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Where Next for Equity Prices?
Imbalances, Dislocations, and Disruptions

These are challenging times for investors. Although equities have been overdue for a correction given the dramatic strong market growth the last few years, investors are alarmed by the severity of the market correction. The year 2021 marked the most rapid economic recovery witnessed in the U.S. over the past four decades. As a result, inflation has reached its highest point since the 1970s. The markets are polarized between the need to raise rates to curb price growth and continuing to stimulate the economy to achieve organic growth. The world is facing a period of painful economic adjustment, as an equity bear market and possible recession ensue.[1] In the near term, investors will become clearer whether this downturn is cyclical or a more serious structural adjustment, which could take a lot longer to resolve. In the second quarter of 2022, the performance of the S&P 500 Index was dismal with a total return of -16.10%. This was not unique. For the same period, the MSCI EAFE Index (USD) Net had a total return of -14.51% while the MSCI World Index (USD) Net had a total return of -16.19%.

Basic needs including shelter, energy, and food, are getting more expensive due to global imbalances, dislocations, and disruptions. Inflation has become a worldwide problem as prices soar. China, Japan, Switzerland and France appear to have the least inflation while Venezuela, Lebanon, Zimbabwe, and Turkey appear to have the most inflation. The U.S., along with the U.K. and Germany, falls toward the middle inflation ladder of approximately 111 countries.[2] The rise in underlying inflation is a bigger problem in the U.S., the U.K., and Canada than in Japan or the Euro area.[3] Many factors have contributed to current inflation. In the developed economies, too much money chased too few physical goods as global production slowed from the pandemic. Much of the service sector shut down causing more money to shift to goods. The production of fossil fuels and food slowed globally during the pandemic, and geopolitical threats additionally disrupted the supply chain of basic materials worldwide. Because new housing supplies drastically decreased globally after the Great Financial Crisis, the present scarcity of housing has driven prices up for owners and renters. Now that economies have reopened, many workers are not returning to their former positions so there continues to be severe labor shortages in many sectors. The workers showing up, particularly in the U.S., are demanding increased wages adding to the inflationary spiral.[4] Wage growth is unlikely to suddenly decline absent a marked rise in the unemployment rate. The trends are not encouraging in that momentum has accelerated, not diminished in many key areas. In addition, although no one appreciates higher prices for goods and services, asset owners do like that the easy monetary policy has boosted both equity and home prices since the pandemic.[5]

In the 2001 and 2008 recessionary periods, inflation shot higher before dramatically dropping as the effect of falling demand forced consumers and businesses to reduce spending. The central banks hope to make inflation dissipate quickly again and avoid a repeat of the 1970s when inflation remained higher and longer than anticipated.[6] The Federal Reserve has no means of controlling the supply side of the equation such as prices of food, energy, or rent. What they do have control over is the supply of money. Over the last 12 years, easy monetary policies have increased the Fed's balance sheet from $2 trillion in 2009 to an unprecedented $9 trillion in 2022 with most expansion occurring during and after the pandemic. This ultra-easy monetary policy has lifted asset values both in private and public markets. In order to fight inflation, a new monetary policy of the Fed and other central banks is to reverse course and drain liquidity from the financial system. Another key tool to cool the economy and reduce demand is to increase interest rates. Both draining liquidity and rising interest rates will pose major headwinds for financial assets just as their former policy enabled financial assets to prosper.[7]

The Fed has to deal with the perception as well as the reality that it wants to keep inflation expectations under control. The Federal Reserve has become more communicative on the "reaction function", how they will set policy in response to the current environment of high inflation. Jon Steinsson, an economist at the University of California Berkeley, believes although the Federal Reserve was initially behind the curve it has caught up by using verbal guidance. He believes that when the Federal Reserve tightened or eased in the past, the markets would not anticipate the extent to which the policy shift was going to continue nearly as much as is presently occurring. "That means the tightening is showing up in long term interest rates much quicker and is affecting the economy much quicker."[8]

The Fed would not have found itself in the desperate situation it faces without a series of bad decisions leading up to today. The Fed has a doctrine that bubbles cannot be identified but need to be dealt with after they burst. To offset "systematic risk" after the fact constituted a necessary condition for the outright printing of money and near-zero fed funds rate. When the Fed decided to keep interest rates low long after the 2008 Great Financial Crisis, they were taking inflationary risks down the road.[9] Because the Fed dismissed inflation as transitory in the summer of 2021, they missed an early opportunity to address rising prices, which often do not directly or immediately respond to the Fed's action.[10] In addition, the government has contributed to the rise in asset prices as more fiscal stimulus was added to the financial system during and after the pandemic, creating more inflation and uncertainty about what will happen when policies are normalized. The risks from easy money were massively underpriced in 2021 as the stock market and housing prices rose to extreme overvaluations. Going forward there is a good chance this uncertainty may not be fully compensated.[11]

The recent meltdown may have its roots in a long-running focus on excessive consumption and housing, rather than on investing in productive, long-term capital and making the country competitive in global markets. The Fed has shown little concern that growth was becoming increasingly dependent on rising asset prices rather than real wealth creation. "Are the policy makers finally allowing some excesses to be washed out because they have previously been too busy trying to shore the system up?"[12] Some argue that government bailouts have just perpetuated failing businesses, and that the economy would benefit from allowing weak debtors and creditors to fail. The short-term imperatives of keeping the system together overwhelmed any desire to deal with the underlying problems.[13]

Quantitative easing (QE) has created distortions in other developed economies. The Fed and many other central banks, the Bank of Japan (BoJ) being a notable exception, now want to emphasize forward guidance rather than QE as the best way to stimulate the economy. The European Central Bank (ECB) has expressed more concern about inflation and fragmentation than growth. The ECB is laying the groundwork for a strong euro bias which would require speeding up the end of net asset purchases. There is no longer a desire to see funds flow out of Europe. However, Europe is still in a solvency problem from the peripheral economies. If peripheral economies had their own currencies, they could simply devalue to restore their competitiveness. Christine LaGarde said the ECB will raise rates gradually over the coming months, veering from a global push toward faster increases.[14]

With annual rates of inflation set to move even higher over coming months, investors expect the Bank of England (BoE) to raise its key interest rate.[15] The BoE has not reduced its balance sheet expansion it began in 2009 but will begin to do so now.[16] Japan is caught in a tight vise between the need to sort out its fiscal finances and weak growth fundamentals. The Bank of Japan (BoJ) believes a better outcome for Japan is a weakened yen and, unlike other central banks, is committed to quantitative easing. The BoJ is under duress having to defend its easy monetary policy with the recent abrupt slide of its currency and the resulting negative effect on the economy.[17] Australia and Canada are more dependent on the commodity markets, so have less risk to the downside except for high consumer debt from home mortgages. The U.S. dollar has benefited from the present unsettled economic and financial conditions because no other major currency can compete with the dollar's dominant global role and perception of safety.[18]

Central bankers will find it almost impossible to fully convince investors that promises about future policy moves will be kept. Thus, markets will remain hypersensitive to even subtle shifts in the direction of policy. And the fact that policy makers are themselves at odds over what to do adds to the confusion. Many investors are beginning to worry about slowing U.S. and global growth. Some view slowing growth as not yet built into consensus expectations, neither for GDP nor earnings, which have potential downgrades and negative surprises ahead. On one side some believe that slowing growth at home and abroad, rising costs of raw materials and wages, as well as fading demand for goods will weigh on earnings over the balance of the year.[19] While others hold that the compression in earnings may already be priced into the present market price, which means the market will not fall further unless there is a recession.[20]

At this time, we concur with BCA Research that downgrades and negative surprises may be both already priced in or ongoing as all conditions for a sustainable rebound are not yet met.[21] The Fed and other central banks have just started their tightening campaigns. Martin Investment Management, LLC believes that central banks have a lot of power to slow the economy. However, if fighting inflation is their primary goal then the funds rate needs to rise above the inflation rate. This has not yet occurred.[22] Purchasing of cars, homes, and major appliances have cooled since the start of the year and will likely continue to do so as the Fed aggressively raises interest rates to tame inflation. Vacation plans softened further as rising prices took their toll. Consumer spending and economic growth are likely to continue facing strong headwinds from further inflation and rate hikes.[23]

Since geopolitical threats abound, investors are facing increased political risks.[24] Globalization is no longer a powerful source of disinflation. Labor market shortages are still ongoing, most acute in the U.S. Despite strong labor demand and rising wages, the U.S. labor force participation presently remains 1.7% below its pre-COVID-19 level.[25] On the positive side, the labor market in Europe had weathered the pandemic reasonably well, with the labor force participation at the end of the second quarter in 2022 just 0.7% below its pre-COVID-19 level due to successful furlough acts. The U.K. participation rate stands at 1% below its first quarter 2020 highs, worse than in the euro area but better than the U.S.[26]

We believe market volatility will persist until there are more signs of a sustainable rebound. Quality companies that are demonstrably good operators and good corporate citizen have a valuation premium over their peers. We also believe that supply chains will continue to be reconfigured and adapt to changing geopolitical realities, improving their resilience after the pandemic. Companies will be looking for technological and process improvement solutions to boost overall productivity offsetting the issues with low labor supply growth.[27] There is a myriad of companies that have the experience, the general knowledge, and the patience to deliver investment returns. Opportunities for investors will be under and over-priced, so understanding valuations will be key to identifying risk and return. Our expectation is that this market inefficiency will persist in the short term and thoughtful, patient investors can use this to their advantage.

Wishing you a healthy and safe summer season!

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