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**Topics for the Market in 2022**

For the fourth quarter of 2021, the S&P 500 Index had a total return of 11.03% and a return of 28.71% for the year. The MSCI EAFE (USD) Net Index returned 2.69% for the fourth quarter of 2021 and 11.26% for the year while the MSCI World (USD) Net Index returned 7.77% for the fourth quarter of 2021 and 21.82% for the year. The year of 2021 has been a year like no other for global equity markets as investors battled against highly contagious COVID-19 variants, supply chain woes, rising inflation, geopolitical tensions, and the Evergrande crisis to name a few. Despite these headwinds, equity markets remained resilient throughout the year with major indices consistently reaching new all-time highs. The economic impact of payments and supplemental unemployment insurance benefits may have stopped worldwide, but their full impact has yet to be felt. Fiscal and monetary policy will continue to support demand. Fiscal spending, monetary policy, energy, immigration, and COVID policies are contributing to the present reflation.[1] Going forward, the tailwinds of policy support, pent-up demand, and sidelined cash will conflict with the headwinds of equity valuation and inflation likely causing positive but more muted and volatile market returns.[2]

U.S. stocks raced toward a third consecutive year of big gains with major indexes near records at year end 2021. In this past year the percent increase in the S&P 500 Index came primarily from the corporate earnings growth rate of 34.5% while at the same time there was a P/E multiple compression with the average price/earnings multiple declining by 7.6%.[3] Superior real returns (the rate of return less inflation, which is important to maintain purchasing power) have been easy over the past several decades. Going forward, deceleration in earnings growth and margin contraction may occur if there is a slowdown in top-line growth, a decline in corporate pricing power, or increases in labor and input costs. Growth is coming off a high level. According to BCA Research, this phase is likely prolonged and does not mean the end of the bull market that started in 2009.[4] At this point, U.S. stocks are trading at a significant premium to the non-U.S. developed world stocks.

U.S. households are sitting on more than $2 trillion of excess pandemic savings at the beginning of 2022. If they were to spend just half of their savings over the next two or three years, the U.S. economy would have a steady tailwind. Because the change in behavior from the pandemic is likely long lasting, the demand for services is unlikely to regain its pre-pandemic trend in 2022. To keep overall demand on trend, spending on goods will have to stay above its pre-pandemic trend. This is difficult as durables last a long time. In addition, how many iPhones, clothes, and gadgets do people need? If spending falls short of income as it did during the pandemic, savings goes up. Previous episodes of excess saving in 2004, 2008 and 2012 did not boost spending. A dollar in someone's checking account will be spent, but a dollar in the savings account will not be spent.[5] Part of the savings has gone into equity ownership among American households, which has soared from $5 trillion in 2009 to more than $30 trillion in 2021. The economic ramifications on the market are immense.[6]

Pavilion Global Markets shows the impact of stock buybacks on the market over the last decade. The decomposition of returns for the S&P 500 Index breaks down as follows: 21% from multiple expansion, 31.4% from corporate earnings, 7.1% from dividends, and 40.5% from share buybacks. In the absence of share repurchases, the stock market would not be pushing record highs of 4800 but instead levels closer to 2800. The surge in the repurchase of shares over the last decade remains one of the more significant supports to the financial markets. Mostly the major market capitalizatiion weighted companies could afford the multibillion-dollar share buybacks.[7] In 2022 business investment may refocus on building out capacity to rebuild inventories and automate more production in the face of growing labor shortages and costs. After moving sideways for the better part of two decades, core capital goods orders have broken out to the upside. Surveys of capex intentions are improving sharply.[8] Also the transition away from fossil fuels requires an estimated $50 to $100 trillion capital investment to rebuild a net zero global economy.[9]

Strong job creation has been a cornerstone of 2021's robust economic growth and would be relied upon to underpin next year's gains in the face of the prolonged pandemic, elevated inflation and supply shortages.[10] Widespread labor shortages exist across sectors with mismatches of skills and geography. Many people have dropped out of the labor force worldwide due to health concerns, childcare problems, and more generous unemployment benefits. The U.S. labor market is now heating up and very tight. Backing out those who quit their job, the unemployment rate is presently at 1.8% in the fourth quarter of 2021.[11] So far, most of the wage growth has been at the bottom end of the income distribution. Wage growth is expected to broaden over the course of 2022, pushing up service price inflation in the process.[12] What 2021 revealed is that the pandemic had produced not one labor shock, but two. The first was felt immediately in the U.S. when 22 million jobs were shed, and the national unemployment rate jumped to nearly 15%. The second shock hit those who remained in the labor market. They lost their pre-pandemic job and found a new job in its place. Since May 2021 there have been more job openings than unemployed workers. The 2021 recovery has been so perplexing, in part, because these two shocks are becoming increasingly entwined in the labor market.[13]

The U.S. productivity only increased in the initial stages of the pandemic. Productivity declined by 5% at an annualized rate in the third quarter of 2021 leading to an 8.3% increase in labor costs. The drop in productivity was largely driven by composition, as many low skilled poorly paid service workers, who lost their jobs, returned to the labor force. Productivity growth has been extremely weak outside the U.S. The pandemic induced changes in business practices have not contributed to higher productivity. Globalization is contracting, wage rates seem to be rising as the labor market remains tight, and productivity does not seem to be meaningfully improving to offset these other factors. There have been periods of improving and deteriorating productivity during the last 60 years, but the overall trend in output per hour has not secularly changed. Perhaps most revealing productivity has marginally decreased since the Technology Bubble in 1999/2000 despite widespread use of the internet and cellular communications.[14]

The demand for durable goods is the predominant cause of supply-chain and inflation problems. An increasing focus on business profits has led to outsourced production and a focus on 'just in time' inventory management systems that featured very little slack. The system was engineered to thrive in normal economic environments but was clearly unable to deal with the volatile demand surge post COVID-19. In the U.S. the American Trucking Association estimates that the United States is currently lacking about 80,000 drivers, primarily from a shortage of willing participants rather than a shortage of qualified drivers. Because limited warehouses are stocked with filled containers awaiting transportation, more containers remain on docks. The backlog of ships waiting to enter ports is amplified by the interconnectedness of truck drivers, warehouse capacity, the lifecycle of containers, and sufficient dock space.[15] The current inflation crisis is that while goods and commodity prices have surged as expected in a positive demand shock, services prices have not declined, as would be expected with lower utilization, in the mirror image negative demand shock. The result is that aggregate inflation has surged even though aggregate demand has not. The shortfall in services demand is due to behavioral changes which cannot be alleviated by lower prices. Lowering prices will not lure someone to use a service. This creates a major problem for central banks because if the price elasticity of services demand has changed, then surging aggregate inflation is no longer a reliable indicator of surging aggregate demand.[16]

The International Monetary Fund (IMF) anticipates the U.S. cyclically adjusted primary budget deficit to average 4.9% of gross domestic product (GDP) between 2022 and 2026, compared to 2.0% between 2014 and 2019. The budget deficit surged from a wider shortfall in U.S. goods traded from income support policies, a shift in demand to goods from services, and a stronger dollar. U.S. goods imports increased from $46.4 billion per month in the three years prior to the pandemic to $62.6 billion per month after the pandemic. The shift in service trade was even more dramatic since the start of the pandemic, declining $20.0 billion per month compared to $24.2 billion per month the prior three years. Service trade alone detracted 0.50% from the U.S. economic growth over the period. Almost all the decline in service exports can be traced to the reduced sales of travel services to foreigners.[17] Because households saved a large share of the transfer payments the fiscal multiplier will increase next year even as the budget deficit shrinks. Reflecting the USD overvaluation by 20% on a Purchasing Power Parity (PPP) basis, the U.S. trade deficit has widened sharply and is the widest on record as share of GDP. Although equity inflows have helped finance the U.S. current account deficit, these inflows are starting to abate.[18]

The European economy faces near-term growth pressures. In addition to COVID lockdowns, high energy costs continue to slow growth. Natural gas prices are climbing due to delays in the opening of Nord Stream 2 pipeline, Chinese gas demand, and a colder winter. This should subside from increased energy supplies, easing supply-chain bottlenecks, and relief from the pandemic. Capex intentions have risen. Consumer confidence is stronger in the euro area than in the U.S. Euro area fiscal and monetary policies should remain supportive. The IMF expects the euro area to run a cyclically adjusted primary deficit of 1.2% of GDP between 2022 and 2026, compared to a surplus of 1.2% of GDP between 2014 and 2019. The ECB is unlikely to raise rates until 2023 at the earliest. In contrast to the U.S. trimmed mean inflation has barely risen in the euro area. Additionally, European firms are reporting few difficulties in finding qualified workers. In fact, euro wage growth slowed to an all-time low of 1.35% in Q3 2021. The U.K. finds itself somewhere between the U.S. and the euro area where trimmed mean inflation is running above euro area levels, but below that of the U.S. The U.K. labor market data remains very strong, as evidenced by robust employments gains, firm wage growth, and a record number of job vacancies. Although Japan's growth was hit by COVID-19, the new prime minister announced a stimulus package worth 5.6% of GDP. The combination of increased cash payments to households, support to small businesses, and subsidies for domestic travel should spur consumption in 2022.[19]

World central banks are diverging between hawks and doves. It is unusual to see a gap among central banks experiencing relatively similar economic conditions. The Federal Reserve traditionally sets the tone for global monetary policy and is dovish versus the Bank of England, Bank of New Zealand, and the Bank of Canada, which intend to raise rates early in 2022. The Federal Reserve has committed to lifting rates only after the US. economy has achieved maximum employment, which is an unemployment rate of 4%. It may take extraordinary growth in jobs to achieve this by mid 2022, which is when the market expects an interest rate lift off. Full employment is more likely by the end of 2022, giving the Federal Reserve time to assess inflation risks before embarking on a gradual hiking path.[20]

Martin Investment Management, LLC believes that the rebound in economic activity in the wake of the pandemic has been an unprecedented restart rather than a traditional recovery. We see caution in this non-traditional market cycle that is past its peaks of both economic and earnings growth, especially with new variants and policy over or under reacting to higher inflation. We believe that market volatility and stock dispersion may increase given the present confusing conditions. We may need to live with high inflation, and there may only be a gradual path to higher interest rates amidst higher inflation. This may result in persistently negative real rates, which should favor risk assets. In an environment transitioning from unprecedented monetary and fiscal largesse, we believe that the importance of selectivity across sectors and individual stocks, with a focus on quality, has the potential to make an important difference in portfolio outcomes. Martin Investment Management, LLC also believes that the supply of goods will gradually rise to meet demand given the strength of the economic restart and companies' ability to adapt. We believe that the equity sectors with the highest operating margins and lowest labor costs stand to benefit. Quality companies with strong balance sheets and high pricing power also appear to be benefitting from rising inflation.

We wish you a healthy and happy 2022!

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