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

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

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Patience Amid Uncertainties

Equities have remained resilient in 2024, and solid year-to-date momentum suggests more gains might be possible into year's end. Investors may need to understand there are current risks of a slowing global economy, high U.S. equity valuations, aggressively priced expectations for rate cuts, especially in the U.S., lingering geopolitical risks, and the outcome of a U.S. presidential election. This may suggest weaker equity returns and a higher possibility of volatility going forward. David Joshi of BCA Research believes that non-U.S. developed economies have already experienced a recession in 2023.[1] In the third quarter of 2024, the S&P 500 Index had a total return of 5.89%. The MSCI EAFE Index (USD) Net had a total return of 7.26% for the third quarter of 2024 while the MSCI World Index (USD) Net had a total return of 6.36% for the third quarter.

This century, equity investors have suffered through four bear markets. The most recent bear market in 2022 lasted 282 days and saw the S&P 500 Index drop by 25% at its lowest level from the peak. The market drop came after Russia's invasion of Ukraine, and inflation increased to a forty-year high across much of the developed world. This led to steep rate hikes and a sharp decline in the Technology Sector that year. The start of the 2020 pandemic featured a short bear market lasting 33 days with the market dropping 34%. The Great Recession of 2008-2009 was another negative time for equity markets falling 57%. The dot-com bubble burst and 9/11-related recession of 2000 to 2002 caused a bear market, and the S&P 500 fell 49%. None of the market drawdowns lasted as long as the market upsides in the past 24 years.[2]

While we are not suggesting an immediate bear market, we are aware that market complexities will add volatility to the markets. Investors hold different opinions on the economy.[3] For some, particularly the equity investors, the Federal Reserve's 50 basis point cut is just right. Others, particularly the bond market, believe that the Federal Reserve needs to cut more aggressively as the economy is moving into a recession. Another group of investors believes that the economy is too hot, and easier money will stoke a return of inflation. Martin Investment Management, LLC believes each of these divergent opinions is worth further discussion as the developed world economies are very complex.

Many investors believe that the interest rate cut has accomplished a soft landing. The current interest rate cut is intended to sustain what they see as an emerging and healthy balance in the economy, with inflation headed toward target and unemployment near a level consistent with stable prices. Increased price pressures have eased.[4] Although the goods sector has shown some weakness, both in the U.S. and abroad, the service sector has allowed the U.S. and other developed world economies to expand. Growth in services is dependent on the labor market remaining robust. With this risk profile, the Federal Open Market Committee (FOMC) and other central banks have opted for larger and additional cuts before spending on services slackens too. Key for a soft landing is getting previously impaired sectors of the economy such as housing and manufacturing to turn up.[5]

Bond investors believe that the central banks have started cutting rates six to twelve months too late. There are signs of a U.S. recession, which will only increase over the coming months, and the rest of the developed world has already experienced one the past year. Historically, a re-steepening of the yield curve, a fall in ISM manufacturing new orders below 45 (signaling weakening discretionary demand), a rise in household deposits, and a fall in business deposits (both due to households holding back spending) are early present signals of a recession, which are rarely price-neutral and prove aggressively deflationary. The bond market is most attuned to pre-recessionary signals.[6]

Ed Yardeni, president of Yardeni Research, raises the odds of an "outright melt up" in stocks following the Federal Reserve's 50 basis-point cut, which will overheat the healthy economy.[7] The Fed's forecast to accelerate the pace of cuts is dependent on the neutral rate, which many believe is already back to or within reach of their steady or neutral state of unemployment above 4%, inflation just over 2.5%, and real GDP at or above 2%.[8] Some economists believe that both the equilibrium rate and GDP forecasts need to be revised higher than the current projections, concluding that the FOMC is cutting rates with too hot of an economy.[9] By lowering interest rates, investment risk is returning to the markets. Higher risky assets are not pricing in a recession but pricing in cuts. Continued levels of fiscal spending and interest rate cuts could lead to a second round of inflation. The question becomes is the market being driven by speculation and asset price inflation or strong fundamentals of employment, consumer and business spending, corporate profits, and positive earnings growth?[10]

Most investors want rates which are neither too stimulative to overheat the economy nor too restrictive to slow the economy.[11] The central banks are simply moving closer to where the market already is. For now, fears of inflation will subside before fears of a recession rise or inflation returns.[12] Like the U.S., many global central banks also realize that lower interest rates will help finance huge government deficits.[13] The U.S. Treasury has a lot of discretion on how it manages the federal debt. It needs to raise certain amounts but can borrow short-term, long-term, or anywhere in between. Treasury can also repurchase its own debt, replacing that amount with newly issued securities at different maturities. All this activity becomes more important as the amount of debt increases, as it has been and will continue to do.[14] At some point the U.S. Treasury will increase its long term debt issuance. Rate cuts should steepen the 3 month/10 year curve bringing the carry traders and foreign buyers back as a source of Treasury demand for long-term bonds.[15]

China announced a triple stimulus (monetary and fiscal) on September 24, 2024, which cuts interest rates and lowers mortgage rates for existing homes, gives loans to investors and companies to buy back their stock, and promises to inject fiscal liquidity into the banking system and the economy, approximately $142.5 billion.[16] The additional injection of liquidity is meant to jump start the markets and boost confidence.[17] Since the announcements, Chinese stocks have had their best day since 2008, after China took more steps to rejuvenate the economy.[18] Like the Chinese stimulus in 2008, the new one may matter to investors in the Chinese stock markets more than to its economy, as it improves risk-taking but increases government debt. In the short-run, the stimulus helps China exit deflation, but over the long-term China needs real growth from domestic consumption and productive allocation of resources. Separately, Saudi Arabia is boosting crude oil production, which will assist global economic expansion.[19]

The Bank of Japan (BOJ) is one of the only central banks raising rates. Because yen inflation is staying above 3.0%, another rate hike appears inevitable. Japanese currency is cheaper than other developed world currencies and is massively used for carry trades.[20] These trades unwound this past August when the BOJ raised its interest rate by 0.25%, and the yen rose 14% against the U.S. dollar in less than a month (July 10 to August 5). This caused assets to decline in value against yen-denominated borrowing used to fund U.S. purchases. Investors were forced to unwind their trades. Since Japan has the world's largest net international investment position with $3.3 trillion of investments held abroad, the market disruption was costly to many investors.[21] Some analysts view that the 'yen carry trade' and the U.S. Technology AI bubble are one and the same trade, and the trade may further unwind as investors continue to borrow the yen for investments in AI.[22]

At this time, the U.S. equity market represent about 71.6% of the MSCI World Index USD. The U.S. dominates the industries of the future to an extraordinary degree. Sixty-one percent of global funding for AI start-ups goes to U.S. companies compared with 17% to Chinese companies and 6% to European ones. The U.S. attracts 50% of global private funding for quantum computing compared with just 5% for Europe. U.S. companies account for 65% of the global market for cloud computing. However, the extraordinary dominance of the U.S. magnificent seven tech companies is not necessarily a good thing for the broader market.[23] Within the next two years, corporate AI adoption trends need to move higher to avoid a "metaverse" outcome for all the capital deployed.[24] AI remains an important theme, but for investors it is a long game beyond the immediate infrastructure phase of chips, language models, and co-location power. The next phase needs to be used beyond the AI providers. [25]

The U.S. equity market does not appear too bearish despite recent volatility. The U.S. Treasury has added liquidity into the markets ahead of the presidential election, which should help boost the equity market. The Industrial Sector should continue to benefit from infrastructure spending with almost $1 trillion of investment in U.S. reshoring, fiscal spending, and electricity demand. The Industrial Sector is diverse with subindustry groups that each have different fundamental drivers, which are less economically sensitive. Countries are making an effort to increase defense spending due to increased geopolitical tensions, which will again support Industrials.[26] While elevated earnings expectations, positioning, and valuations pose a relative risk to U.S. equities relative to non-U.S. developed world equities, the U.S. consumer, supported by wages, may continue to surprise to the upside providing support for U.S. equities.[27]

A rotation away from U.S. technology stocks is a necessary condition for a healthier and more sustainable advance in global equities. Non-U.S. developed world equities will benefit from continuing global expansion and moderate easing of monetary policies across the major economies. Real GDP improved in both the euro area and the Japanese economies in the second quarter of 2024. Global manufacturing activity has bottomed and should rebound as inventories are rebuilt, and trade increases. Global forward earnings are in an uptrend.[28] There will be variation across individual markets and companies, but we will continue to be focused on equity valuations, profits, return on investment, and growth in both the U.S. and non-U.S. developed world equities.

Investors benefit from public markets, which offer investors more transparency than alternative investments. Because public companies are under increasing pressure to focus on short-term results, Martin Investment Management, LLC has a greater task to emphasize investments with commitment. We add equities to our portfolios for the long term and try not to be distracted by the short term quarterly results. We are disciplined in our clear but thorough investment process. We realize that more complicated investments may require more time but does not necessarily mean more profit. Often times the best portfolios and companies have attributes and metrics that are easily understood. We realize that patience and discipline are two important factors driving long-term investment success. While markets can be bullish, bearish, or sideways, we remain consistent in our investment process and patient in our equity holdings.[29]

Wishing the best of the fall season!

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