest rates by 0.25% in December 2016. A strengthening dollar is a sign of rising optimism for the U.S. economy as prospects of higher inflation and rising interest rates encourage investments in U.S. assets, reflecting growing hopes for better returns. A strengthening dollar increases the currency's purchasing power. If imports are cheaper, U.S. consumers and companies that purchase components abroad have more money to spend. In turn, a strong dollar could increase retail sales, a driver of economic growth, and engender more confidence in the U.S. overall. However, the dollar rally could undermine the Trump agenda of creating more domestic jobs by making exports more expensive. Companies will eventually adjust by boosting capacity at foreign plants while reducing capacity at home, changing their supply chain, or increasing the use of automation.

The major secular investment theme during the past eight years was global deflation. However, the post bubble secular period of deflation and slow nominal growth seems to be ending in the U.S., and reinflation could be a prime investment theme for 2017. The global economy might still be in secular stagnation, but cyclical acceleration is clearly underway. Leading economic indicators (LEIs) around the world are strengthening in a unified manner that has not existed since the credit bubble. Global yield curves are steepening, which supports the forecasts of global leading indicators. The MSCI ACWI reported that in 2008 41% of global yield curves were inverted while only 2% are inverted currently. Historically steeper yield curves forecast faster nominal growth, flatter yield curves forecast slower growth, and inverted yield curves forecast recessions.

We expect that Central Banks' monetary policies will continue to diverge in 2017. While the Federal Reserve is in a better position to increase interest rates, the European Central Bank (ECB) and Bank of Japan (BOJ) are expected to continue with easy monetary policies. Deflationary forces are present in Europe as the output gap remains wide at approximately 4% of potential GDP. Despite a 2.3% fall in the Eurozone's unemployment to 9.8% since 2013, euro wages continue to decelerate from excess capacity in the European labor market. As a result, European income and consumption continue to lag the U.S even though there has been a recent expansion in credit flows from European banks to the private sector. The ECB increased the total size of its asset purchase program. Europe will likely continue its easy monetary policy for 2017. With monetary divergences backed up by economic fundamentals, interest rate spreads between the U.S. and Europe can be expected to become wider.

In Japan, economic slack has dissipated, and the labor market is at full employment with unemployment at 3%. Japan has had a difficult time moving the output gap to positive territory because of fiscal austerity. Moving ahead, Japan's GDP should move above trend, and payroll growth remains strong despite full employment, pointing to potentially higher wages. Before removing accommodations, the BOJ intends to let inflation significantly increase to support growth and a weakening yen. The British pound is weathering the dollar's strength better than most other currencies. While the short-term outlook for the U.K. economy is exposed to the beginning of the Brexit negotiations in 2017 between the EU and U.K., longer term the U.K. present equity valuations appear to make them relatively attractive investments. The Swiss National Bank (SNB) is holding an unofficial bottom in the euro and Swiss franc exchange. Longer term the Swiss franc could appreciate sizably against other currencies, especially against the euro, because of the Swiss currency's net international investment position of 120% of GDP and current account surplus of 11% of GDP.

When the developed world's central banks continued a more accommodative monetary policy for most of 2016, emerging markets (EM) and China benefited. In 2017 emerging markets and China will likely be a source of deflationary shocks for the global economy as U.S. interest rates rise and the dollar becomes stronger. Emerging markets have accumulated too much debt to GDP, rising by 51 percentage points to 146% of GDP over the last five years. While the debt backed up new investments, capital has been misallocated, threatening future debt-servicing capacity. Return on equity in the EM has collapsed despite surging leverage ratios. Excess debt and excess capacity are deflationary and increase the vulnerability of the EM to positive (2016) and negative shocks. The Chinese credit appetite remains low and interbank rates are rising as the People's Bank of China (PBoC) slows liquidity injections. The Chinese economy risks rolling over. Since EM trade more with Europe and Japan and less with the U.S., the EM weaknesses could further contribute to monetary divergences between the Federal Reserve and the ECB and BOJ.

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The pool of investable equity assets has been reduced substantially over the last five years as a number of public companies have gone out of business, become private, merged, or have been acquired. At the same time the number of mutual funds, ETFs, hedge funds, and private equity firms has increased. There have been many more dollars trying to exploit a shrinking pool of assets at the same time that the competitive landscape has become more sophisticated.

In an article in the *Financial Analysts Journal* (FAJ) Volume 72 Number 6 2016, "Fundamentals of Efficient Factor Investing", Roger Clarke, Harindra de Silva, CFA, and Steven Thorley, CFA, estimate that the combination of four fully invested factors: low beta, small size, value, and momentum, captures less than half (e.g., 40%) of the potential improvement over the market portfolio's Sharpe ratio. Recently, factor sub portfolios have become very popular. The evolution of prepackaged portfolios, such as multifactor exchange-traded funds (ETFs), depends on the assumed correlation structure of factor exposures across the securities. In contrast, a long-only portfolio of individual securities, using the same risk model and return forecasts, captures most (e.g., 80%) of the potential improvement. According to the authors, a long-only constrained investor with views about equity market factor returns and risks still needs a portfolio constructed directly from individual stocks using nonmarket factors.

The results of "Fundamentals of Efficient Factor Investing" confirm the importance of individual security selection in a portfolio and reaffirms Martin Investment Management, LLC's investment philosophy. We offer an opportunity for wealth creation over time by selecting a focused portfolio of individual securities using a fundamental bottom-up investment process. When a company is bought, we are paying for its future expected performance. A company's intrinsic value is not only a function of current levels of profitability and growth, but also where its productive and invested capital is migrating over the long-term. Martin Investment Management, LLC believes that growth and valuation are very important concepts in the investment process. The investment team seeks to find quality companies for which the market has mispriced the economic cash flows that are being discounted or are trading at a discount to their intrinsic value by using its long established multi-stage investment process. In 2017 Martin Investment Management, LLC will continue to be very focused and disciplined in its equity selections with the goal of using the power of compounding of returns over the long term.

Wishing you health, happiness, and prosperity in the New Year!

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