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The Unquiet of the Second Quarter of 2019

In the first quarter of 2019, U.S. economic growth rose at a strong 3.1% seasonally and inflation-adjusted annual rate. The pace of growth in the first quarter of 2019 was much stronger than the 2.2% rate in the fourth quarter of 2018. Slowing global growth, weak inflation, and trade wars continue to cloud the outlook for the rest of the year as positive economic sprouts appear. Although the recent downward revision to consumer spending, especially service spending increasing at a 1% annual rate rather than the estimate of 2.1%, suggests the momentum could be difficult to maintain in the second quarter of 2019, corporate earnings, business investment, exports, and government spending rose at a quicker pace in the second quarter of 2019.[1] The current global slowdown did not originate in the U.S. or Europe, but in China affecting the economies that sell to China the most.[2] Although China is able to shrug off the U.S. tariffs in the short-term, China's immense structural economic problems and rigid political system give it less room to maneuver over the long-term.[3]

The Atlanta Federal Reserve recently estimated U.S. gross domestic product (GDP) of 1.9% in the second quarter of 2019. U.S. GDP growth is set to decline in the second quarter of 2019 because inventory destocking is detracting from growth, having contributed to it in the first quarter of 2019. Inventory destocking is a positive sign as final sales are running above current production levels. The Federal Reserve signaled in June 2019 that short-term interest rates may be cut in the months ahead giving the economy a boost. Other global central banks have already eased their monetary policy in 2019 as global economies slowed.[4] Although slow growth, low inflation, and neutral interest rates present economic concerns, recessions rarely occur when monetary policy is accommodative, while equity bear markets rarely happen outside of recessionary periods. With little signs of inflation, equities will most likely rise than fall until interest rates increase significantly.[5] The total return for the S&P 500 Index was 4.30% for the second quarter of 2019 and 18.54% for the first half of the year. The MSCI EAFE Index (USD Net) returned 3.68% for the second quarter of 2019 and 14.03% for the year to date. The MSCI World Index (USD Net) increased 4.00% for the second quarter in 2019 and 16.98% for the first half.

Analyzing and interpreting global economic data has become more difficult as the sheer volume and speed of data increase. When so much could go right or wrong, the capital markets appear to either respond forcefully or ignore important data. As uncertainty continues to surround global economies, invest-

ment decisions become more difficult for companies in their long-term capital allocation and for investors in their opportunity set. Recent numbers exemplify the difficulty in interpreting data. In 2018, tariffs began to take a toll on domestic demand, even before the May 10, 2019 escalation, pulling forward imports and adding to inventory growth. In the first quarter of 2019, revised numbers reflect that U.S. exports increased at a 5.4% rate, versus a prior estimate of a 4.8% rate. Imports, which are subtracted in the calculations of GDP, declined at an 1.9% rate at the same time. Trade tariffs, which are deflationary, appear to present more headline risks than actual ones at this time according to Strategas Partners.[6] Central banks are responding to the uncertainties of the second quarter of 2019 by easing, giving a further boost to the equity markets in 2019. Quantitative easing (QE) in the developed markets has prompted an expanded search for yield and has produced substantial compression in risk premia globally.[7] The monetary easing still appears to be justified on precautionary grounds especially if trade disagreements, low inflation, and slow growth continue in 2019.

Additional effects of monetary easing can be seen in the Chinese and U.S. real estate markets. Since the global financial crisis of 2009, China's policymakers have moved their economy from export driven to one dependent on domestic consumption. The change has attempted to rebalance production away from the "old economy" with secondary industries dominated by state-owned enterprises and property to the "new economy" based on service industries and specialist manufacturing. In order to achieve this transformation, China has repeatedly stimulated its economy through the Bank of China. Unfortunately, China has often chosen to juice the economy with constituents of the "old economy." Between 2009-2011 and 2016 to 2017 economic growth was almost entirely driven by the "old economy." The property sector in particular has been driven by wide swings in China's economic growth. Property accounts for almost 86% of household wealth, while about 87% of urban households own their own property, and 27% own at least one empty investment property. Around 65% of loans are backed by property collateral, and the government funds a majority of its spending through land sales. The property market is the fulcrum of the Chinese economy. If the Chinese monetary stimulus is going to help drive a reacceleration of global growth in 2019, it will be through China's property market rather than its consumer.[8]

The Federal Reserve Bank of New York in conjunction with Equifax released the latest quarterly report on trends in U.S. household debt in May 2019. Total household debt rose to a new record high of $13.67 trillion in the first quarter of 2019, a $124 billion increase from the fourth quarter of 2018. The good news is that household balance sheets improved recently to a strong level as wages increase and interest rates decline. As of the first quarter of 2019 the level of disposable personal income was 41.8% above its prior cyclical peak in 2008.[9] At $13.67 trillion the level of outstanding household debt stands 7.83% above the prior cyclical peak of $12.68 trillion seen in the third quarter of 2008. The first quarter of 2019 represents the 19th consecutive quarterly increase in outstanding

household debt. Outstanding mortgage balances rose by $120 billion in the first quarter of 2019. In the first quarter of 2019, mortgage debt accounted for 67% of total household debt, with student loan debt accounting for 10.9%, auto loan debt accounting for 9.4%, credit card debt accounting for 6.2%, revolving home equity lines accounting for 3.0%, and other accounting for 2.9%. Households, in particular, stand to benefit from renewed Federal Reserve monetary easing as the lagged effects from the substantial decline in bond yields will also be hitting the economy with full force in the second half of 2019. Meanwhile, the Chinese stimulus will be working its way through the global economy in 2019, likely lifting global growth in the process.

A recent study by Martin Hirt, Kevin Laczkowski, and Mihir Mysore of McKinsey & Company addresses geopolitics, economic cycles, and many other factors, which can have a substantial effect on the fortunes of business. These factors are inherently uncertain. Even if one could correctly assess the uncertainties, there is no guarantee to respond appropriately. In times of crisis and in times of economic slowdown, not everybody fares the same. By tracing the histories of more than 1,100 publicly traded companies across industries and geographies with revenue exceeding $1 billion, the authors discovered about 10 percent of the companies fared materially better than the rest. The characteristics of the "resilient" companies, that delivered excess total return to shareholders and excess growth during downturns, are noteworthy. In the boom years prior to 2007, the "resilient" companies under-delivered to their shareholders slightly. During the downturn, these companies began to outperform which extended through the recession. By 2017, these companies had grown more than 150 percentage points over the non-resilient companies, a trend hard to reverse. The authors summarized that the "resilient" companies created earnings advantages by improving flexibility, cutting costs, and focusing on growth. They conclude that the more recent characteristic of digitization has widened the gap in capabilities and performance among companies. Advances in technologies and analytics are creating opportunities for investors as some companies are dynamically reshaping their competition. Companies further along in digitization are realizing a seven percent higher revenue growth and six percent higher EBITDA than their industry peers. The digital divide is resulting in very different outcomes for companies.[10]

Credit Suisse empirically found that companies entering the financial crisis of 2009 with higher returns on invested capital (ROIC) not only were able to sustain superior returns on invested capital through the financial crisis, but these companies saw greater multiple expansion after the crisis relative to peers. Alternatively, companies with superior growth entering the crisis were not able to consistently sustain higher growth as a group during and after the crisis.[11]

Martin Investment Management, LLC believes that we best serve our investors through our disciplined approach to the equity markets. Every market cycle and every downturn are different, presenting investors new challenges.

The firm consistently employs an investment approach that regards debt skeptically, reviews acquisitions carefully, and growth strategies wisely. A company consistently and methodically needs to address its flexibility to a changing marketplace. The economic margin a company makes above and beyond its cost of capital is important in understanding a company's operational effectiveness and future growth. Competition in global markets and shareholder activism has only accelerated this process. In 2019, challenges of cost cutting are made more difficult with the pressure to develop digitalization and the wider social costs of layoffs to a community. Creating new products and services, seamlessly addressing new geographies and regulations, and understanding priorities to grow the business become critical in the new economy.

Our firm continues to believe that uncertainty creates new opportunities for investors as existing businesses adjust to changing circumstance. We expect that the current monetary easing policy is expansionary with the effect of accelerating U.S. and global growth in 2019. The result will most likely be positive for the global equity markets. Any resolution to the trade tariffs will also contribute to a growing optimism.

Wishing you and your family an enjoyable summer!

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Note:

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