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

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

October 2023

The Outsized Influence of Monetary and Fiscal Policies on Markets

In the third quarter of 2023, the S&P 500 Index had a total return of -3.27%. For the same period, the MSCI EAFE Index (USD) Net had a total return of -4.11% while the MSCI World Index (USD) Net had a total return of -3.46%. Amid the sharpest rise in interest rates in more than four decades in the developed world to fight inflation, investors have been on recession watch worldwide**.** Interest rates need to be neutral for inflation to be in check. Unfortunately, given the long and variable lags in monetary policy, the neutral rate cannot be observed directly, "making central banks' work easier said than done".[1] Economists are far from united on what a neutral rate of interest is, depriving monetary policy of an important "North Star".[2] There are differences on what is most important for the economic outlook, the rate of change in policy rates, or their overall level and duration. A changing supply side, both domestically and internationally, is also an input into a much needed debate about the desirable rate of inflation for the present as well as future economies.[3]

Central banks must believe that present interest rates are high enough to slow growth and end inflationary spirals. As long as there are imbalances in labor demand and supply as well as price increases, the central banks are likely to continue restrictive policies. At this point, central banks will need to choose the policy error of least regret, either remaining restrictive in the face of a sharp economic downturn to tame inflation or revert to the policy of the last fifteen years, easing policy at the first sign of trouble. The quickest means to verify that inflation is finally anchored will be a recession and higher unemployment.[4] The slower way is for inflation to drift down, but this takes time to be certain about what is happening. The current data may not be precise enough to guide central banks in the way they need.[5]

Eurozone equities have performed strongly in 2023, but the European Commission reduced its Eurozone economy growth forecast to 0.8% this year and 1.3% in 2024, down from 1.1.% and 1.6% respectively. "Weakness in domestic demand, in particular consumption, shows that high and still increasing consumer prices for most goods and services are taking a heavier toll than expected in the spring forecast."[6] China's economic downturn is also spilling over into Europe through weak export demand. The U.K. equity market remains fairly valued as their economy has been tracking sideways since 2022. Since unemployment is rising and housing prices are falling, the Bank of England (BoE) may need to reverse course in 2024 from its present restrictive level of 5.25%.[7]

Japanese equities have been strong performers in 2023, assisted by cyclical tailwinds and new governance initiatives. Their economy has rebounded from COVID with services spending back to pre-pandemic levels and inbound tourism recovering. The Bank of Japan (BoJ) continues to relax its yield curve control policy (opposite other developed economies), but will need to monitor that their inflation is at a sustainable target. Going forward Japanese equities are sensitive to a global slowdown and any yen strengthening.[8] China's problems, focused on the property market and highly indebted local governments, are influencing global growth. China's state-directed economy has led to excess debt tied to projects, whose returns do not cover the cost of borrowing.[9]

While Canadian GDP is downshifting as rising credit card balances and household insolvencies suggest stress is building, the U.S. appears to be in better shape.[10] The inherent resilience of the U.S. economy and many institutions have enabled the Federal Reserve to battle inflation by raising interest rates 11 consecutive times bringing its benchmark interest rate to the highest in 22 years, ranging from 0.25%-0.50% in March of 2022 to 5.25%-5.50% in July of 2023.[11] Consumer Price Index (CPI) inflation reached 9.1% in 2022 but has dropped as low as 3.0% in 2023.[12]

Avoiding a U.S. recession has been easier to understand when put into the context of the surge in money supply derived from continued fiscal and monetary inputs. Fiscal policy has stimulated the U.S. economy by growing its deficit from a 3.9% annual rate of GDP in August of 2022 to 8.3% in June of 2023.[13] The deficit continues to swell each year, but the spending continues to keep the economy from the widely expected recession.[14] Consumers and businesses have also benefited from pre 2022 low interest rates, locking in long-term loans with no new need to refinance at the higher rates.[15] Because of the strong consumer and U.S. stock market many believe that the Federal Reserve has successfully accomplished the inflationary battle by bringing down the rate of price increases, avoiding a recession, and sidestepping financial instability.[16]

Unfortunately, many one-time supportive fiscal policies will end in 2023 making the U.S. domestic economy more fragile. The fading of these tailwinds will be a gradual process, but the peak of their support to the economy has ended, and the consumer is beginning to suffer.[17] For fiscal stimuli that have already been enacted into law, the allocation is now shifting from subsidizing consumers and discretionary spending to subsidizing investments in infrastructure, energy, and semiconductor technology.[18] Given rising energy prices and sticky wage inflation, future markets are no longer pricing in a decline in Federal Reserve rates in early 2024.[19]

At this time, U.S. equities account for nearly 70% of the MSCI World Index, the next five largest in Japan, U.K., France, Canada, and Germany total less than 20%. The top ten U.S. equities constitute 20% of the MSCI's World index. The market dominance is partly built on the faster economic growth of the U.S. compared to the EU and U.K. since the Great Financial Crisis (GFC), and enhanced by U.S. corporate earnings level related to share buybacks. Using data and estimates from multiple sources, non-U.S. investors

own $14 trillion of U.S. equities, which is up since 2008. There is a virtual cycle of new listings from U.S. and overseas issuers attracted by the depth and liquidity of the U.S. equity pool.[20]

The U.S. stock market has also benefitted in 2023 from the Federal Reserve's neutral rate of interest, which diverged to the upside from the neutral rates in Japan, China, Europe and the U.K. both in the short term and possibly the medium term. Another catalyst in 2023 for the U.S. equity markets has been the rise in Artificial Intelligence (AI). Many investors have fully embraced AI's impact on growth, profits, and productivity. While AI does speed certain processes, such as locating data and massing amounts of text efficiently, AI cannot think and reason.[21] AI has very low emotional quotient (EQ) and no sensorimotor skills.[22] Most importantly, AI requires enormous processing power, presently unavailable on the current grid.[23] Oil and the U.S. dollar prices are also adding to the strength of the U.S. markets. The rule that the U.S. dollar is inversely correlated to oil has been less relevant since the U.S. became an oil producer, with natural gas flipping into a significant exportable surplus. The U.S. dollar has become a 'petrocurrency'.[24]

The positive market gains of 2023 may become more difficult to sustain as the U.S. and other developed global equity markets respond to tighter yields, asset repricing, and lessened market liquidity. Rising interest rates and slowing economies are also making the global debt burden heavier. There is three hundred trillion dollars in global debt, which global governments, households, financial, and nonfinancial corporations owed in June 2022 as estimated by the Institute of International Finance. Demand for debt, to help consumers with inflation, mitigate climate change, and rebuild infrastructure will continue. Mature market governments tend to be more leveraged. China is of particular concern, as its debt makes up a third of global corporate debt. To mitigate the risk of a financial crisis, trade-offs between spending and savings may be needed. Productive new debt needs to replace unproductive old debt. This will take discipline and coordination to reduce leverage.[25]

Martin Investment Management, LLC believes that the global debt, accumulated since GFC and increased by the response to the COVID pandemic, will take a long time to unwind. The sheer size of global debt may suggest higher inflation continues. Inflation is a cost of living crisis, but it is also a cost of capital crisis and an investment crisis, challenging corporate leaders to find new ways of living with or expunging inflation.[26] We favor a slightly cautious approach to the U.S. and developed world equity markets as aggressive monetary tightening typically leads to slowing growth. We continue to find selective areas of opportunity in quality global companies with strong balance sheets weathering the current interest rates and low growth environment. When structural changes happen in the markets and economies, the old rules no longer apply. It may take decades to know when structural changes started, but they do become clear over time.[27]

Wishing you a beautiful fall season!

1. Global Investment Strategy/US Equity Strategy, *BCA Research*, September 18, 2023.
2. El-Erian, Mohamed. "Fed's Last Mile of Inflation Will be No Cake Walk", *Advisor Perspective*, September 11, 2023.
3. El-Erian, Mohamed. "Fed's Last Mile of Inflation Will be No Cake Walk", *Advisor Perspective*, September 11, 2023.
4. Rissmiller, Don. "Deer In Headlights Cause Accidents", *Strategas Partners Economic Report*, September 25, 2023.
5. Investment Research Group. *Guggenheim Quarterly Macro Themes*, Third Quarter 2023.
6. Lees, Andrew. "Morning Headlines" *Macro Strategy Partnership*, September 12, 2023.
7. Russell Investments. "Falling With Style", *Global Market Outlook*, Q4 2023.
8. Russell Investments. "Falling With Style", *Global Market Outlook*, Q4 2023.
9. Russell Investments. "Falling With Style", *Global Market Outlook*, Q4 2023.
10. Russell Investments. "Falling With Style", *Global Market Outlook*, Q4 2023.
11. "Star Reset: end of the low-rate era? *Nationwide Financial*, September 25, 2023.
12. Investment Research Group. *Guggenheim Quarterly Macro Themes*, Third Quarter 2023.
13. Investment Research Group. *Guggenheim Quarterly Macro Themes*, Third Quarter 2023.
14. Lance, Robert. "A Recession is Coming, Or Is It Not?", *Advisor Perspective*, August 8, 2023.
15. Investment Research Group. *Guggenheim Quarterly Macro Themes*, Third Quarter 2023.
16. Clifton, Dan. "Fiscal Stimulus Shifting from the Consumer to Investments", *Strategas Partners*, September 13, 2023.
17. Tunkel, Irene. "End of Summer Blues", *BCA Research*, September 12, 2023.
18. Clifton, Dan. "Fiscal Stimulus Shifting from the Consumer to Investments", *Strategas Partners*, September 13, 2023.
19. Cemblast, Michael. "Eye on the Market", *JP Morgan*, September 26, 2023.
20. Augur, Philip. "How the US is crushing Europe's domestic exchanges", *Financial Times*, September 25, 2023.
21. Cemblast, Michael. "Eye on the Market", *JP Morgan*, September 26, 2023.
22. Joshi, Dhaval. "4 Predictions for The Fourth Quarter", *BCA Research*, September 26, 2023.
23. Mauldin, John. "Clips That Matter, *Over my Shoulder*, September 27, 2023.
24. Barish, Brian. "Crude Reality of Energy Markets," *Advisor Perspectives*, August 2, 2023.
25. "Global Debt Leverage: Is a Great Reset Coming?" *S&P Global*, January 13, 2023.
26. Richards, Ann. "Inflation tapeworm makes companies more susceptible to shocks", *Financial Times*, August 24, 2023.
27. Schrager, Allison. "" Big U.S. Stocks Surely Can't Outperform Forever", *Advisor Perspective*, June 12, 2023.

Note:

© 2023 Martin Investment Management, LLC ("MIM") is a registered investment adviser. SEC registration does not imply a certain level of skill or training. Past performance is no guarantee of future results. Investments involve risk, and accounts may lose value. The information presented in this letter is not intended to be investment advice and reflects the opinion of MIM on the date written and is subject to change without notice. If data is presented that has been prepared by third parties, such information will be cited. These sources have been deemed to be reliable. However, MIM does not warrant or independently verify the accuracy of such information. All market prices, data and other information are not warranted as to completeness or accuracy, may not be audited information and are subject to change without notice. Forward-looking statements contained herein are based on our current expectations and assumptions of economic and other future conditions and forecasts of future events, circumstance, and results outside of our control. Actual results could differ materially from those expressed or implied by such statements. For additional information about MIM, please read Part 2 and Form CRS of the firm's Form ADV. They are available upon request.