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Research

LKCM International Economic Commentary

May 8, 2023 Mason D. King, CFA

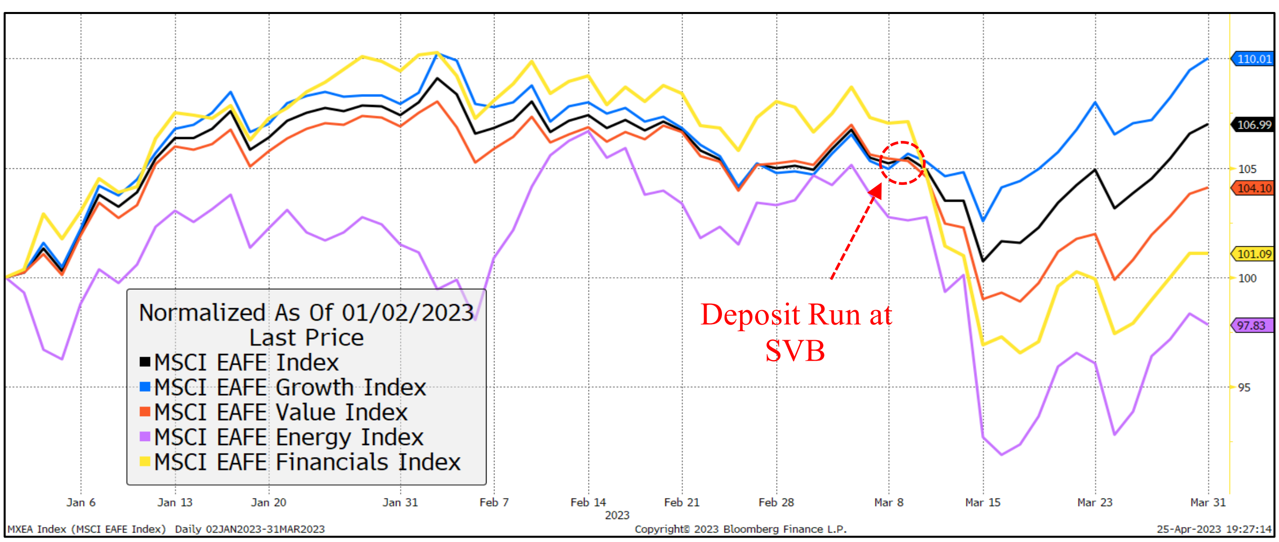
Executive Summary

International markets continued to recover during the first quarter. The MSCI EAFE Index returned 8.6% during the quarter. Value lagged growth as bank woes weighed heavily on cyclical industries during the final month of the quarter. Currency contributed to some of the positive return, but momentum faded from the strength in the fourth quarter. While the Euro and Pound were up slightly, the Yen was actually down modestly. Many foreign currencies still trade at a discount to estimates of purchase price parity.

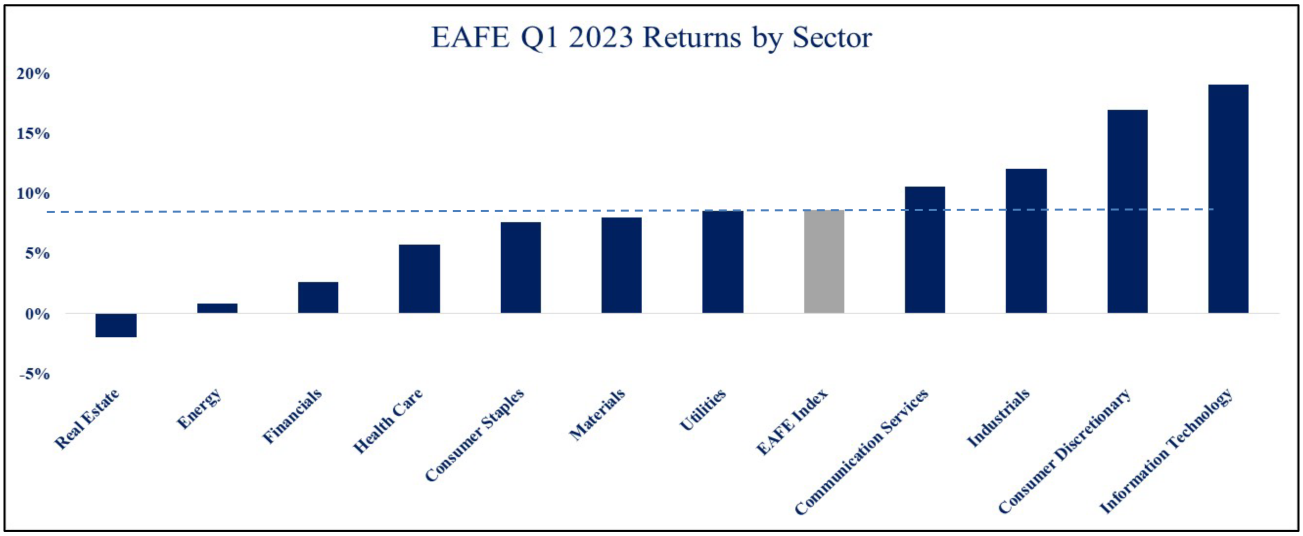
The aversion of an energy crisis in Europe and the reacceleration of Chinese demand have led to a more sanguine outlook for economic activity. Calls for an imminent recession are not as loud, but fundamentals still point towards challenges ahead. Costs of capital have increased across the globe and measures of credit expansion indicate further deceleration in most markets. Policy efforts to contain inflation and introduce economic slack will continue to flow through monetary systems. These impacts will continue to be felt as domestic fiscal excess and China's reopening start to fade, likely, over the next few quarters. We still see a high likelihood of recession developing, but the resilience of some recent measures of economic health provides hope for a more modest slowdown in the effort to contain inflation.

Capital Markets Commentary

The lift in equity market values continued in the first quarter, with all but one sector ending the quarter in the black. Energy and Financials are value-oriented, cyclical sectors that outperformed throughout much of 2022, but the cyclical nature of their industries now weigh on earnings' prospects. Though Energy was volatile early in the quarter, all sector prices were within three percentage points until early March and, ultimately, ended with a thirteen percentage point spread in performance. The move coincided with spate of bank failures, including SVB, Signature Bank, and Credit Suisse, which exhibited the first breaks in financial institutions due to the stresses of a more restrictive monetary environment.

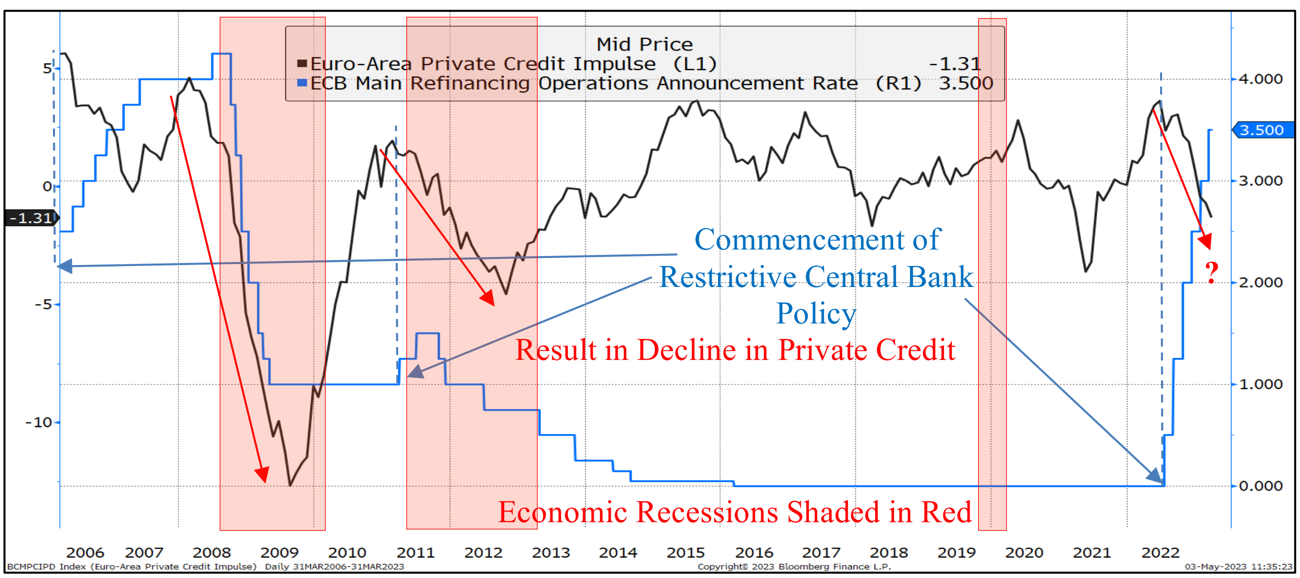


Source: Bloomberg LP



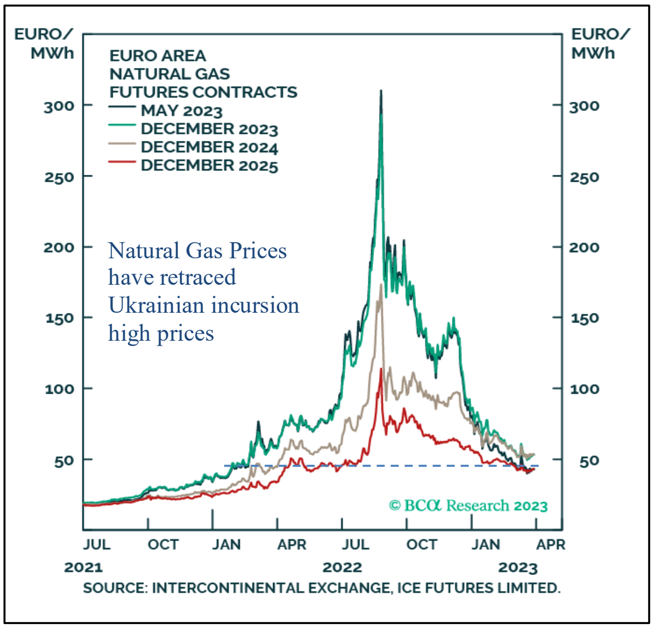
Source: Bloomberg LP

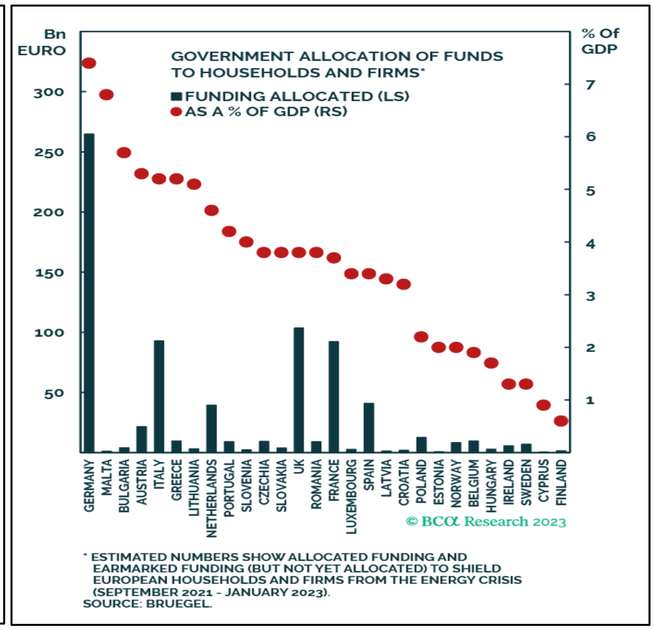
Monetary policy typically experiences a twelve-to-eighteen-month lag before the impact flows through the credit and economic system. The Bank of England kicked off the rate tightening cycle with their initial move in December 2021, with the Federal Reserve (US) and European Central Bank following suit March 2022 and July 2022, respectively. According to this historical precedent, initial moves off ZIRP (zero interest rate policy) are just impacting credit systems with twelve months of additional hikes yet-to-flow fully through economic systems. Recent data shows that demand for loans from Eurozone businesses has already fallen at the fastest rate since the 2008 financial crisis, and the central bank noted "further substantial tightening in credit standards for loans to firms and for house purchases" in the first quarter, as rising borrowing costs and fading confidence weighed on economic activity. The commentary from the ECB highlights exhibits that policy has started to reverberate through financial markets, and policy action over the past year will continue to temper credit creation and economic activity over the next few quarters.



Source: Bloomberg LP

While we see a deceleration in subsequent quarters, the environment – particularly, in Europe – has proven to be more resilient than feared with the first quarter GDP for the European Union posting slightly positive growth. This positive number reversed a GDP sequential decline during the fourth quarter. Energy fears weighed on consumer and business confidence last year, and most European states responded with fiscal policy intended to backstop consumers in the face of higher energy prices. Fortunately, regional leadership scrambled to fill natural gas storage facilities and a mild winter alleviated concerns for persistent shortfalls in supply through 2024. Natural gas storage levels exited the withdrawal period with storage at 55% full, the highest on record since 2008, versus 25% full in 2022. The falling natural gas prices have dampened fears of an imminent recession. Contributing to lower cost inflation for consumers and businesses, fiscal policy has also helped. European governments have either distributed or plan to distribute ~€750 billion (4.3% of GDP) in support of the private sector in order to mitigate the energy costs. The fiscal stimulus provides an offset to more restrictive monetary policy, and the consumer has exceeded more draconian forecasts resulting from an "energy tax" from high prices.

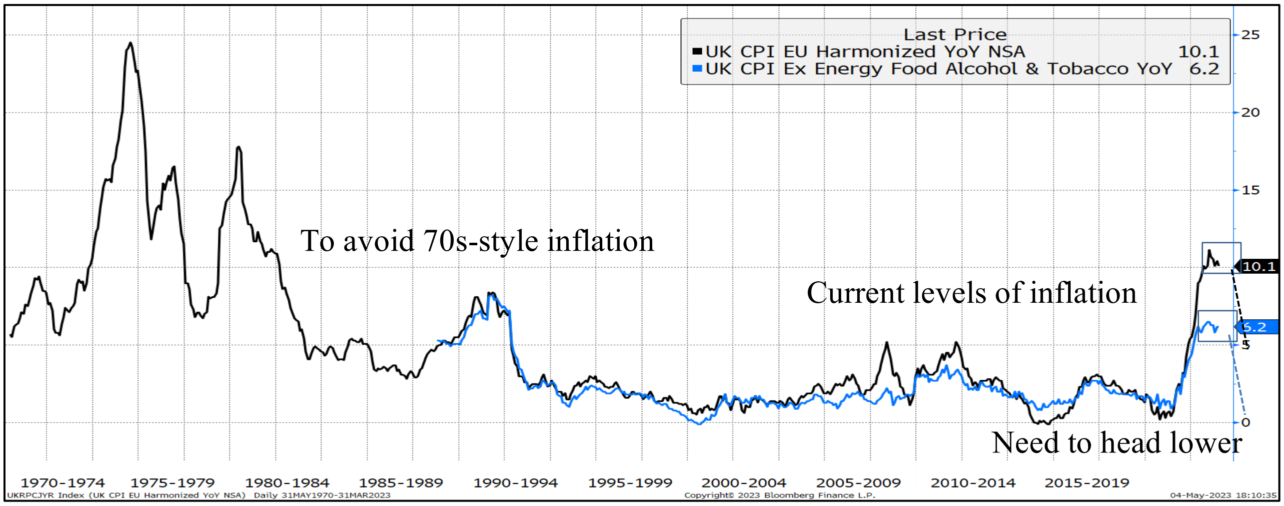




Source: BCA Research

The UK economy is also performing better than many pundits forecast last year. This economy has benefited from a similar set of tailwinds that has supported the European Union. The decline in energy costs has provided the largest positive surprise, but they have also benefited from the rebound in activity in their largest trade partner, Europe, reflected in the improving Manufacturing PMI from October through January. Unfortunately, this measure has rolled over again and touched on a new low in April. The British government has also provided generous fiscal support (3.8% of GDP) in response to last year's inflated energy costs, which have abruptly fallen towards 2021 levels as mild weather supported a healthy inventory. This fiscal stimulus should temper some of the effect of restrictive rate policy. The Bank of England was the first developed central bank to move policy rates in December 2021, and many believe that they will be the first to reverse course.

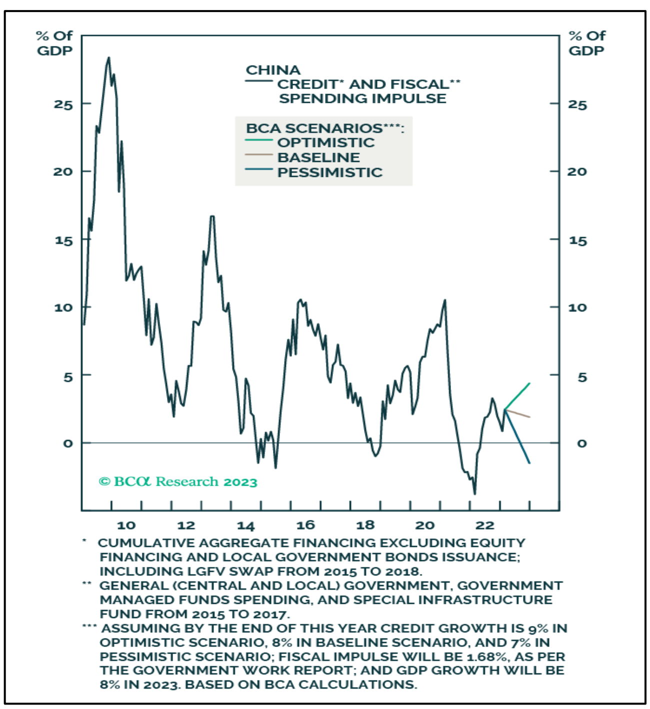
A course reversal will hinge upon a less pervasive inflation outlook. Inflation, as measured by headline CPI, hit 11.1% in October for the UK and has remained stubbornly high despite the decreases in energy prices. Core CPI, which excludes Food and Energy, has been range-bound between 5.8-6.5% for the past twelve months. Any course reversal will depend upon the outlook for prices and labor. Both the U.K. and Germany have the lowest levels of unemployment since 1975 and 1974, respectively. These tight labor markets are contributing to wage growth of 7.4% in the UK. Surveys indicate that job vacancies have declined this year, as have companies' employment intentions. Some areas of past strength now show signs of weakness; residential housing construction, sales, and prices have all fallen over the last few quarters. So, while growth has recently been stronger than anticipated, underlying drivers remain weak. In this context, the emergence of a sustained, European wage-price spiral seems unlikely.



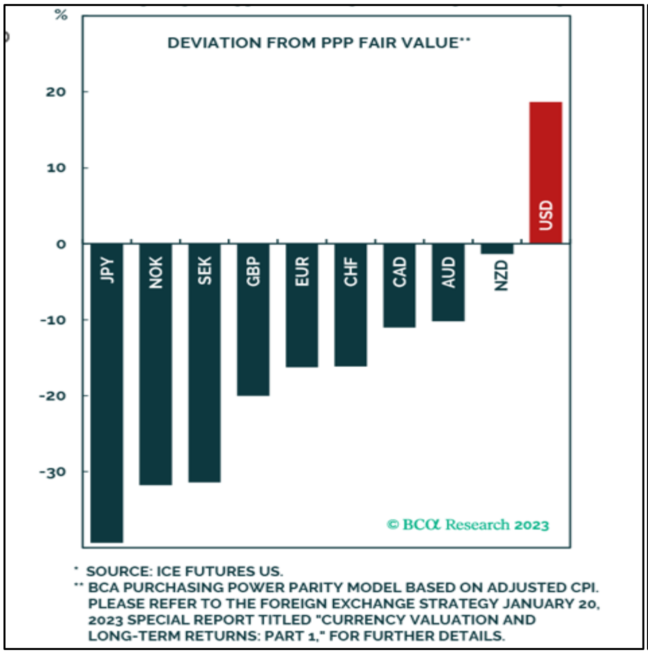
Source: Bloomberg LP

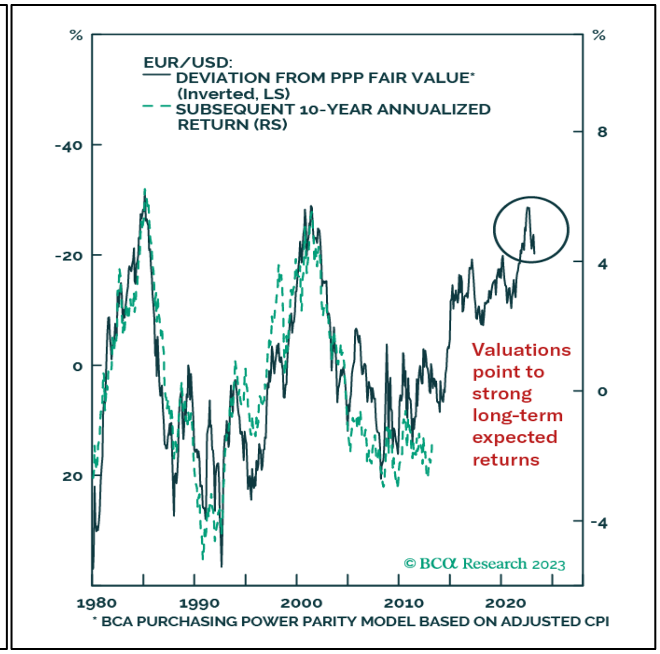
China has emerged from its zero-COVID policy lockdowns from 2022, and the much-hyped rebound in economic activity has led to an additional offset over the prior quarter. Unfortunately, pundits now fear that China's economic growth will decelerate and struggle to maintain trend-like growth (~5%). Consumer products companies have noted increases in sales, and Chinese households continue to hold excess pandemic savings that should provide some near-term support for retail sales. Additionally, the government has expanded support for property developers, allowing them to complete a large pipeline of projects and support construction activity. Demand appears to have stabilized with an increase in sales of residential units after declines throughout 2022. While we have some concerns related to sustainability of further residential expansion due to demographic headwinds, the increased activity should provide another offset to global monetary headwinds. For perspective, China's housing sector alone represents 17% of global demand for refined copper. A Chinese recovery softens any demand erosion resulting from restrictive global, monetary policy in other regions.

The durability of their recovery will be important in determining an outlook for global trade. Last quarter we highlighted the reacceleration of money supply in China, which should provide lubricant for credit and economic expansion. Unfortunately, credit impulse, which is an indicator of credit creation, has stalled after a rapid recovery from contractionary levels. It will be important for continued expansion of credit – and thereby, capital – to support further economic growth, and the baseline scenario in the accompanying chart should support 4.5%-5.0% real GDP growth.



The more benign economic impact of restrictive policies and energy shocks supported rotations into equities and currencies that currently still trade for historically wide discounts. Interest rate differentials and purchase price parity point towards a pretty constructive outlook for many non-USD, developed currencies. The current fundamentals point to a potential bull market. Contributing to recent positive momentum are valuation discounts, which remain high relative to the United States' large capitalization companies.





Source: BCA Research

Over the last two months, concerns have surfaced as to the health of the banking system after some recent failures highlighted the stresses from increased rate policy. The European credit system is unlikely to witness the same deposit runs that have weighed on the US regional banks. European banks' balance sheets are much healthier and capital positions are robust. Debt securities represent <10% of total assets, whereas they represent approximately 19% of total assets for aggregate US banks. Bank deposits are also more stable with money market alternatives representing only 3% of deposit mix versus 16% for US banks. Additionally, Common Equity Tier 1 ratios remain at very high levels, providing better cushion for any potential credit cycle. Balance sheet growth will remain tepid with the current economic backdrop, and demand for credit has declined as growth in money supply has recently turned negative. While a solvency crisis may be contained for these banks, the cyclical stressors will still lead to deceleration in economic growth, though deposit mix and excess capital could mitigate the severity.

We would be remiss if we didn't point out some of the increasing geopolitical risks. Russian invasion of Ukraine has led to an increase in geopolitical tension extending well beyond the confines of Eastern Europe. China-US relations have deteriorated, as military maneuvers over Taiwan have escalated. China has raided consultant offices of US entities, and the US has cracked down on sharing sensitive semiconductor technologies with China (to name a few). Iran has felt emboldened and seized two tankers in recent weeks. They also are rumored to be weeks from enrichment of weapons-grade uranium. These remain tail risks to the global economy, and we pray for peaceful resolutions to all of these diplomatic challenges. But, the increase in political brinkmanship naturally leads to an increased risk of a kinetic conflict.

In summary, the European economies are faring better than feared. China's reemergence from zero-COVID lockdowns provides some offset for many regions, which offsets some portions of more restrictive monetary policy. While tone has shifted less negative, the fundamental backdrop still remains challenging. Inflation remains persistently high – and unemployment record low. These require a monetary prescription that chokes down credit availability in an effort to moderate potential imbalances by creating more economic slack. Credit impulse and bank stress are two recent manifestations of impacts from the central bank action. The full scope of this economic impact will fully work through the system over the next few quarters, and we will reserve our "all clear" from a risk of recession until these headwinds start to subside.

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May 8, 2023

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