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April 2021

One Year Later

In March of 2021 the U.S. marked the one-year anniversary of the beginning of the COVID-19 pandemic. Over this period, more than 540,000 Americans have died from COVID-19 and almost three million people globally. Martin Investment Management, LLC shares our thoughts and prayers for those impacted by the COVID-19 virus and gives our gratitude to all essential workers who have performed extraordinarily in atypical times.

A high level of global fiscal and monetary policy coordination in the developed world continues to address the destruction from the COVID-19 virus. In the U.S., Federal Reserve balance sheets have risen to 35% of GDP.[1] The economic impact from COVID-19 was severe. In just a two-month period (February to April 2020), the U.S. unemployment rate rose from its lowest peacetime rate since the 1920s to the highest rate of the Great Depression as activity collapsed because of government mandated shutdowns. In the second quarter of 2020, the U.S. experienced the worst quarterly drop in real GDP in 74 years of recorded history, an annualized decline of 32.9%. After the S&P 500 Index reached an all-time high of 3,386 on February 19, 2020, it fell 33.9% in just 32 days to 2,237 on March 23, 2020.[2]

In the third quarter of 2020 the U.S saw the biggest annualized S&P 500 Index market gain in history of 33.4%. The S&P 500 Index regained the previous high in less than five months on August 18, 2020 ending 2020 up 67.9% from the low and up 18.4% for the year. In 2021 investors continue to be optimistic about an economic recovery with the distribution of COVID-19 vaccines and the continuation of monetary and fiscal policy. The S&P 500 Index had a total return of 6.17% for the first quarter of 2021. There were gains on a total return basis in the MSCI EAFE (USD) Net Index of 3.48% and in the MSCI World (USD) Net Index of 4.92% for the first quarter of 2021.[3]

The current U.S. macro environment is characterized by a lack of clarity. Experts are expressing highly divergent opinions regarding the outlook of the U.S., with strong arguments both bullish and bearish. On the positive side, there is a healthy economy. The Federal Reserve and both the Trump and Biden administrations have provided unprecedented levels of financial support and stimulus to the economy. This is especially good for potential consumer spending, traditionally about 70% of the U.S. economy. Harvard economist Jason Furman estimates that the combination of above-trend income and below-trend spending has created roughly $1.8 trillion of extra disposable personal income since the beginning of the pandemic. There are also the positive wealth effects from 2020's multi-trillion dollar appreciation of stocks and homes. The combination of the extra disposable income with the ending of the prolonged period of isolation and release of pent-up demand has the potential to add substantially to short-term economic growth. While the lockdown-related recession was painful, it set the stage for some very positive year-over-year comparisons in the period immediately ahead.[4]

On the bearish side, the biggest risks to U.S. investors are long term rising interest rates, increased taxes, and inflation. Interest rates have been declining steadily for the last 40 years, which has been a huge tailwind for investors. Although the present asset prices are justified by current interest rates, stocks and bonds are vulnerable to rising rates, which will imply higher required expected returns on stocks and bonds. If U.S. fiscal programs do not result in increased productivity, increased tax revenue will be necessary to pay for the huge deficit overhang. Higher corporate taxes will result in lower equity returns. Not including the most recent American Rescue Plan in 2021, the stimulus plans of 2020 total nearly $150 billion a month, which is three times the size of the output shortfall. In contrast, the 2009 stimulus measure provided an incremental $30 billion to $40 billion a month during 2009, an amount equal to about half the output shortfall.[5] While inflation may be rising in the short term due to fiscal stimulus, supply constraints, and rising rates in the long part of the yield curve, a persistent rise in inflation is hard to predict at this time because of the present slack in the labor market and low nominal underlying GDP growth without the extraordinary comparisons to the pandemic GDP results. The economic recovery remains uneven and far from complete, and the path ahead is highly uncertain.[6]

Investors favoring risk have also returned, and fear of missing out is greater than the fear of losing money.[7] Speculative investing is increasing. Risky choices include investing in the equities of bankrupt companies or bond yields with low contractual protection. Momentum investing can be unprofitable for late adopters of unsuccessful IPOs or special purpose acquisition companies (SPAC), as initial investors abandon their position.[8] The credit market is now surfing on waves of money. The prospect of inflation and rising rates make floating rate debt, such as corporate loans, attractive to a swath of investors. Banks are searching for a place to invest cash, making collateralized loan obligation (CLO) debt an attractive option. Riskier borrowers, rated B-minus or lower, are making up an historically high percentage of this loan issuance in 2021, now more than 40%. This may be a good sign in helping companies continue to fund themselves cheaply even as Treasuries point to rising rates, but investors may be exposed if and when short term rates rise and a struggling company cannot so cheaply and easily refinance itself.[9]

Global markets are correctly interpreting the $1.9 trillion U.S. fiscal stimulus package in 2021 as a factor justifying higher global growth expectations. Central banks around the world have both the tools and the inclination to keep bond yields from rising excessively. Higher yields are unwelcome in most countries, barely recovering from the pandemic. Most central banks will not begin to tighten before the Federal Reserve does.[10] Europe's economic recovery has been delayed with more COVID-19 cases, increased hospitalizations, new lockdowns, and a limited vaccine supply. Europe's virus-driven setbacks are temporary. The vaccine rollout should improve over the next few months, and a robust economic recovery in the second half of the year is possible. An improving global outlook will directly benefit Europe as its listed companies derive more than 50% of their revenues from outside the region, by far the highest percentage among the major regions. Another tailwind for European equity markets has been the European Central Bank's direct action against rising government bond yields with maturities longer than five years. As a result, Eurozone yields have risen about half as much as U.S. yields.[11]

Real interest rates in the U.K. are the lowest in the developed economies, while inflation breakeven is the highest. The U.K. interest rates have had a series of rolling shocks dating back to the 2008 financial crisis preventing the Bank of England (BoE) from normalizing crisis-era levels of interest rates, even during years when inflation was overshooting the BoE's 2% target. Brexit and COVID-19 were the last of those two shocks, but the growth and inflation dampening effects of both are fading fast as a strong economic rebound is anticipated in the U.K. economy. The pound has upside in this environment, especially if depressed U.K. productivity starts to recover.[12] Negotiations of new trade agreements between the U.K. and the Eurozone are still ongoing.

Japan's recovery from the Great Lockdown continues to be slow, but upward. The data is changing, and forward-looking indicators have improved. Japan households have amassed record financial assets as Covid-19 lockdowns have hurt spending. Shipments, machine orders, trade, and industrial production are all recovering to pre-pandemic levels according to the latest data releases. Japan's market has been the biggest market outperformer in local terms in the first quarter of 2021.[13]

China is a very different place than the rest of the world, having circumvented the negative economic effects of the pandemic. In February 2021, electricity, consumption, investment, production, and retail sales growth spiked as the economy recovered from the lockdowns in early 2020. Money and borrowing continue to steadily grow.[14] A strong Chinese economy will boost the RMB.[15] The country's current growth rate of 8% does not need massive economic aid or an ultra-easy monetary policy. China is keeping its fiscal deficit target unchanged at about 3% of GDP while promoting monetary restraint greatly diverging from developed countries.[16] China has detailed new initiatives on making "science and technology self-reliant." The semiconductor supplies are of a particular concern as U.S. exports of semiconductors to China rose 22.2% in 2020 and 27.0% in the fourth quarter of 2020.[17]

Martin Investment Management, LLC believes that massive increases in government fiscal spending will boost economic growth in the short term. A significant increase in the monetary base during a period of robust economic growth is likely to result in higher temporary levels of inflation. Longer delivery times are consistent with bigger order volumes, more online shopping, raw material shortages, costlier shipping due to higher WTI crude prices, prioritizing vaccine shipments, and weather disruptions. Typically, higher inflation follows a run up in supplier delivery diffusion indexes.[18] Greater volatility in inflation is likely to lead to greater volatility in price/earnings multiples. Earnings will begin to take over as the driver of equity returns and play a larger role as elevated equity multiples unwind due to higher interest rates.[19] Our firm believes that rising interest rates will matter less for companies able to finance operations internally, and rising inflation can be addressed more easily by companies with pricing power.

Profitability and growth are individual factors but interrelated. While high growth companies with robust profitability provide the largest opportunity to grow cash flow, companies with low growth and robust profitability can also steadily grow cash flows thereby returning capital to shareholders. High growing unprofitable companies, which rely on external financing, tend to be destructive for shareholder value. Applied Finance Group (AFG), an investment research firm used by Martin Investment Management, LLC, studied the relationship between profitability and growth through a "financing yield" factor for a shareholder-yield. In its out of sample study, AFG, which aligns to forward-looking returns over long-term horizons, found that more robust financing yields appear to offer additional capital appreciation potential to shareholders. This study also provides significant evidence in the luck versus skill debate to further justify the decision to allocate capital towards active management with valuation-based research and migrate away from passive alternatives. Our firm believes valuation-based factors, such as "financing yield" in AFG's research, as well as a company's business model and competitive positioning are important variables for shareholder return.[20]

Wishing you a delightful spring season!

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