MARTIN INVESTMENT MANAGEMENT, LLC
1560 SHERMAN AVENUE SUITE 1250
EVANSTON, ILLINOIS 60201

(847) 424-9124
FAX (847) 424-9182

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Investing at a Time of Critical Changes

In the first quarter of 2022, the S&P 500 Index had a total return of -4.60%. For the same period, the MSCI EAFE Index (USD) Net had a total return of -5.91% while the MSCI World Index (USD) Net had a total return of -5.15%. Although present since 2015, deglobalization is accelerating in 2022. Global markets are impacted by major changes, most starting before Covid-19 and the Russian invasion of Ukraine. Global transactions, 23% lower than in the same period in 2021, have slumped to their lowest level since the start of the pandemic after what had been a record period of mergers and acquisitions. Global stocks have had their worst quarterly performance in two years.[1] We believe that increased market volatility will continue as globalization reverses, economies slow, and the list of disruptions grows. With the rising rate environment, bond prices are declining. According to the April 1, 2022 Morning Star Market Update, bonds had their worst quarter in 20 years in the first quarter of 2022 with long-term core bonds returning -11.3%, more than double the negative return of the S&P 500 Index.

As globalization continues to decline, costs will increase, and that may mean long-term inflation may be at marginally higher levels than in recent decades. These changes will provide additional opportunities and threats.[2] Rising global and domestic inflation continues to wreak havoc in housing, food, consumer durables, and energy markets. Fossil fuel energy has become more expensive as western developed economies enlarged their preference for alternative sources to support their climate policy, and Russia invaded Ukraine. The Covid-19 virus continues to infect nations disrupting existing supply chains, closing factories, and reducing international travel. Transports, burdened by increased energy costs and continued labor shortages, are contributing to supply shortages. Previous global alliances are being replaced by new partners, closer to the source. Automation and technology allow companies to move their operations back to their domestic shores, replacing cheap foreign labor with more skilled domestic labor. Foreign direct investments have plummeted, and trade wars have increased. A stark drop in correlations in March 2022 suggests a further decoupling among major economies, as certain regions and countries are affected by global events. [3]

Our hearts continue to go out to the people suffering under fire in Ukraine. While the direct impact of the Russian invasion is significant, the indirect effects of this war are substantial. The invasion has highlighted how nations need to increase their energy independence and enhance their national defense capabilities including cyber security. Taken together, Russia and Ukraine account for a small fraction of global trade about 3.5% of global gross domestic product (GDP) in purchasing power parity (PPP) terms and only 1.9% in US dollar terms. However, Russia is a key player in the global energy and metals markets, providing rare materials like palladium and nickel. Ukraine is a sizable agricultural producer, as well as an exporter of specialized products such as neon. Prices of commodities from oil and natural gas to palladium and wheat surged on the back of the conflict. Shortages of energy, metals, materials, and agricultural goods will reverberate across the global economy, exacerbating shortages, prices, and supply disruptions.[4]

The war in Ukraine is a political one. Professor John Mearsheimer anticipated in a 2015 speech at the University of Chicago that the consequence of the West's acquiescence of NATO membership for Georgia and Ukraine would not bode well. After the first European Union (EU) statement, Georgia was invaded by Russia in 2008 and after another comment made by NATO in 2014, Crimea was invaded. He predicted that Putin would rather destroy Ukraine than allow the country to be part of the NATO Alliance. Secondly, he feared that the united West against Russia would only drive Russia closer to China. Lastly, he viewed that the West should be focusing on Asia and the Middle East rather than Europe. Although the West has been more unified in its response against Russia, Putin, and the Russian oligarchs in contrast to 2008 or 2014, the severe sanctions will force Russia closer to China.[5]

There are two kinds of inflation. "Demand-Pull Inflation", caused by demand for goods or services exceeding supply, which is occurring now because supply chains have been disrupted by Covid-19. The other form of inflation called "Cost-Push Inflation" is not transitory. Too many dollars chase too few goods. It happens when governments print too much money, as has been happening globally over the past 13 years. The central banks around the world are taking different paths to address continued price inflation. Ongoing supply constraints are an impediment to gage the impact of monetary policy, which may be a key reason that central banks are being cautious in raising short-term rates. Central banks can exacerbate the tightness of supply constraints if they follow through on a more aggressive tightening policy. Commodity supplies will remain tight, and this will keep inflationary pressures on the real economy elevated. Stagflation could be the likely outcome.[6] Policymakers would be wise to look to the past in designing policy that can successfully end the current surge in prices. Markets, themselves, have the power to set prices and balance supply and demand. Policymakers who target short-term rates and limit credit creation through controlling their balance sheets and the money supply are risking an error of under or overheating their economies.[7]

The U.S. economy remains in a "full employment" position with unemployment dropping to 3.6% in March 2022, but the labor force participation rate is puzzling. Since the pandemic, the failure of the employed population to recover to pre-pandemic highs has been cited as a major issue with respect to higher wages.[8] There are now eleven million openings for seven million unemployed workers. Wage data, especially the U.S. Employment Cost Index & Atlanta Fed wage tracker, remains key for the Fed's outlook. If inflation becomes entrenched in future expectations, it becomes self-reinforcing through local contracts and a wage price spiral. If demand is strong, firms believe they can raise prices to combat higher input costs. Eventually a tight labor market means wages (input costs) rise making prices rise again. Inflation also becomes entrenched in housing and rent. Although price increases are slowing in 2022, according to the Federal Housing Finance Agency House Price Index, housing prices rose 18.2% from January 2021 to January 2022 from increased demand and limited supply. The Federal Reserve has raised interest rates by .25% this past month and has gone into an inflation fighting mode, possibly raising interest rates by .25% or more at the next five meeting in 2022.[9]

From 2009 to 2019 the U.S. consumer price inflation (CPI) averaged 1.77% annually rising to 2.75% in the previous two business cycles.[10] Presently, U.S. CPI has now reached over 7% and the producer price index (PPI) is about 9% to 10%. Since 2012, the Federal Reserve has missed its 2% inflation target rate for 90% of the time as deflation pervaded, the Federal Reserve has had a hard time accepting inflation from deflation with the current policy rate increase of only .25% in March 2022.[11] The Federal Reserve has just begun to address its sizable balance sheet by contemplating the stoppage of its purchases of mortgages and treasuries.[12] The Federal Reserve has been trying for an economic soft landing, however, domestic and international markets have considerable say in whether they succeed. The pathway for inflation to moderate has gotten narrower for the outcome of a soft landing as the Federal Reserve has continued with an ultra-easy monetary policy at a time when the economy and inflation are running high. An important question is whether wage growth can hold at 4% year over year. If the Federal Reserve wants to defend a 2% inflation target, real wages and productivity need to move together in the long run.[13] While Federal Chairman Jerome Powell believes that the U.S. economy can withstand higher interest rates and a diminishing balance sheet, we are watching for the possibility of rising recession risk and slower growth.[14]

U.K. housing prices continue to soar at the annual rate of growth of 14.3% in March of 2022, the fastest in 18 years. As inflation rises, though, households' real income is falling.[15] The Bank of England (BoE) has been a leader among the major developed market central banks in normalizing policy. It has hiked interest rates by .50% two times in a row to tame accelerating inflation and rising house prices against the backdrop of a healthy labor market recovery. The BoE is likely to remain more hawkish than the central banks in Europe and Japan because of its high inflation and healthy employment outlook. However, as the U.K. energy bills sore, and Covid-19 benefits fall, inflation is curbing consumer spending. Besides the inflationary problems, the U.K. is still wrestling with the incoherence of Brexit.[16]

Stagflation is much more likely in Europe as energy security is far more vulnerable, especially in Germany and Italy. At this point in time, even though the European Union has not cut off Russian energy, it is already facing a 44.7% increase in energy prices. Europe is amidst an unprecedented energy crisis from increased global demand for gas, the decline in the use of nuclear power and fossil fuels, and difficulties in developing alternatives. Investors now fear that the energy crunch will threaten the European economic recovery and could even plunge Europe into a recession.[17] New eurozone data has unemployment falling to an all-time low of 6.8%, but rising wages are failing to keep up with galloping inflation. Real hourly wages fell 3% in the fourth quarter of 2021, the biggest drop since 2014 as inflation hit a new record of 7.5% in March 2022. Core inflation of food, alcohol, and tobacco are also increasing.[18] The European Central Bank (ECB) is confronting a delicate balance of moving between a rapid removal of monetary accommodation or an increased tightening of monetary policy to fight inflation.[19] Because of current issues, European equities have had large outflows in March of 2022.[20]

In Asia, Japan is pushing back on higher rates, and its currency is weakening notably as the Bank of Japan acts to step into the market to purchase government bonds amid a global bond selloff. Because the Japanese yen tumbled to a seven-year low, pressure has been added to other Asian exporters' currencies. The Bank of Japan revealed that business confidence in the country has been slumping from the pandemic, rising energy costs, and the war in Ukraine.[21] China's equity market has become increasingly volatile in the wake of news regarding new Covid-19 lockdowns in 29 cities and provinces, China's role in the Russia-Ukraine war, and the ongoing conflict between Chinese and American regulators regarding auditing requirements for Chinese equities. The recent rise in Covid-19 case numbers, in the context of the Chinese government's strict zero-Covid policy, is a major force behind equity market volatility.[22] The lockdowns remain a headwind to growth and a tailwind to inflation. The People's Bank of China (PBoC) will announce more interest rate and reserve requirement cuts soon in attempt to boost credit growth. Fiscal thrust has moved from -2% in 2021 to 2% in 2022. Lastly, China's decision to neither condemn nor support Russia has escalated tensions between the West and China.[23]

Martin Investments Management, LLC agrees with Jason De Sena Trennert of Strategas that the commitment to renewable energy by developed countries is continuing "regardless of the costs that must be borne by their citizens." Because of these policies and before working alternatives are fully developed, the world is experiencing "an artificial shortage of fossil fuels" and "high demand for industrial metals like copper, lithium, and manganese."[24] Martin Investment Management, LLC believes that environmental, social, and governance issues are important non-traditional risk factors to use in evaluating a company. From our perspective, a company's quality is represented by more than fundamental numbers. The non-material ESG factors can contribute to the overall health and risk of a company. Our emphasis has been on stewardship of resources, products/services, and capital. While the energy and material sectors have not been fundamentally attractive over the last decade, some companies in these sectors could eventually present solid fundamental investments, provided that they are also strong stewards of capital and natural resources. Increasing production requires multi-year and multi-billion dollar commitments. Carbon capture technologies may also create additional investment opportunities.[25]

We remain concerned that there is no recent real roadmap for conducting quantitative tightening by the Federal Reserve and other central banks. Quantitative tightening began in October of 2017. When liquidity appeared to be scarce in 2019, the Federal Reserve ended its tightening although it was not even halfway to reducing its balance sheet. Shortly thereafter, the pandemic forced a full reversal of the tightening process. The Federal Reserve's balance sheet is currently twice as large as it was in early 2020.[26] Federal Reserve officials have offered different views publicly regarding how the central bank should approach both interest-rate hikes and the reduction of its bloated $9 trillion balance sheet. The Federal Reserve's suboptimal decisions over the past 12 months mean that its next policy decision is also likely to be suboptimal. The Federal Reserve is less likely to implement a stronger policy, given how far policymakers have delayed interest rate hikes in full employment.[27] The main reason that exploding federal deficits and debts have not bothered financial markets is low and declining interest rates, which has held down the cost of financing the debt. If interest rates rise, the burden of bloated balance sheets could become a major issue.[28]

Stubbornly high inflation and higher long-term interest rates are likely, in our view, to compress corporate earnings multiples. We believe higher interest rates will lead to greater dispersion in equity returns and an increased need for active management. Identifying leading companies with growth potential and pricing power is very important as is understanding key innovators. We understand the difficulties for investors when volatility enters the market. However, history shows that rather than giving in to fear, staying invested and buying additional stocks during volatile times can be beneficial in the long run. It is impossible to tell when the market will resume its upward course after a bout of volatility. Staying invested means participating in the recovery as soon as it happens, rather than waiting to see improvement and missing the early days of a recovery.

Our hope to you for a splendid spring season!

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