First Quarter 2022 Review: International Equities Strategy

Economic and Capital Markets Commentary

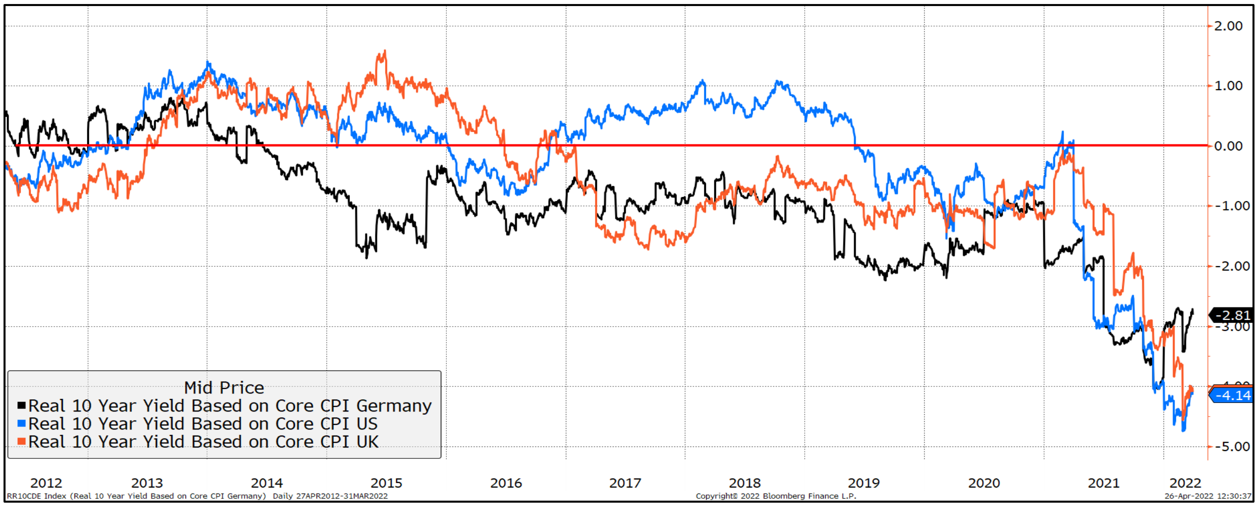
Executive Summary:

The market outlook continues to be wrought with high levels of uncertainty. Inflation continues to present challenges for both the economy and policymakers. Disruptions in supply continue to weigh on prospects for a recovery in quantities available to industrial and personal consumption. Though a declining *real* purchasing power of liquidity at the business and consumer should weigh on prices in a free market, the available supply in an incongruous marketplace currently still satisfies demand at elevated price points. The more recent disruptions in China's manufacturing and from Russian invasion of Ukraine pose further challenges to any potential supply responses. More persistent inflation coupled with future fears of elasticity in demand and, thereby, protracted economic deceleration have weighed on *both* growth and cyclical constituents in the market, which is an unusual development at this point in a market cycle. Central bankers are at an unenviable juncture where rates need to move from extraordinarily accommodative levels to neutral rates more prescriptive to the inflationary environment, despite the risk of tipping markets into an economic recession.

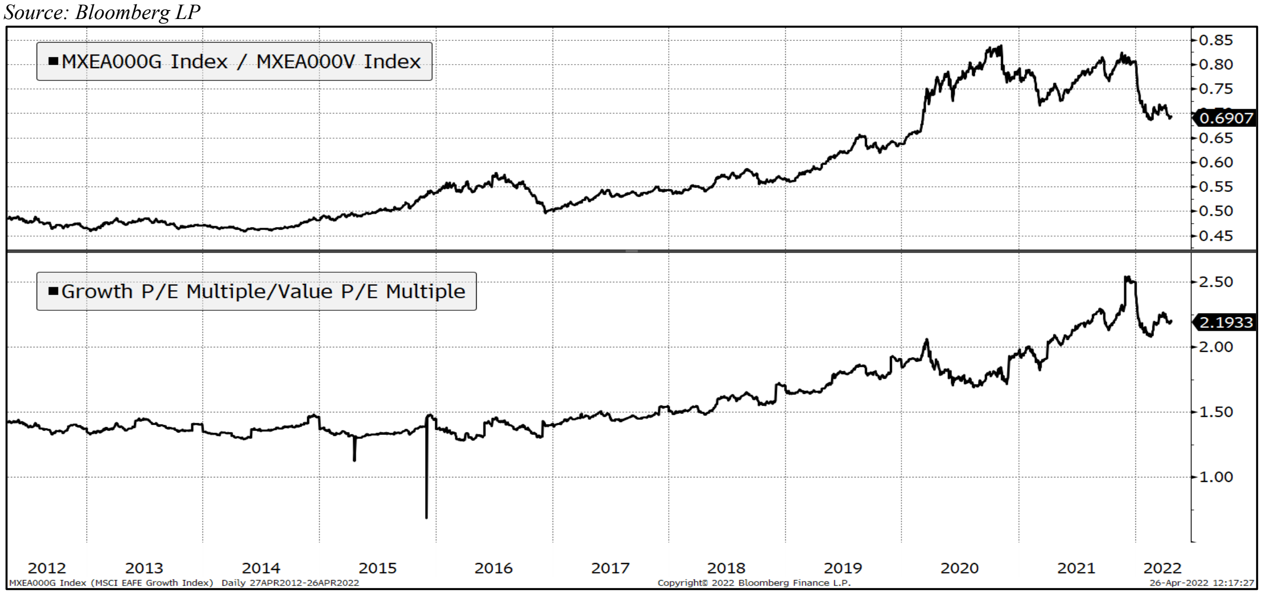
Capital Markets Review:

International capital markets experienced a violent rotation during the first part of the year. The MSCI EAFE Growth Index lost -12.3% of its value during the quarter, while the corresponding MSCI EAFE Value Index declined only -0.7% in price. Adding to the pressures on index constituents, other factors relating to Quality, Low Risk, and Momentum were all negative contributors during the quarter. Global rates moved aggressively in response to persistent inflationary pressure, increasing discount rates on future cash flows. The relatively stable environment with historically low *real* yields, combined with tame inflation and low unemployment, provided a "Goldilocks" situation for growth during the last decade.

Capital markets have responded with increased volatility, prompting a reset in valuations – particularly in the segments of the market where future growth had benefited from excessive liquidity and unnaturally low risk free rates. Compounding pressures on the market, high inflation and rising rates, which historically correlate to outperformance of cyclical shares, increases the probabilities of stagflation in the current environment. Cyclical companies' price action has recently split from its historical patterns during this period of a market cycle. Currently, the market participants wrestle with the interplay of core inflation, central bank policy, and elasticity of demand in order to determine a path forward for cost of capital in determining enterprise and asset values.

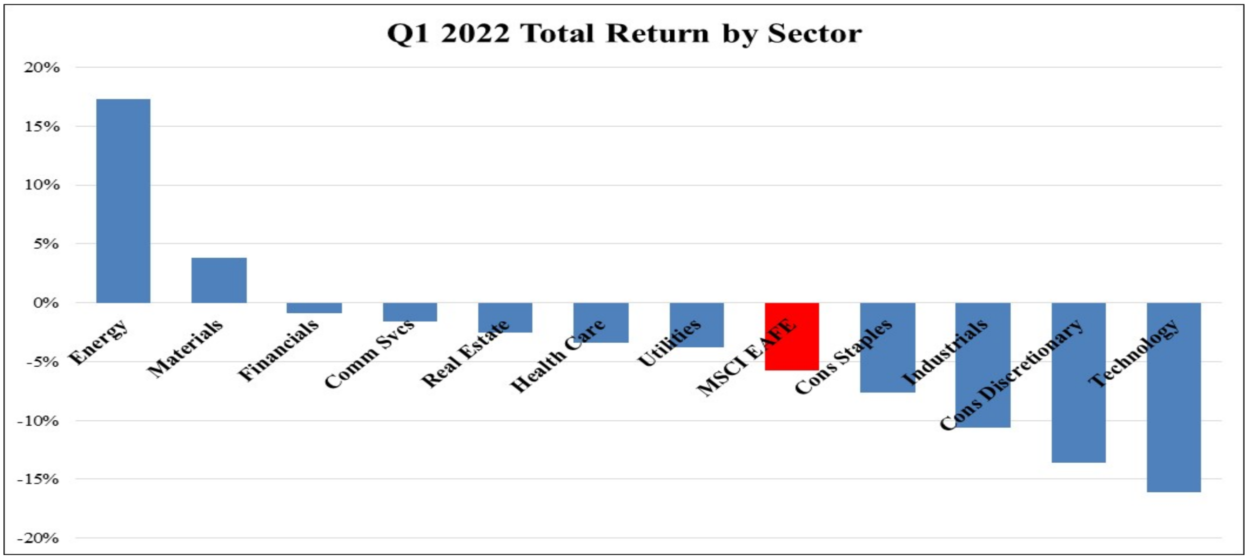


Source: Bloomberg LP



Source: Bloomberg LP

The equity market is a strong predictor of forward economic activity, and the first half of 2022 has prompted a change in leadership among market sectors. Despite the lower real rates, current valuations contemplate moves in nominal rates and prospects of moderating core inflation, driving up real rates as the year progresses. As expressed in the previous charts, negative real rates supported the growth/value trade. Now, the inflation tax on consumption presents countervailing forces, introducing potential headwinds for more cyclical components of the market despite the record savings for consumers in Europe, Japan, and the United States. These risks to more cyclical industries has recently weighed on valuations which obstruct a reversion towards historical growth premium of 1.5x (see last chart). While we keep a close eye to cyclical headwinds, our investment discipline tilts towards structural growth and should appreciate ahead of the broader market over time, though is not immune to adjustments in costs of capital or decreased economic activity. These risks to the cyclical components of the market just typically develop later in an economic and interest rate cycle.

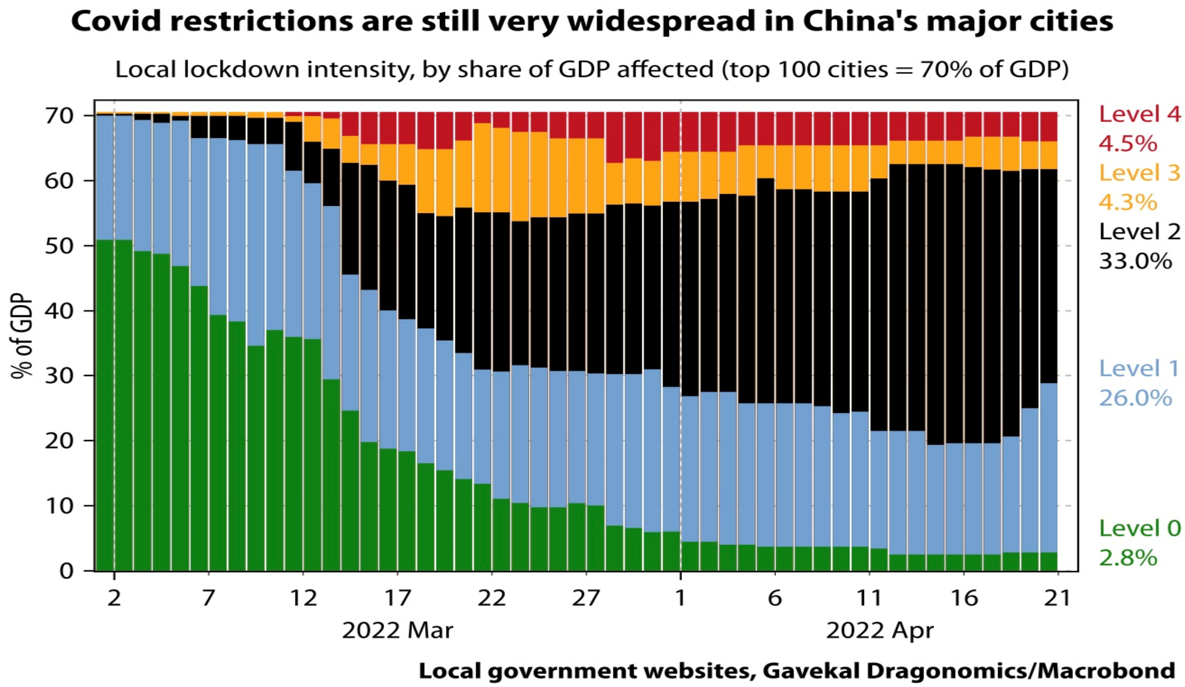


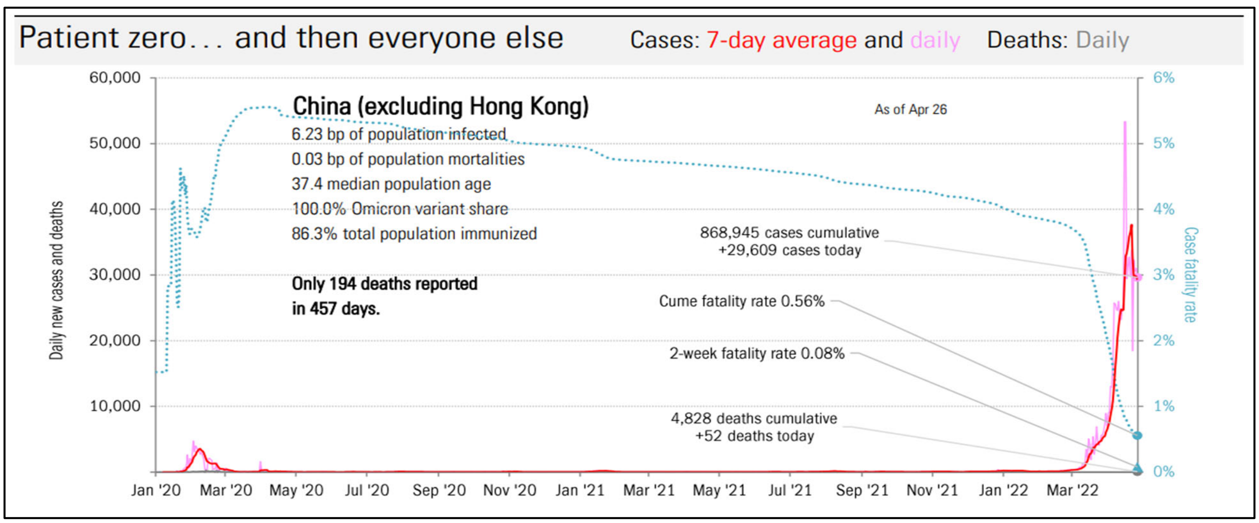
Source: Bloomberg LP

Economic Overview and Outlook:

The extraordinary monetary and fiscal stimuli introduced by policymakers in response to the COVID pandemic has introduced an environment of extraordinary global liquidity. Conversely, the pandemic led to widespread supply chain disruption. While the run on toilet paper in the early stages seemed to be more FOMO ("fear of missing out"), the real impact of the disruption ultimately manifested itself in the price responses to decreased supply, increased costs, and stimulated demand. Many central bankers initially believed that this inflation would prove transitory, as initially it appeared rooted in base commodities and consumer goods – both easily explained by the disruption. Unfortunately, inflation can spread like a virus if circumstances permit, and an overstimulated consumer with a tight labor market, low inventory, decreased global trade, strong personal savings, accelerating services demand, and strained supply-chain for consumer goods introduced more persistent inflation than many anticipated. The narrative at the extremes has shifted from an inflationary boom to stagflation.

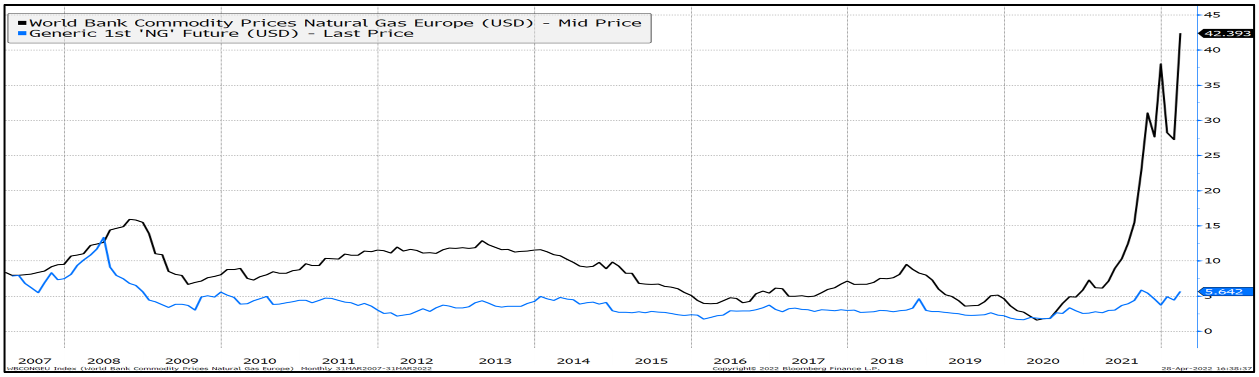
While many parts of the world have wrestled with multiple bouts against COVID, China's restrictive policies insulated – at least according to official data – the manufacturing superpower from shutting down… or at least until now. The more transmissible Omicron variant has forced China to introduce draconian quarantine policies across entire cities. Ignoring the emotional toll experienced by citizens, these lockdowns have introduced another catalyst that may lead to further price increases for imported goods. Lead times for consumer and industrial goods have continued to be long. The recent decrease in manufacturing activity by the world's largest exporter will likely add to existing supply chain disruptions. At its peak the end of February, there were 17 million container waiting days — essentially cargo that's bogged down in congestion globally. Two or three weeks ago that number had fallen to about 6 million and this week it had crept up to about 7.5 million. Taken together, they pose a threat of decelerating global economic activity and promoting inflation.



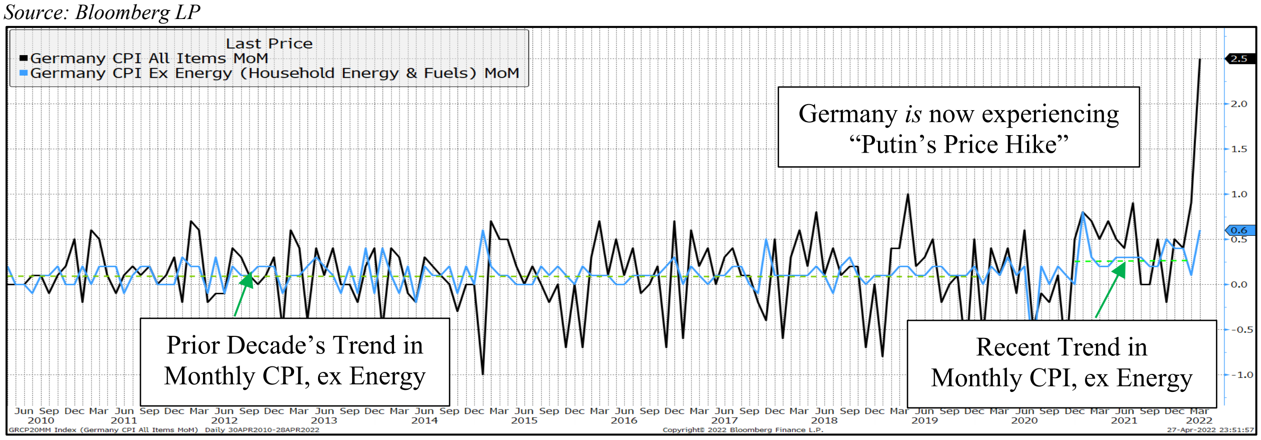


Source: Trend Macrolytics LLC

The Russian invasion of the Ukraine presented the world with a major geopolitical challenge. Much of Western Europe had already experienced an energy crisis last fall, reflecting a much more vulnerable energy mix than promised by policymakers. Solar and wind are seasonal sources of power; wind adds to variability; power storage is immaterial; coal and nuclear plants decommissioned; increased dependence upon natural gas; and Russia controls natural gas imports into Europe. Honestly, I believe that many Europeans were blinded by virtue policy and made serious misjudgments during an unusually peaceful period, all the while Putin cheered and tightened his control over the continent’s energy. As students of business strategy and investments, we always assign risk to supplier and customer concentrations. Prices had already increased for energy due to the variability of renewable power during the fall, but the Ukraine war now has natural gas trading at *seven times* last year’s price. Power costs are up similarly. These policies had already proven inflationary to power costs over the last decade, but these two events exacted a one-two catalytic “punch” for energy inflation. Additionally, German PPI increased at a 31% annual rate in March, the highest on record since the series started in 1949. These constrictive prices could plunge Germany – and, potentially much of Europe – into recession.



Source: Bloomberg LP



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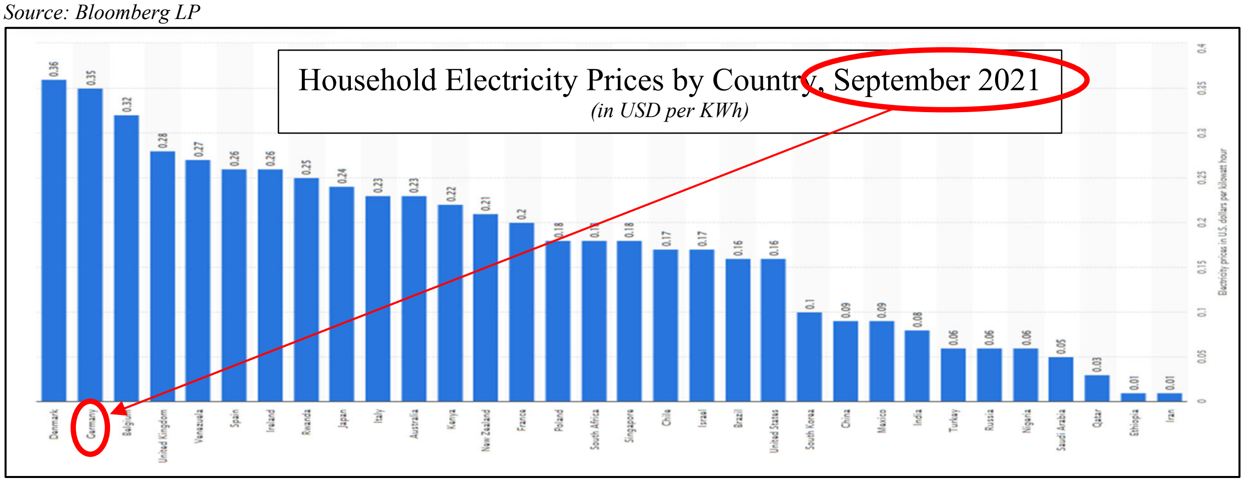
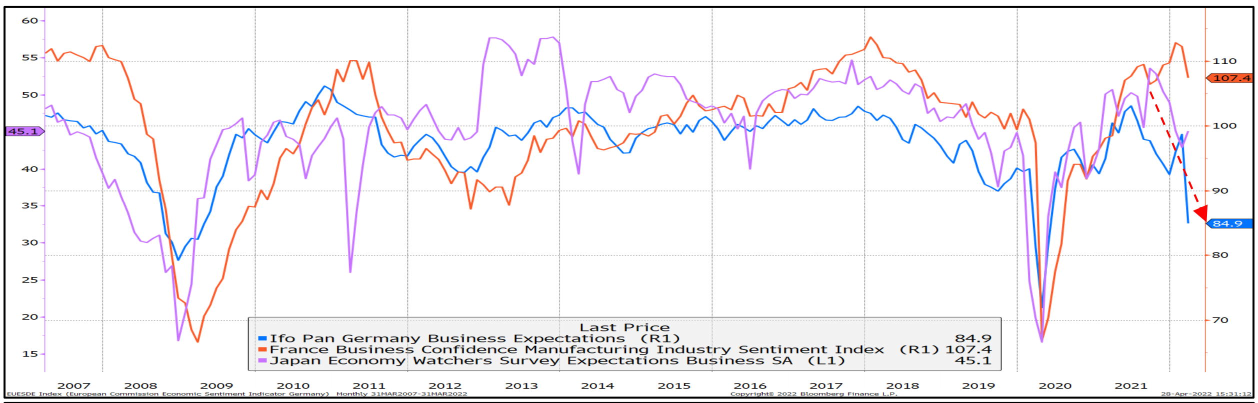
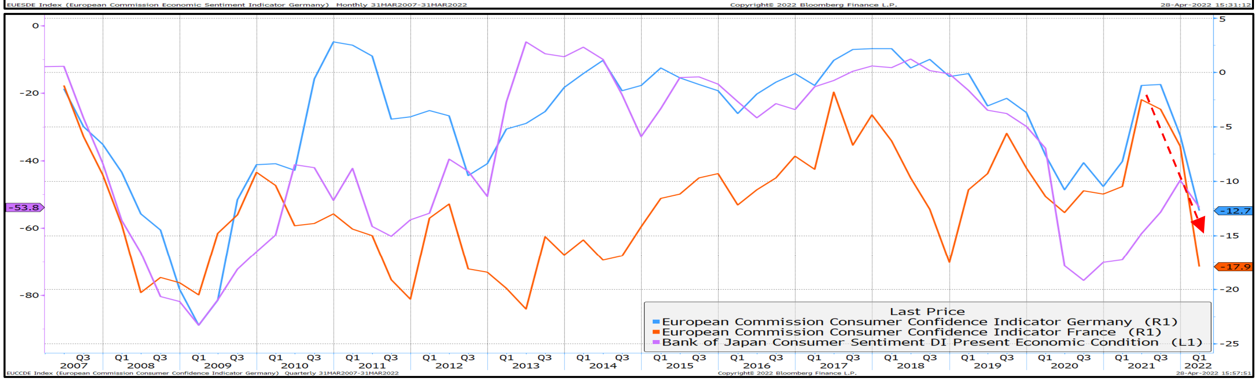


Source: Statista

Central banks are now faced with a more challenging dilemma as they attempt to balance mandates for price stability and employment. While the Bank of England was responsive earlier to the risks of excessive monetary stimulus and inflation, other central banks have become more hawkish over the last two quarters, as risks now overshadow accommodating economic activity in a tight labor market. Contractionary policies will introduce a risk of further restriction of economic activity as fiscal policies expire (the fiscal "cliff") and supply chain bottlenecks undermine earnings power. A lower quantity of goods available will support elevated prices until production normalizes, but, alternatively, increased production could return supply/demand balance to equilibrium and reintroduce price elasticity. Until such time, economic rent should exist for many products, but earnings may underwhelm as companies struggle to manage increases in costs and future elasticity of demand with measured price increases.

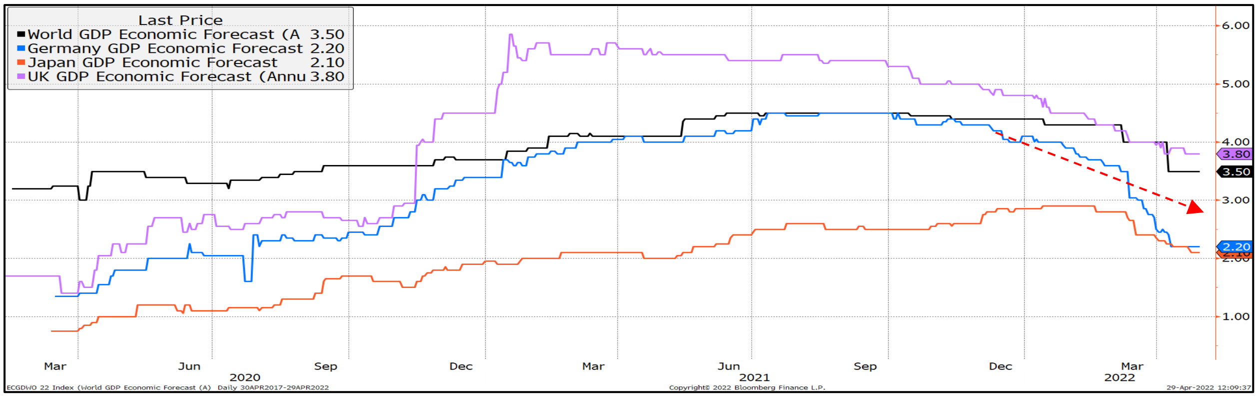
The unusual environment has started to exact a toll on the consumer and business sentiment. Businesses may be unable to achieve earnings potential despite record liquidity. The charts below exhibit the shift in economic sentiment through various surveys in France, Germany, and Japan. The most dramatic decline in expectations are in Germany, which is closer to the Ukrainian "impact zone." They have a higher dependence upon trade with Russia and Ukraine for their energy and industrial sectors. The French survey is a more coincident series, and I expect that this will further erode in subsequent data. Consumer sentiment has also deteriorated across these markets, as exhibited in the next chart. Despite excessive savings prompted by fiscal transfers in response to the pandemic, the inflation tax is undermining the positive sense of economic well-being with disposable income and personal savings declining in real purchasing power.





Source: Bloomberg LP

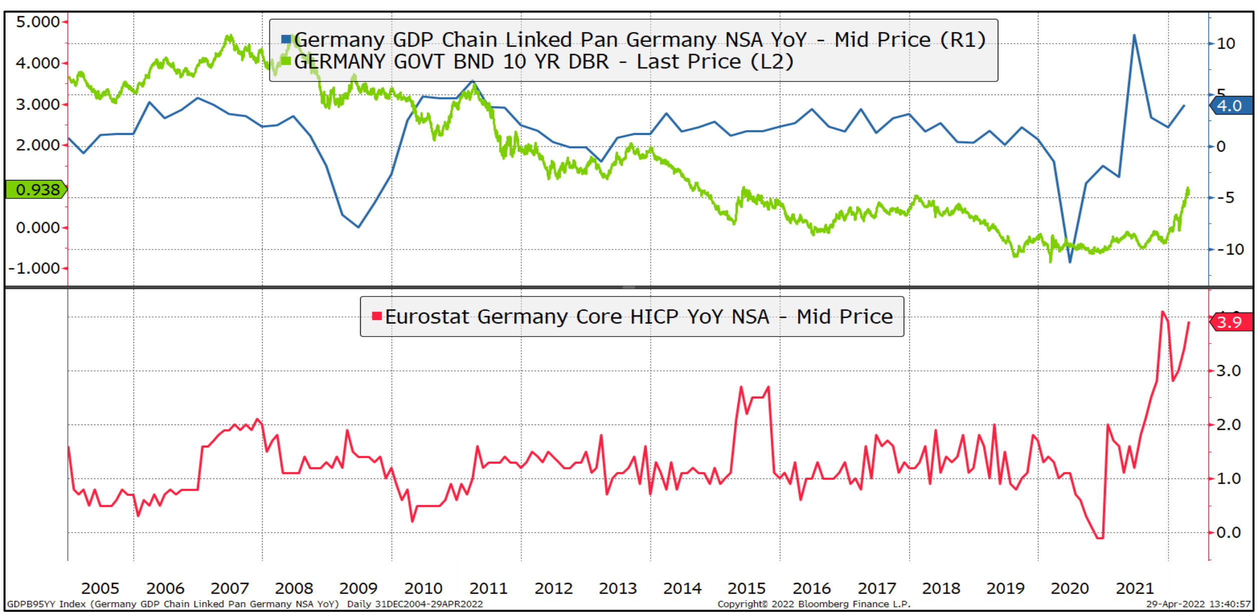
As policy shifts towards more hawkish policies to stem inflation, the increase in capital costs and decline in purchasing power have led to declining estimates of global economic growth. Revisions to consensus for Real GDP growth in Germany have already been cut by 50% for 2022, and these numbers will likely see further revisions to the downside in future months. China and the United States, the two largest global economies, are also experiencing downward revisions to Real GDP growth estimates, contributing to the decline in global estimates.



Source: Bloomberg LP

A more sanguine outlook could be made for free market forces through price elasticity of demand mitigating inflationary pressures without full engagement of monetary policymakers. The outcome would still be a slowdown but more targeted; rising prices of goods and services would elicit a decline in demand. It is like the old adage says, "the best cure for high prices are high prices." Wage growth could offset inflationary impacts on quantity but only if it grows *coincident and at an equal or greater rate* as price inflation. Otherwise, lagging and insufficient wage growth undermines equilibrium in real terms. Despite strong wage growth and elevated savings, we don't foresee this pressure easing for consumers in the short term, and real consumption may be a contributor to economic deceleration in subsequent quarters.

Central bankers use rate policy to alter costs of capital across a marketplace. These are blunt tools which ignore forces in individual commodities or industries, but they do serve to manage systemic industrial and consumer demand. But, this environment is inconsistent with history when prices were more stable, as the central banks respond to decelerating activity with monetary accommodation. If we continue to see inflation continuing to run ahead of target, policymakers may be required to act. Unfortunately, rate policy takes twelve to eighteen months to fully work through the system. If supplies rebound, demand stalls, and prices stabilize, then an aggressive policy risks exacerbating downside risk to economic growth.



Source: Bloomberg LP

Our economic outlook acknowledges a downside bias to current economic growth estimates. Unfortunately, the crosscurrents in today's market make it much more challenging than a non-inflationary business cycle. An inflationary "boom" with inflation returning to neutral levels as productivity increases seems unlikely in the short term, as some were predicting last year. The nature of the deceleration is yet-to-be-determined, and economists debate probabilities of mid-cycle slowdown, recession, or stagflation. As wage growth takes hold, productivity underwhelms, and prices respond, the probabilities for the last two scenarios, recession and stagflation, in many markets have increased. Time will tell if high prices alone solve the dilemma or if aggressive policy will be required to arrest stickier inflation despite potentially weaker economic activity. Unfortunately, many central bankers will need to move forward with the prescription of more restrictive policy before the dynamic fully plays out.

Mason D. King, CFA
May 6, 2022

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