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Shifting Currents for 2018

The total return for the S&P 500 Index was 6.6% for the fourth quarter of 2017 and 21.8% for the year. The MSCI World Index (USD Net) increased 5.5% for the fourth quarter and 22.4% for 2017. The MSCI EAFE Index (USD Net) rose 4.2% for the fourth quarter and 25.0% for the year. For the first time in a decade global growth has solidified and has accelerated, suggesting the improvement has been broad based. Economic indicators are above expectations. Worldwide economic growth looks healthy and strong for 2018. Strengthening economies and corporate earnings growth have helped send the equity markets up this year. The equity market usually does best when expectations are moderate, and economic data can comfortably beat them. If expectations become too high, economic data may not be strong enough to support future equity share gains.[1]

In the U.S. economic data are beating expectations by the widest margin in nearly six years. Four important economic indicators: non-farm employment, industrial production, real estate sales, and real personal income (excluding transfer receipts such as Social Security), continue to show positive but slow improvement since the Great Recession. Employment has been relatively strong, and the U.S continues to add jobs at a brisk pace.[2] Manufacturing data is robust with increased new orders and elongated delivery times. Industrial production has been slow to recover and finally has been showing signs of improvement.[3] Real estate retail sales have been rising. According to the S&P/CoreLogic Case-Shiller National Home Price Index, U.S. home prices are up 6.2% year-over-year in October of 2017. "Home prices continue their climb supported by low inventories and increasing sales."[4] Strong job creation and wealth effects are boosting spending although the failure of compensation to respond to advancing utilization levels in the labor force remains a puzzle. The globalization of the workforce and technology has played a prominent role in recent years in keeping wage growth modest in relation to declining unemployment.

After raising short-term rates for a third time in 2017, the Federal Open Market Committee (FOMC) is still committed to raising short-term rates in 2018 as the economy improves. BlackRock officials are expecting three increases of the federal funds rate, each at 25 basis points in 2018.[5] The U.S. Federal Reserve is delivering on its promise to begin to reduce its balance sheet. The recent moves of raising short-term rates and reducing the balance sheet have gone smoothly for the final three quarters of 2017. The U.S. Federal Reserve may not be able to keep normalizing policy at a slow and measured pace going forward. Economists have revised their estimates of U.S. economic growth over the coming two years due to the Tax Cuts and Jobs Act of 2017 and proposed fiscal spending increases. This combination could boost gross domestic product growth by an additional 0.3 % in 2018 and 0.2% in 2019.[6]

The world stock markets are benefiting from improved global growth and the continuation of accommodative monetary policy outside the United States. Corporate profits of individual companies have been both rising and predictable. Banks and other financial institutions appear better capitalized and more liquid than they were prior to 2008. Sentiment is positive in most of the world, and inflation seems unlikely to accelerate out of control. The Bank of England (BOE), the Bank of Canada, and the European Central Bank (ECB) have begun to get slightly less accommodative. Europe's economy has become more self-sustaining with less vulnerable imbalances from unemployment and income. In Japan, Abenomics continues to progress as deflation has diminished. Labor shortages have emerged as Japan's unemployment rate has declined to a 23 year low. Although the growth rate of China may slow in 2018 to 6.3%, the economy is still expanding. President Xi Jinping is refocusing his agenda from top-line growth to boosting the quality of life for Chinese citizens. Chinese officials remain accommodative as needed. For 2018 PIMCO expects worldwide GDP growth in the 3% to 3.5% range, U.S. GDP growth at 2.25% to 2.75%, and China GDP growth at 5.75% to 6.75%.[7]

For 2018, many economists forecast increased disruptions and greater market volatility. Disruptions may arise from geopolitical situations and monetary policy changes. Large-scale asset purchase plans of central banks have suppressed market volatility and positively impacted risky asset prices. As the central banks begin to "normalize" their experimental monetary policy, the capital markets may react unfavorably.[8] Additionally, the new tax cut bill creates new opportunities and challenges, affecting sector allocation. Increased debt levels are becoming riskier for 2018 as traditional bond covenants are waved, and buyers of debt seek riskier leveraged debt. Searching for yield in a limited yield world, terms on loans are changing to allow greater flexibility for the borrower to take on more debt, extract cash from a deal, and even restrict who owns the loans.[9]

China's highly leveraged financial system, Japanese government debt to GDP, European debt and faulty structural issues, U.S. government debt and entitlements, U.S. consumer debt, and Canadian household debt are only a few areas with unhealthy debt levels. The UK continues to face uncertainty in the Brexit negotiations. The longer the process takes, the more likely companies will relocate elsewhere. The BOE is responding to a relatively high level of inflation by temporarily raising rates in order to move the pound sterling higher. The result, thus far, has been stagflation. World currencies may experience increased fluctuation as central banks begin to tighten at different times.[10] Because the current expansion, particularly in the U.S., has spanned nearly a decade, and the risk of policy mistakes is real, some economists view that a possible deep world recession within the next three years is inevitable.

The investable equity universe has changed remarkably since the beginning of the 21st Century. The number of public companies in the U.S. has been on a steady decline since peaking in the late 1990s. In 1996, there were 7,322 domestic companies listed on U.S. stock exchanges. Today there are only 3,671 companies. Easy access to private equity, venture, and growth capital has meant companies no longer need to pursue an initial public offering (IPO) to find liquidity. The number of annual IPOs has declined from 845 in 1996 to 128 in 2016. The lack of new companies has increased the average age of public companies, from 12 years in 1996 to 18 years in 2016 as the companies are waiting longer before they become public.[11] As the number of public companies has declined, the number of investable equity products has dramatically increased.

In 1992 Eugene Fama and Kenneth French published a paper, "The Cross-Section of Expected Stock Returns" and changed the way portfolios were diversified. With the introduction of Fama-French's paper, a three-factor model began to be used to diversify portfolios by tilting the factors of size, value, and beta in a portfolio.[12] Academic literature now contains over 600 factors which mutual funds and ETFs use to invest their investment vehicles.[13] While investors are now able to access 600 multiple factors to which they want exposure, there is little information on how many of these tilts perform over time.

Although Martin Investment Management, LLC invests for the long term, we do have thoughts about the current and future investment horizon for the equity markets. Because the past Great Recession was so profound and severe, we believe that the recovery has been deep and slow. While perceived changes in taxes, regulations, and monetary and fiscal policies appear to lift or lower the stock markets, we believe more fundamental data and individual company earnings growth are contributing to the stock market expansion. Going forward, we believe that there may be more opportunities in individual stock selection than in equity market indexes. We anticipate that public companies with reasonable valuations, compelling secular growth stories, low leverage, and competitive advantages may be attractive investments regardless of the broader market multiples. We believe that investors still do not fully appreciate the magnitude of opportunity costs. Investors still remain fearful of the equity markets. Drawdowns in the stock market similar to 2008 and 2009 have occurred only 0.5% of the time, yet investors are structuring their investments for a replay of this scenario in the marketplace.[14]

Central banks' policies have made the global financial markets awash with liquidity. By mid 2016, about a half-trillion dollars had flowed into bond funds and bond ETFs.[15] Equity bear markets are generally seen through an inverted yield curve where the central banks raise short-term rates higher than long term rates in response to growing inflation or a heated economy. At this time inflation is low, and the economy is still recovering. The Federal Reserve may be cautious before overly tightening interest rates in a moderately growing economy.

Martin Investment Management, LLC believes that long-term returns come from the power of compounding by investing in growing companies with strong fundamentals, low leverage, and reasonable valuations. We continue to see positive signs in the market of public companies benefiting from a growing economy, manageable inflation, continued low interest rates, and pro-growth tax reform legislation for 2018. With overall trailing price multiples at 20.5x, higher aggregate market multiples will be more difficult to achieve going forward. However, valuation multiples that are above historical averages in most developed markets do not necessarily mean that global equities are overvalued. In the context of low interest rates, low inflation, and increasing growth, equity risk premiums in many markets still appear to be reasonable.

We wish you a very healthy and happy 2018!

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