LKCM International Economic Commentary

February 10, 2023 Mason D. King, CFA

Executive Summary

Economic outlook continues to be challenging though sentiment appears to have improved over the last four months. While consensus economic forecasts call for a recession, the recent weaker core inflation in the United States holds optimism for European economies, which appear to be lagging the United States. Prospects for lower inflation may provide an opportunity for less restrictive monetary policy. Additionally, the reversal of zero-COVID policies in China, expansive Chinese money supply, and fiscal support of weak Chinese property markets should boost economic activity. An acceleration in China's growth should help to offset some of the weakness expected in both European markets and the United States, as decelerations take hold. If weaker economic data should start to materialize, the markets will start to discount a cyclical pivot before data improves. The trajectory for both inflation and employment will likely continue to determine sentiment for capital markets and will likely contribute to volatility.

Economic and Capital Markets Commentary

The fourth quarter was a relief rally from the pressure exerted on equity markets throughout the other quarters during the year, though far from recapturing the total amount of lost ground. The MSCI EAFE Index hit the lows for the year in mid-October, and started to march higher during November, pausing in December, before renewing the rally in January 2023. Predictably, the German 10-year yields hit highs when the market hit its lows, before spiking again in December. Though both growth and value performed similarly during the first two months of the quarter, the move in German 10-year yields in December weighed on growth, providing better returns for the value index for the quarter. More recently, these yields have moved lower.

While sector leadership throughout 2022 widely favored Energy, which was the only sector with positive returns, the fourth quarter provided a much more favorable distribution of returns across the sectors. Financials had the best returns during the quarter, followed by Materials and Utilities. These three sectors tilt towards value, providing the support for value to slightly outperform growth during the quarter. Regardless, all sectors provided positive returns as the market rallied into yearend.

Source: Bloomberg LP

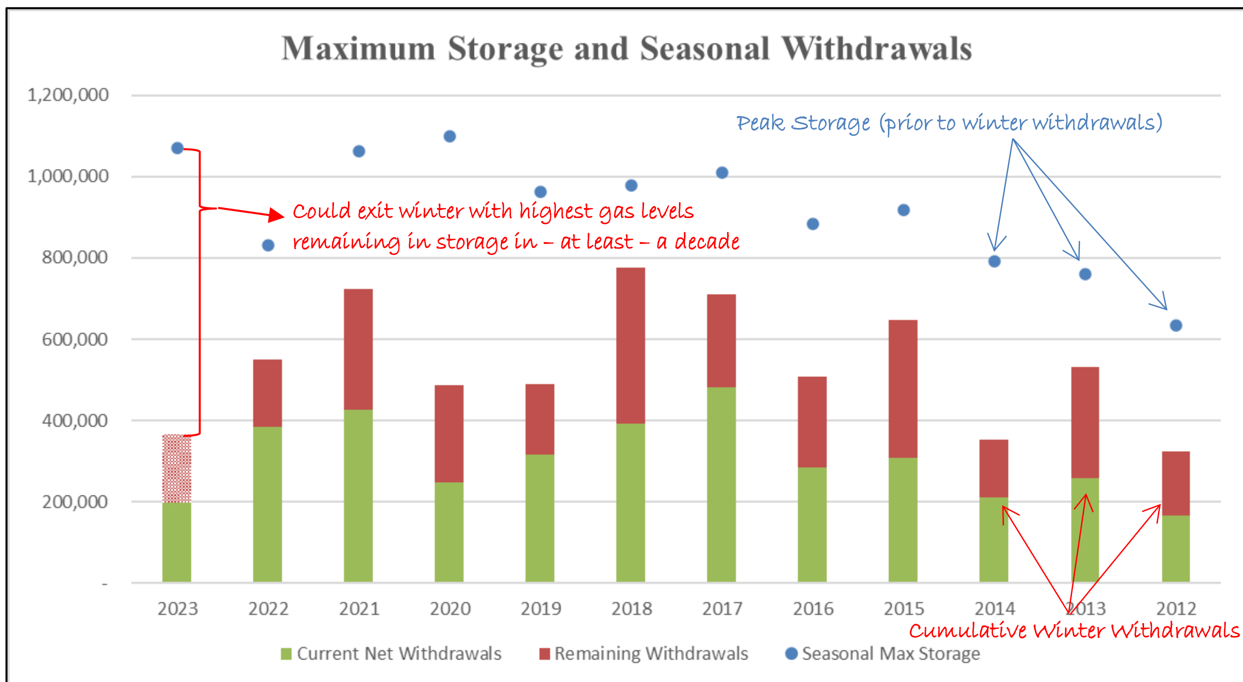
Source: Bloomberg LP

Many of the same cross-currents haunt the markets, but the data has recently been more constructive. A trend reversal has led to more favorable outlooks for inflation, rate trajectory, fiscal stimulus, and economic activity, though our base case still remains for a global recession developing during 2023. The short-term impact of falling inflation is boosting Eurozone real purchasing power with beneficiaries of discretionary income now expected to see less impact on financial performance over the next few quarters. China's retracement of its zero-COVID policies should also help offset some of the headwinds to global growth during the first half of 2023. Further, Chinese fiscal support of their weak real estate markets, while perhaps delaying future pain, should also incrementally support Chinese – and global – economic activity.

During the economic commentary of last quarter, we discussed the challenges of the European energy crisis, the impact on discretionary income, and risks to profitability for some industries. The continent responded beyond many expectations in their efforts to fill natural gas inventories during supply disruptions and prior to winter withdrawals. The rate of withdrawals also posed a serious threat to another supply challenge as they rebuilt storage this year. Fortunately, a mild winter – along with some

curtailments in demand and reactivation of "brown" power generation – has preserved the gas in storage better than markets feared.

Europeans successfully raised gas storage inventory to the second highest level in a decade in 2022, which eased concerns for the current winter. La Niña appears to have come to the rescue with warm weather curbing consumption, supporting better estimates for the seasonal trough in storage in 2023. Net withdrawals have been running at 60% of average trends over the last decade, and the most recent year with lower withdrawals was 2011/2012, which was, coincidentally, another La Niña cycle. The recent plunge in European natural gas prices reflects this new reality, and Europe appears ready to emerge from the withdrawal season with over 50% of gas in storage remaining (likely, well over). Exiting the season at these levels was only experienced during COVID disruptions to demand, whereas today's challenge is navigating disrupted supply. The current year's more favorable backdrop eases economic risks, as Europe attempts to substitute alternate sources for Russian pipeline natural gas. Key will continue to be an effective expansion of both liquefaction and regasification terminals to tap global natural gas supplies over the next few years, along with expanding renewable power supply.



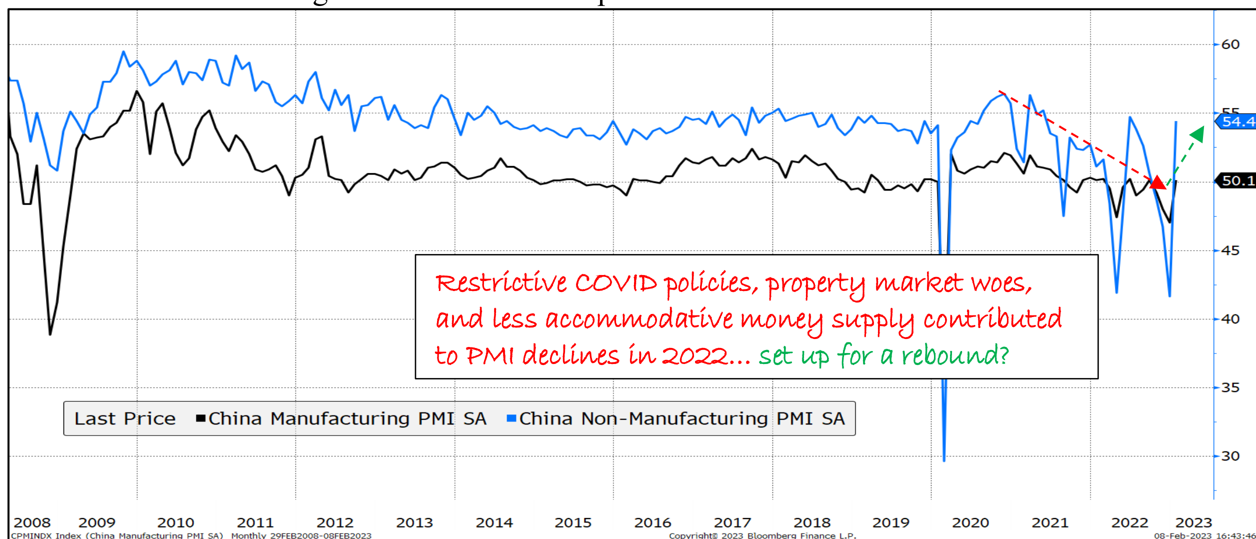
Source: Gas Infrastructure Europe (GIE)

This outcome appears to be the "best case" scenario possible for the European markets. The reduced price for natural gas, along with the subsidies to many consumers in 2022, should help ease the impact on disposable income. Additionally, the decline in prices for natural gas – and thereby power – could offset some headline inflation. The de-risking of 2023/24 winter withdrawals also provides support to heavier industry in Europe, which experienced both disruptive prices and supplies last year. While concerns still exist over the ability to navigate the energy transition over subsequent seasons, the current environment eases concern about declining comparative advantages for European exports due to energy.

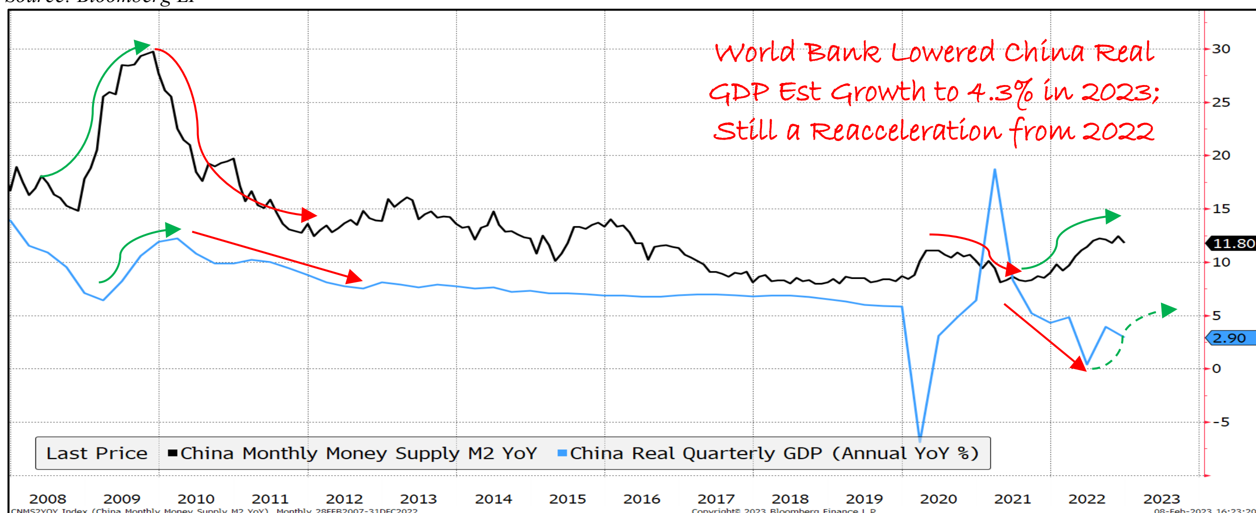
As economic risks around European energy have eased, China appears to be positioned to reaccelerate growth over the next few quarters. The earlier than expected pivot from the zero-COVID policy is expected to raise domestic consumption. Lockdowns drove domestic consumption for both goods and services to levels below trend, and economists now expect some of this spread to narrow. Conversely, youth unemployment rates remain elevated and property markets remain under stress. While unemployment

could weigh on potential consumption, the government has continued to press towards additional support of the property markets. Copper futures prices have risen nearly 20% over the last three months, reflecting the better outlook for this market in addition to potential demand from incremental infrastructure spending in Europe and the United States. High frequency data for the China's economic activity has recently moved higher, which typically leads the Manufacturing PMI, further supporting the prospective improvement in months to come. Eurozone Manufacturing PMI tends to lag improvements in Chinese PMI by three to four months.

China has also been maintaining a more expansive monetary regime. After a deceleration in growth during 2021, money supply, as measured by M2, reaccelerated in 2022. In December, this measure grew 11.8% from the prior year. Changes in monetary policy take time to work through the economy, and the additional supply should start to impact economic activity during the first part of 2023. This expansive policy is an interesting juxtaposition to the restrictive policies in Europe and the United States, where M2 declined by 0.5% in December. While China could provide an offset, European exports to the United States are a larger contributor to the region's GDP. Chinese exports represent 1.6% of Eurozone nominal GDP versus 3.5% for exports to the United States. So, the current slowdown – and possible recession – in the U.S. would still weigh on a positive reversal in Chinese demand.



Source: Bloomberg LP

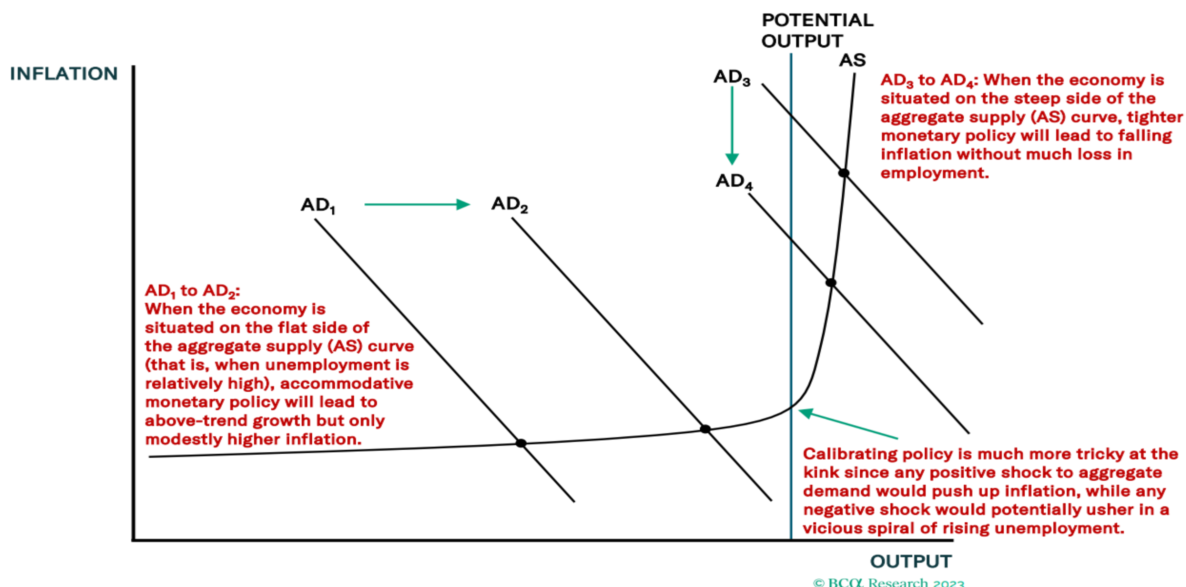


Source: Bloomberg LP

While the outlook has certainly become less negative over the last few months, there remains a determined effort by central bankers in the European Central Bank, Bank of England, and Federal Reserve Bank (U.S.) to pursue restrictive policies in order to curtail the risks of structural inflation. The majority of these efforts will be felt during the course of 2023, driving up costs of capital and driving down economic activity. Pundits now refer to the future economic outlook as the "most predicted" recession in recent history with near unanimity amongst leading economists. But, many economists also echo former US Treasury Secretary and economist, Larry Summers, comments on Bloomberg that "It's as difficult an economy to read as I can remember."

The impending slowdown should help to drive down aggregate demand and erode pricing power. Job markets remain very tight, and bankers are keen to increase slack so that wage cost inflation doesn't promote a wage-price feedback loop – particularly, in services – and entrench structural inflation. Additionally, inflation expectations remain anchored at the same levels as 2000-2015, despite the recent bout with higher readings. Keeping inflation expectations anchored at these levels will prevent shifts in the supply curve towards higher prices. We see headline and core inflation declining throughout the year, providing more headroom for policymakers as they search for the appropriate "neutral" interest rate policy. They will likely overshoot, as they historically do in an effort to hit a moving target.

Inflation tends to be a non-linear phenomenon across the supply curve. The final remnants of inflation will be the hardest to drive from the economic system *and* also carry the greatest risk to output. We will see the initial declines likely coming with limited impact on aggregate output, but as we approach the economy's potential output, these shifts will start to have less impact on the prices. Basically, the slope of the supply line declines, requiring greater declines in output per unit of inflation. This phenomenon explains some of the difficulties of policymakers in calibrating policies to hit a neutral stance without triggering an economic recession. The target zone is right where being too restrictive has greatest risk to economic activity. It also explains the difficulty with forecasting economic impacts of these policies in an environment not seen in a half century.



Source: Bank Credit Analyst (BCA)

The current rally reflects the initial indications of tempering inflation and some softer headwinds. Increases in economic activity from China should soften some of the impact. But, restrictive monetary policies in regions suffering from inflation will likely overshoot and not stick the landing. Fortunately,

markets tend to lead recessions, typically bottoming when the recession begins. The market is digesting more positive data despite medium-term challenges still ahead. Inflation is headed down, but what will be the economic cost of the policies? How quickly will it decline? And where does it settle? We aren't far from being at neutral rates, and further excessive restrictive policy will likely deepen any impending recession.

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