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Evaluating the Financial Recovery from Covid-19

In the second quarter of 2021, the S&P 500 Index had a total return of 8.55%. The MSCI EAFE (USD) Net Index returned 5.17% for the second quarter of 2021 while the MSCI World (USD) Net Index returned 7.74% for the same period. Approximately 80% of stocks in the S&P 500 Index are in an uptrend and reflective of how broad this advance has been. S&P 500 earnings per share estimates for 2021 currently are $191, up from $167 at the beginning of the year.[1] In 2021, the developed non-U.S. markets are following the broad U.S. benchmark in local currency terms and lagging by roughly 2.6% when measured in U.S. dollars. European benchmarks have significant exposure to the global growth cycle, which has been strengthening. European markets (44%) hold more industrials, energy, and financial stocks than U.S. counterparts (30%), which may benefit from a recovery. European companies in aggregate have more non-European revenue exposure, deriving over 50% of revenue from outside the region. In contrast, Japan and emerging markets outside China are likely to see growth slow or even contract in the second quarter due to a surge in COVID-19 cases. These situations illustrate that the rising infections remain a key risk to both public health and economic performance.[2]

Although global monetary and fiscal policies are pushing in the same direction, which is that more is better, the COVID-19 recovery is not proceeding at the same pace everywhere. It depends on prior trends, virus conditions, vaccinations, and other factors. The U.S. economy will probably be first to regain its pre-pandemic record because of the progress made on vaccinations, monetary and fiscal policies. A year after the economic trough, spending volume on consumer goods is more than 12% higher than it was before the downturn began. The spending volume increase took six years post the 2008 and 2009 Financial Crisis and three years following the 1990-1991 and 2001-2002 economic downturns to achieve the same outcome. While consumer goods sales have responded to stimulus immediately, spending on services is still far below pre-COVID-19 levels.[3]

Despite a stellar earnings season, market action over the last few months has highlighted a discreet tension between general optimism for a continued improvement in world economies, as no one wants to sell stocks, and concerns about increasing inflationary pressures. The question is whether this is on-going or temporary. There is consensus that for the most part inflation is transitory and caused by low inventories. Inflation is not a one-off change in the price level caused by a short-term distortion to protect profit margins but is a persistent acceleration in prices. COVID-19 appears to be comparable to a natural disaster on a global scale, which has created many temporary disruptions and dislocations.[4] After the summer, inflation will likely become less of an issue as production expands, and demand growth recedes. The end of the stimulus checks and generous

unemployment benefits are expected to dampen consumption in the third quarter of 2021. Post summer demand production is expected to expand just as demand growth recedes, and price inflation should lessen. Because there is still significant slack in the labor markets, aggregate demand growth is likely to lower in the future from the consumer base, which is tapped out when it comes to durable goods expenditure.[5]

Some sectors, including airlines, autos, hotels, leisure, industrials, and retail, are experiencing moderate to severe input cost and workforce pressures that are likely to persist into 2022 and beyond. These sectors were among those most hurt by shuttered factories and stores or by travel restrictions at the height of the pandemic. Most of these businesses will never recover the lost revenue missed during the pandemic. In contrast, basics, homebuilding, consumer products, food and beverage have seen higher costs stemming from shortages in underlying commodities, production slowdowns, and supply chain bottlenecks.[6]

The U. S. federal government dissaved approximately $3 trillion over the past year while the household savings ballooned to $4 trillion and the net savings in the corporate sector expanded by $100 billion. The household savings rate is higher than the pre-COVID-19 level of 7% just as the household savings was higher than the 5% that existed before the Great Financial Crisis. Less than 25% of the stimulus checks are going into the real economy. One third is going down to pay debt and over 40% is being saved.[7] When pandemic life is all over, there is likely to be a major reassessment of the U.S.'s response to COVID-19. A growing school of thought holds that there was an overreaction that will cost the country for decades. The nation spent almost as much in one year to defeat the virus as it did to win World War II. Two decades ago, the national debt stood at $5 trillion. Today it is approaching $30 trillion, and nearly 40% of that was created in the past year. The United States' fiscal spending as a percentage of GDP climbed 25% as the government fought the pandemic, while that figure was only 16% in the U.K., 11% in Germany and 5% in China. Unfunded guarantees in the U.S. are nine to ten times GDP, which is a major financing risk.[8]

Housing prices are surging around the world. In the first quarter of 2021, the average annual nominal house price growth accelerated to the fastest pace since 1990 across 37 advanced economies according to the Organization for Economic Co-operation and Development's (OECD).[9] Increased demand for homes amid a scarcity of listings has pushed up prices to the point of giving owners more collective equity than before the pandemic: $8.1 trillion according to data provider Black Knight.[10] The National Association of Realtors stated in June 2021 that the median existing-home sale prices in the U.S. rose above $350,000 for the first time in April of 2021. Half of existing home buyers in the U.S. who took out mortgages put up at least 20% in down payments.[11]

Because U.S. private sector savings dramatically increased during the pandemic, with bank deposits worth 79% of GDP, the highest level in history, individuals shifted some of their funds into the stock market. With corporate buybacks outpacing new share issuance, stock prices had nowhere to go but up. Falling bond yields further

supercharged equity valuations. The values of pension funds and investment portfolios have soared. Private sector financial balances in most other developed economies have followed a similar trend.[12] Inequality of wealth has grown during the pandemic as owners of stocks, bonds and real estate grew to a record $250 trillion according to the Boston Consulting Group Inc., while people with lower incomes and few assets have not benefited from the growth in the financial markets.[13]

Martin Investment Management, LLC believes that some macro factors are significant. The longer-term structural changes will be addressed in a future writing. The pandemic has had adverse effects but did motivate companies to use their resources more productively and efficiently through the adoption of new technologies. Increased profitability and better earnings were the result for the most efficient companies. In our view, maintaining exposure to strong secular growth names along with those value sectors that have above average earnings growth and low debt and leverage to the global recovery is constructive.

We believe that certain industries are being misclassified as cyclical when they possess secular growth characteristics. For example, the semiconductor and semiconductor capital equipment industries are presently more secular than cyclical. From the 1990s the semiconductor industry was mainly driven by PC trends, and over the past decade smartphones have become the major driver. In 2021, there is a digital inflection point that should drive sustained growth across multiple areas, including data centers, 5 G, auto sensors, the Internet of Things, and Artificial Intelligence. We believe that the semiconductor industry is doubling over this decade from $500 billion to $1 trillion.[14]

We also believe that corporate executives will need to compete not only for investment capital deployed but on labor employed. Human resources may well represent the newest growth area in business management. Return on labor may become just as important as return on capital with respect to company valuations as long as productivity maintains its upward trend.[15] Proxy voting and shareholder advocacy in 2021 are covering multiple issues related to the environment and public health. Martin Investment Management, LLC has been very dedicated to address non-material issues and risks in our global ESG investment portfolios, Eco-Investing (2008) and Martin Signature (2018).

Although growth and quality stocks have lagged cyclicals in 2021, we remain steadfast in our belief that secular growth is important to generate long-term returns. This trend makes sense, as cyclical stocks are more sensitive to changes in GDP, and the economy has been expanding rapidly throughout the post-pandemic recovery. We believe that this is an anomaly as the combination of pent-up demand and generous government stimulus is a once in a century event. Our investment philosophy focuses on the long run, finding quality companies based on reasonable growth, return on investment, cash flow, low debt, competitive advantage, and long-term earnings power. We believe that pricing power and the ability to maintain profits are essential qualities in changing markets.

Wishing you a very happy summer season!

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Note:

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