LKCM International Economic Commentary

August 22, 2023 Mason D. King, CFA

Executive Summary

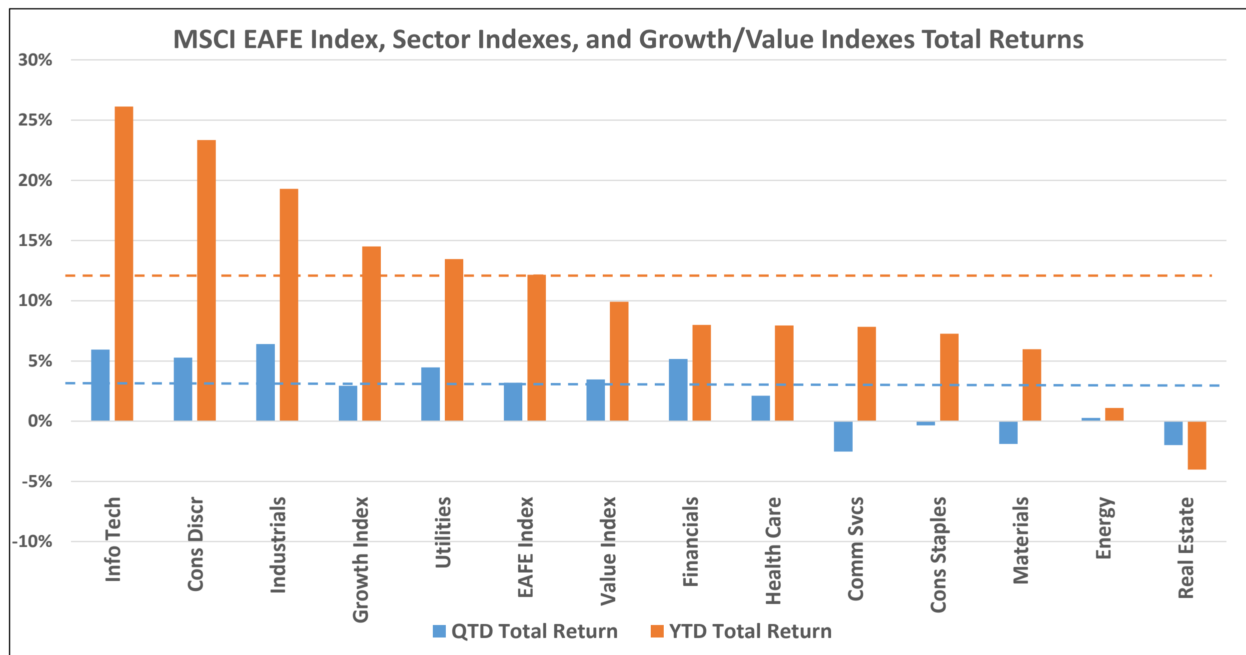
International markets continued to recover during the second quarter. The MSCI EAFE Index returned 3.2% during the quarter. Value led as more positive data on inflation, economics, and earnings promoted cyclical versus growth sectors and industries. Currency had mixed impacts on index returns, depending upon region. While the Pound was up slightly during the quarter and the Euro was essentially flat, the Yen was down meaningfully, returning to levels not experienced in three decades.

The forecasts for global growth have become more sanguine with unexpected resiliency of consumer demand in many markets. Leading Indicators still telegraph weak conditions in manufactured goods and new orders have remained weak. Services PMI have remained barely at expansionary levels, though has shown sequential declines since April for the Eurozone. Manufacturing PMIs have remained in contractionary territory since last July and hit cyclical lows this July. Commercial real estate could pressure future growth, as financial stress decreases construction backlogs and deliveries. While we want to remain constructive on our outlook and acknowledge the recent, more positive data series, the lagged effects of monetary policy, the weak Chinese recovery, and any persistence in domestic inflation prevent us from abandoning the risks of recession over the medium term. Equity markets have responded to the spate of more positive data, but the markets will likely need another economic catalyst before any sustained "Bull Market."

Economic and Capital Markets Commentary

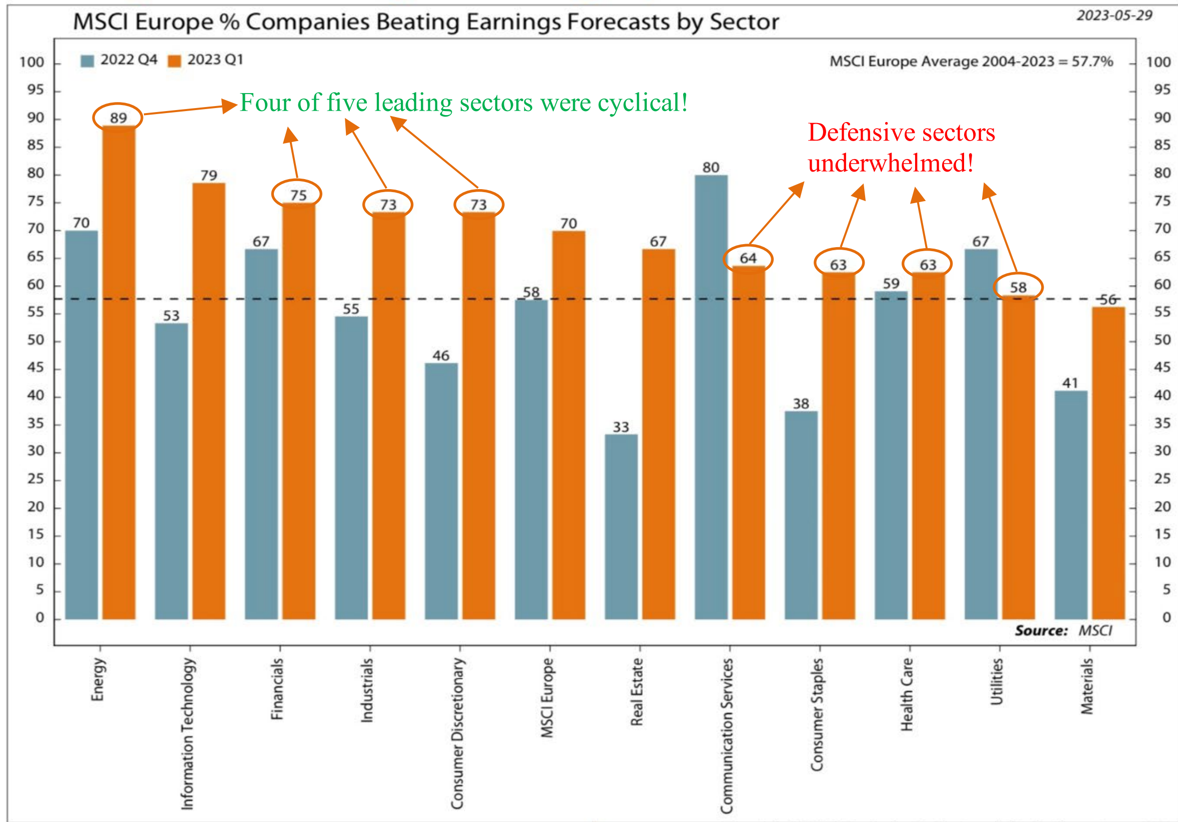
Some of the market momentum in equities from the first quarter started to fade during the second quarter. The leadership in the Industrials and rebound in Financials, drove the Value Index slightly higher for the quarter, though smaller cyclical sectors, Materials and Energy, continued to lag the broader markets. Real Estate also continued to lag the broader markets in both quarters, as concerns remain for persistent stress with higher interest rates, increased construction costs, and on-premises work. Information Technology continued to post the strongest returns for the year with strength continuing in the second quarter.

International markets, represented by the MSCI EAFE Index, are much less concentrated than the United States indexes with the largest single security weight of 2%. The S&P 500 Index has Apple at 7%, Microsoft at 6%, Amazon at 3%, NVIDIA at 3% and Alphabet at 2%. This lower concentration in the international market muted some distortions in returns exhibited in the domestic index, resulting from performance in large constituents as capital flows resumed into our generation's "Nifty Fifty" drove headline index higher without market breadth. Cap weighted indexes versus equal weighted indexes spreads were only +300bps in the MSCI EAFE Index during the first six months, while they were +1000bps for the S&P 500.

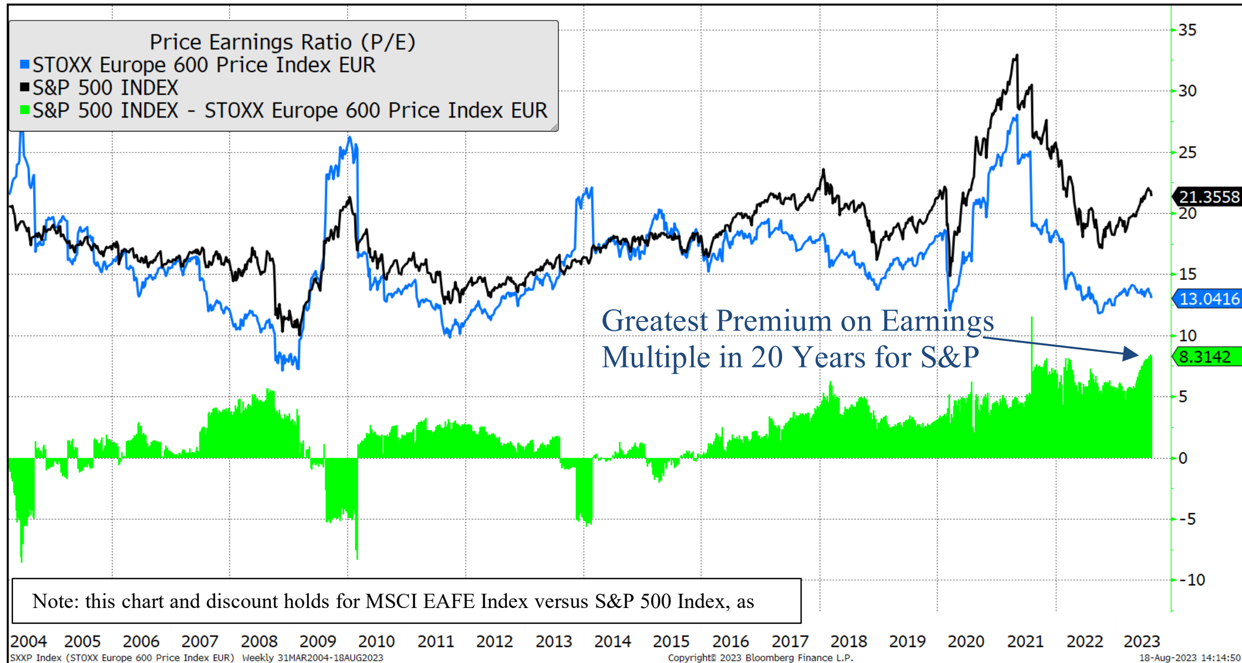


Source: Bloomberg LP

The economic outlook remains very uncertain for markets across the globe. A wave of positive data has provided some optimism for economic forecasts. Cyclical companies continued to post solid earnings surprises, allowing for the rebound in more economically sensitive sectors during the quarter. Retail sales for the European Union rebounded into positive territory from negative real retail sales (y/y) coming into the quarter before turning negative for the month of June, which was released after quarter end. Despite the rise in prices, retail volume has remained resilient – likely, due to both accumulated savings and low unemployment rates. Wages, though inflating due to a tight labor market, have not kept up with consumer price indexes over the last two years. Despite these concerns, the rebound in equity prices reflect good fundamental execution, as the S&P 500 P/E premium to the Stoxx 600 is at levels not seen during the last two decades.



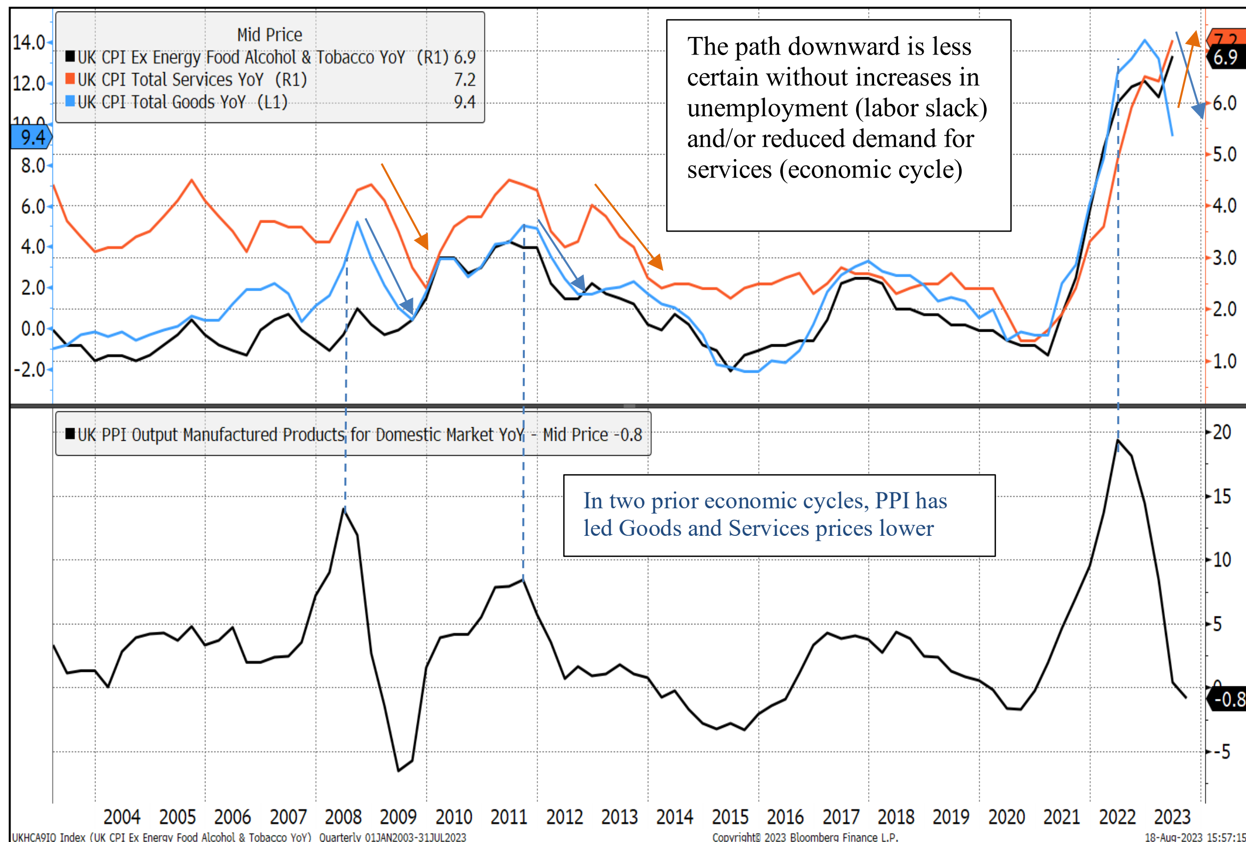
Source: Ned Davis Research, Inc.



Source: Bloomberg LP

Headline inflation continued to decline for both the European Union and United Kingdom, though the decline was driven by falling energy costs and lower goods inflation. Services continued to be a sticky component of

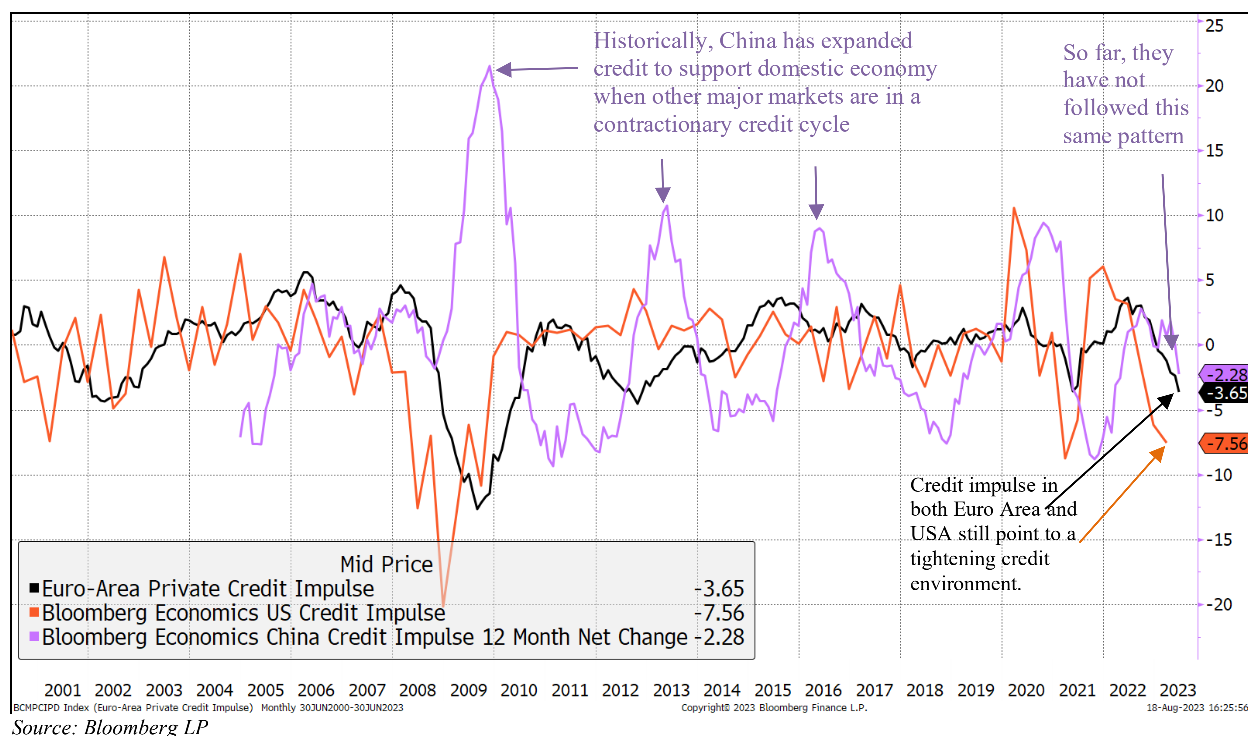
the price indexes, while food and beverage prices remained elevated despite some tempering from the extreme levels. Producer prices have rolled into negative territory over the last few months for both European Union and United Kingdom. The region is now benefiting from lower import prices from China, as they struggle with deflation. Historically, a decline in producer prices lead a decline in consumer price index, but, typically, these periods have services inflation remaining closer to target levels. Services inflation doesn't trend lower until unemployment claims increase, services' demand declines, and wage pressure wanes. At this point, there remains economic "slack" in labor markets, wage pressure remains, and services prices have remained sticky. Lower producer prices with stable demand and employment – and avoiding recession – still appears to be a rosy scenario for prospects of a global "soft landing" as many central banks have charged into restrictive monetary policies.



Source: Bloomberg LP

While the market appears to be pricing a more stable path in discount rates, we still remain cautious on the outlook for economic growth. Most of the aforementioned data reflects coincident or lagging economic indicators. Other data series signal further economic deceleration with prospects for a recession developing in future quarters. The Leading Economic Indicator ("LEI"), which incorporates various data series, continues to weigh on forecasts for growth but has seen some marginal improvement off lows in select markets: United Kingdom, Japan, and the United States. Any continued improvement could support market sentiment for the prospect of avoiding a deep global recession. Manufacturing PMI saw a brief respite from an 18-month slide during the first part of the year, but this series has resumed its slide further into levels indicating a contraction in manufacturing activity. Price expectations for manufactured goods in these surveys have also plummeted, which indicates a swing from disequilibrium during supply disruptions to a more balanced market. Maintaining manufacturing output levels in an environment of deteriorating pricing power would be unusual.

Rate policy continues to both increase costs of and restrict access to capital. As we communicated in our last quarter summary, monetary policy typically takes 12-18 months until the full impact of a rate change to translate into commercial activity. The Bank of England and the European Central Bank have been raising rates consistently over the past year, which poses monetary policy headwinds through 2024. Euro-area private credit impulse still points to tighter lending environment, falling further since highlighted in last quarter's charts. Levels are now consistent with those during 2012 and 2001, which preceded recessions in this region; levels dropped much further during the "Great Financial Crisis", though initially declined less in 2007 before collapsing to record lows in 2008 and 2009. We remain cautious of a default cycle in commercial real estate in key markets (Germany, United Kingdom, United States, and China) weighing on future availability of credit for marginal borrowers.

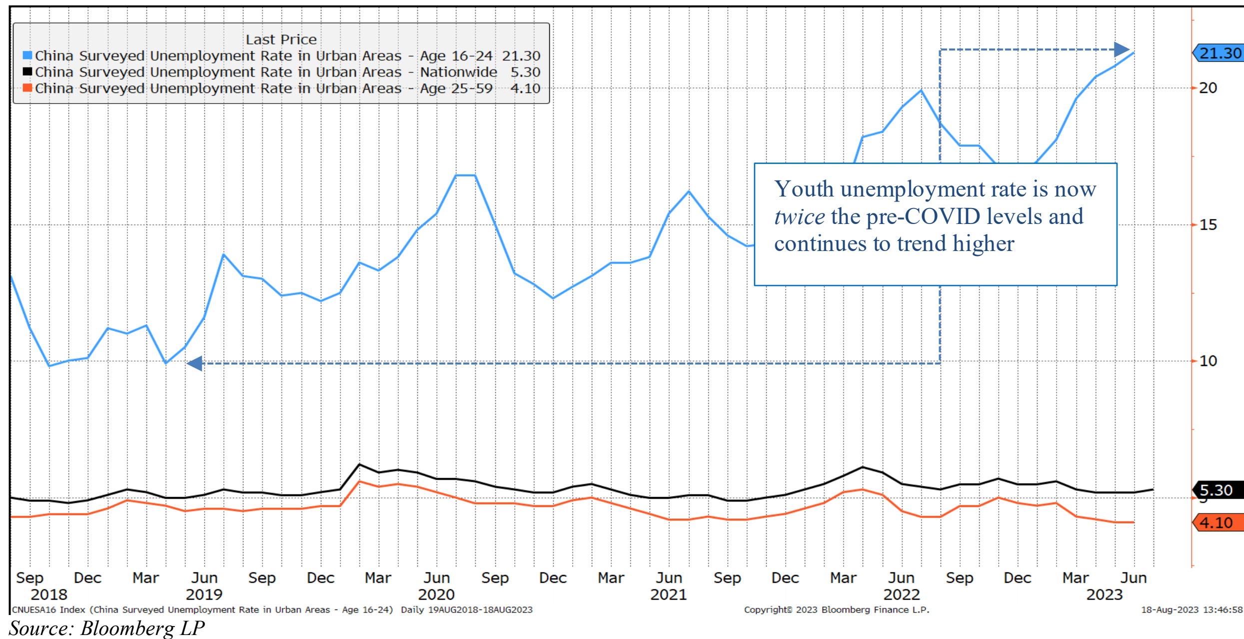


Source: Bloomberg LP

Gross Domestic Product continued to exhibit resiliency. While Germany technically fell into a recession with two consecutive quarters of slightly negative real GDP growth, the European Union maintained a 0.5% year-over-year rate for the second quarter. Japan and Australia saw real GDP growth around 2% during their most recent quarters, but Japan's sequential jump in net exports in the second quarter may prove fleeting as their largest trading partner, China, struggles after an initial – albeit brief – honeymoon period following "zero-COVID" restrictions. In July, Japan experienced its eighth consecutive quarter of declines in exports to Chinese, which was offset by increases experienced in exports to the United States and European Union. Domestic demand in Japan was negative, driven by lower demand from the private sector. Australia hasn't released their second quarter numbers for Gross Domestic Product. As a resource-based exporter, weaker prices for many key commodities could weigh on any rebound in Chinese import volumes. Despite the uncertainty, copper import volumes for China still grew 7% through July in 2023 versus prior year. Demand for construction materials should pose a headwind as real estate developers remain financially stressed and sentiment remains depressed.

China continues to be a source of uncertainty, as they struggle with structural challenges in their financial and real estate markets. The rebound in economic growth was principally driven by domestic services, as domestic activity resumed after lifting restriction. Unfortunately, the real estate malaise continues, reflected in the recent news of defaults by Country Garden – another large developer. Sales of flats fell by another 27% in June from prior year, providing a headwind to achieving the pace economists feel reflects longer-term structural demand.

Additionally, the minor improvement in unemployment was not reflected in the youth unemployment numbers, which hit a record high of 21.3% in June. The National Bureau of Statistics has conveniently suspended additional releases of this economic data, following a pattern of restricting unflattering data. Overall unemployment has declined to 5.3% from 5.6% last December (and high of 6.1% during peak "lockdown") but hit lows in June of 5.2% before ticking higher in July. Credit impulse increased coming into 2023 but abruptly reversed course, dropping to levels below those experienced last year. Peoples Bank of China unexpectedly reduced one set of key interest rates this month, but many pundits feel that it will have a muted impact on financial activity.



Source: Bloomberg LP

Reflecting risks for their markets, the offshore yuan has fallen in value after surging in January, declining 8.5% relative to the USD since those highs. Current rates now match historical lows experienced in the fourth quarter of 2022, when prospects for global growth were much bleaker. Measures of retail sales, industrial output, and investment have failed to match expectations. Additional pressure continues to mount with risks of *deflation* actually weighing on their markets. Forecasts for real GDP growth have fallen since reaching 5.7% in May, and economists currently predict 5.2% growth in 2023. Market participants continue to wait for a more comprehensive response to these mounting risks, and estimates for growth could fall further (Barclays dropped their estimate to 4.5%). Risk aversion has pushed their currency to low levels not seen since the imposed draconian lockdowns on over 70 cities and over 300mm in their population (nearly the population of the United States).

Source: Bloomberg LP

Geopolitical risks remain with the persistent war of attrition in Ukraine. The recent expansion of strategic aggression to focus on *both* Ukraine's *and* Russia's export capabilities for both energy and food products will likely have a muted impact this year, as storage levels for both natural gas and food remain elevated. A more persistent impairment of global supply could undermine these storage levels in the future. German milling wheat futures contracts spiked on the resumption of Russian strikes on agricultural infrastructure, they have subsequently fallen to new lows. European natural gas prices in July have also fallen to prices not seen since prior to the Ukrainian conflict. Geopolitical risk premiums have continued to fall for these key commodities. These military actions punctuate the already existing geopolitical tensions, which drive a deglobalization narrative. The costs of shifting supply chains and responding to diplomatic uncertainty could pose further economic costs – potentially, muting some of the global, deflationary offsets from China. International policy and military engagement remain a large risk, but we do not see these risks posing a "Black Swan" event barring a steep escalation.

International markets continue to benefit from an equity market rally off the Bear Market lows. Despite the increase in value, the price-to-earnings multiple remains at cyclically high discounts relative to domestic large caps, as represented by the S&P 500. Companies have been supporting margins and earnings with pricing power and [now] declining input costs. Stronger than expected earnings have supported current prices in the absence of meaningful multiple expansion. The discount reflects residual concerns with cyclicality in international markets and future economic headwinds, in which this investment universe also carries both lower structural growth and lower return on equity profiles. While recent economic data and company earnings have improved sentiment, high levels of uncertainty for global and regional economies support a price-to-earnings discount to more defensive indexes like the S&P 500. Our economic forecast remains cautious, as the restrictive monetary policy continues to work its way through the marketplace over the next twelve months. Fiscal offsets remain in some markets, but, like the excess consumer savings resulting from fiscal transfers, some portion of fiscal stimulus continues to ebb. Our investment style strives to target great platform companies which should achieve solid long-term returns, despite a high level of nearer-term uncertainties.

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August 22, 2023

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