Quarterly Point of View
Paradigm Shift?

July 7, 2022

Stock and Bond markets suffered again in the second quarter as accelerating inflation and rising interest rates weighed on valuations and investor psychology. The S&P500, down 20% for the year through June, marked its worst first half to a year since 1970, according to Dow Jones Market Data. Bonds, which for decades could often be counted on to cushion the blow of losses in stocks, have done nothing of the sort in this period. According to Deutsche Bank research, this was the worst first six months for the U.S. 10-year Treasury Note since 1788. In other words, the loss of more than 10% for the most watched of all global government bonds, had not seen negative volatility to this extent halfway through a calendar year since before the presidency of… George Washington.

The reasons for this dismal performance appear relatively straightforward to us, though they were years in the making. We've discussed our disagreement with Federal Reserve policy in our writings since at least 2014, where in October of that year we wrote in our letter *Impolitic Fed*:

The Fed has to ask itself - what is more 'out-of-the-norm', the condition of the economy, or our policy to address it? We think the answer now is without a doubt, the Fed's policy. If that is true, then any benefits the economy might see by a continually hyper-accommodative monetary stance are not commensurate with the risks of a prolonged out-of-the-norm policy… Artificially low interest rates for extended periods like this will distort decision making thereby creating long run, unintended consequences… Taking the first step is clearly the hardest, and removing the ZIRP (zero interest rate policy) medication will come with its own price, but that price will continue to rise until policy starts to normalize. The Fed would be wise to begin this process by raising interest rates sooner rather than later…

The Fed's failure to normalize interest rates for a grossly extended period, and its experimental "quantitative easing" programs, swelling its balance sheet, fueled bubbles in a multitude of assets globally. Then came the pandemic and with it an unprecedented fiscal response, with the Coronavirus Aid, Relief, and Economic Security Acts (CARES) doling out roughly $5 Trillion in total through Acts I, II and III combined. This all proved to be way too much gasoline poured on an already lit fire, resulting in an inflationary environment not seen for 40 years.

As inflation started to spike last year, the Federal Reserve believed much of the data was "transitory" and would be alleviated over the next year. This view was misguided, and the Fed has now changed course, with the Federal Open Market Committee in June raising the Fed Funds rate by 75 basis points, it's largest one session increase in 28 years. "With inflation at 40-year highs, we think that policy is going to need to be restrictive, and we don't know how restrictive," Chairman Powell said, adding that in order to bring inflation down to sustainable levels, "it is not going to be easy."[1]

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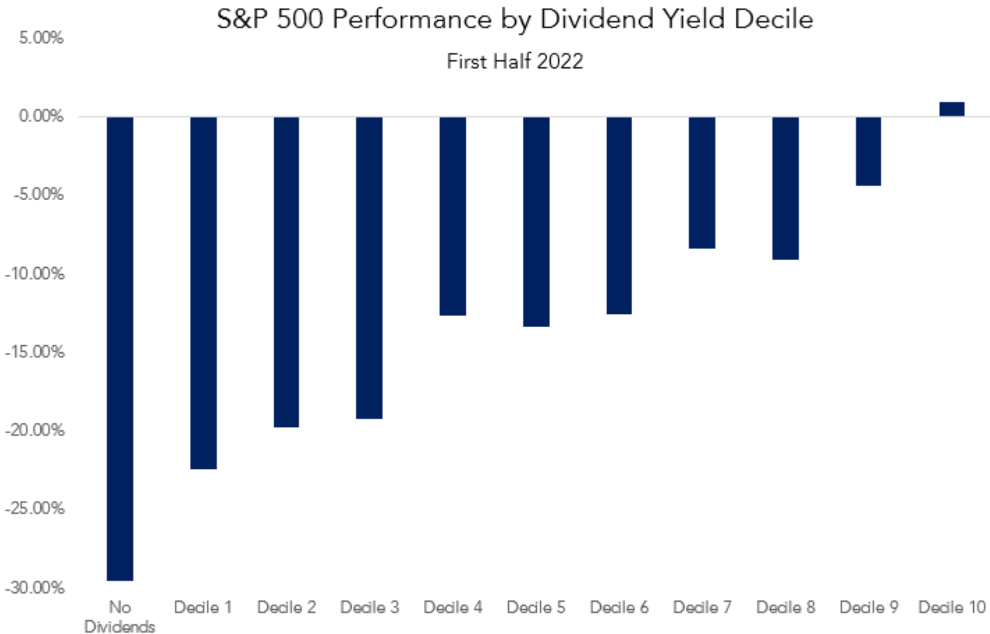
Since the mid-1950's, there's been 15 Fed tightening cycles prior to the current, and of those 15, only three did not end up inducing a recession.[2] That 20% historical "soft-landing" rate is probably the best we can hope for currently. The Fed appears to be coming fully to terms with the challenge of taming inflation and knows its policy now will likely force a recession, hoping to curb demand and halt price rises before they become systemic.

Whether or not the Federal Reserve is successful in taming inflation, we don't think it's hyperbole to call this current period a paradigm shift for investors. One of the most enduring trends in finance had been the secular decline in interest rates over the previous 40 years, from nearly 16% for the 10-year Treasury in the fall of 1981 to 0.50% in 2020, investors became accustomed to an ever lower "cost of money." With that rate rising from one half of a percent to a recent peak of 3.5%, it seems the "enduring trend" may have run its course.

In April of last year, we wrote of the concept of equity duration in our piece *Inflation & Duration* (www.martincp.com/forinvestors). Though less precise than duration utilized in bond markets, it's a helpful concept to analyze interest rate risk for stocks. Simply put, the more dollars in regular cash flows an investor receives in the form of dividend payments, the less sensitive it should theoretically be to changes in interest rates. We highlighted several revealing samples of outperformance for dividend payers during the 1970's, a period of distinct inflation and rising interest rates. Given that these are predominant market themes currently, we thought it would be useful to view performance for the first half of the year through June based on the level of dividend yield. Below is the S&P500 performance for 2022 broken out by the non-dividend payers, and then deciles of dividend yield from lowest to highest. It is very clear that on a relative basis investors are currently saying "show me the cash."



Highlighting relative performance during a bear market is difficult, because interpreting any level of losses in a positive light can be an emotional challenge for many investors, but it matters for a couple of important reasons.

First, bear markets are an inevitable part of investing, and the more assets retained when these periods materialize, the greater the likelihood of long-term investment success. Looking at the chart of performance above, the "No Dividends" group lost 30% on average so far this year, meaning that that basket of stocks

will require a 43% return to get "back to even" where it started the year. On the other hand, using decile nine for example, that 5% loss for the year requires a very doable 5.3% gain simply to get "back to even." The math of losses is extraordinary, and seeking to limit them is a worthy pursuit.

Secondly, the relative trend above may be highlighting a meaningful shift in investor preferences at a time of elevated inflation and interest rates not seen for a generation or more. The past decade was all about "innovation." Growth stocks ruled and companies were rewarded not for producing and distributing cash to investors, but developing ideas, concepts, and products for things we *may* use in the future. An example would be commercial human spaceflight. From the start of 2020 to it's peak just 13 months later, Virgin Galactic Holdings (SPCE) rocketed (pun intended) nearly 500% based on concepts it was trying to develop for human spaceflight. With Federal Reserve policy switching from overly accommodating to restrictive, interest rates rising and inflation accelerating, investing in ideas we *may* use in the distant future is much less appealing, even trivial. Virgin Galactic is now down over 90% from its peak last year, and even 40% lower than where it started 2020. This is a cherry-picked example of course, but still illustrative in our view of changing investor preferences.

With the environment meaningfully changing we think it will be highly important for investors to seek characteristics such as these in the next cycle:

- Strong free cash flow producers, owing to distinct competitive advantages
- Dividend "cultures" with clear policies regarding sharing of profits in this manner
- Prudent use of leverage, not habitual borrowers
- Reasonable valuations

These characteristics already play a meaningful role in our investment process, and are likely to play a bigger role for most market participants than they have in the recent past. Nothing works in a straight line in the investing world however, and time will tell if this really represents a paradigm shift, but we think the odds greatly favor market leadership with a different set of attributes over the coming decade.

Please feel free to call or email with questions you may have regarding our strategies or Martin Capital Partners in general. You can also find information on our website at www.martincp.com.

It is a sincere privilege serving those that have entrusted us with their capital.

Respectfully,

Cameron K Martin
Chief Investment Officer
Martin Capital Partners, LLC

1. Federal Open Market Committee. June 15, 2022 Press Conference Transcript.
2. Wall Street Journal. July 2, 2022, Real Time Economics: Brave New World of Inflation.

Statistical and analytical data provided by Factset.

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