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**The Influence of Liquidity**

Global markets have been overwhelmed by conflicting surprises on growth, employment, and inflation in the second quarter of 2024. While cracks are appearing, equity markets continue to imply very optimistic conditions and have discounted various negative impacts.[1] In the second quarter of 2024, the S&P 500 Index had a total return of 4.28%. The MSCI EAFE Index (USD) Net had a total return of -0.42% for the second quarter of 2024 while the MSCI World Index (USD) Net had a total return of 2.63% for the second quarter.

Survey data have been frustratingly mixed recently. This matters because many central bankers have expressed a desire to be data dependent, but the data is not resolving quickly. Monetary policy in the developed markets has begun to diverge this quarter, even though the central banks remain hesitant in the face of continued inflationary pressures in their economies, many central banks have begun to cut interest rates. Global central banks' pivot to rate cuts will not be complete without the Federal Reserve, and based on recent FOMC member speeches, there is still a desire to wait and gather more data in the U.S.[2]

On the positive side, growth, employment, and inflation indicators are resilient. The developed world economies have done a reasonable job of staying online through geopolitical disruptions, supply chain challenges, and economic uncertainty.[3] Both global service and manufacturing sectors are rising and well above their boom/bust levels. Manufacturing bore the greatest weakness in goods prices over the last several years and has been the main source of downward pressure on overall inflation rates. Corporate profits remain robust and supportive of positive labor market conditions. Although not as great as earlier this decade, new hiring remains solid. Unemployment has increased recently, but new unemployment claims are relatively low. While wage growth is slowing, it is still stronger than last decade.[4] Although the rate of inflation continues to fall further, albeit at a slower pace, the price level remains uncomfortably high for many people. Inflation will have a hard time settling back to the 2% target that the Federal Reserve and other central banks judge to be consistent with price stability. History also suggests that once inflation appears a second wave tends to build in the near future.[5]

Despite the gains in equity markets, particularly the U.S., there is a general lack of conviction among investors. Housing remains problematic as home prices continue to rise as both demand for and supply of homes has come down. High interest rates remain restrictive and continue to hurt sales activity. There is a commercial real estate bust.[6] Government debt, particularly in the U.S., is concerning, especially as interest expense on the debt soars. Most importantly, U.S. government dissaving is crowding out investments in the private sector.[7] With a few brief exceptions, the nation's indebtedness has been going up yearly for half a century although it has increased markedly since Covid.[8]

For over two years, data dependent economists have been predicting a no landing, a slow landing or a hard landing for the economies of the developed world. David Lin Report of Yardeni Research predicts the S&P 500 Index will reach 6,000 by the end of 2025, and potentially rally to 8,000 by the end of the decade, suggesting a 46% upside benchmark index.[9] Strategas Research Partners see a soft landing in 2024.[10] Peter Berezin of BCA Research Partners believes a recession will occur within the next twelve months, most likely in the second half of 2024.[11] The question becomes who we are to believe as the impact of tighter monetary policy from interest rate hikes has been slow to materialize. We believe that fiscal spending has helped discount predictions of a Federal Reserve induced recession.

In the U.S., fiscal and monetary policies diverged near September of 2022 when the U.S. Treasury started its quantitative easing program (QE). The Federal Reserve had already begun its quantitative tightening (QT) earlier in March of 2022. Net liquidity in the system stopped declining in the fall of 2022, roughly six weeks ahead of the 2022 mid-term elections. Because the Federal Reserve cannot stop the Treasury driven liquidity from offsetting its QT, the Federal Reserve raised short-term interest rates at a fast pace in 2022 and 2023, causing the monetary conditions index to diverge from broader credit conditions.[12] The amount of M2 needed to support the economy is currently $19 trillion, versus current money supply of $20.8 trillion. While M2 money supply is decreasing, it is still $1.8 trillion above trend.[13] The U.S. election year will prompt additional fiscal stimulus by the administration.[14] To add to the complexities, the Federal Reserve's tightening has affected borrowers unevenly. Main Street has been punished by rate hikes, while Wall Street has been spared with slow quantitative tightening (QT) and Treasury-driven liquidity injections (QE), little of which has found its way into small businesses and households except if one owns financial assets. The top quartile consumer who is overly reliant on asset price inflation of its equities and home value continues to benefit from the increased liquidity as it has inflated financial assets.[15]

Unfortunately, the rise in government debt is more related to consumption, like the debt-fueled housing boom in the 2000s, than productive investment. The CBO's projections suggest that the sum of federal non-discretionary spending and interest costs will soon exceed total revenues, and the gap will continue to increase. Over the last five years, government spending has increased from 19.9% of GDP to 22.4% GDP.[16] This is unsustainable, especially with full employment and no major war. Leverage related crises always seem to follow as debt encourages financial excesses.[17] The U.S. runs a budget deficit that is more than two times as big as Canada's, Eurozone's, Japan's, and the U.K.'s debt combined, and unlike everyone else, the U.S. funds all this with very short-term debt.[18] As debt begins to crowd out other investments, Niall Ferguson recently commented that "Any great power that spends more on debt service interest payments on the national debt than on defense will not stay great for very long."[19]

Equity concentration has been increasing the last few years, especially in the Technology sector. Historically, the S&P 500 Index has delivered returns above the average when concentration is rising and below the average when concentration is falling. The results were pronounced for the concentration changes associated with inflating and deflating of the dot-com bubble, with compound annual returns 23.5% from 1994 through 1999 with more concentration, and just 3.6% from 2000 to 2013 with a less concentrated market. Starting from 2014 to 2023, the top 10 stocks were 19% of the market capitalization of the S&P 500 Index, on average, while the companies made up 47% of the total S&P 500 Index profit. In 2023, the top 10 equities were 27% of the market capitalization but 69% to the total economic profit in the Index. Fundamental results of the top companies have justified the recent rising concentration. The largest stocks in 1999 were trading at high multiples of earnings and cash flow. The top stocks presently are at a premium to the overall market but also represent companies with solid returns on invested capital (ROIC) and growth prospects.[20]

The excitement over artificial intelligence (AI) suggests that this area may be another perfect candidate for financial excesses and extreme concentration. Any tightening of present liquidity and/or more increased regulatory pressures pose the biggest threats to Big Tech and its corresponding wealth effect.[21] Investors should not take for granted that U.S. outperformance, especially of the Magnificent Seven, will continue indefinitely.[22] Martin Investment Management, LLC is cautious on the AI boom for two reasons. The AI revolution is now moving into the "trough of disillusionment" as the practical difficulties become more apparent. The AI-driven stock market has not yet felt this disillusionment, but history suggests it may.[23] The demand to use AI is growing far more quickly than the development of alternative sources of energy-nuclear, solar, wind, and hydro. There will be greater electricity costs and use of fossil fuels in the short-term. Most of the servers, used for AI, are located in the U.S., where 16% of electricity still comes from coal. We believe the enormous energy needs of AI cannot be fulfilled in the short-term.[24]

There are opportunity costs in capital allocation. The public equity market provides a transparency that is not provided elsewhere. The U.S. stock market, even after a decade of increasing concentration, remains one of the more diversified markets in the world. There are many opportunities in companies with great products and services. The outlook for the non-U.S. equities of the developed world continues to improve. Stocks can rebound once earnings expectations are upgraded in line with improving economic conditions.[25] While there is a range of fundamental concerns that could hinder financial markets in 2024, staying on market sidelines is not likely the most effective countermeasure. Although a change in investor sentiment can happen quickly, we believe that downside protection is best addressed by maintaining a consistent exposure to what we believe are quality businesses purchased at reasonable valuations.

Wishing you a relaxing summer season!

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**Note:**