MARTIN INVESTMENT MANAGEMENT, LLC
1560 SHERMAN AVENUE SUITE 1250
EVANSTON, ILLINOIS 60201

(847) 424-9124
FAX (847) 424-9182

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Overweighting Negative News and Underweighting Positive Surprises

The news of the third quarter of 2019 has focused on the financial impact of continuing trade wars, a potential global slowdown, geopolitical unrest, an inverted yield curve, central bank monetary policies, currency depreciation, market volatility, a risk of a recession, and the potential impeachment of the U.S. President.[1] In spite of all the daily market swings this past quarter, there was a relatively small overall change in the market. The U.S. economy has been driven by strong consumer spending and robust job growth. The dividing line between the beleaguered manufacturing sector and the healthier services/consumer sector presently remains firm.[2] The total return for the S&P 500 Index was 1.70% for the third quarter of 2019. The MSCI EAFE Index (USD Net) returned (1.07)% for the third quarter of 2019. The MSCI World Index (USD Net) increased 0.53% for the third quarter in 2019.

On September 18, 2019 the Federal Open Market Committee (FOMC) cut the Fed Funds rate another 25 basis points, the second FOMC's 25 basis point rate cut this summer. At the same time, Brazil cut interest rates. The cuts come on top of People's Bank of China (PBOC) and the European Central Bank (ECB) also easing this past September.[3] Inflation is so far below the misplaced two percent target, that the central bank's drastic and prolonged monetary policy easing has depressed the five-year bond yield to near zero.

Global bond yields have plummeted to historical lows and inflation has continued to undershoot the two percent target, which most central bankers target for price stability. Near zero bond yields and inflation are categorically not portents of a long-term drought in economic progress. As an example, Japan has experienced near zero bond yields and inflation for decades. Yet since the late 1990s, the growth in Japan's real GDP per head has outperformed every other major economy. In the post credit boom era, Japan's economic progress has come entirely from productivity improvement, which is more sustainable to economic progress than credit booms or asset bubbles.[4]

In Europe, Swiss bond yields and inflation have been near zero for decades, but they have defied secular stagflation as real GDP per head and living standards continue to rise.[5] The former British Empire is another example of near-zero inflation and low bond yields where consumer prices changed little for three centuries from the end of the English Civil War in 1651 to the height of the British Empire in 1914. As structural credit booms have sequentially ended, economies have one by one entered the state of price stability. First it occurred in Japan in the 1990s, then Switzerland in the early 2010s and more recently the euro area followed by the United States.[6]

If economic growth and prosperity can occur during periods of low interest rates and low inflation, what should this imply about the situation today? While certain countries and economies have experienced low yields in the past, economies are currently exhibiting near-zero or negative rates in unison. Negative-yielding debt now makes up 30% of the debt globally as bond prices rose over the summer. This leaves few places for yield seeking investors to turn to in the sovereign fixed income market. This drop in sovereign yields has increased the equity risk premium in most countries; implying stocks are trading very cheaply on a relative basis to government backed debt.

The mathematics behind a discounted cash flow analysis (DCF) support that companies with stable cash flows should receive valuation multiple expansions during periods of minimal inflation and interest rates. The Japanese market provides the longest recent example of what happens within a market during a period when monetary policy sets low to zero interest rates. Over the course of the last 25 years, investors have typically assigned higher market premiums to defensive, stable growth companies compared to cyclical counterparts in Japan. A similar effect also has taken place in European equities since European countries began issuing debt with zero or negative interest rates. On a 12-month forward P/E basis, defensive equities in Japan typically have been valued at a 30% to 50% premium to cyclicals since 1995, while defensive equities in Europe have steadily risen to a 30% premium to cyclicals since 2010.[7]

According to Andrew Lapthorne, the head of quantitative research at Société Générale SA, the equity and bond markets are distorted because the Federal Reserve has flooded the market with liquidity. While the first quantitative easing by the FOMC was necessary after the Great Recession of 2008, the subsequent quantitative easing in 2010 and 2012 were not necessary and have presented distortions in the equity and bond markets, particularly in 2014 and 2015 where U.S. debt increased by 30% to 40%.[8]

Quantitative easing has led to credit easing and the creation of more bonds in the private sector. Many of the newly created corporate bonds offer extremely high yields to investors compared to Treasuries. Since the easing, many of the corporate bonds issued were by small and mid capitalization companies to buy back their shares. While this appeared to be an attractive decision given low interest rates, many of these companies, often now embedded with leverage, have low profit margins and unstable cash flows. The danger is that without stable cash flows, some of these companies could easily become impaired if earnings diminish as the debt becomes due.[9]

Some companies with increasing debt have been categorically classified as "value stocks". Fears of a global slowdown or recession have unfortunately not only compressed the valuation multiples of companies straddled with debt but also companies with cyclical businesses. As Andrew Lapthorne notes, if the market is over-weighting the likelihood of a recession, and the economy instead grows, many of cyclical "value stocks" trading at attractive valuations have upside potential for investors. Andrew Lapthorne believes that many "value stocks", more cyclical in nature, have high earnings and are greatly underappreciated in the market. He concludes that these stocks offer a diversification to a portfolio and have the potential to appreciate based on their present valuations if the companies are not significantly leveraged and produce positive earnings.[10] Martin Investment Management, LLC believes several, "value stocks", more cyclical in nature, have relatively stable business models, manageable debt, and currently offer attractive valuations. Just as we believe purchasing bonds with negative yields will end badly for investors, we believe purchasing most purported "value stocks" will end badly for investors as many of these companies have impaired business models and carry significant leverage.

Martin Investment Management, LLC believes the current world of investing presents challenges. There is a large disconnect between present economic growth and asset prices as so much liquidity has been injected into the economy by the global central banks. Some of the money has gone into productive enterprises while other money has not been used wisely. While the longest economic expansion in U.S. history continues, investors are becoming increasingly worried that the status quo will change. We believe the short-term issues driving the current market's volatility include manufacturing weakness, trade conflict, lack of fiscal stimulus, inventory cycles, Eurozone weakness, and dysfunctional politics but that market uncertainty and volatility typically lead to opportunities for active managers.

The primary long-term issue of so much global debt will not easily be resolved. The Federal Reserve has recently experienced this difficulty by raising interest rates too quickly compared to the rest of the world. Deutsche Bank recently stated that major world economies now have government debt, on average, exceeding 70% of GDP, the highest peacetime level of the past 150 years.[11] The good news is that in spite of record U.S. debt of $22.5 trillion, the net interest on the debt should finish the year at 1.8% of GDP. For perspective, this number is lower than the percentage of U.S. net interest on the debt from 1980 to 2001, during which time it averaged 2.7% of GDP. In addition, the assets of U.S. households combined are at $129.7 trillion leaving a net worth of $113.5 trillion.[12]

Martin Investment Management, LLC believes that the U.S. economy is still expanding but possibly at a slower pace. Cycles have always existed and will always exist. We prefer to look at the profits and losses of companies as feedback to our investment decisions. While we cannot control the market, we can have a better understanding of individual holdings. We aim to avoid investing in companies with excessive corporate debt. Corporate earnings, invested capital, free cash flow, and valuation will continue to dominate our thoughts as the economy transitions in a new direction. Our major objective is to find growing companies, which have reinvested in their business using the excess return on capital from their existing enterprises.

Our wishes for a pleasant fall season!

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