LKCM
LUTHER KING CAPITAL MANAGEMENT

Research

Quarterly International Economic Commentary

Executive Summary

International equity markets rose during the third quarter, as optimism and lower capital costs favored reflation of equity assets after multiple central banks commenced their accommodative cycle for policy rates.

Rate sensitive sectors (Real Estate, Utilities, and Financials) tended to be the better performing sectors for the quarter. Value has led Growth over the last two quarters by 430bps.

The overall MSCI EAFE Index rose 7.3% during the quarter as sentiment seemed to look through the challenging environment and toward economic stability and, eventually, strength.

Exports will be a key component to watch, as China, a major trade partner to many developed economies, continues to languish, weighing on some of the demand from multinational companies serving this market.

Europe continues to navigate treacherous waters as Germany teeters on the edge of recession and industrial output and manufacturing surveys for Europe point to better, though still contractionary, levels.

Japan teeters on the edge of recession, as they continue to see their domestic consumer contributing less and their exports negatively impacted by the poor consumer environment in China. Australia has avoided recession through an acceleration in government spending, while the consumer and exports decelerated to historically low rates.

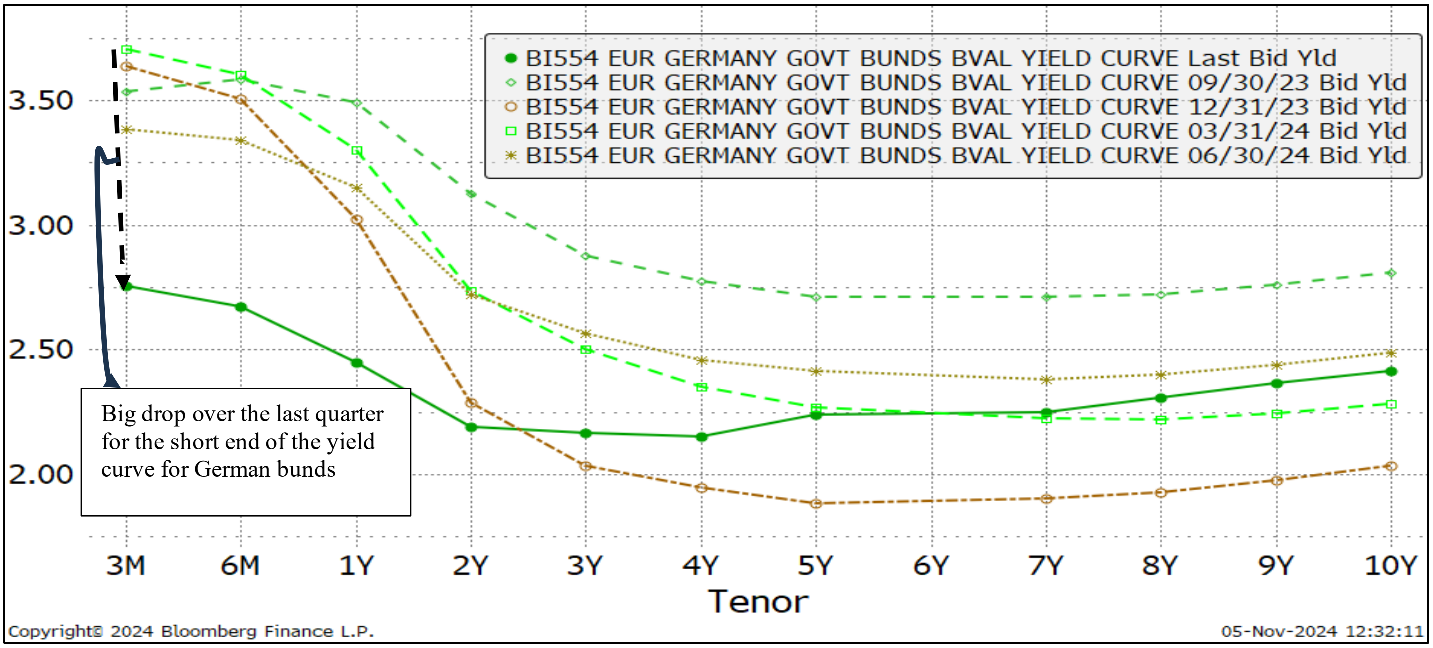
Datasets point to economies late in a cycle, but current economic forecasts point to resiliency.

Unemployment rates in many markets remain structurally very low but, cyclically, appear to be turning higher. Domestic consumption – both public and private – have prevented recessions, despite pressure of increased costs of capital and inflated costs on many consumers and companies.

European industrial activity has remained under pressure as demand remains tepid, wage pressure builds, and labor productivity has turned negative. We will look for improvement in industrial sentiment and employment trends to underpin a thesis for durable "soft landing."

Economic and Capital Markets Commentary

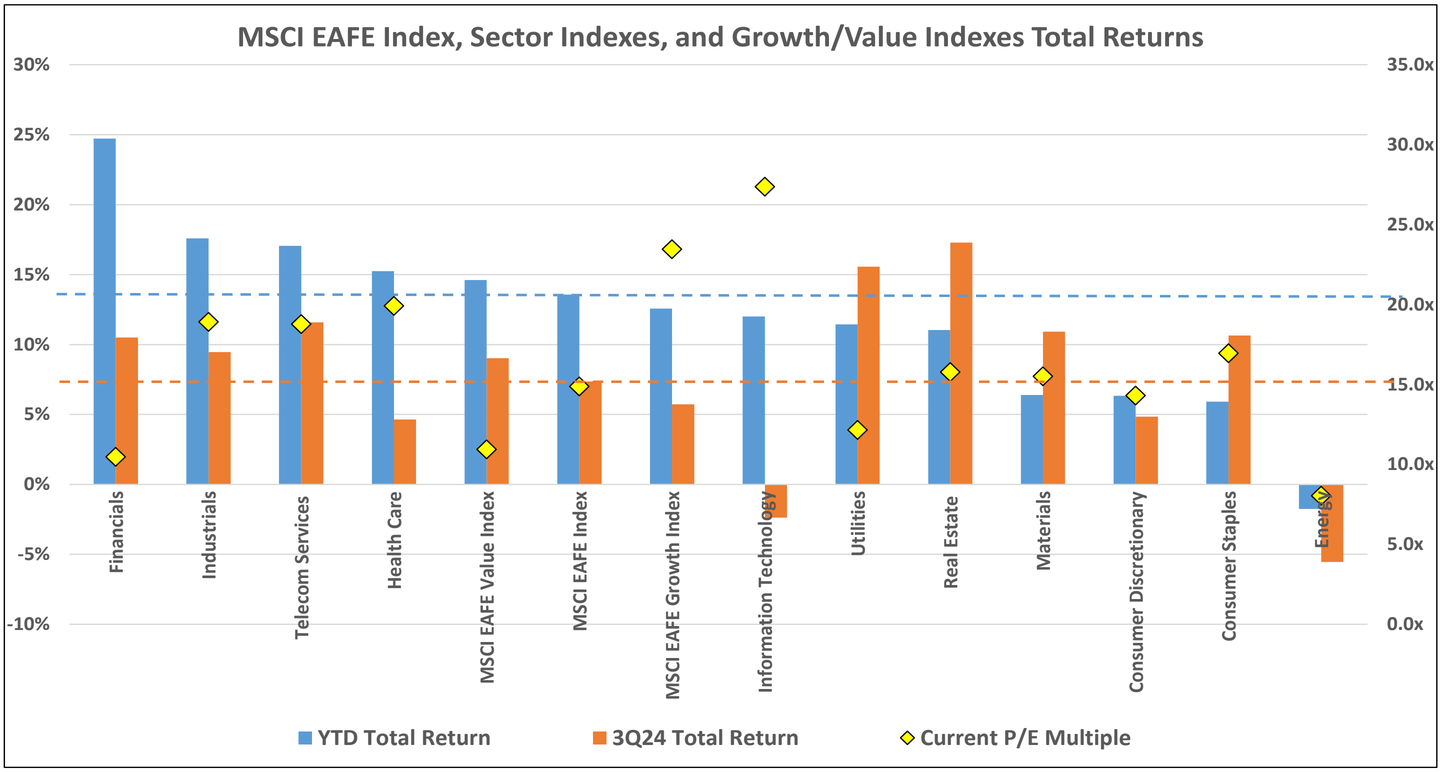
The international markets, as represented by the MSCI EAFE Index, rose 7.3% during the third quarter as more asset and yield-sensitive sectors led the move higher. As such, the MSCI EAFE Value Index continued to outperform its corresponding growth index by 330bps during the quarter. As many central banks further cut policy rates for their markets, global short-term rates fell from cyclically high levels. The decrease in the shorter end of the yield curve drove values higher for companies providing current yields relative to those with greater anticipated future yields.



Source: Bloomberg LP

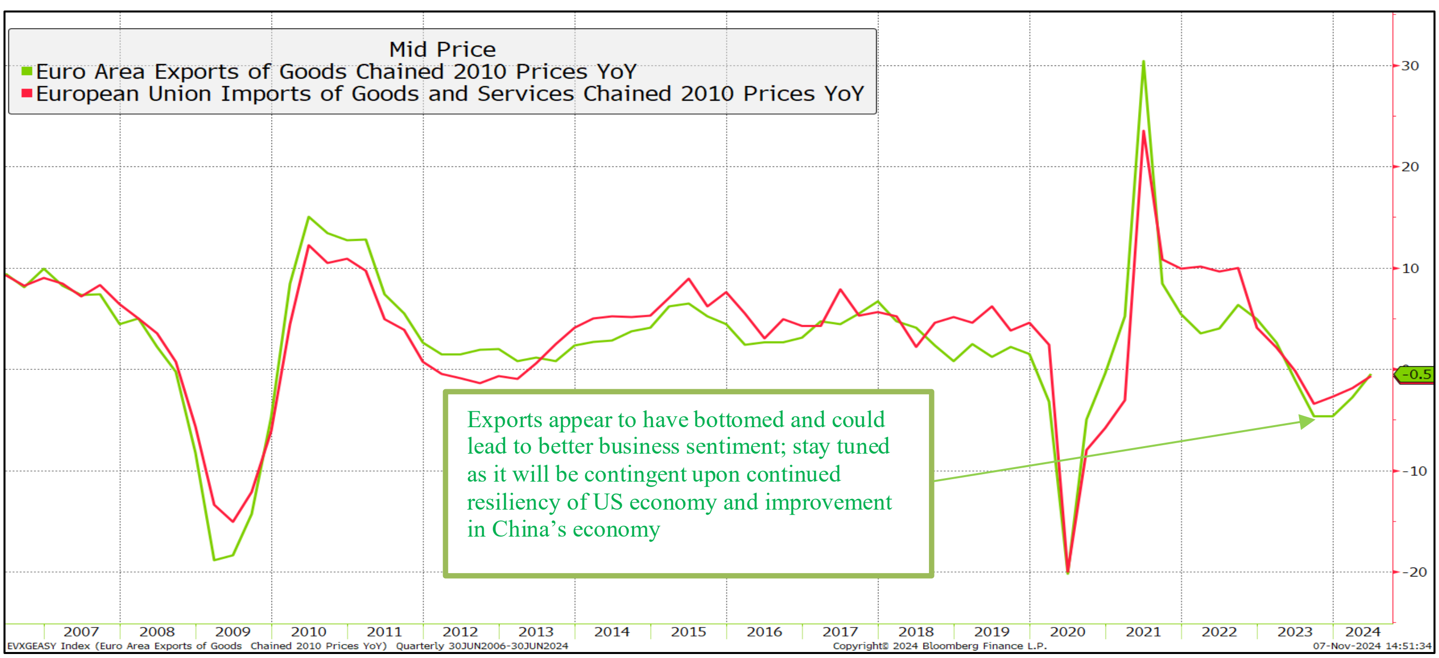
Source: Evercore ISI

Real Estate, Utilities, and Telecommunications led sector performance during the quarter. Financials continued to perform well during the quarter, overtaking Information Technology to lead sector-level performance year-to-date. Information Technology and Energy were the only two sectors with negative performance during the quarter. Information Technology continues trading at premium multiples, while Energy trades at the lowest multiples on the current year's estimated earnings. Brent Crude prices continued to fall, dropping from $87/barrel to $79/barrel as potential supply imbalance overshadowed geopolitical risk premium. The lower price environment reduced expectations for cash flows on production estimates. Overall, sectors experienced further broadening from the narrow leadership earlier in the year with all sectors except Energy in positive territory. The MSCI EAFE Value Index now leads the MSCI EAFE Growth Index by 200bps for the year.



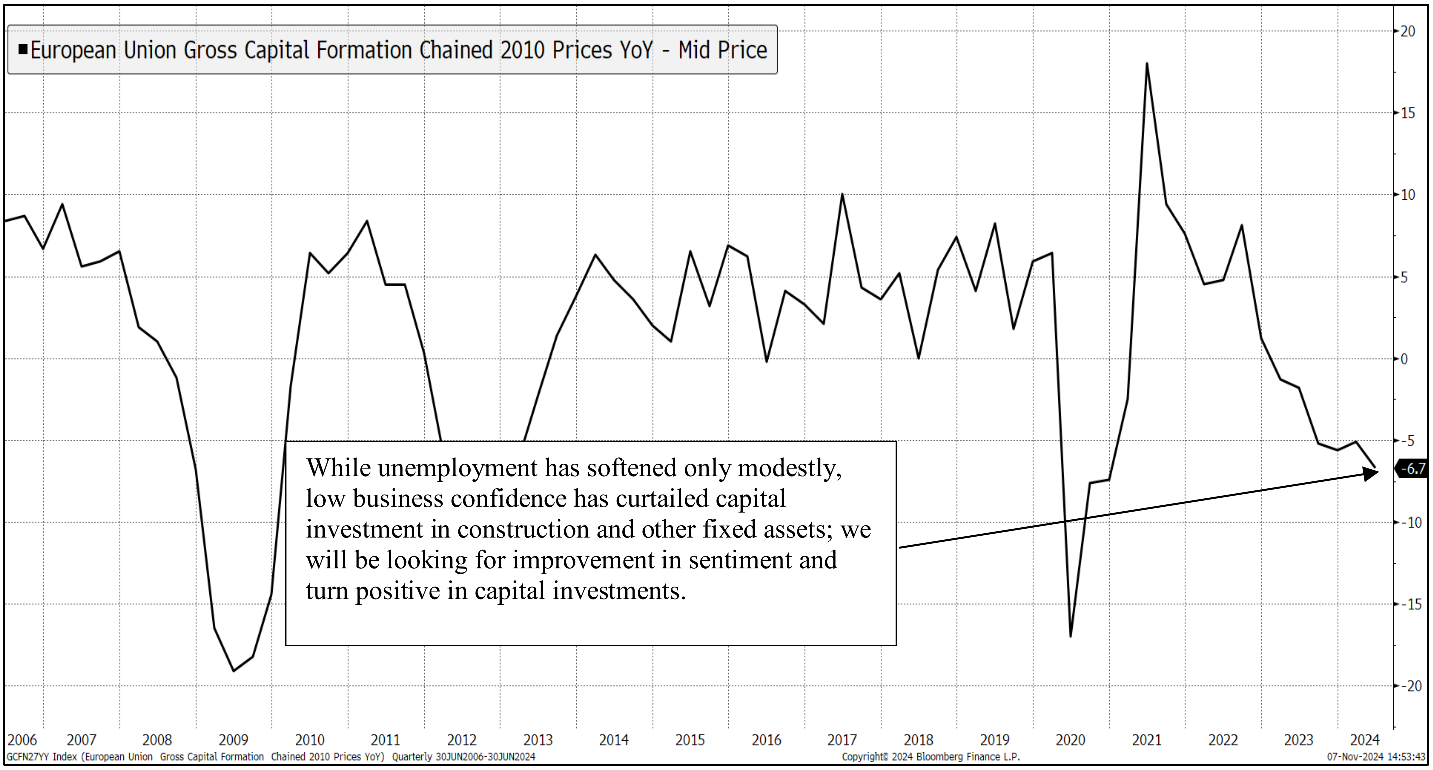
Source: Bloomberg LP

Though decelerating, European economies continue to struggle with the challenges of manufacturing malaise with, generally, more optimistic services activity. The Manufacturing PMI in the Eurozone for October gained a point to 45.9, but this level has remained in contractionary territory (<50) since July 2022. Services were slightly higher for the month at 51.6 but remained below the seasonal strength from the second quarter, which averaged 53.4. Fortunately, this service index is marginally above the contractionary levels of last year's third and fourth quarter. After turning negative in early 2023, exports turned positive in 2024, while imports followed a similar pattern. We would look for continued improvement in trade to support further stabilization in economic activity for the region, which appears to lead to annual real GDP growth.



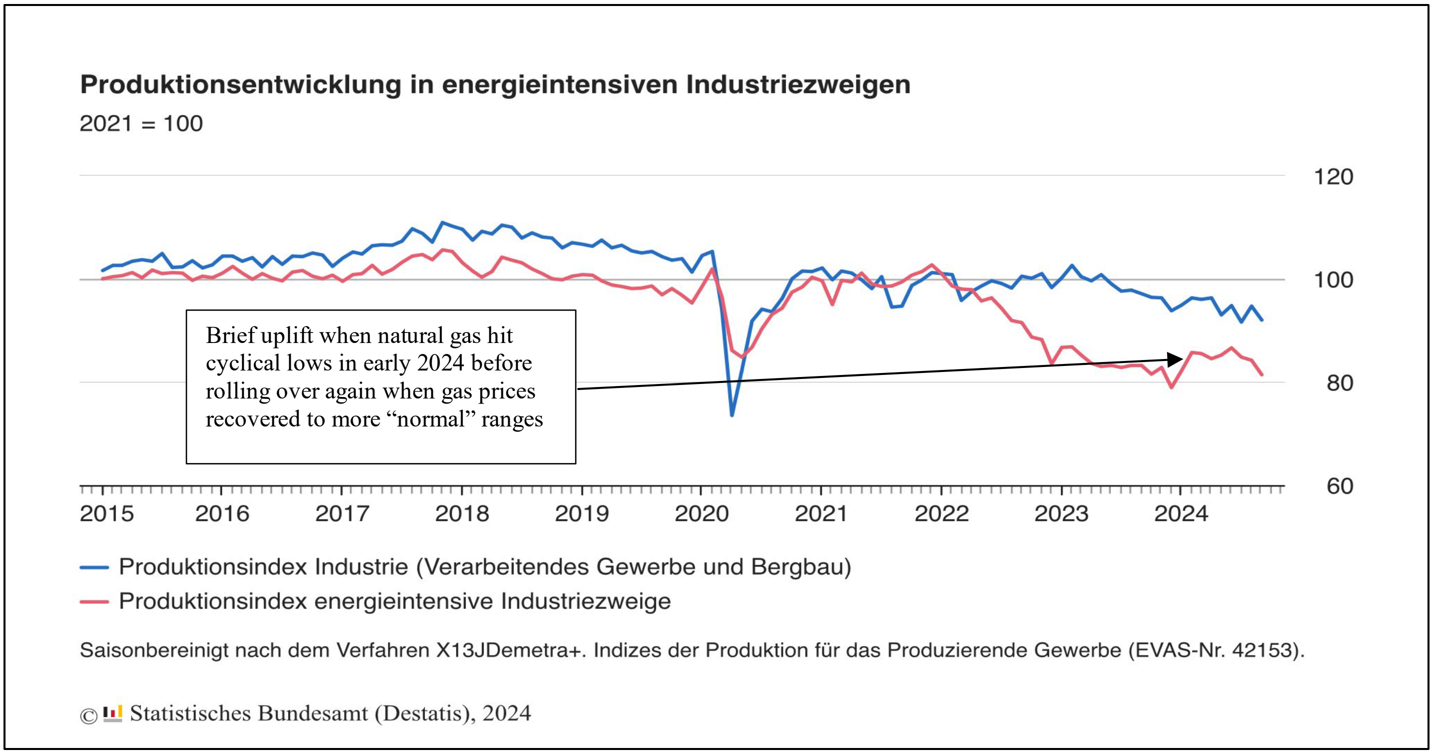
Source: Bloomberg LP

Domestic consumption contributed positively to GDP growth during the last few quarters. Still, government expenditures grew disproportionately relative to GDP *and* household consumption, contributing to the rise in growth in the previous four quarters. Alternatively, Gross Capital Formation (Investment portion of G+C+I+(X-M)) has been plummeting, as construction activity and business investment soured over the last eighteen months. Manufacturing and exports should improve capital investment activity in future quarters. These rely upon healthy export markets. Central bankers in Europe have acted to spur activity through a more accommodative rate policy. The European Central Bank has lowered policy rates three times this year, despite core inflation leveling around 2.7% in aggregate for member states. Germany and Great Britain maintain core inflation over 3.0%, while other countries now have core inflation closer to 2.0%.



Source: Bloomberg LP

Structurally, policy and its resulting environment have hamstrung some local manufacturing. The aggressive mandates on EV vehicles and flood of Chinese imports, prompted Volkswagen to announce the closure of "at least" three factories in Germany, which is a first in the company's long history. Further, energy-intensive industries continue to feel the strain of rising costs, partly due to carbon mandates and energy transition. Industrial production from energy intensive industries continues to remain at ~82% of pre-pandemic levels. While probabilities for recession have remained subdued for many European economies (20-30%), Germany has seen the likelihood of recession climbing to an average of 60% across the 13 economic forecasters providing estimates to Bloomberg.

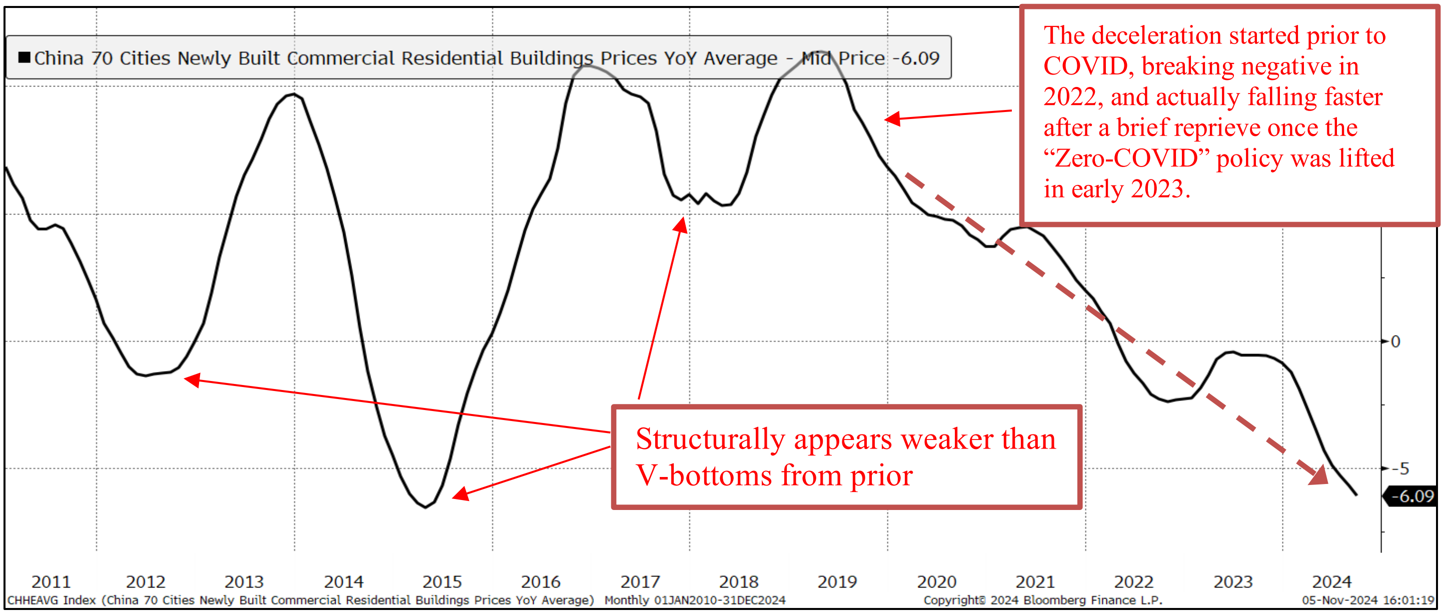


Source: Federal Statistical Office of Germany

While Germany struggles with their economic transition, Japan continues to dance along the edge of recession. They have seen their domestic consumption bounce in the last quarter, but this will not significantly boost GDP growth. The more significant contribution will be prospective contributions from a recovery in export trade, which has been under pressure, volatile over the last six quarters, and averaged only half the growth rate of the prior twelve years. Japanese public spending has remained constrained and does not provide fiscal support for GDP growth like some of its OECD peers. Despite two consecutive quarters, Q1 and Q2 2024, of negative real GDP growth, the recession probability remains low at 30%. Despite the challenging environment, Japan appears to be bumping along with underwhelming prospective growth over the next two years. Japan also remains the outlier, with its central bank, the Bank of Japan, *increasing* policy rates *twice* during the year. The rate differential against the U.S. rates set up carry trades, which pressured the Yen. Some of the calculus for the rate decision may have been to preserve the purchasing power of their domestic currency and consumers, while balancing against maintaining opportunities for exports with a weaker currency.

Australia continues to have positive economic growth, led by government consumption (estimated to increase by 4.4% in 2024) and offset by weak export activity and capital investments. Like many markets, inflation continues to cool – albeit slower. Australia appears to be set to show some acceleration in real GDP growth after the deceleration experienced in 2024. The prospects for improved Chinese demand for raw imports from Australia will determine the trajectory of a market. 60% of their total exports are tied to natural resources (mining and energy), and 32% of their total exports head to China, according to the Reserve Bank of Australia.
China continues to struggle with a weak consumer and real estate market. Monthly retail sales in China averaged 12.6% annual growth from 2010-2019 but only 3.8% since 2020 (the last numbers were 3.2% for September). Despite efforts to raise domestic consumption to provide domestic support to GDP growth, consumption contributed approximately 60% of total growth for five years before COVID. This contribution to GDP growth was 52% in the most recent year. The Chinese consumer continues to struggle as nominal wage growth has decelerated over recent years, and residential real estate prices negatively impact wealth effects, as real estate is a large portion of Chinese household investments. The People's Bank of China (PBOC) has reduced its medium-term lending facility rates by nearly 100bps since December 2021, and average mortgage rates have fallen by 230bps. The Ministry of Finance announced in mid-October further action, saying that it would issue more federal

debt to boost property markets, recapitalize state banks, and assist struggling local governments. This more direct fiscal support would supplement monetary action, but capital deficiencies are significant, and few details were provided. Economists have estimated that China needs to spend up to $1.4 trillion in additional stimulus over the next two years, representing ~56% of total tax revenue realized in 2021.



Source: Bloomberg LP

These actions taken by the central government appear to be working to rebuild household and investor confidence. While they pressed forward with stimulus, the government also took action against finance and e-commerce. The uptick in the disappearance of individuals critical of the CCP has turned increased as the government tightens its grip on dissent. Additionally, government officials have asked wealthy individuals and companies to carry out "self-inspections" of tax payments and pay any deficiencies. This action has stirred unease and fear, and authorities have also asked individuals to start paying back taxes, including from their personal overseas investment gains, people familiar with the matter said, in some cases citing a little-used legal provision from 2019. Total tax revenues in 2017 in China were approximately 30% of GDP, according to the State Administration of Taxation, which is close to the OECD average of 34%. The drive by central and local governments also includes significant increases in fines and penalties, as *both* total tax revenue dropped 5.3% *and* revenue from land sales fell another 25% this year. These moves to increase revenue come as China's debt levels rise. China government debt-to-GDP ratio increased to 83.6% at the end of 2023 – now higher than the aggregate European Union government debt ratio of 80.8%. The Chinese economy continues to work to find a solution to plug its capital and consumption holes with a renewed push toward tax revenue and increased debt. The tone appears to be very different than earlier in the millennia when central and local governments benefited from tailwinds of high [positive] levels of foreign direct investment, government influence on capital allocations, and low debt levels. Over the next few years, the actions will determine if they can navigate these more challenging economic waters with less external support, as foreign direct investment was again negative for the recent quarter.

The current outlook remains for China to maintain mid-4.0% growth. China posted a 4.6% real GPD annual growth rate during the third quarter. This was a slight deceleration from the prior quarter. Economic forecasts continue to express a protracted deceleration over the next two years. Still, they have decreased the likelihood of a recession to 13% from 15% last quarter, likely due to the new stimulus efforts. These estimates consider an orderly cycle in China, but systemic disruption (e.g., financial crisis) in their capital markets could introduce more significant hurdles to overcome. Challenges experienced by China will spill over to major, developed economies, as approximately 9%, 20%, and 32% of exports from European Union, Japan, and Australia, respectively, were bound for China during the 2022-2023 timeframe. Surveys of China Sales by Evercore ISI continue to hover at new, two-decade lows.

Source: Evercore ISI

Geopolitical risks will always be an issue for multinational companies and portfolios. Though we would like to remain optimistic about the current state of the world, there appears to be a higher risk of conflicts expanding. Iran and Israel have had two episodes of direct engagements, which have mainly been avoided over the last few decades as Iran relied upon proxies for its dirty work: Hamas, Hezbollah, and Houthis. Iran has recently promised a more significant response after Israel's successful attacks following Iran's initial, two – largely – failed attacks. North Korean troops have entered Russia to train and, possibly, engage in the Ukrainian conflict. While North Korea and Iran had provided weapons, this move marks an escalation, as soldiers appear ready to participate alongside their Russian allies. China continues to loosely support these states with accusations of providing components for weapons and supporting trade activity for this axis. The election of Donald Trump, with a mandate through the expansion of Republican control of the legislative branch, could provide further uncertainty. His "peace through strength" and brinkmanship tactics, yet desire for less involvement, could lead to many outcomes, some of which could increase geopolitical risks. We will watch carefully how his new administration navigates these volatile waters.

The economic soft landing continues to be the consensus forecast for most major markets. The European Union, Japan and Australia continue to look towards a reacceleration into 2025 and 2026. Risks for a recession have increased in Germany, as they struggle with increased competition, restrictive policy mandates, and increased energy costs. China continues to search for the silver policy bullets to recapitalize local governments and state banks, stabilize real estate markets, and rebuild consumer confidence, which continues to plumb new depths in September, according to the series from China's National Bureau of Statistics. The government may have less flexibility to respond, as [known] debt levels have risen and foreign direct investment has dropped. While growth is expected to continue its deceleration, a recession is not expected.

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November 15, 2024

IMPORTANT INFORMATION

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