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

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

April 2023

Not A Normal Sequence of Events

In the first quarter of 2023, the S&P 500 Index had a total return of 7.50%. For the same period, the MSCI EAFE Index (USD) Net had a total return of 8.47% while the MSCI World Index (USD) Net had a total return of 7.73%. Summing up year-to-date market leadership, 2023 has been one of reversion to the mean. The stocks, which fell the most in 2022, have been outperforming in 2023. The best performing stocks in 2022 have had relatively muted gains in 2023. Reversals have been just as strong on the sector level. Another defining characteristic of the market's rally this year has been the outperformance of growth stocks relative to their value counterparts. It has been a volatile start to 2023 for investors coming from a challenging 2022, when both the S&P 500 Index and long-term bonds declined by double digits.[1] The economic signals and a host of geopolitical risks confronting investors suggest that 2023 could be similarly challenging for both stocks and bonds.[2]

Volatility and liquidity tend to be inversely correlated. Unfortunately, volatility spikes can drain liquidity from the system, and once the ball starts rolling, it can be hard to stop until markets become more confident.[3] The collapse of several U.S. banks and Credit Suisse is a symptom of a more acute stress in the world economies. Until now, they have held on in the present late cycle despite some typical hallmarks of recession, such as the inverted yield curve, the magnitude of monetary tightening, and a slow motion decline in corporate earnings.[4] The macroeconomic implications from the turmoil of the banking crisis are still unclear. In the higher rate world, institutions, whose business models were predicated on the post-Global Financial Crisis (GFC) easy money world lasting forever, have run into trouble.

After 2020, world inflation rose dramatically from pandemic supply chain disruptions, the outsized fiscal and monetary responses, as well as, the war in Ukraine. Money supply then shot up in 2020 relative to nominal GDPs, creating an excess of savings, which has since largely been consumed. The process of temporarily delinking money and prices from productive demand lifted consumer prices, raising inflation dramatically.[5] U.S. consumer price index (CPI) peaked at 9.1%, lower than the U.K. at 11.1% and the eurozone at 10.6%.[6] The Bank of England (BoE) was the first central bank to react to inflation raising base rates by 0.25% in December 2021 and continuing up to a present base rate of 4.25%. The Fed followed in March of 2022, eventually increasing the base rate to 4.75%. The European Central Bank (ECB) did not begin to raise rates from zero until July of 2022 and has a current base rate of 3.5%. The Bank of Japan's monetary policy remains fairly loose with lower rates than other developed markets because of their lower inflationary prices.[7] The tighter monetary policies of most world banks

have made some progress against inflation over the past 12 months. For example, U.S. interest rates have risen 450 basis points, and the Federal Reserve has contracted its balance sheet by $645 billion. The Federal Reserve's aggressive action has tightened policy to the equivalent $6.945 trillion, almost reversing the entirety of the mid-2019 through 2021 stimulus.[8] In the first quarter of 2023, underlying inflation is proving sticky, meaning that the central banks may need to continue to hike rates in the near term.[9]

The U.S. government's distribution of relief payments in 2020 and 2021 to individuals and businesses caused bank deposits to soar with many above the FDIC insured limit of $250,000. As interest rates rose in 2022 and 2023, depositors searched for higher yields on their deposits than banks could provide.[10] The flood of cash pouring into U.S. money market funds, which invest primarily in short-term government bonds, has the potential to exacerbate strains in the banking system. While banks offer less than a half percent interest rate on saving deposits, money market funds are offering four percentage points on investors' savings. Much of the cash in money market funds ends up outside of the banking system altogether because the funds are heavy users of a facility that offers generous interest rates for parking cash overnight at the central bank. By using the central bank's overnight reverse repo facility, money markets leave banks collectively with fewer deposits, which disincentives banks from lending.[11]

As depositors fled banks in search of higher yields, losses began to occur at banks. When a run on deposits occurred at Silicon Valley Bank (SVB), $42 billion on March 9th alone, panic ensued. The cash liquidity needed to cover these withdrawals was not there. SVB had invested heavily in long-term government bonds, whose face value had been badly depreciated by the Fed's interest rate increases over the past year.[12] The Treasury bonds are only marked against a capital base to market when sold not marked to market on a continuous basis so SVB was not prepared for this moment.[13] There are roughly 200 other banks that appear to be in similar condition as SVB's, whose strategy was profiting from taking duration risk, or borrowing short and lending long. About 94% of SVB's deposits above $250,000 were uninsured. As of mid-2022 U.S. banks also had $10.5 trillion in uninsured deposits, and only $7.4 trillion insured.[14] Even though in the 1980s all the deposits at thrift and banks were insured deposits, between 1980 and 1994, 1617 banks and 1295 thrifts either were closed or received government assistance. Initial losses became a crisis because of combination of bad accounting, valuing assets at book value rather than market value, and complacency produced by deposit insurance and regulators.[15]

While the Federal Reserve's new Bank Term Funding Program (BTFP) is placing about $2 trillion into the banking system to reduce the present reserve scarcity and reverse the tightening that has taken place in 2022,[16] Credit Suisse's problems were years in the making with multiple scandals, losses, management shake-ups, and unsuccessful restructurings. With significant financial assistance from the Swiss government, UBS agreed to acquire Credit Suisse on March 19th for 3 billion Swiss francs in an all-stock deal. In the process, the Swiss government determined that Credit Suisse has reached the "point of non-vitality," which triggered a full write down of the group's

subordinated Additional Tier 1 (AT1) bonds. Credit Suisse serves as an example that a global systematically important financial institution can have significant losses. It is thought that the UBS deal should help prevent contagion and will have little direct fundamental impact on other global banks even though they have exposure to each as counterparties. Though contagion risk is limited, market volatility to global banks may persist.[17]

As lenders and key drivers of the credit cycle, financial institutions can be a catalyst for a future crisis.[18] A banking or financial crisis, may not only lead to tightening credit conditions and negative wealth effects, but may also impair long-term growth prospects. According to various academic studies, previous banking crises on average lowered the long-term level of gross domestic product by 5% to 10%.[19] Going forward, bank investors who had been focused on a potential earnings tailwind from higher interest rates may shift focus to banks' deposits base, the risk of potential deposit outflows, and how excess deposits are being deployed.[20]

Larry Summers believes the Federal Reserve is challenged with a credit crunch on one side and overheating on the other side making for a difficult balancing act. His solution for financial stability is not a choice between easy money or more inflation. He believes that the Federal Reserve can fight inflation and that easy money is not a solution for the excesses of the last ten years. He suggests, for example, that distressed banks should have higher standards and proper regulations for financial stability. While the Federal Reserve's decision to provide liquidity to the distressed banks had to occur, he believes that its resolution might sow a seed for a future financial crisis. He referred to Long Term Capital Management and the Russian defaults in the late 1990s, which set the stage for the Nasdaq bubble at the turn of the millennium. The Federal Reserve cannot save too many "in limbo" enterprises not in a position to be restructured because of their debt and shortage of covenants to empower their debt. Better use of capital is important going forward.[21]

The first quarter of 2023 was the slowest start to a year since 2013, as rising interest rates put an end to the flurry of deals that followed the onset of the pandemic. Europe was the chief laggard this past quarter, with regional deal activity down 63% while the U.S. saw a 47% drop, and the Asian region only declined by 24%. Sectors of healthcare, technology, and industrials were bright spots for mergers and acquisition in the first quarter of 2023. A main concern to transactions remains falling valuations.[22] U.S. 2022 fourth quarter corporate profits declined the most in five years, down 1.4% year over year.[23] Despite this dismal news, corporations have healthy balance sheets and have limited debt exposure to higher rates. Only 25% of S&P 500 Index companies have floating rate debt. Corporates have also amassed large cash balances of roughly $8 trillion. The consumer remains resilient and is benefitting from a solid labor market and higher interest rates on savings. The new worth of consumers is still well above pre-pandemic levels, having risen from $110 trillion in the fourth quarter of 2019 to $135 trillion as of the third quarter of 2022. Consumers now hold $17.8 trillion of their assets in cash and cash equivalents, meaning the interest income on those assets is set to rise.[24]

The relationship among inflation, the economy, and financial markets, is highly complex. Investors generally assume that higher inflation is negative because it often leads to higher borrowing costs and increases the discount rate applied to earnings. This leads to a fall in the price-to-earnings (P/E) ratios. According to Strategas, the sweet spot for earnings growth, which usually drives stock prices, is when inflation is between 2% to 4%. In this range, which should occur in 2023, the average quarterly earnings growth rate for the S&P 500 Index is usually 7.0%. Equities generally act as an excellent protection against inflation over time. The U.S. inflation rate, measured by the Consumer Price Index (CPI), averaged around 3.2% from 1914 to 2023. The S&P 500 Index returned a respectable 10.4% annual compound growth rate return from 1926 to 2022.[25]

Judging what is and what is not working at any given time is extremely important to Martin Investment Management, LLC. We are very disciplined in our philosophy. The types of stocks which do relatively well in rising rate environments are stocks, which exhibit "Quality" factors. They have generally outperformed speculative stocks in rate-hiking cycles over the past 35 years. High quality stocks of companies with strong balance sheets and exhibiting a high return on equity and high quality earnings have outperformed low quality stocks in all five federal rate-hiking cycles since 1987, with a median outperformance of 8.41 percentage points. Similarly shares of companies with low leverage have significantly outpaced highly levered companies during rate-hiking cycles, when the markets tend to be in "risk-off" mode. We favor quality and low-leverage stocks regardless of the interest rate environment, as one of our tenets is to avoid combining operational risks with financial risks whenever possible. We believe that quality and low leverage factors provide significant margins of safety when combined with a valuation discipline.[26]

Wishing you a warm Spring season!

---

1. Sonders, Liz Ann, and Kevin Gordon. "Caveat Emptor: Important Market Shifts Underway", March 8, 2023.
2. Swedroe, Larry. "First Quarter 2023 Economic Review and Forecast", *Advisor Perspectives*, March 27, 2023.
3. Swedroe, Larry. "First Quarter 2023 Economic Review and Forecast", *Advisor Perspectives*, March 27, 2023.
4. Swedroe, Larry. "First Quarter 2023 Economic Review and Forecast", *Advisor Perspectives*, March 27, 2023.
5. Lees, Andrew. "Betting Against the Fed", *Macro Strategy Partnership*, March 30, 2023.
6. Ferguson, James, "Eurozone Deflation" *Macro Strategy Partnership*, March 16, 2023.
7. Savery, Patrick. "Tracing Treasury Liquidity Lower: Once the Ball Starts Rolling. It's Hard to Stop" *Loomis Sayles & Company Insights*. March 17, 2023.
8. Grabonski, Ryan. "Daily Macro Brief", *Strategas Securities, LLC*, March 27, 2023.
9. Arnold, Martin. "Eurozone Inflation Falls Sharply to 6.9% as Energy Costs Recede", *Financial Times*, March 31, 2023.
10. Ip, Greg. "Threat of a Slow-Boil Bank Crisis Endures", *Wall Street Journal*, March 30, 2023.
11. Duguid, Kate. "Flood of Cash into U.S. Money Market Funds Could Add to Banking Strains", *Financial Times*, March 31, 2023.

---

12. Ackerman, Andrew. "First Citizens Buys Silicon Valley Bank", *Wall Street Journal,* March 28, 2023.
13. Mauldin, John. "Another Unstable Finger", *Advisor Perspectives*, March 18, 2023.
14. Calormiris, Charles W. and Phil Gramm. "In Today's banking Crisis, Echoes of the 80s", *Wall Street Journal*, March 29, 2023.
15. Calormiris, Charles W. and Phil Gramm. "In Today's banking Crisis, Echoes of the 80s", *Wall Street Journal*, March 29, 2023.
16. Lees, Andrew. Morning Headlines, *Macro Strategy Partnership*. March 16, 2023.
17. "Credit Suisse Takeover by UBS: Implications for Global Banks" Decoding Stress in the Banking Sector. *Loomis Sayles & Company Insights*, March 28, 2023.
18. Savery, Patrick. "Tracing Treasury Liquidity Lower: Once the Ball Starts Rolling. It's Hard to Stop" *Loomis Sayles & Company Insights*, March 17, 2023.
19. Tandon, Vaibhav. "The Consequences of Credit Suisse", *Advisor Perspectives*, March 28, 2023.
20. Savery, Patrick. "Tracing Treasury Liquidity Lower: Once the Ball Starts Rolling. It's Hard to Stop" *Loomis Sayles & Company Insights*, March 17, 2023.
21. Summers, Lawrence H. "A Conversation with Dr. Lawrence Summers". Conducted by Seema Shah, Principal Asset Management, March 23, 2023.
22. Levingston, Ivan. Dealmaking at 10-year low in first quarter as bank crisis hits confidence", *Financial Times*, March 31, 2033.
23. Lees, Andrew. "Morning Headlines," *Macro Strategy Partnership*, March 31, 2023.
24. Amoroso, Anastasia. iCapital Market Pulse: "No Landing Now, Hard Landing Later," February 23, 2023.
25. "Inflation's impact on stocks", Nationwide Chart of the Week, March 13, 2023.
26. Fleming, Andrew. "The Case for Quality Stocks Now," *Advisor Perspectives* May 23, 2022.

Note:

© 2023 Martin Investment Management, LLC ("MIM") is a registered investment adviser. SEC registration does not imply a certain level of skill or training. Past performance is no guarantee of future results. Investments involve risk, and accounts may lose value. The information presented in this letter is not intended to be investment advice and reflects the opinion of MIM on the date written and is subject to change without notice. If data is presented that has been prepared by third parties, such information will be cited. These sources have been deemed to be reliable. However, MIM does not warrant or independently verify the accuracy of such information. All market prices, data and other information are not warranted as to completeness or accuracy, may not be audited information and are subject to change without notice. Forward-looking statements contained herein are based on our current expectations and assumptions of economic and other future conditions and forecasts of future events, circumstance, and results outside of our control. Actual results could differ materially from those expressed or implied by such statements. For additional information about MIM, please read Part 2 and Form CRS of the firm's Form ADV. They are available upon request.