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August 2021

Challenging Times for Investors

Some investors are highly confident the Federal Reserve can support markets against any risks. Other investors have worries that monetary policy has lost effectiveness in supporting consumer confidence. The significant risk to investors could be a market decline that the Federal Reserve cannot stop. This is akin to the market crash of 2008 and 2009 where all financial assets lost value quickly. During the 2008-2009 recession the financial and central bank policies reacted slowly to the situation. Once action was taken in response to the financial crisis, many became concerned about the inflationary impact of these policies. What followed quantitative easing and government stimulus was not accelerating inflation, but income inequality, and economic stagflation and deflation.

However, this time response needs have changed. The nature of the present economic shock is entirely different from the last one. Where 2008-2009 was a classic debt deflation demand shock, this time large parts of our economies have been closed. This has led to a supply shock that has generated a demand shock.[1] Supply chain problems from the pandemic in general are continuing longer than expected. In 2020 a lockdown deflation scare occurred as businesses closed, staff was laid off, and the economy shut down. In the first half of 2021 inflation skyrocketed as the economy began to reopen with too much demand chasing too little supply. The second half of 2021 appears to be morphing into stagflation as new lockdowns occur from the Delta variant of COVID-19 and upward pressure on prices continue.[2]

For services in hotels and restaurants, the resulting higher prices will continue to abate as the labor supply will rise to meet demand in the coming months if the COVID-19 virus subsides or more people gain protection. In the goods sector, however, it may take longer to bring supply and demand into closer alignment as demand is far out in front of supply in developed economies. Goods inflation may prove too persistent for comfort as the present bottlenecks in global production are testing the patience of monetary policy makers. They could be prompted to tighten sooner and more forcefully than previously thought. The Federal Reserve has concerns about the sticky inflation in rent and wages.[3]

Just like 2008-2009, the Federal Reserve and fiscal responses have been called into question. According to some experts, the two leading causes of the present inflation/stagflation are increased fiscal deficit spending and the central bank's loose monetary policy, which are at record levels not seen since World War II. Larry Summers suggested that the current fiscal and monetary policies "are the least responsible macroeconomic policies for 40 years."[4]

In the last 75 years, total federal spending has grown by more than the inflation rate in all but 11 years. More federal spending is not a real increase unless it is above the inflation rate. Historically, inflation has been particularly cruel to the working poor. Inflation erodes the value of wages and takes away the purchasing power of savings accounts. Average earnings since January 2021 are up to $15.59 per week, but with inflation surging to levels not seen since the early 1980s, real wages are down $8.99 per week, the largest real dollar drop in wages since data was first collected in 2006 by the Bureau of Labor. Consumer prices have risen at an annualized rate of 7.1% in 2021 and 8.4% in the past three months.[5] Federal Reserve Chairman Jerome Powell believes that inflation "will come down" on its own, and interest rates will not rise until 2023. Since March 2020, the Federal Reserve produced a 94% increase its already inflated balance sheet. The Federal Reserve's injection of new money into the banking system from their security purchases has exceeded the expansion of reserves, so the money supply has grown three times as fast in 2020 as it did in 2008. The Federal Reserve now holds 33.6% of all publicly held federal debt and 35% of all federally insured mortgage-backed securities. However, the excess reserves of the private banking system are about $4 trillion. If inflation does not subside and market interest rates rise, the excess reserves could be an issue. [6]

Goldman Sachs expects 2021's slowdown to be manageable, but in 2022 expects the growth rate to shrink substantially to a trend of 1.5% to 2% from the potential taper of "quantitative easing". According to the Mercatus Center at George Mason University economists Jones and de Rugy there is almost no multiplier effect from government spending. On net, incomes grow, but privately produced incomes shrink. "There are no realistic scenarios where the short-term benefit of stimulus is so large that the government spending pays for itself."[7] When economists like Robert Barro and Charles Redlick studied the multiplier, they found once they accounted for future taxes required to pay for public spending, the multiplier could be negative. Non-productive debt does not create economic growth. Since 1977, the ten year average of GDP steadily declined as debt increased. The increase in debt will lead to slower economic growth rates in the future.[8]

As long as individual investors believe the Federal Reserve is lifting asset prices higher through low interest rates and quantitative easing, they take action to buy stock and real estate, driving asset prices higher. The investors action delivered the desired outcome. Since 2007, the stock market has returned nearly 200%, which is more than twice the growth in GDP and nearly four times the growth in corporate revenue. While the Federal Reserve has gotten the desired outcome of increasing asset prices after the Great Financial Crisis, the quantitative easing has failed to translate into higher wages or economic growth. The Federal Reserve actions have also exacerbated the wealth gap. The percentage of families with investable retirement accounts is lower in 2021 than in 2001, despite the surging asset prices.[9]

Given the amount of debt required to sustain current economic growth and financial assets, the Federal Reserve has no choice but to continue to monetize the Federal debt indefinitely with two possible outcomes. If interest rates are kept at zero, the cycle, which started forty years ago, will continue. If the economy decouples, this will likely lead to a massive deleveraging process, where a reduction in liquidity triggers a decline in asset prices, hinders consumer confidence, and contracts economic growth. This started in 2008 but was cut short by the central banks' interventions. In 2020, central banks quickly halted the deleveraging process from the pandemic. Surging debt and deficits from both periods inhibited organic growth.[10]

The consequence of this process is the failure to enable the system to clear itself of the excess debt, which diverts capital away from productive uses. Policymakers remain trapped in the process of trying to prevent recessions from occurring due to the extreme debt levels. This has led to skewed preferences and policymaking of more increased debt and more money printing as they respond to ordinary boom and bust cycles. The by-product of increased private and public debt, artificially low-interest rates, negative real yields, and inflated financial asset valuations is problematic. Pulling forward future consumption by inflating asset markets, has exacerbated an artificial wealth effect, which has led to decreased savings rather than productive investments.[11]

Future corporate earnings have been guided down going forward for a variety of reasons, including the possibility of increased corporate taxes, higher wages, inflationary input costs, higher interest rates, and increased regulations. Labor shortages are forcing workers to cover more ground until other workers begin to return to the workplace. The scores of open positions in the U.S. economy and evidence of rising wages, suggest that firms are looking for workers. But in many cases, firms report the aggressive application of automation to overcome tight labor markets. The examples are many and varied: technological coding and e-commerce sites have reduced the need for sales clerks; digitized restaurant menus allow fewer servers to cover more tables; and telemedicine visits allow clinicians to visit more patients daily. Individuals that have kept their jobs have fewer places to spend their money, while those laid off from closed businesses have less income to engage in consumption.

Martin Investment Management, LLC believes that although fiscal spending and an easy monetary policy will likely be supportive of financial assets, changes are occurring. Structurally, aging demographics, de-globalization, government versus private spending, limited pricing power, and zero risk-free interest rates will also contribute to softer growth. We also concur with Federal Reserve Chairman Powell that the COVID-19 pandemic "has turned out to be a very different type of macroeconomic shock than the global financial crisis."[12] While leaders worldwide are debating the surging inflation, fiscal, and monetary policies, Martin Investment Management, LLC believes that central banks will follow the play book from the 2013 taper tantrum of notifying the market of its intentions, gradually reducing its purchases of longer-term assets, and that tapering have no connection to the first rate hike.

While we worry about low growth, particularly in the private sector, we are more positive on productivity. Although aggressive spending is necessary, it is not sufficient. Spending needs to be designed to raise productive capacity, potential growth and true investments. On the bright side annualized productivity growth has averaged above 3%

since the current recovery began in April of 2020. Overall investment in information technology is growing much faster than the overall economy, and much faster than other types of business investment, for example, data science allows firms to study their operations and their markets to provide goods and services more efficiently. The discoveries that emerge from these processes should result in better products and lower costs.

We also believe that after a period of increased volatility, due to policy changes adjusting to more sluggish growth, investing in quality equities with market dominance, strong cash flows, and low correlation with the business cycle may assist in preserving capital as well as generate possible future wealth creation.

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