Quarterly International Economic Commentary

Executive Summary

International markets appreciated during 2023, alongside of strength in the domestic markets. The total return for the MSCI EAFE Index was 18.9% for the year ended December 31, 2023. Information Technology and Industrial sectors were the strongest performers throughout the year.

International markets gained value during the fourth quarter, as a more dovish tone supported a seasonal rally in many major economies. The MSCI EAFE Index returned 10.5% during the quarter. Growth led again this quarter, as sector performance from Information Technology exceeded the benchmark performance by nearly 1100bps.

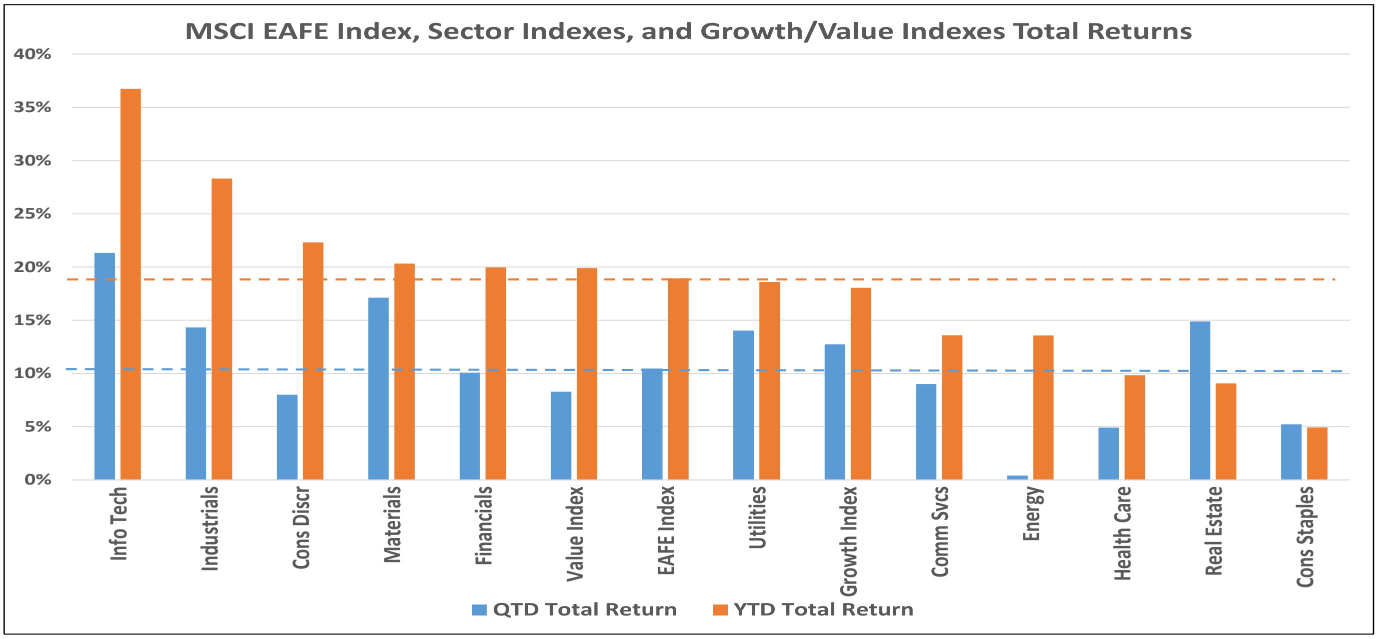
The further deceleration in many markets, weighed on economic growth during the second half of 2023. Europe's real GDP grew at just over 0.0% year-over-year. China grew at approximately 5.0% year-over-year during this time period, which was pretty low against easy comps during severe, zero-COVID lockdowns of the prior year.

Composite Purchasing Managers Indexes (PMIs) for most markets hit lows in late 2022 and retraced back towards lows in the fall of 2023 before heading higher again into 2024. The market returns reflected the shifting market sentiment, rebounding aggressively during the fourth quarter as PMIs recovered and interest rate expectations came down.

Consumer sentiment followed a similar path, but higher lows were realized in the fall as inflation levels ameliorated stress on disposable income. The outlook continues to be opaque, as residual liquidity battles with more restrictive policy over the last two years.

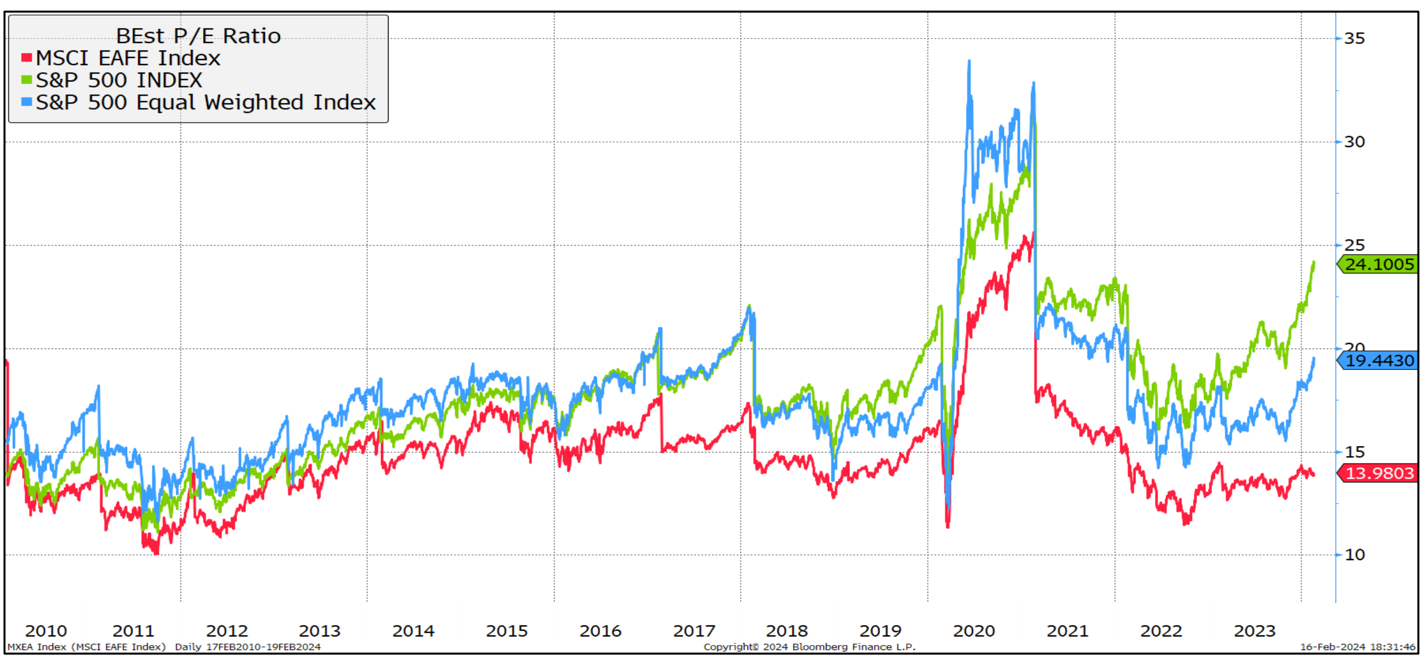
Economic and Capital Markets Commentary

The international markets rallied with the domestic markets during the fourth quarter, as seasonal strength was encouraged by dovish language from the Federal Reserve Bank's chairman, Jay Powell. All sectors posted positive returns for the quarter – and year. The Energy sector reversed course, providing the weakest stock price appreciation during the quarter. Information Technology and Industrials continued to build on the strong performance from the first three quarters to lead the other sectors in the index for the year. These are two of the four largest sectors, representing nearly 25% of the index. Consumer Staples was the worst performing sector for the year. With the tone shift in rate outlook, rates on sovereign debt declined throughout the quarter. This retracement in risk-free rate supported The MSCI EAFE Growth Index, allowing it to outperform the corresponding value index for the quarter. The value and growth indexes performed very similarly for the full year, despite variability quarter-to-quarter.



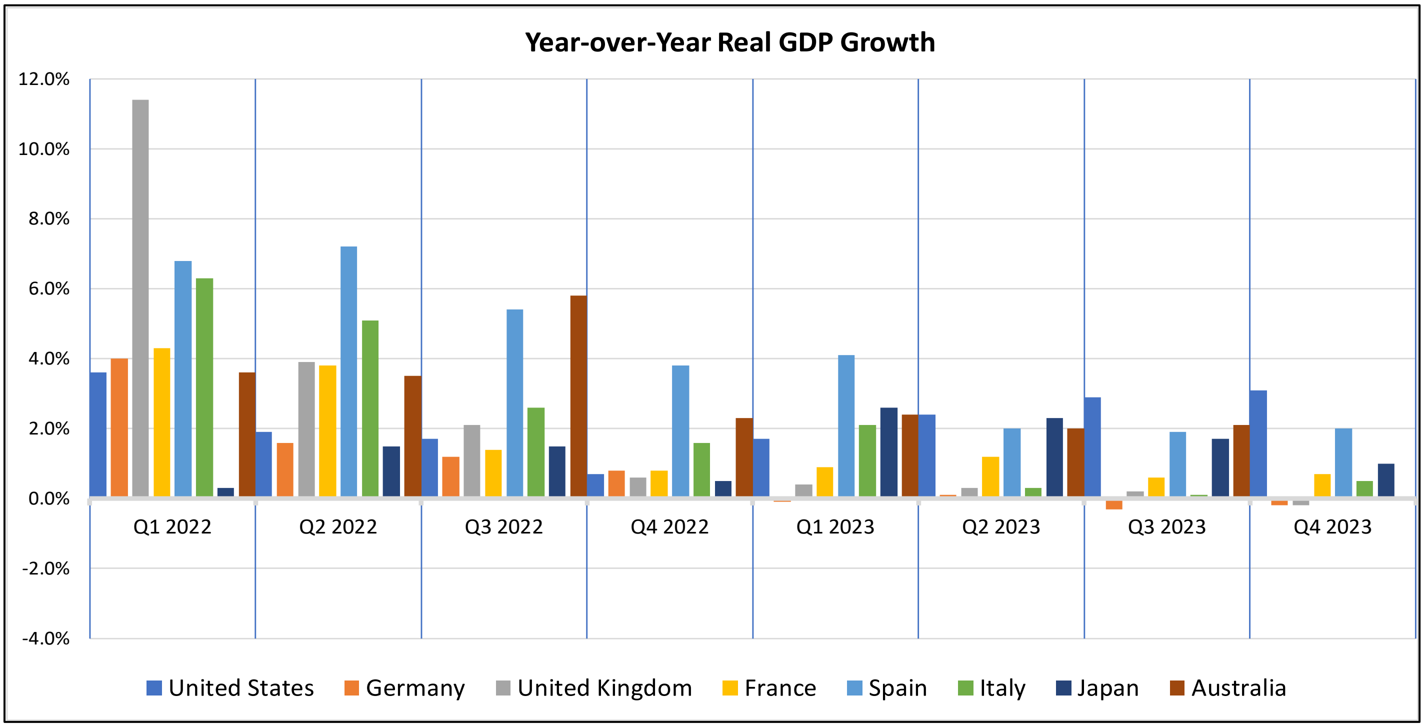
Source: Bloomberg LP

Though the price levels appreciated similarly to the S&P 500 Index during the final quarter, the price-to-earnings multiple for developed, international markets have not seen the same multiple expansion as the domestic markets. While these markets participated in the fourth quarter rally, the breadth of performance enjoyed in the fourth quarter dissolved after the New Year. In the domestic markets, the Magnificent 7 (AAPL, MSFT, AMZN, GOOGL, TSLA, META, NVDA), which represents roughly 30% of the market capitalization weighted S&P 500 Index, broke out again. This small subset has increased ~11% in price this year, while the equal weighted S&P 500, Russell 2000 Index, and MSCI EAFE Index have increased only 0.0-1.5%, explaining the divergence in valuation. The wider discount appears to account for the stresses, whereas the mega cap companies – and, more specifically, mega cap growth companies – appear to benefit from residual liquidity searching for a home. While these seven companies are – generally – great businesses, we also see value propositions for long-term investors in international and smaller capitalization companies, which have not seen the same strength of capital flows supporting premium valuations.

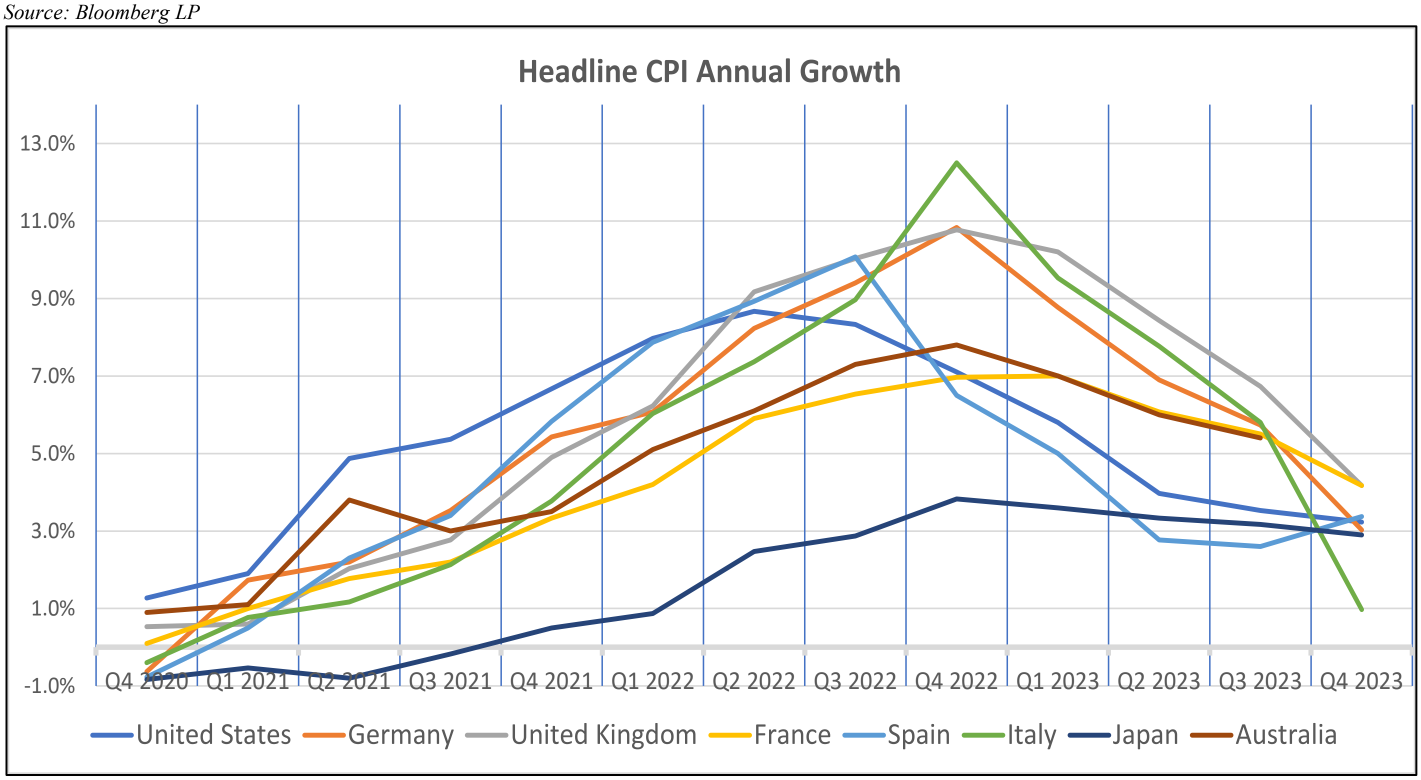


Source: Bloomberg LP

The economic outlook continues to suffer from opacity, and many markets have not shared the resilience of the US economy. As the chart below shows, the current year contains relatively anemic growth for developed countries outside of the United States. Germany currently suffers in a stagflationary environment, where negative annual growth coexists with elevated inflation. Germany has realized consecutive quarters of negative real GDP growth (year-over-year) and has technically moved into an economic recession. The United Kingdom remains another weak economy, though they have been barely able to avoid recession at this point.



Source: Bloomberg LP



Source: Bloomberg LP

While inflation continues to be a persistent issue, the inflation rate for most major markets has come towards much more digestible levels. The energy and goods components that led to an increase in headline prices during 2022 have largely moderated with fuel costs actually decreasing throughout most of 2023. While goods have moderated, they are still running at levels slightly above the target with some exceptions, such as household appliances. Elevated rates of inflation for food supported higher inflation during the first half of the year, but these rates have also moderated. The destructive levels of inflation over 7% have subsided, but the last move to break below 3% appears to still be pretty allusive. The economies with better, recent economic growth – like Spain and the United States – are currently seeing inflation sticky around 3%.

Current forecasts predict further deceleration in global GDP growth to the lowest rates since 2009, excluding 2020 pandemic disruption. Economic weakness is expected to persist in much of the Eurozone during the first half of the year but re-accelerate during the second half. Forecasters expect China and the United States to follow a similar pattern. Unemployment rates are expected to hold firm at these low levels, while inflation is expected to continue its grind lower. With inflation at lower levels, the market currently prices lower policy rates across all major markets by yearend 2024, implying a potential monetary pivot to promote economic expansion. China has been experiencing deflation and weak property markets, and their central bank, PBOC, recently moved to cut its 5-year prime borrowing rate.

The current consensus for global economic forecasts likely relies on both China's economic resilience and the United States avoiding a recession. Both of these appear to be a solid base case, but there is still a collection of risks that could weigh on this outlook: further lags in monetary restriction, persistent stress on property markets, further acceleration in credit losses, and persistent inflation above the target rate. This current outlook seems to incorporate a goldilocks scenario: low unemployment, low inflation, economic growth, *and* lower policy rates. Though Europe continues to languish with little growth, we worry that the expectations of a global recovery in the second half could be derailed with modest changes to economic expectations.

	Real GDP (yoy %)				Real GDP (yoy %)		
	Q1 24	Q2 24	Q3 24	Q4 24	24	25	26
LatAm	0.6%	1.1%	0.9%	1.6%	1.4%	2.4%	2.4%
E. Europe	3.1%	2.1%	1.9%	2.1%	2.5%	2.8%	2.6%
Middle East & Africa					2.9%	4.0%	4.1%
Asia	4.3%	4.8%	4.6%	4.6%	4.7%	4.5%	4.4%
China	4.2%	4.8%	4.7%	4.7%	4.6%	4.4%	4.2%
Taiwan	5.1%	3.7%	2.3%	1.7%	3.1%	2.6%	2.5%
USA	1.1%	0.5%	1.0%	1.5%	1.6%	1.7%	2.0%
Japan	0.9%	1.1%	1.2%	1.1%	0.8%	1.0%	0.9%
Euro	0.1%	0.2%	0.7%	1.0%	0.5%	1.4%	1.4%
United Kingdom	0.0%	0.1%	0.4%	0.8%	0.4%	1.2%	1.6%
Canada	0.3%	0.4%	1.3%	1.6%	0.5%	1.7%	2.0%
Australia	1.2%	1.0%	1.2%	1.6%	1.4%	2.2%	2.5%
Switzerland	0.5%	1.1%	1.2%	1.5%	1.2%	1.5%	1.6%
Germany	-0.2%	-0.1%	0.2%	0.7%	0.2%	1.2%	1.3%
France	0.7%	0.4%	0.7%	1.1%	0.7%	1.3%	1.6%
Italy	-0.1%	0.5%	0.7%	1.0%	0.5%	1.1%	1.1%
Spain	1.7%	1.6%	1.6%	1.7%	1.5%	1.9%	1.7%

Source: Bloomberg LP

While geopolitical risks seem to remain at elevated levels, the markets do not appear concerned with any further stress on supply chains and global trade. The Israeli offensive moves into its fifth month, as Iranian proxies continue to attack Israel, Red Sea shipping lanes, and United States' military assets. Despite their cowardly drone, missile, and rocket attacks, these terror groups have been unsuccessful in prompting an escalation. Iran likely would not desire a direct conflict with Western nations, but they are walking a fine line of "plausible deniability" and interwovenness into the fabric of these terror networks through financial support, military equipment, and strategic guidance. Ukraine continues to be a war of attrition, with munitions and manpower slowly being depleted, and international support will be crucial to holding the current battlelines.

China continues to conduct military exercises and to harass shipping lanes. Taiwanese have voiced their opinions at the ballot box, electing a President who staunchly supports independence. Certainly, there may be lessons for the Taiwanese from the disenfranchisement experienced by Hong Kong citizens after the United Kingdom handed their territory to China. In elections last year, China prevented any candidates from outside of the CCP, and the election turnout plummeted to only 27% of eligible voters. This stands in stark contrast to the 71% turnout in 2019, when pro-democracy candidates won a landslide victory.

Many major economies have increased scrutiny of China for its trade practices. The United States has already tightened some of its restrictions on chips, renewable energy, and electric vehicles. Last September, the European Commission launched a probe into Chinese industrial subsidies for electric vehicle manufacturing. Industrial subsidies have been a common tool utilized by national, regional, and local officials to drive development in China. This sponsorship can lead to excess global supply, typically costing global market share from more market-driven companies. The current tenuous environment poses risks for further protectionist policies.

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February 22, 2024

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