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Disruptive Forces and Market Corrections

Although U.S. gross domestic product (GDP) for 2018 achieved a year over year increase of approximately 3.25%, the S&P 500 Index on a total return basis was -13.52% for the fourth quarter of 2018 and the total return for 2018 was -4.38%. The MSCI EAFE (USD) Net Index returned -12.54% for the fourth quarter of 2018 and returned -13.79% for the full year. The MSCI World (USD) Net Index returned -13.42% for the fourth quarter in 2018 and returned -8.71% for the full year. Nearly 50% of the S&P 500 Index traded at a 52-week low on December 24, 2018, marking the highest readings seen in the last decade. All 11 sectors of the S&P 500 are on track to end the year with losses for the first time since 2008. According to BCA Research, the "key question is whether the pessimism is overdone or an extended equity bear market is underway."[1]

Markets are now searching for a new equilibrium. The drop in oil prices, political tensions, monetary deleveraging, and the late cycle of the market began to worry equity investors, all contributing to the recent sell-off. We believe the correction of more than a 10% market decline in the last quarter of 2018 is a reactive move to inconsistent market data. While many fundamentals appear solid, especially in the U.S., there are signs that global economies have not totally abandoned deflationary concerns. Energy markets are being disrupted by the crosscurrents of oversupply, shale fracking, and increased wind and solar power. A number of political risks have the potential to disrupt global markets in 2019, particularly the trade war between the U.S. and China. U.K.'s Brexit resolution, Italy's budgetary woes, and U.S. domestic politics have the potential to destabilize markets. The Federal Reserve's deleveraging policies of quantitative tightening through U.S. interest rate increases and balance sheet reductions are reducing the amount of liquidity in financial markets. The interest rate the U.S. economy could take in 2018 was higher than the rate of comfort for forward looking financial markets.[2] The U.S. dollar (USD) increased 8% the first ten months of 2018 relative to other currencies, hurting emerging market economies that borrowed in USD. The fear of too much corporate leverage and of reduced future corporate earnings has distressed the market. Many asset classes have struggled this past quarter.[3]

Since 2008, stock markets around the world rose consistently with little volatility as central banks expanded their balance sheets. Now that the central banks are no longer continuing to promise easy monetary policies, and the

Federal Reserve continues to predictably raise interest rates while running off its balance sheet assets, the markets of risky assets have reacted negatively. Recent market volatility began in September of 2018 with the FOMC removing the word "accommodative" in describing its policy to becoming more data dependent.[4] The Federal Open Market Committee (FOMC) raised interest rates again by .25% in December for the fourth time in 2018. Their reasoning was based on economic data points, near full employment numbers - with 3.7% unemployment - and core inflation of 2.2%.[5]

Going into the fourth quarter of 2018, the economic expansion, low employment, tax and regulatory reforms were just beginning to positively influence domestic and global economies. By committing to more interest rate increases after the equity markets began to sell off, the Federal Reserve exacerbated the sell-off. In the *Wall Street Journal*, December 17, 2018, Stanley F. Druckenmiller and Kevin Warsh comment in their opinion piece, "Fed Tightening? Not Now" that "The Fed's balance sheet is where the money is…Accelerated Fed QT, in the absence of rate rises, would have been much less disruptive to the real economy. Asset prices could then have found a more durable equilibrium and laid a stronger foundation for future growth."[6] The U.S. Conference Board's measure of consumer confidence dropped -8.3% points month over month this past December to 128.1, primarily due to a drop in the future expectation component. Because the consumer consumption is still 70% of the U.S. GDP, a sharp decline in consumer confidence should be taken seriously as it may predict a recession 12 months in advance of its start.[7]

U.S. employment growth is an incomplete picture as low productivity sectors of transportation, accommodation, education, and health care have accounted for the majority of employment growth since 1990. Unfortunately, these sectors have both low levels of productivity and low growth rates of productivity. Zero productivity growth has grown hand-in-hand with zero real wage growth. Most all of the productivity gains have been in the manufacturing, information, and wholesale trade industries. In the high productivity sectors, such as manufacturing, wages have grown significantly more slowly over this time than in the less productive sectors. In 1990, the low productivity sectors accounted for 46% of private sector employment, while presently they account for over 60% of all private sector employment. The economy is increasingly fissured, with 90% of the economy experiencing low growth, low productivity, and low wages.[8]

Even without monetary tightening and trade wars, the global economy is off balance. Production is outpacing demand, a problem for the many countries that have risked their economic production on exports. Germany generates 47% of its gross domestic product from exports.[9] The German economy actually contracted in the third quarter of 2018, becoming vulnerable to a recession. Economic growth in much of the European Union is slowing, and some

countries' economies can be expected to contract. Switzerland's growth contracted due to weak domestic demand and faltering exports. A threat of U.S. automotive tariffs and slow growth in trade are hurting European economies.

China's economy, with low wages and commoditized products having driven the global economy for almost three decades, is beginning to unravel. Since 2008, the Chinese economy has been sustained by cheap capital, stimulus, and quantitative easing. Recent retail sales and industrial production reports, which reinforced momentum, are receding.[10] A Chinese hard landing or at least continued currency devaluation could put some pressure on the global economy, particularly as trade tensions worsen. Although the U.S. and China may reach a deal on trade, the trade war will not easily end. The U.S. is creating incentives for U.S. manufacturers to use non-Chinese suppliers as well as impeding Chinese investments in the United States. China will have a more challenging time disengaging from the U.S. given its dependence on the U.S. consumer and investments from U.S. firms. China is battling the U.S. while addressing its own structural dysfunction stemming from too much debt. Managing the repercussions of a U.S. trade war and too much internal debt, China will likely use modest fiscal stimulus to sustain growth. The main focus will be to manage the yuan and rescue ailing exporters.[11]

Martin Investment Management, LLC believes that equity markets may continue to feel disruptive influences from diverging monetary policies, technology magnifying valuation disparities, and geopolitical uncertainty. The global corporate landscape continues to be transformed by technological innovations and changing consumer preferences, which is upending established business models. Although disruption creates risk, we believe disruption also generates potential opportunities. Higher quality active managers can benefit from having a longer-term time horizon. In a time of rising interest rates, our firm's focus on higher quality stocks with solid balance sheets is particularly important. We believe that we have the potential to add value to our clients' portfolios over the next five to ten years because we evaluate stocks as representative of underlying businesses, and as a means to participate in present and future cash flows of the businesses in the firm's portfolios. In the long run, a stock price will reflect a company's intrinsic value, but in the short run, equity pricing is random.

An advantage of staying invested and resisting fear is that it is impossible to tell when the market will resume its upward course after a bout of volatility and market decline. A Fidelity Investments team compared the returns of retirement accounts for those who stayed invested in 2008 versus those who sold all their stocks in 2008. In the ten years following the financial crisis, those who stayed invested saw their retirement account balances increase by 240% while the investors who sold when the market declined only saw a 157% increase from their pre-crisis account balances.[12] Martin Investment Management, LLC believes remaining invested during market dips means participating in the recovery as

soon as it happens, rather than waiting until things seem to be back on track and missing the beginning of the turnaround.

Our warmest wishes for a healthy winter season!

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Note:

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