Research

Quarterly International Economic Commentary

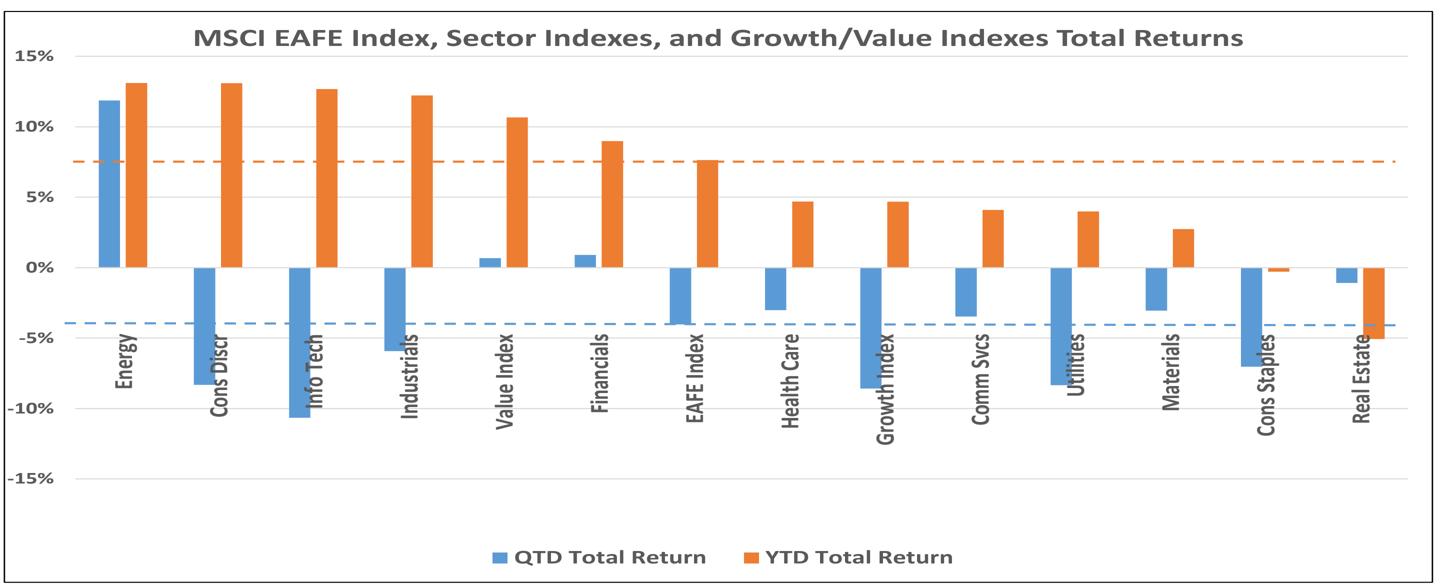
Executive Summary

International markets lost value during the third quarter, as economic concerns mounted in many major economies. The MSCI EAFE Index returned -4.1% during the quarter. Value led again this quarter as Financials, which is the largest sector weight in the index, exceeded the benchmark by nearly 500bps.

Though the United States surprised with strong real GDP growth, both Europe and China decelerated during the third quarter. Eurozone manufacturing PMI hovered at deeply contractive levels after falling to these new cycle lows during the second quarter. Fortunately, the corresponding index for services has remained above contractionary levels – albeit barely. China wrestles with a host of challenges, which could lead to further decoupling despite their aggressive subsidies and falling export prices. Their initial rebound faded, and they are not expected to exceed 5% real GDP growth throughout 2024. Current economic forecasts point to continued deceleration into 2024 for most major economies.

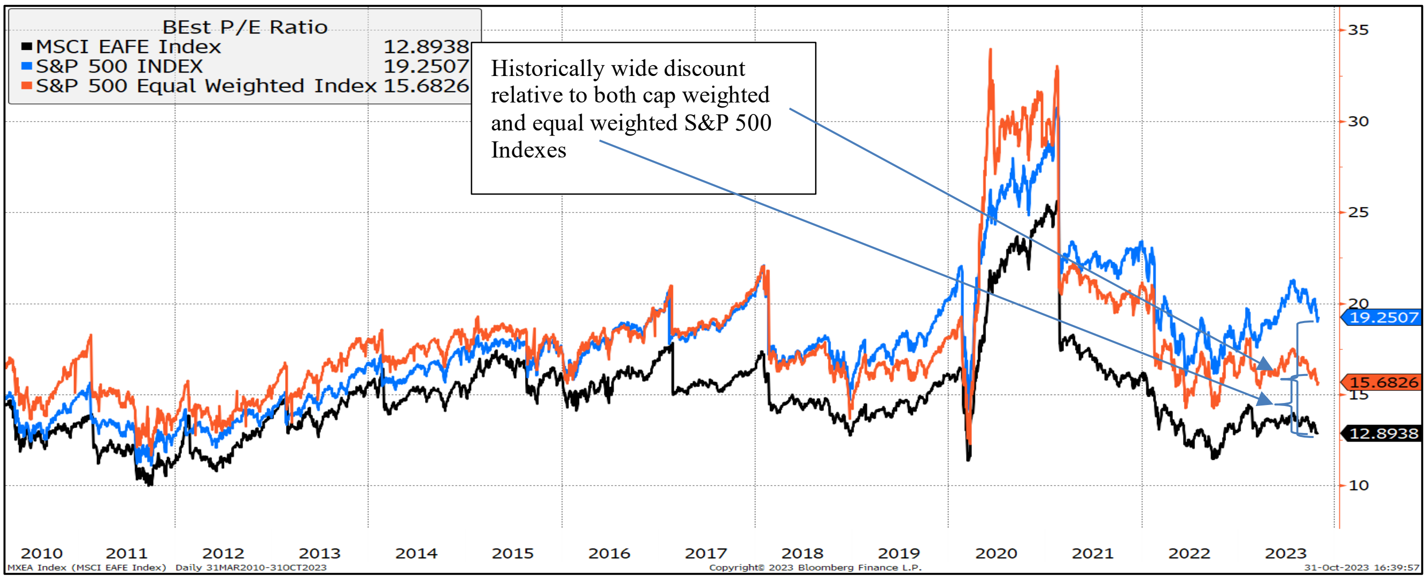
Economic and Capital Markets Commentary

The international markets sold off during the third quarter, as greater economic concerns conspired with a seasonally weak period to drawdown multiple sectors that had provided leadership during the year. Though Energy surged to the top of the list after a strong quarter, the bigger impact on the MSCI EAFE Index came from Financials, which is the largest sector in the Index. This sector represents 19% of the total and was up slightly during the quarter, anchoring Index performance higher for the quarter. Leadership from Information Technology, Consumer Discretionary, and Industrials faded, as they were some of the worst performing sectors during the third quarter. These sectors surged in the first quarter on anticipation of economic benefits from China's reopening. As some of this enthusiasm has faded, the more positive sentiment on these securities has also faded. With the sector leadership during the quarter focused on the Financials and Energy sectors, the MSCI EAFE Value Index meaningfully outpaced the respective Growth Index. After strength in the first quarter, growth has now fallen behind and lags the value index by 600bps for the year.



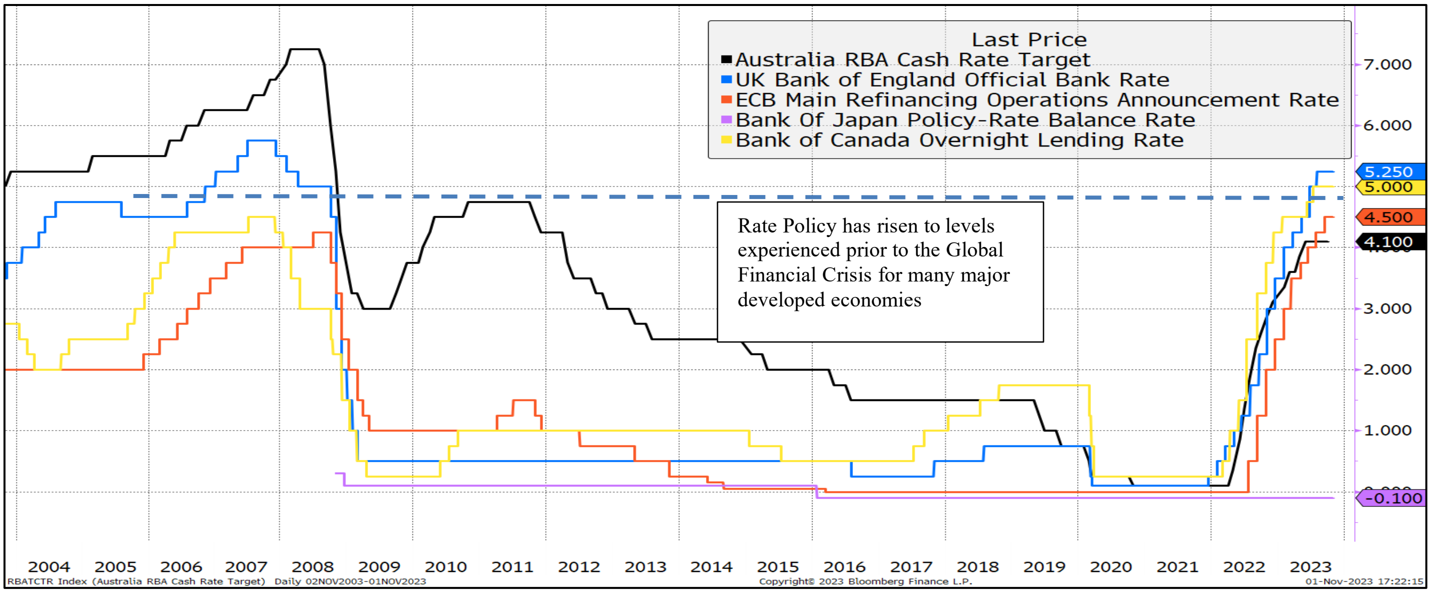
Source: Bloomberg LP

While the price gains for the year remained in positive territory at quarter end, the price for the index weakened relative to the domestic S&P 500 Index. Historical discounts on earnings multiples expanded towards 7x. While the S&P 500 capitalization weighted concentration could impact the simple comparison, we can exercise a bit of "windage". The current contribution to S&P 500 Index price-to-earnings ratio from the top weights is ~3x premium given their rich valuations. Said another way, even after taking into account the distortions created by the "Magnificent Seven" during a period of peak concentration, the discount in the chart below would still be ~3-4x on earnings. This discount certainly appears to be consistent with perceived risks to market and operating fundamentals, and more reflective of the broader U.S. market represented by an equal weight index.



Source: Bloomberg LP

The stress on the market reflects both the reintroduction of inflation into many developed economies and the responsive central banks, which have lifted policy interest rates to cool inflation and introduce economic slack. We are approaching two years since the Bank of England initiated restrictive policy, and many major central banks followed shortly thereafter. Between expansive policy rates and balance sheet expansion, monetary volumes exploded in these major markets, leading to extraordinary liquidity with low costs of capital promoting both fixed and financial asset values. Recent measures of monetary volume have now started to show year-over-year declines for many of these markets in an attempt to reverse some excesses. While most central banks have neared the end of their rate cycles, the impact of these restrictive rates will continue to reverberate through market activity. Actions continued through much of this year, and these actions typically require twelve to eighteen months in order to fully transmit through the credit system and into economic activity. The coordination and magnitude of policy shifts is unique in this period, but prior excesses could temper potential impact. We are in uncharted territory as all central bankers shifted to ZIRP (zero interest rate policy) and then collectively reversed course – with the exception of Japan.



Source: Bloomberg LP

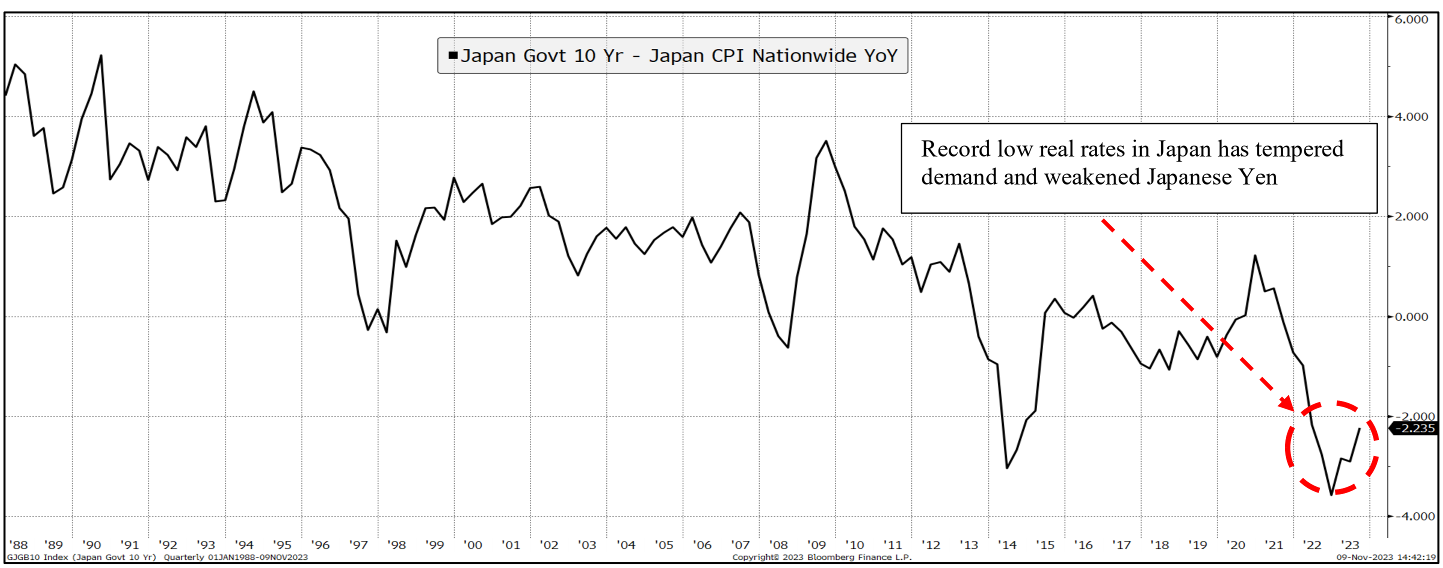
As the year has progressed, economic activity appears to be slowing in Europe. The European Union recently announced their third quarter real GDP growth, and it disappointed expectations with year-over-year growth of only 0.1%. Capital spending and consumptions offset a large trade deficit during the quarter. Germany, which is the largest economy in the union, experienced a *decline* in real GDP from the prior year of 0.8% during the third quarter, following a decline of 0.4% in the second quarter. Sequential growth also declined with recent weakness, falling further into negative territory. Some members exhibited some positive growth – albeit anemic. France posted a 0.7% real GDP growth versus prior year's quarter, but sequential growth also slowed to only 0.1%. The United Kingdom has not released their third quarter Gross Domestic Product, but during the second quarter their economy, as measured by real GDP, grew only 0.6% from the prior year. Collectively, this region saw a dramatic decline in economic growth over the last six quarters.

	Actual Real GDP (yoy %)				Actual CPI (yoy %)				Actual Unemployment (%)			
	Q4 22	Q1 23	Q2 23	Q3 23	Q4 22	Q1 23	Q2 23	Q3 23	Q4 22	Q1 23	Q2 23	Q3 23
China	2.9	4.5	6.3	4.9	1.8	1.3	0.1	-0.1	-	-	-	-
G-10	1.9	1.9	1.6	-	7.5	6.1	4.4	4.2	4.4	4.4	4.4	4.5
USA	2.6	2.2	2.1	4.9	7.1	5.8	4.0	3.5	3.6	3.5	3.6	3.7
Japan	0.2	3.2	4.8	-	3.8	3.6	3.3	3.2	2.5	2.6	2.6	2.7
Euro	1.8	1.2	0.5	0.1	10.0	8.0	6.2	4.9	6.7	6.6	6.5	6.5
Canada	-0.1	2.6	-0.2	-	6.7	5.1	3.5	3.7	5.1	5.0	5.2	5.5
Australia	2.7	2.4	2.1	-	7.8	7.0	6.0	5.4	3.5	3.6	3.6	3.7
Europe	1.6	1.3	0.6	-	9.6	8.1	6.5	5.2	6.0	6.1	6.0	6.5
Austria	2.2	1.6	-1.1	-1.2	10.6	10.4	8.9	6.8	5.0	4.8	5.0	5.5
Belgium	1.4	1.7	1.3	1.5	11.1	7.1	5.0	3.5	5.7	5.6	5.6	5.5
Denmark	0.5	2.6	0.6	-	9.2	7.3	3.6	2.1	4.8	4.8	4.8	4.9
France	0.8	1.0	1.1	0.7	7.0	7.0	6.1	5.5	7.2	7.1	7.3	7.3
Finland	-0.4	0.0	-0.4	-	8.8	-	-	-	6.1	7.1	8.0	6.9
Germany	0.8	-0.2	0.1	-0.4	10.8	8.8	6.9	5.7	5.5	5.5	5.6	5.7
Ireland	10.2	1.1	-0.7	-4.7	8.8	7.5	5.5	4.9	4.4	4.3	3.8	4.3
Italy	1.6	2.1	0.3	0.0	12.5	9.5	7.8	5.8	7.9	7.9	7.6	7.4
Netherlands	2.9	1.9	-0.2	-	11.3	6.7	5.7	2.6	3.6	3.5	3.5	3.6
Norway	1.2	3.3	0.7	-	6.6	6.6	6.5	4.5	3.3	3.7	3.4	-
Portugal	3.4	2.5	2.6	1.9	10.2	8.4	5.7	4.8	6.5	7.2	6.1	6.1
Spain	3.8	4.1	2.0	1.8	6.5	5.0	2.8	2.6	12.9	12.8	12.0	11.9
Sweden	-0.4	1.0	-1.0	-	11.6	11.4	9.8	7.7	6.8	7.8	8.2	7.2
Switzerland	1.2	1.4	0.6	-	2.9	3.2	2.2	1.6	2.0	1.9	2.0	2.1
United Kingdom	0.7	0.5	0.6	-	10.8	10.2	8.4	6.7	3.7	3.8	4.0	-

Source: Bloomberg LP

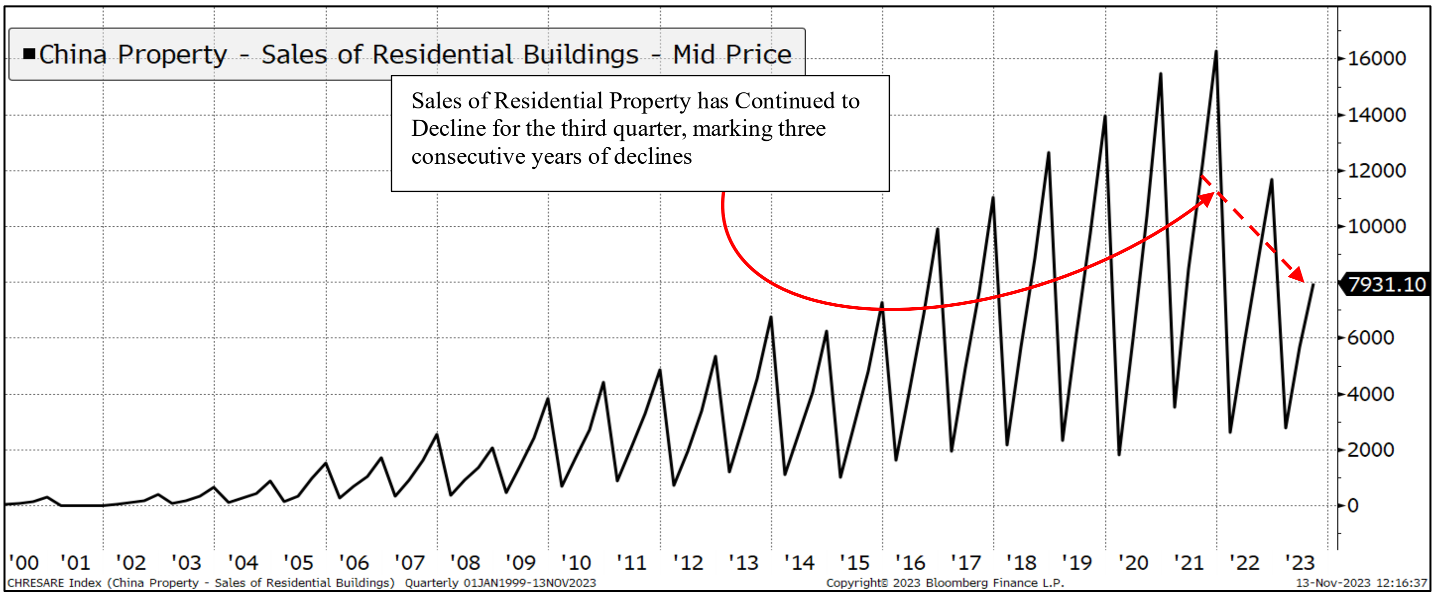
Despite the deceleration, unemployment remains cyclically low, and recent economic stress has yet to lead to material increases in unemployed. With further impact from monetary restriction and less fiscal offset, relative to the United States, we expect many of the European markets to decelerate further over the next few quarters. The progress thereafter will be determined by the actions taken by both fiscal and monetary policy makers. Both unemployment and inflation will determine these actions. Headline inflation, as measured by the CPI, has trended lower, and we expect this trend to continue. While there are many baskets contributing to decelerating price inflation (producer price indexes, consumer prices in China, Chinese export prices), the continued decline towards targets will be important for both consumers and capital markets. Unemployment has moved negligibly at this point in the cycle, but this measure tends to be a lagging indicator. Forecasts call for unemployment in Europe to rise over the next twelve months, but the modest forecasted increase could be manageable without triggering a major decline in consumption. Currently, recent company comments echo the recent rollover in consumer confidence after recovering from the lows set after the invasion of Ukraine. Business and consumer confidence will need to rebound in order to engender demand for goods and services and promote a reacceleration later in 2024.

Japan has continued to realize positive real GDP growth at seasonally adjusted annual rate of 4.8% during the second quarter. Economic growth accelerated during the first two quarters of the year. Domestic consumption in the first quarter and exports in the second quarter led to unique strength. Their industrial production remains very volatile, but after enjoying a solid rebound, excluding brief COVID dislocations, they could see this beginning to trend lower, as major trade partners (US, China, and EU) wrestle with growth over the next few quarters. Current economic forecasts contemplate a slowdown, but expectations are for Japan to avoid a recession. I believe that much will hinge on the external demand, as exports represent 20% of Japanese GDP versus only 11% for the United States. In Germany, exports represent ~50% of GDP. Inflation has been largely absent from Japan, and they have maintained an accommodative rate policy, despite reintroduction of inflation into this market. Japanese rate policy and higher inflation has reduced the attractiveness of both Japanese yields and yen, which has been the weakest of the major currencies, having lost 15% of its value during the course of the year. Their determination to keep rates low with increased inflation has reduced real yields, and they currently sit on the lower end of real returns for major, developed markets. The impact on foreign exchange has likely improved value proposition of yen-originated trade, hopefully supporting exports in the face of reduced domestic purchasing power.



Source: Bloomberg LP

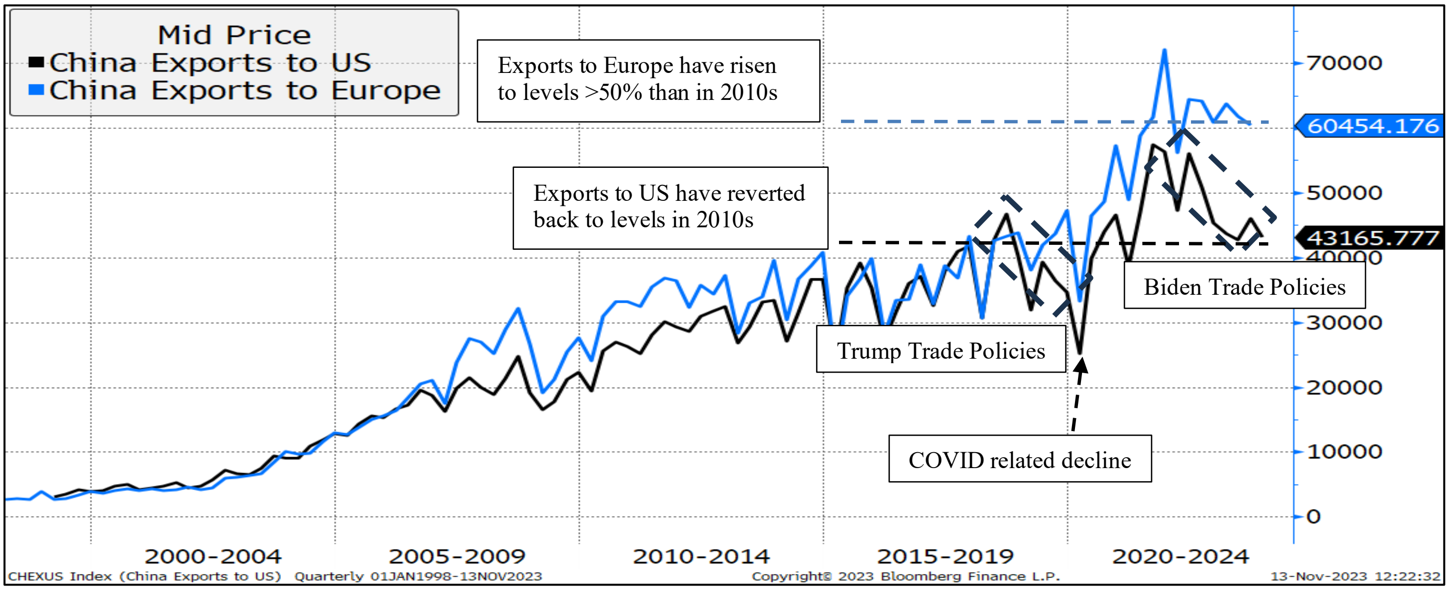
China continues to be a large unknown for the global economy. While they expressed a bounce off the zero-COVID, lockdown policies, the sustainability of this rebound remains uncertain, as property market woes, youth unemployment, and US exports continue to underwhelm. The headline unemployment rate continues to decline – at the margin. This rate declined earlier in the year while youth unemployment continued to rise, but they suspended the release of this data series after June. That raises some questions. Additionally, the attempts to stabilize the property markets have now prevented further stress. Evergrande, once the country's second-largest property developer, initially defaulted in 2021, and recently started proceeding through a bankruptcy process. Unfortunately, real estate transactions continue to weigh on their ability to service debt with monthly sales running at ~6% of 2021-2022 average sales rate. That set them up for a failure to honor a payment in October after a thirty-day grace period. National residential sales data for the most recent quarter have slipped to levels not realized since 2017, showing that these large developers are emblematic of national stress. Property developers were promoted by Chinese cities, provinces and national party, as they drove massive capital programs during the last two decades.



Source: Bloomberg LP

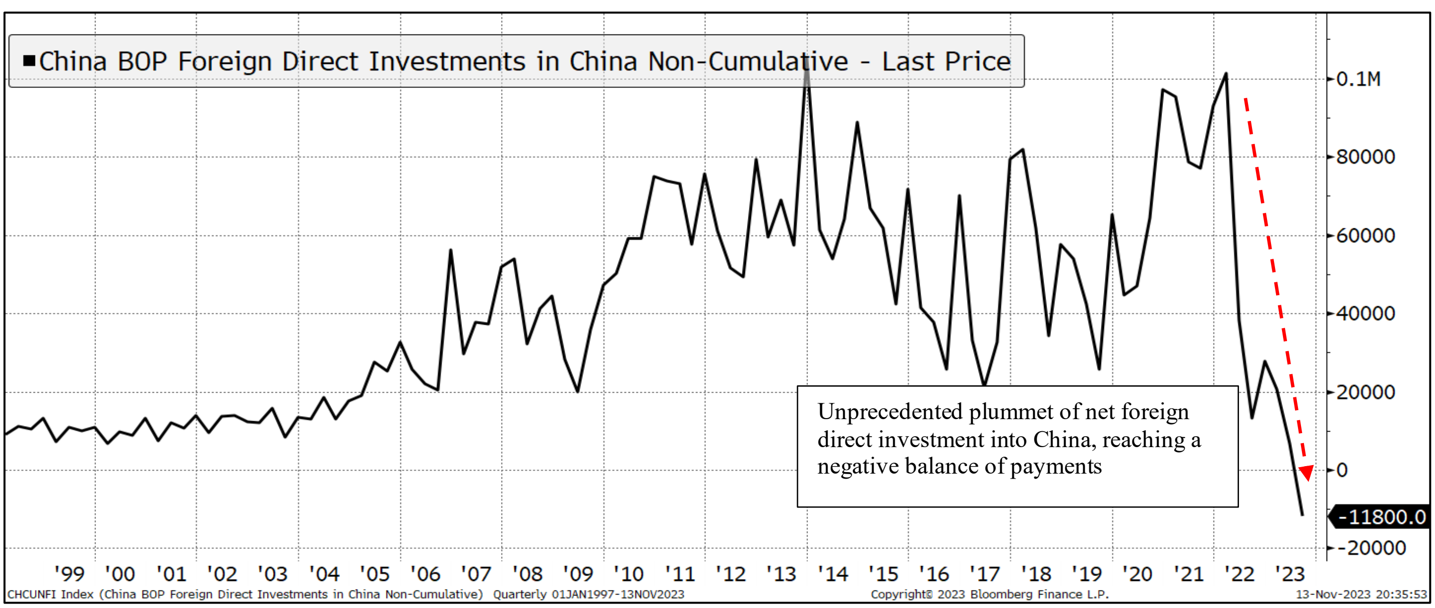
China also has experienced slowing exports to the United States, though exports to Europe have been maintained at elevated levels. The United States has taken more direct action to curb Chinese supply chain concentration. One example of Chinese goods flooding into Europe are the number of EVs now sold in Europe, where tariffs are only 10% versus 25% for the United States, which were imposed by the Trump administration and extended under Biden. They now account for over 8% of the European EV market – up from 6% last year. Their explosive expansion of automobile manufacturers in China and subsequent price advantage over local producers has now led the European Union to both initiate investigations into unfair subsidization and explore ways to protect their domestic industry.

In addition to the disruptive flood of these cars onto European markets, China has also targeted Europe as a destination for other goods now experiencing challenges in the US market. Solar panels and related renewable energy products have been flooding Europe, and local manufacturers are calling for action despite developers embracing cheap foreign panels. According to the Wall Street Journal, "China's state-guided economy spent nearly $80 billion on clean-energy manufacturing last year, around 90% of all such investment worldwide." There are plans for more expansion, and more than 70 listed companies have entered the solar sector in 2022, many with primary businesses in unrelated industries (dairy, fashion, jewelry retail, real estate, etc). According to one company, 60% of the investment in the new manufacturing facilities would be provided by the local government. As the capacity expands, creating a further glut of supply, Europe could take further action to level the playing field and prevent additional disruptive imports (aka dumping). That would leave China with less market access for their exports, as resistance builds on both sides of the Atlantic.



Source: Bloomberg LP

Adding to their potential challenges, China has increased the frequency of actions taken against foreign companies in China. There has also been an increase in the number of prominent business leaders who have simply disappeared. With the political incentives in other regions to diversify supply chains, onshore manufacturing, and near shore manufacturing, companies have been quietly building facilities elsewhere. Foreign direct investments have plummeted and the balance of payments for capital has turned negative – a first. Defaults on real estate, subsidization of domestic industry, autocratic government, poor protection for intellectual property, and export dumping have certainly tempered the amount of capital flowing into China. Time will tell how this impacts their economic structure, but it appears to be limiting foreign capital contributions which could support a rebound in the Chinese economic activity.



Source: Bloomberg LP

Geopolitical risks seem to be increasing though there is very little risk premium priced into the market at this time. The most recent attack by Hamas and subsequent Israeli response only introduced a modest war premium for two weeks in crude oil before the commodity resumed it decline to lower lows. If this war brings in Iran, then the economic impact could be much greater. The lifting of sanctions has brought their exports from 400mmbpd in 2020 to just over 1,000mmbpd in 2023, adding to record supplies from the US. Proxies funded by Iran continue to attack Israel in the north and east, and militant proxies in Syria and Iraq now are staging attacks on US military. Russia and Ukraine continue to battle over the eastern front, but the headlines have been surprisingly quiet, as the war shifts to continued loss of life but with few gains by either side. China has also continued to rattle its saber but, fortunately, with less kinetic military action. Their coast guard continues to harass shipping lanes and shoals near the Philippines. They continue to perform military exercises around Taiwan. While Hamas' terrorist act on October 7th shocked the world, the global economic repercussions have been limited. Instead, this new conflict likely only perpetuates protectionism and deglobalization.

Mason D King, CFA
November 21, 2023

IMPORTANT INFORMATION

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