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Research

LKCM International Economic Commentary

November 21, 2022

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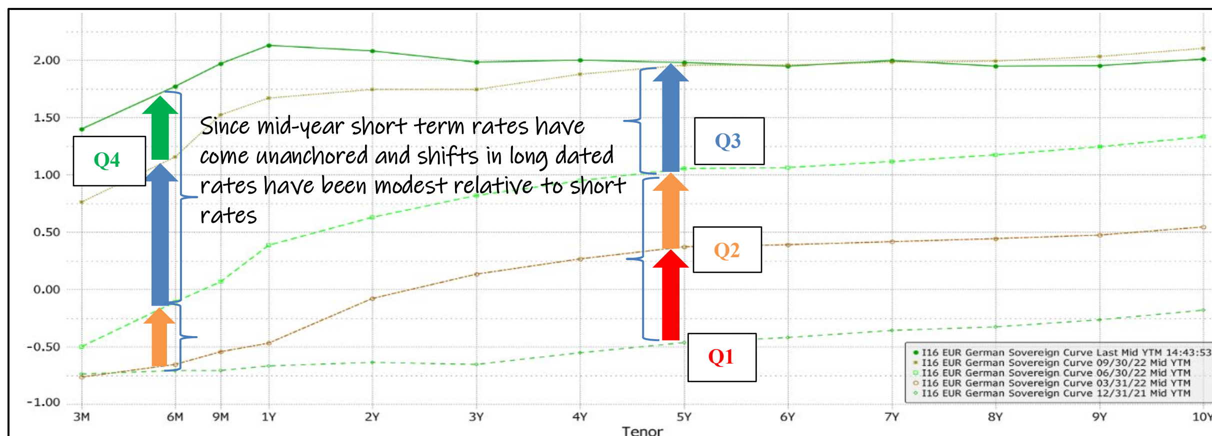
Executive Summary

Economic and earnings outlooks continued to weaken as the quarter progressed. As these have taken greater hold, there is greater anticipation that economic weakness will ultimately lead to a return towards price equilibrium and trend reversal in inflation. Exogenous factors in Europe complicate some of this reversal and highlight some competitive challenges, but diminished discretionary, real income should still weigh on inflation as their economies progress into 2023. With rates having moved closer towards restrictive levels, markets can start to anticipate a deceleration in central bank policy rates and, thereby, long-term, risk-free rates. Alternatively, markets will have to now look towards the potential trajectory of an economic slowdown, the impact on company cash flows, and the ability (and timing) of any future fiscal or monetary accommodation. So, we believe *most* of the damage from a shift away from the sustained timeframe of accommodative rate policy has occurred, and now the focus narrows to this recession's unique impact on fundamentals for various industries and companies.

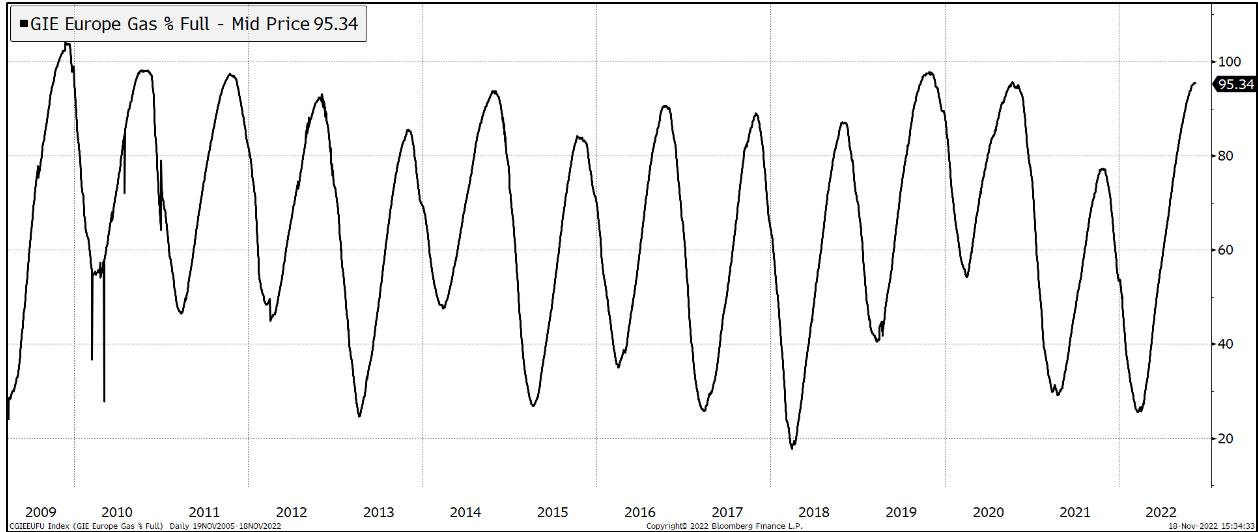
Economic and Capital Markets Commentary

The third quarter brought further negative returns for the international equity markets, as measured by the MSCI EAFE Index, due to the weakening outlook for global economic activity. These negative returns differed from the first quarter, which brought the most dramatic compression in valuations for growth versus value. The MSCI EAFE Growth Index actually outperformed the MSCI EAFE Value Index, reflecting a smaller impact of rates on longer duration growth equity. Additionally, the reversal reflects a greater *relative* concern for cyclical earnings, as policy rates have become more restrictive in order to avert structural inflation. The increase in global short rates will pull forward restrictive behavior in parts of the monetary supply that have greater impact on current economic activity and liquidity. These policies temper activity to offset excessive demand, driven by prior disproportionately low costs of capital relative to structural dynamics, risking persistent inflation and economic imbalances. The initial move by the longer terms on the yield curve reflected these concerns much earlier than the short end which became unanchored due to policy action.



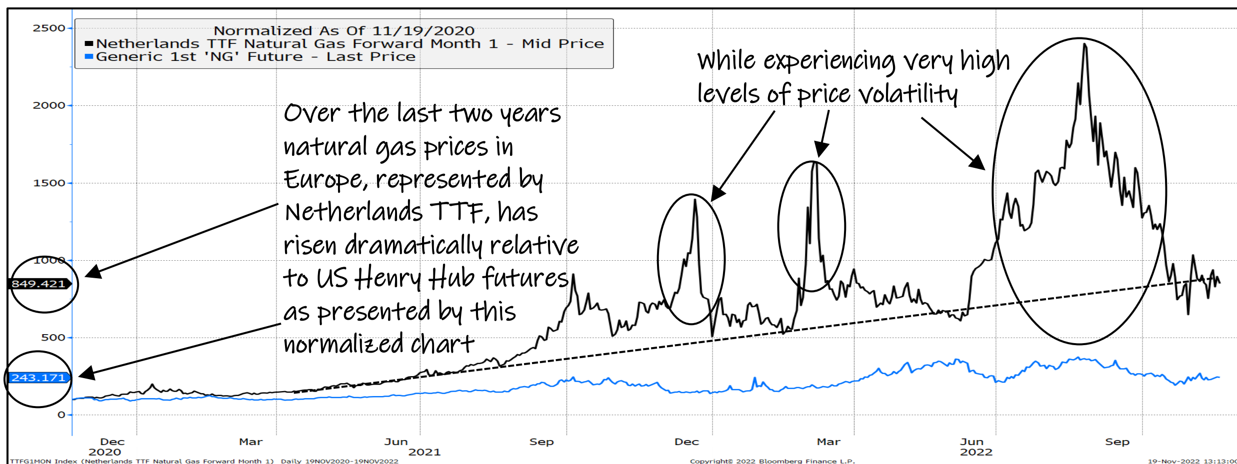
Source: Bloomberg LP

Europe suffers from a confluence of slower global economic growth and persistent energy shocks, creating an additional threat to supply chains. The "Green" revolution, emboldened by a targeted Russian misinformation campaign over the past decade, led to an allusion of competitiveness with concentration on imported natural gas from a geopolitical adversary. Though initial – and unsustainable – spikes in prices for energy commodities have softened with the aggressive push to fill storage, natural gas prices still remain ~50% above this time last year, according to World Bank. Storage levels currently stand at approximately 95%, but Russian imports have historically contributed to ~20% of the winter's demand, implying that withdrawals may be much more pronounced this season in the absence of ample LNG diverted to this region.



Source: Bloomberg LP

Rebuilding storage in the absence of any Russian supplies in 2023 could prove to be a greater challenge and highlights a more persistent risk of competitive disadvantage for basic industries, as Europe competes for limited LNG supplies on price. During a recent conference BASF commented on their suspension of two large ammonia plants in Antwerp and Ludwigshafen, "it remains uncertain if we will ever resume production in the future given the, now, clear competitive advantage of the US Gulf Coast." Additionally, Germany's metal association disclosed that electricity prices last summer required €9,000 per metric ton of aluminum; aluminum prices were €2,500/ton during that same period. While curtailments will reduce some local demand, it remains unclear if industrial consequences of local policies and disrupted supplies from Russia, combined with "voluntary rationing" by businesses and consumers, will enable storage to enter the 2023/2024 withdrawal season with comfortable margin to insure against future economic pain and reduce prices to more competitive levels.



Source: Bloomberg LP

There are a few longer-term opportunities to manage transition in a more balanced fashion, but they require a "political will" that grinds against the popular narrative. Action by the European Union in July led to approval of "Green" labeling for natural gas and nuclear power facilities, assuming they follow certain guidelines. Already, lawsuits filed by Greenpeace and a few member states (e.g. Luxembourg and Austria) in European courts risk this more constructive framework. The key on the labeling is the ability to narrow punitive costs of capital for these power sources vis-à-vis renewables. Wind and solar have limitations on supplying consistent power in the absence of utility scale power storage. RWE, a German largest power company, acknowledged during a panel in September that they had only received ~60% of nameplate capacity from their extensive wind and solar facilities during the year – with it ticking as low as 1% at one point. That must have certainly been a windless night. These comments highlight the challenges with balancing a mandate for increased renewable energy with nameplate capacity in excess of GWh demand *and* expansion of utility scale storage to manage supply, both of which we expect will dramatically increase both the capital and time required for successful energy transition. While wind has greater variability than solar, both have seasonality components, contributing to this need to smooth weak periods of production to prevent power disruptions. They also point to potential pressures on local industry and consumers in future years in the absence of a balanced transition.

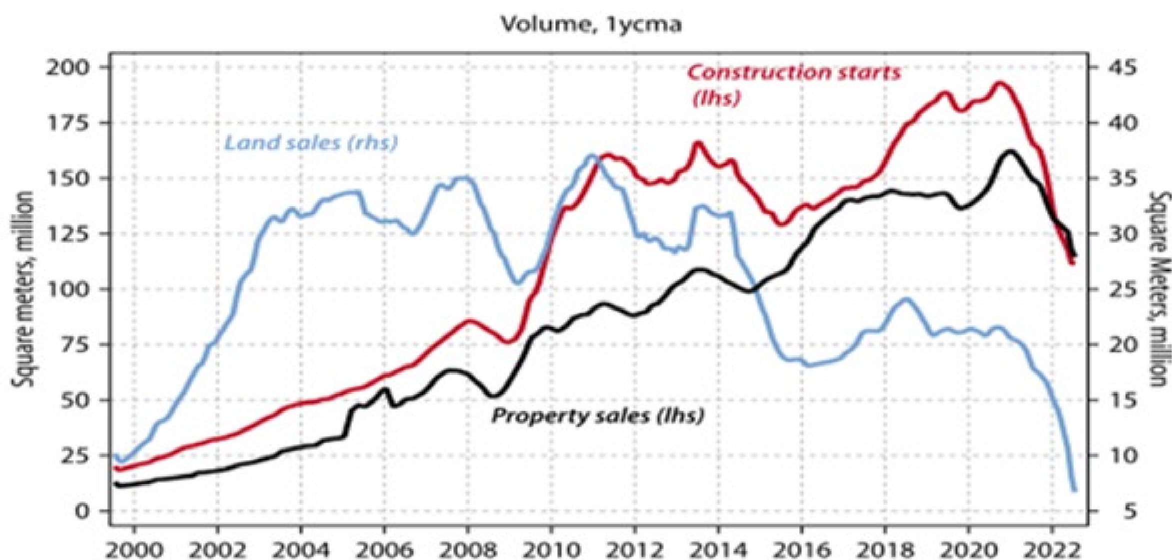
These energy challenges have just further contributed another exogenous shock to inflation throughout the continent. Global short rates have continued to rise, and central bank policymakers – particularly in the European Central Bank and the Bank of England – have been actively raising policy rates to stave off structural inflation. The unemployment rate in the United Kingdom has reached a four-decade low of 3.6%. Though new hires appear to have softened somewhat, the tight labor market has increased wages by 6.6% for the private sector, according to the Office for National Statistics. This increase is still below the most recent jump in consumer prices of 10.1% - another four-decade record. So real wages continue to deteriorate – in both the United Kingdom and European Union.

Policymakers face a challenge to subdue inflation before it becomes more entrenched with a wage-price feedback loop (or "spiral"). Higher rates will be needed to temper demand for goods and services while also increasing unemployment rates. Monetary policy acts with lags of twelve to eighteen months, and current rates in Europe and the United States have shifted towards much more restrictive levels. A "soft landing" may be possible, but a more likely scenario will be an economic recession in order to reset the balance of supply and demand after ten years of negative real rates stimulating demand and asset prices. Markets are discounting mechanisms, and the weak equity markets throughout 2022 reflect the likely economic slowdown to resolve imbalances. Equity markets also will start to recover once a trend reversal occurs, though the consequence may be weak economic data in 2023. We are keeping a close eye on the labor markets and price indexes.

During the last international economic update, we discussed some of the near-term challenges with China's deceleration in growth. One of the major drivers of growth for China was the extraordinary level of property development, which accounts for ~33% of GDP. This market has started to become vulnerable to past excesses. Longer-term, there are structural components that will limit the ability to lean on this pillar of growth. Demographic "bulges" in the population pyramid exhibit a disproportionate concentration in the 30-60 age groups, while the population of the 15-30 cohort falls off dramatically. This decline will ultimately weigh on the ability to expand household formation in addition to increased dependency ratios. Home ownership rates are already nearly 90% in urban areas of China (versus ~65% for the United States). Recall, residential real estate also accounts for ~70% of a Chinese citizen's net worth (versus ~50% for the United States citizen). The CCP will take – and has already taken some – action to prevent any losses from spilling into civil unrest and to stabilize their economy.

The government historically pushed for greater engagement of their working age population through efforts for urbanization. The initial productivity benefits were low hanging fruit, as they increased national output with greater engagement of human resources. This trend also contributed to the momentum in property

development, but urbanization has experienced a dramatic decline in recent years. While declining prior to COVID, the rate of urbanization declined 33% from 2020 to 2021, and current indications point to further declines in 2022. While the pandemic and related lockdowns likely contributed to the decline, they are unlikely to return to the pre-pandemic levels, as most models were predicting declines prior to the step-change experienced over the last few years. A modest increase in urbanization after lifting COVID restrictions could support some urbanization and activity during 2023. However, structurally lower levels of urbanization will temper residential development, and increased productivity of urban labor force will be required to support future growth.



Source: GaveKal Dragonomics/Macrobond

China appears to be shifting their economic model from labor urbanization and property development towards increased domestic consumption and labor productivity. Time will tell if they are successful in this transition, but changes to their market will likely alter dynamics of trade partners. China represented nearly 30% of Brazil's total exports in 2021, but more impressively, accounted for ~66% of their export of iron ore. Australia is another major provider of iron ore, in addition to other natural resources (e.g. copper), and has seen declining demand from China for its resources. China's property markets account for 39% of domestic steel consumption, and increased infrastructure projects likely won't provide the panacea for local mills, which have been posting losses since August. Prices and demand for these resources should stabilize with appropriate policies, but growth in demand likely remain lower than past decades.

Property markets, along with global weakness and zero-COVID policies, are contributing to revisions lower of expected growth for Chinese GDP. Bloomberg surveys for growth in 2022 have fallen from 5.0% to 3.3% during the course of the year, and while a relaxation of zero-COVID policies should provide support in 2023, growth points structurally lower over the next decade. Real GDP growth averaged 8.7% from 2000-2019. Bottomline, the boom for more export-driven economies historically serving China may see fewer tailwinds to future export growth, impacting both resource-based and techno-industrial economies. Despite the structural slowdown, the autocratic leadership by the Xi Jinping government will likely act to support property markets to prevent widespread destruction of wealth and capital, while methodically easing COVID restrictions to further stimulate economic activity.

Japan appears to be the one outlier with anemic growth but subdued inflation in a market with very low unemployment rates over the last two decades. Inflation started to move from these very low levels, hitting 3.0% in the most recent data on core CPI, which excludes food and energy. Excluding periods of increases in

"value added taxes" pushing consumer prices, these are the highest levels in over two decades. Of more concern, the increases in producer prices reached four-decade highs in August before cooling… slightly. The Bank of Japan appears determined to maintain their rate policy, which is currently at -0.10%. As the spread widened against other sovereign rates, their currency weakened over the past year. While potentially adding to recent producer prices, they could be in a position to improve competitiveness against other developed markets. A global slowdown should curb input prices, stabilize sovereign spreads, and prevent a need for Bank of Japan to move in tandem with other central banks to control nascent, local inflation. Japan has some demographic headwinds which will prevent high structural growth, but they could see some tailwinds over the next few years if the right environment evolves.

As we move into 2023, the outlook remains fluid. Inflation remains the primary concern, but action by central banks and eroding real purchasing power should help to move supply-demand balance back towards equilibrium. China's economic slowdown has already contributed to lower prices in certain commodities markets – specifically, iron and copper – during the course of the year. The structural tightness in local supply of labor and resources in Europe will have a less defined path with the potential for further exogenous shocks as they attempt to navigate a tricky energy transition. In the absence of ample supplies, prices could continue to handicap domestic consumption and some industries' competitiveness. We have seen better opportunities develop as global equity markets have accounted for increased policy rates needed to temper demand and price assets. Valuations reflect the sentiment, as companies in the international, developed markets in the MSCI EAFE Index now trade at steep discounts to domestic peers in the S&P 500 Index. Our focus now, as always, will be on the durability of operations in each market and the proper pricing of these fundamentals in different regime for interest rates.

Source: Bloomberg LP

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