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**A Rock and A Hard Place**

In the third quarter of 2021, the S&P 500 Index had a positive total return of 0.58%. This marked the sixth consecutive positive quarter since the pandemic began. For the same period, the MSCI EAFE Index (USD) Net had a negative total return of -0.45% while the MSCI World Index (USD) Net almost broke even with a total return of -0.01%.

The anemic third quarter returns across all developed markets masked several adverse events and corresponding negative returns for the month of September. Corporate earnings and estimates have begun to fall below their expectations due to lost sales from supply shortages and increased inflationary input costs. The production issues in Asia are affecting the global economy. Shortages are increasing inflation expectations according to the recent University of Michigan and New York Federal Reserve surveys.[1] The potential default of Evergrande, the largest Chinese real estate debtor in the world, may dampen the growth of the Chinese economy and be a negative headwind to trade.[2]

A key factor in the U.S. supply chain disruption is the continuing labor shortage crisis. The reasons behind this crisis are complex and include the highly contagious Delta variant of Covid-19, unreliable school schedules, childcare, bus transportation, and the recently eliminated expanded jobless benefits. Typically, when unemployment is high, inflation is low, and the Federal Reserve is able to use monetary policy to increase employment. Today with inflation well above the Federal Reserve's target of 2% and the economy far away from full employment, the Federal Reserve's options are limited.[3]

It is important to differentiate between the Federal Reserve's plan to taper its bond buying program as early as this November and a hike in interest rates. The Fed still will grow the size of its balance sheet but doing so at a decreased pace. Tapering implies a slower pace of easing rather than outright tightening, a subtle but important distinction. With at least five million jobs still not filled since the pandemic eliminated them, the Federal Reserve is many months away from raising interest rates under current market conditions. Tightening looks extremely premature and would hinder economic growth if it were to occur at this time. In September turmoil in both the equity and bond markets seemed to result from just incremental increases in the 10-year Treasury bond yield to above 1.5%, with the reaction being more psychological than material. At this level, stocks continue to look relatively attractive with potential for both yield and capital appreciation.[4]

Consumer sentiment rose slightly in early September, but remained close to a near-decade low, while buying conditions for household durables deteriorated to their

worst level since 1980. Buying conditions for household durables, homes, and motor vehicles all fell to the lowest level in decades due to high prices. Consumers expect inflation to rise 4.7% over the coming year, matching the highest rate since 2008.[5] With consumer spending roughly flat since the spring, third quarter GDP growth could be limited to an annual rate of 3%. This estimate is less than half of the second quarter's final revision of 6.7% annualized. The third quarter estimate of 3% is above the Federal Reserve Bank of Atlanta's latest GDP estimate of 2.3% with consumer spending growing at only a 1.4% annual rate.[6]

The consumer's reluctance to spend is not due to lack of funds. Currently U.S. households have $2.4 trillion in excess savings. About half of this is from decreased spending on services since the pandemic began and the other half is from increased transfer payments. Banks are flush with funds with deposits elevated due to stimulus funds[7] Global home prices have risen 26.5% since the first quarter of 2013, while the U.S. housing market is up 36% since 2013. Even though the pandemic ended the business cycle followed by a recession, the virus acted as a propellant to the appreciation of housing prices. Low mortgage rates are supporting affordability. The monetary accommodation by central banks since the Great Financial Crisis has also resulted in more than a decade of an equity bull market, particularly with U.S. equities.[8]

With vaccination rates accelerating globally, broader economic reopening should continue through the rest of 2021. Focus is on supply chains for evidence of some clearing. Global central banks remain challenged by choppy growth in the third quarter of 2021 with sticky inflation expectations.[9] Inflation outcomes as well as the pace and timing of tapering will vary by country.[10] Beyond elevated coronavirus cases and increased inflation, negative market impacts may occur from other disruptions caused by central bank missteps, higher taxation, a stricter regulatory environment, and increasing geopolitical concerns.[11]

The U.S. and the EU announced the Global Methane Pledge, which will be launched at the UN Climate Change Conference in November 2021. It calls for countries to commit to reducing methane emissions by at least 30 percent from 2020 levels by 2030.[12] Unfortunately, energy prices have surged worldwide. Supply pressures in fossil fuel energy markets are spilling into other commodity markets, raising the cost of producing and shipping commodities. Demand for liquefied natural gas in Europe has soared due to waning wind production, the shutdown of coal and nuclear plants, and lower Russian gas deliveries. Asia and Europe are having to burn more coal to keep their lights on. Coal is in short supply, and factories in China are shutting down as local governments ration power. U.S. oil production remains 15% below pre-pandemic levels. OPEC predicts the Middle East will make up 57% of crude exports by 2045, up from 48% in 2019. Until energy prices stabilize, inflation worries will persist globally.[13]

The European Central Bank (ECB) has used quantitative easing aggressively in recent years to support the euro area economy, banks and asset prices. Two separate quantitative easing programs, Asset Purchase Program (APP) in 2014 and the Pandemic

Emergency Purchase Program (PEPP) in 2020, differ in that the former aims to reinforce the ECB's negative interest rates and counter downside risks to price stability while the latter, which is flexible and temporary, counters downside risks to the inflation path caused by the COVID-19 pandemic. Although the Delta variant has clouded the outlook, the European economy has improved rapidly in recent months, and the ECB should have sufficient information by the end of 2021 to confirm that the PEPP will expire in March of 2022. If core inflation continues to rise, the trajectory to tighten will be accelerated.[14]

In the U.K. supply bottlenecks and labor shortages triggered a sharp rise in underlying inflation and have led to concerns that the Bank of England (BOE) may begin raising rates in the first half of 2022.[15] Japanese equities appear expensive relative to their earnings. We maintain the view that the Bank of Japan will significantly lag other central banks in normalizing policy. The Reserve Bank of Australia has begun the process of tapering its bond-purchasing program as consumer and business balance sheets continue to look healthy. In Canada, growth remains above trend and is not likely to change the Bank of Canada's tightening bias.[16]

The People's Bank of China uses a variety of measures, rather than one primary rate, to implement monetary policy and has preferred to not initiate a large scale stimulus. Their benchmark interest rate, the loan prime rate, has remained the same for sixteen straight months.[17] Some uncertainty remains regarding the future path of regulations as it relates to technology companies, and as a result, investors will likely remain cautious on Chinese equities in the near term. There is a risk of a sharper than expected slowdown in China as credit growth has slowed in 2021 and recent purchasing managers' indexes have trended lower.[18] China's decision to limit power consumption is hurting growth and may be a larger concern than Evergrande, despite its headwinds in the Chinese property market. China's power cuts to meet energy use targets may foreshadow shortages of global goods.[19]

Globally, the remainder of 2021 will likely prove challenging with potential themes of guarding against inflation, searching for income, seeking quality companies as well as looking to future monetary and fiscal policies. We believe that a return to higher and less stable inflation in many major economies would result in a rise in exchange rate volatility, and, over time, the depreciation of the currencies of those countries, which are experiencing higher inflation. Fiscal tightening in the U.S. and credit tightening in China are headwinds to the global economy, which may contribute to continuing volatility.[20] On the other hand, global infrastructure spending may contribute to economic momentum potentially shaping a long positive industrial cycle with positive implications for the global economic outlook.[21]

Martin Investment Management, LLC invests globally and follows companies headquartered in the U.S. and non-U.S. developed world with an emphasis on each company's end market. We focus on specific stock characteristics rather than where the company is domiciled. We look for quality companies with strong and improving competitive positions, sustainable growth drivers, experienced and talented

management teams, and financial strength. While we see opportunities from the global economic recovery, we also are seeking to insulate our portfolios from a potential uptick in inflation and volatility. From an inflationary perspective, we are focused on those companies that have pricing power as a potential hedge against rising prices. The speed of the recovery and resulting pressures on central banks to change policies will be dynamic and require flexible and active portfolio management. We will continue to monitor the changing dynamics of the marketplace.

Wishing you a bountiful and healthy fall season!

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**Note:**

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