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Investing in a Time of Fiscal Dominance

Market sentiment towards the future of the developed markets has greatly improved in 2024 as recession and growth fears have receded. The economic landscape surprised to the upside by robust employment data, moderating inflation, sustained consumer expenditure levels, and prolonged fiscal stimulus impacts.[1] Market volatility continues to be low. We believe that interest rates will be receding in western developed economies and that the enormous worldwide funds presently held temporarily in money markets and bank deposits will begin to flow toward riskier assets. Equity markets are implying very optimistic conditions and have discounted various negative impacts. In the first quarter of 2024, the S&P 500 Index had a total return of 10.56%. The MSCI EAFE Index (USD) Net had a total return of 5.78% for the first quarter of 2023 while the MSCI World Index (USD) Net had a total return of 8.88% for the first quarter.

Global interest rates are in the process of finding equilibrium after two material external shocks over the last 15 years. The first was the Great Financial Crisis (GFC) of 2008 caused by the collapse of the U.S. residential housing market and the second, a mere twelve years later, followed by the Covid-19 pandemic. In both crises the developed world monetary policy response was to drive interest rates to negative levels and to flood the economy with liquidity so that any possible economic harm could be minimized. During the pandemic, supply constraint and too much money chasing too few goods caused inflation to return. Central banks responded by raising interest rates quickly. Now that inflation is moderating, policy is again changing among the world's eleven major central banks. This marks the most synchronized policy loosening cycle in sixteen years with the exception of the Bank of Japan.[2]

The inefficiencies in this present cycle have been made worse by the market's fixation on interest rates. The Federal Reserve has just introduced its own monthly data source, called the Financial Conditions Index. In its report dated March 22, 2024 report, the Fed's two of four main indicators of financial conditions suggest that monetary policy has shown a drastic loosening of financial conditions since summer of 2023 and are no longer restrictive.[3] Because the Federal Reserve policy is not as restrictive presently as it would appear, financial markets are going to continue to rally inflation related assets, such as equities, bitcoin, gold, commodities, and other hard assets. If monetary policies continue to be loose, inflationary pressures are likely to remain. Larry Summers believes that this distortion in the Federal Reserve's estimate of the neutral policy rate, the setting where it is neither stoking or slowing the economy, means that policymakers believe their current setting is more restrictive than it really is. Summers believes that the Federal

Reserve should not be too dismissive of the faster than expected inflation reading in 2024 and remain cautious before lowering rates.[4]

In Europe the Covid money printing was less expansive than in the U.S. (relative to GDP), so the excess savings have worked their way through the system. Policy rates at 4.5% are dissuading new bank lending so that there is no need to keep interest rates where they are. In Europe wage growth and inflation have decreased to a degree that the European Central Bank (ECB) expects inflation rates to drop to 2.5% in 2024 and 2% in 2025. Keeping policy rates at their current levels would not make sense in that scenario, because real rates would increase, possibly causing a recession which would be unnecessary since inflation would already be under control. The Bank of England (BoE) held interest rates steady, as a lower than expected. U.K. inflation slowdown is focusing on service inflation, given sticky wages. The Swiss National Bank (SNB) unexpectedly cut rates ahead of other major central banks to try to lower their currency risks.[5]

Japan's engineering innovation propelled it to become the world's second largest economy by the 1980s, peaking in 1989 when Japan represented 45% of the world's stock market capitalization. After a series of lost decades Japan's stock market capitalization declined to roughly 6% today. The long-beleaguered market is showing signs of resurgence due to government support and corporate transformation. The Tokyo Stock Exchange has made changes to compel companies to invest in their businesses and improve shareholder returns. With a return of inflation, companies will be able to increase prices, leading to margin expansion and enhance profitability. After 17 years, the Bank of Japan (BoJ) on March 21st finally raised its interest rate to 0.1% from the previous rate of -0.1%. The rates are staying around zero as a fragile economic recovery forces the BoJ to go slow on further rises in borrowing costs.[6]

Martin Barnes, of BCA Research analyzed world economies based on several factors: capital growth in real GDP, unemployment, inflation, government finances, financial market performance, and investing in the future. He concludes that the U.S. is best at economic growth and financial market performance, but Asia leads in the important category of investing in the future. The U.S. experience suggests that running "irresponsible" fiscal policies pays off in the terms of short and medium economic growth and asset price performance. Similarly, Germany continues to pay a price for the bias of fiscal discipline and austerity. Those who favor the Austrian rather than the Keynesian School of Economics believe that the U.S. approach will end in disaster, but such views have been held for decades and thus far have been proven wrong.[7]

Unfortunately, there are issues, in no particular order, that pose serious concerns that could affect global financial stability.[8] The huge liquidity growth has not been fully absorbed in the real economy and may be helping to fuel inflated equity valuations and create highly speculative and narrow leadership in the U.S. equity market.[9] U.S. Treasuries, considered the safest and easiest to trade on Wall Street, have grown more than 60% to $27 trillion since the end of 2019 and sixfold larger than before the GFC. While present demand has been adequate from hedge funds, money market funds, and foreign investors, many worry that instability could arise from their rapid growth, and spread globally. In the fall of 2023, mounting bond sales sparked market turmoil, prompting the Treasury to shift toward selling more short-term debt through Treasury bills.[10]

A useful cushion to the U.S. economy has been Yellen's "stealth" quantitative easing (QE) overpowering the Fed's quantitative tightening (QT) by $433 billion from Treasury General Account (TGA) and Reverse Repo Facility (RRP) since October 2022. More than $75 billion per week was leaving the RRP to finance Treasury's T-bill issuance in the final weeks of 2023. The magnificent seven stocks have correlated with T-bills outstanding. About half of the liquidity gains have happened in the past five months. This tailwind will become a temporary headwind through April 2024. The U.S. is about to enter a temporary liquidity and fiscal squeeze, which can impact the USD, bond yields, and liquidity sensitive stocks. All three components of liquidity are turning negative at the same time, the Fed balance sheet, the Treasury General Account (TGA), and the Reverse Repos (RRP). The biggest temporary squeeze is April tax season, but other factors are also involved such as the end of the Bank Term Funding Program (BTFP), which allowed banks and other financial institutions to pledge their Treasuries to the Fed at par following the collapse of Silicon Valley Bank. This was a vital source of liquidity last year, which is now set to reverse.[11]

US. policy makers have the tools available to them to keep liquidity flowing into the 2024 election, post April tax season. The Fed has indicated the central bank will cut rates and slow quantitative tightening (QT) this year. Treasury will have $1 trillion in the TGA post tax season and is likely to spend that account down just as was done leading into the 2022 midterm election. This means the tailwind for equities is reversing. It is hard to overstate just how important the Yellen-Powell pivot on November 1, 2023 was for financial conditions, resulting in bond yields falling 81 basis points and stocks rallying for nine consecutive weeks into 2023 year end. The Treasury Quarterly Refunding announcements have become market-moving events because they determine the level of liquidity. In November 2023 Treasury reversed itself, and coupled with Powell signaling no more rate increases, money flowed out of the RRP and into the T-bill market. The ultimate effect was the term premium on the 10 year note was punctured paving the way for a sustained equity market rally, but this is reversing now. Despite the $8 trillion shareholder wealth increase in 2023, the sharp increases in tax payments will significantly lower private disposable income. Bank reserves and bank cash assets will reverse, causing more headwinds with tighter liquidity conditions for banks.[12]

An unintended consequence of quantitative easing and fiscal stimulus has been the complete indifference to long-term market returns.[13] Since 1957, the 10 largest stocks in the S&P 500 Index have underperformed an equal weighted index of remaining 490 stocks by 2.4% per year. In the last decade there has been a very notable departure from that trend with the largest ten outperforming by a massive 4.0% per year on average.[14] There is also the fact that the number if not size of public equities is dropping. U.S. listed stocks dropped from 8,090 in 1996 to 4,642 in 2022. Public companies face a variety of new tax and regulatory headaches making that status less enviable. For many companies going public with the hassles and expenses no longer outweighs staying private, especially with better developed venture and private equity industries supporting them.[15]

The Bain & Co. annual survey of private equity industry found that there are a record 28,000 unsold private companies worth more than $3 trillion as a sharp slowdown in deal making creates a crunch for investors seeking to sell assets. The numbers show how rapidly the industry has grown over the past decade, as well as the challenges it faces from higher interest rates that are increasing its financing costs. It may be a few years before the money starts to come back to investors. This also causes a shortage of emerging growth stories to attract investor interest in the public markets as private companies own thousands of companies they would like to sell.[16] Initial Public Offerings (IPOs) are the vehicle for a private company to go public so that early investors can be rewarded by more capital in the public markets. Now these companies hope instead of an IPO that they get acquired by a larger, already public company.[17]

What has occurred in the last several years is that a growing money supply going into a smaller number of stocks increased the demand for each stock. Rising stock prices and valuations are a natural result. The nature of market capitalization weighted portfolios concentrates most of the demand on the largest stocks.[18] While the magnificent seven are no longer cheap in aggregate, they have deep moats and are quality businesses. Apple, Inc. has brand value and success in its App store. Google and Meta are extremely successful in acquiring potential competition. Amazon and Microsoft dominate cloud infrastructure. Nvidia has outclassed AMD and has become the world's main GPU manufacturer.[19] Reuters Analysis reported though that Big Technology companies are facing their biggest challenge in decades as antitrust regulators on both sides of the Atlantic recognize that they must do something to stop their anti-competitive practices. While a break-up-order might be suggested, a more likely result will be fines and take years to resolve.[20]

The S&P 500 Index market weighted stock price index is up 43% since the start of the current bull market from October 12, 2022. The equal-weighted version of the index with the 500 stocks assigned an equivalent weighting regardless of their market capitalization is up 29.5%. since it bottomed on September 30, 2022. The bull market, according to Ed Yardeni has been broad all along. It just has not risen as much as the market capitalization weighted index.[21] Martin Investment Management, LLC believes that there is a market of many stocks. Even in a very concentrated market, there are always opportunities to be found. We believe diligent investing requires commitment and focused portfolios based on solid fundamentals.

Because of the extreme concentration in the U.S. market, Martin Investment Management, LLC believes there continue to be opportunities in non-U.S. developed world equities. The MSCI EAFE Index is less concentrated than it was 20 years ago. The top five companies in the MSCI EAFE represent just 9% versus 23% in the S&P 500 Index.

Non-U.S. markets have very different sector and style compositions relative to U.S. markets leading to natural diversification benefits. Rising stock prices in U.S. equites has resulted in a significant valuation premium relative to non-U.S. equities. While non-U.S. equities have lower estimated three to five year earnings per share (EPS) growth estimates, the asset class appears very attractive on price per unit of growth measures. Martin Investment Management, LLC is proud of our track record in our non-U.S. developed international and global strategies. We invest in U.S. and non U.S. companies of the developed world which are broad based and may benefit as the market become less concentrated to a handful of equities.

Wishing you a bright spring season!

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