LKCM
LUTHER KING CAPITAL MANAGEMENT

Research

Quarterly International Economic Commentary

Executive Summary

International equity markets maintained their momentum during the first quarter on the heels of modestly higher economic optimism, despite a modest increase in rates. The MSCI EAFE Index returned 5.8% during the quarter.

Growth led again this quarter, as sector performance in Information Technology again exceeded the benchmark performance by over 800bps. Continued uncertainty in the economic outlook still weighs on more cyclical and value-oriented segments of the market.

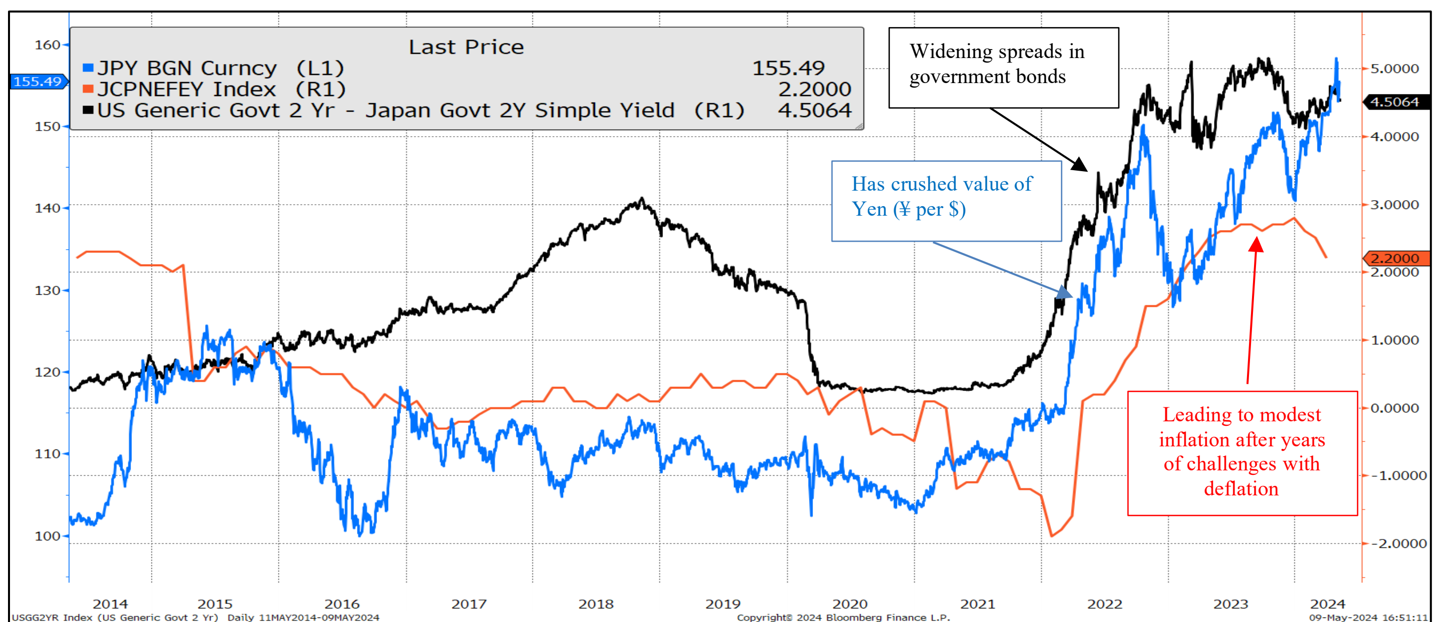
Consumer and business sentiment improved during the first quarter in many markets. European markets grew ahead of expectations, driven by the marginal shift toward positive growth in Germany.

Uncertainty remains high, as consumers remain stressed in all markets and government spending has disproportionately contributed to positive GDP growth. Manufacturing Purchasing Managers' Indexes need to shift into expansionary levels above 50, and consumers need to regain solid footing to provide greater confidence in the sustainability of a path for modest growth.

Disinflationary trends must allow central banks to maneuver towards more accommodative rates to ease burdens on business investment and consumer debt.

Japan remains an outlier with relatively low inflation – albeit bucking their deflationary tendencies. Their two-year government bonds moved meaningfully into positive rate territory for the first time in a decade, though they provided little support to the Yen, which suffered from rate spreads and carry trade (sell Yen, buy Dollar).

Yields moved higher during the first four months in all developed markets, as higher than expected economic growth, positive sentiment, and persistent inflation reset expectations for the expected pace of interest rate cuts.

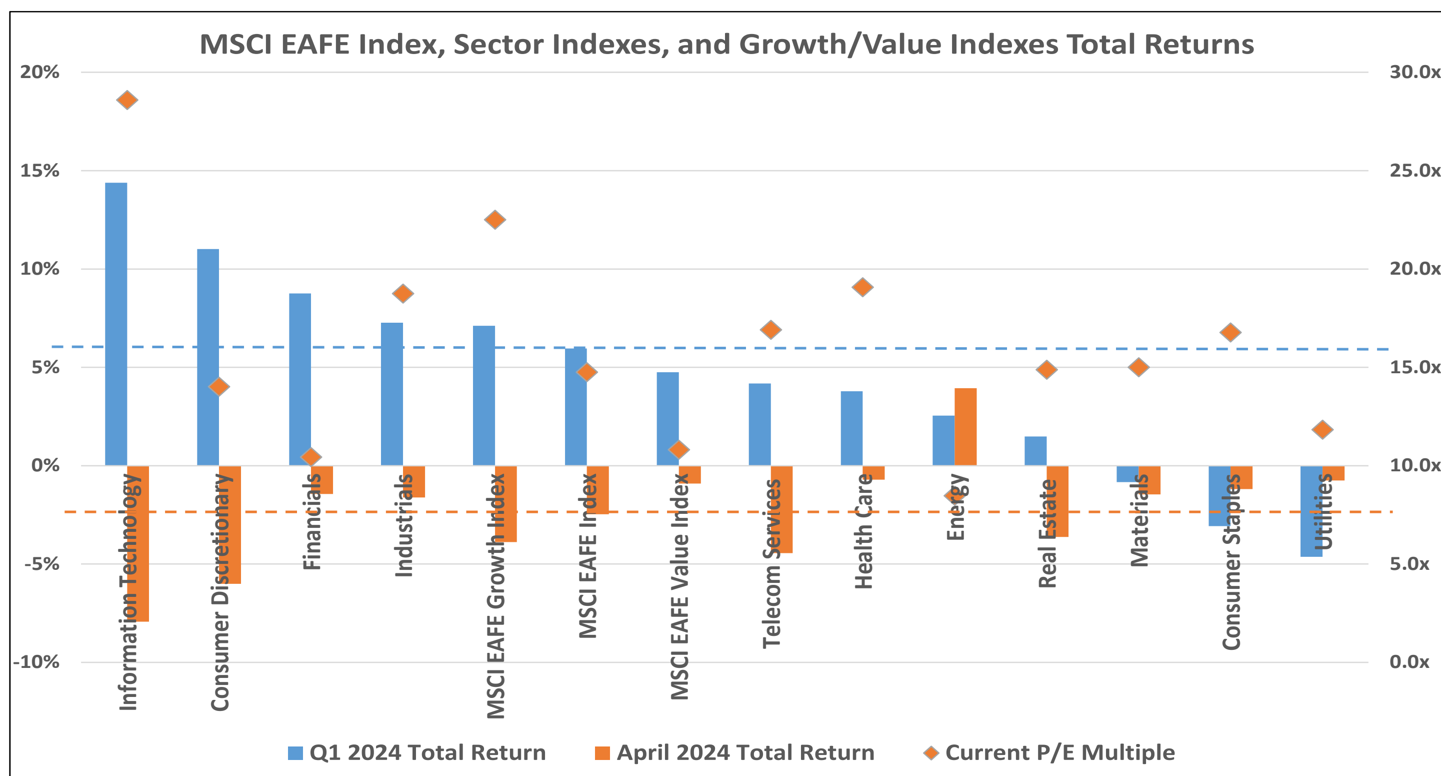


Source: Bloomberg LP

Economic and Capital Markets Commentary

The momentum in international markets continued during the first quarter on the prospects of economic rebound, continued disinflation, and lower rates. Most sectors responded positively to this optimistic outlook, and Utilities was the worst underperformer. Growth continued to lead during the quarter, benefiting our tilt towards growth within the portfolio. Despite elevated multiples, prospects of lower rates coming into the year buoyed high multiples in certain sectors. Information Technology still trades at multiples of 29x earnings, while Financials and Energy traded at 11x and 9x, respectively. This bifurcation in earnings multiples was supported by ASML and SAP, which both trade at elevated multiples and represent ~30% of the sector. Additionally, Health Care's elevated multiple was supported by Novo Nordisk, which is the largest weight in the MSCI EAFE Index and represents ~20% of the sector's weight.

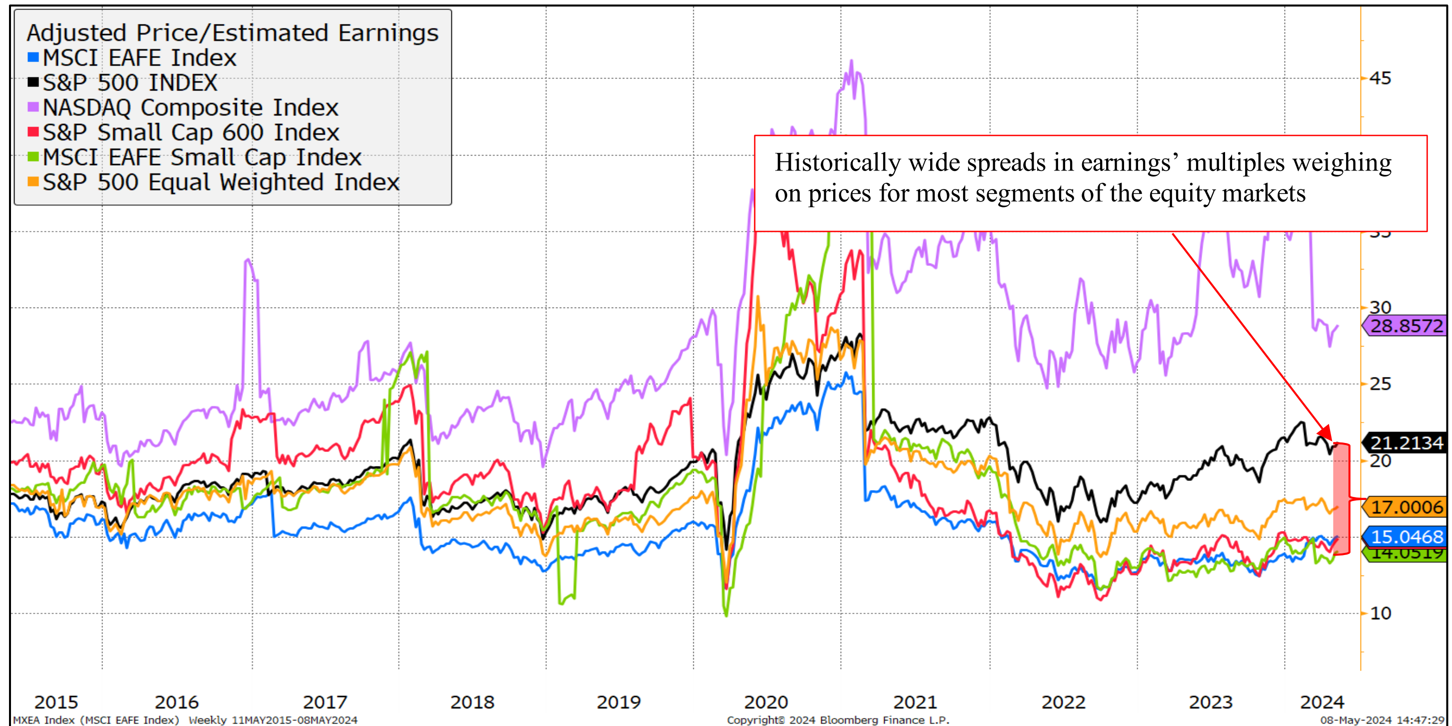
During the month of April, the markets experienced a correction. Information Technology experienced the greatest drawdowns, followed by Consumer Discretionary. As shown in the following chart, these two sectors led the performance during the first quarter. While Information Technology likely resulted from an adjustment in the discount rate, the pressure on Consumer Discretionary likely resulted from concerns of "higher for longer" rates and weak Chinese consumers on global discretionary spending. The shift in sentiment was a healthy reset after a particularly rosy outlook faded to a more balanced outlook, given persistent economic uncertainty.



Source: Bloomberg LP

Despite the high multiples in Information Technology, the overall discount for the MSCI EAFE Index remains at historically high levels. The greater influence of Financials, Basic Materials, and other cyclical sectors certainly anchors earnings multiples at lower levels relative to more growth and technology-weighted indexes, such as the capitalization-weighted Nasdaq Composite and S&P 500 Index. International small caps (MSCI EAFE Small Cap Index), domestic small caps (S&P 600), and international large caps (MSCI EAFE Index) trade at historically wide discounts relative to these domestic, capitalization-weighted, technology-heavy indexes. Continued disinflation, coupled with economic resilience and increased consumption, could narrow the discount, as earnings growth broadens

to include companies outside of a few mega capitalization names. We remain cautious on too rosy an outlook as challenges still remain, but recent trends have been supportive to forecasts over the next few quarters.

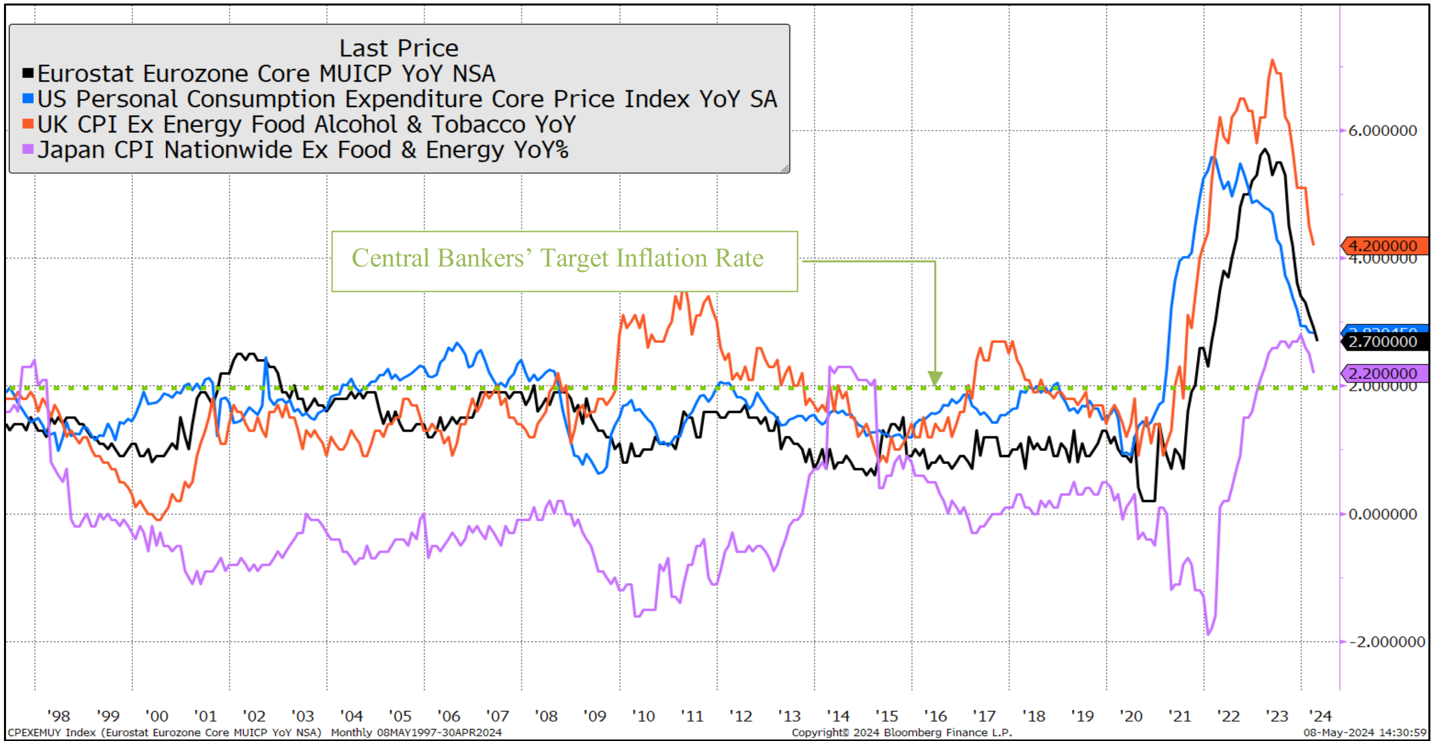


Source: Bloomberg LP

The European economy grew faster than expected during the first quarter, as Germany experienced positive sequential economic growth, supporting regional optimism. The largest economy in the European Union posted the strongest sequential growth in two years after a series of six of eight quarters with sequentially flat or negative numbers. As a result of their improvement, the European Union, in aggregate, posted the strongest real GDP growth since Q3 2022, coming at 0.3% q/q and ahead of the consensus forecast of 0.1%. These positive numbers from Europe complemented strong, sequential real GDP growth from Japan during the fourth quarter, which was supported by strength in exports. Australia also continues to show economic resilience, growing sequentially in the fourth quarter, led by persistent domestic consumption, despite weak net exports.

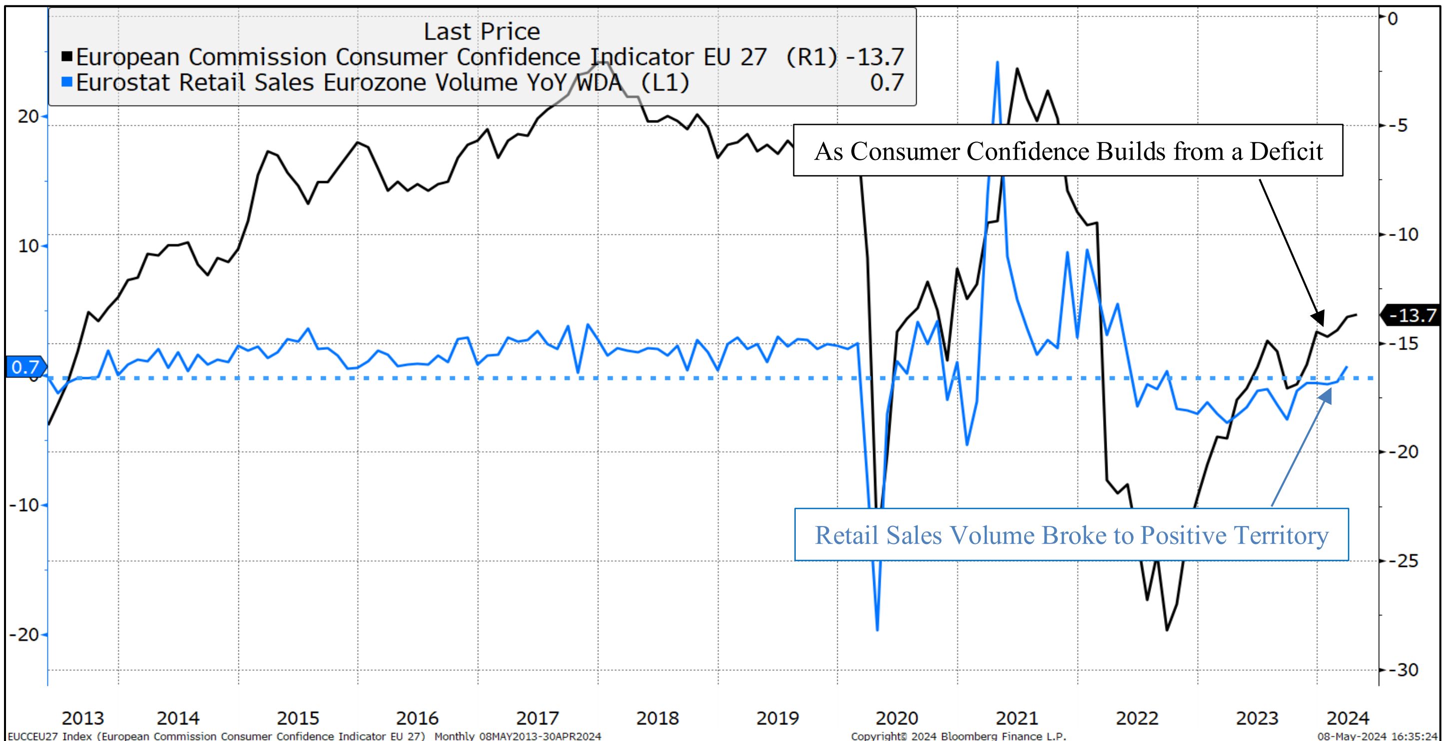
Additionally, the Purchasing Managers' Index (PMI) for these regions showed some marked improvement. In Europe, the German surveys of economic conditions moved higher and broke again into expansionary (>50) levels for the first time since mid-2023 in April. Though up from the mid-2023 doldrums, manufacturing surveys continued to wallow in contractionary territory, while the services survey moved to high, seasonal levels, buoying the aggregate composite. These surveys from Germany reflect the broader European Union, where the aggregate PMI broke into expansionary levels in March and was supported by service sector resilience, despite manufacturing malaise. Aggregate surveys in Japan have remained at expansionary levels since 2022 but continued to trend higher in April, supported by – again – services, though manufacturing was just a hair shy of expansionary levels.

Despite positive real GDP and favorable trends in PMIs, current forecasts for only a modest recovery haven't moved much from their prior levels. In Europe, economists currently forecast only 0.6% real GDP growth for 2024, increasing from only 0.4% in 2023. Conversely, these economic pundits estimate deceleration in real GDP growth for both the United States and Japan, though still averting economic recession. The European Central Bank appears to be committed to a reversal in monetary policy during 2024, and disinflation appears to be on a current trajectory to allow for easier policy in Europe. The United Kingdom – among others, like Sweden – continues to have elevated levels of inflation, which could still keep rates elevated. Uncharacteristically, the Bank of England recently hinted at possible cuts this year, despite current high levels of core inflation at 4.2%.



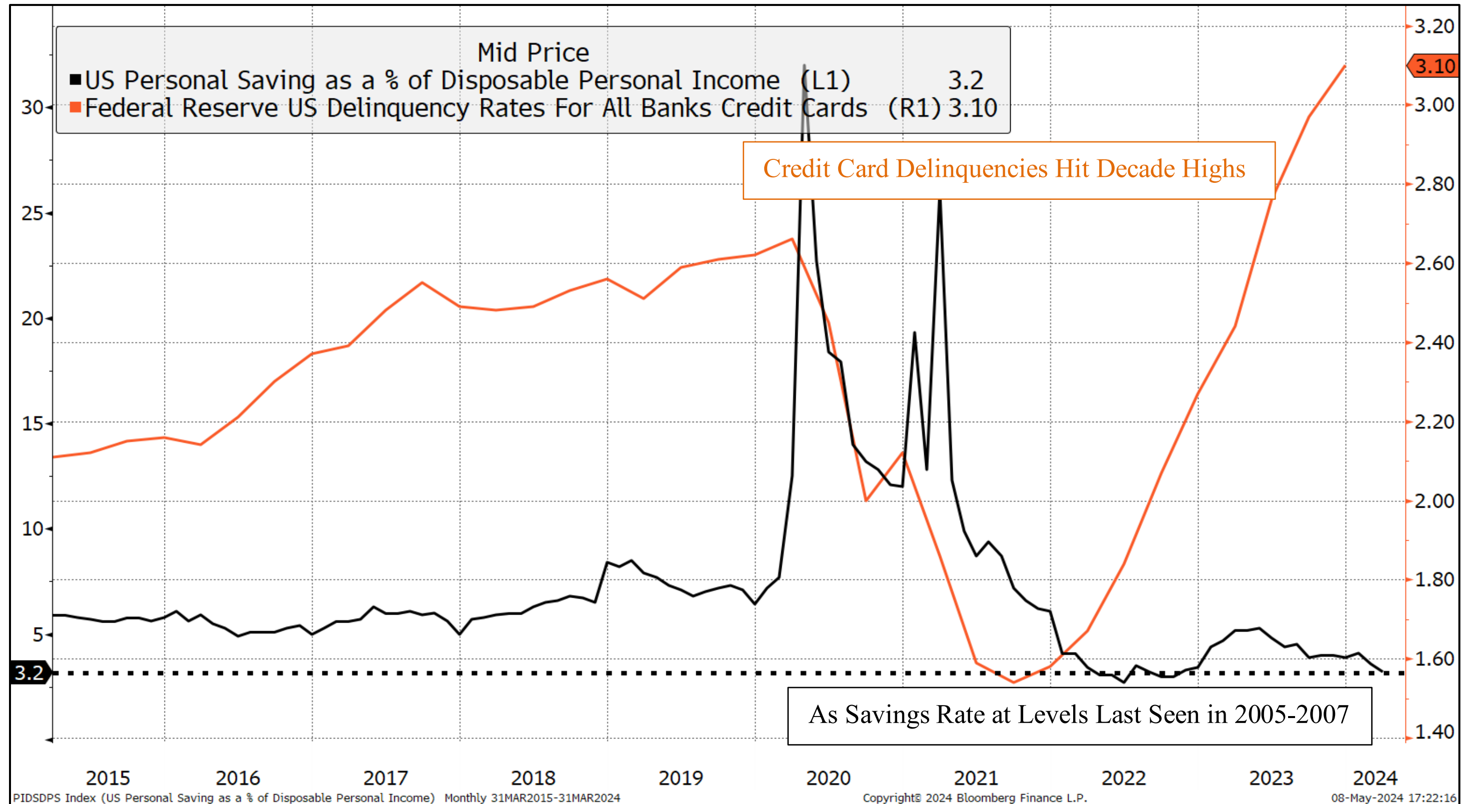
Source: Bloomberg LP

With inflation still above target, weak real GDP growth, and marginally expansionary aggregate PMIs, international developed markets have little margin between expansionary and contractionary scenarios. Recent data on Industrial Output for Germany in March showed a sequential *decline* of 0.4%, while prior data was revised down from +2.1% to +1.7% for February, tempering some enthusiasm. Consumer Confidence in the region has recovered from the lows in 2022, which matched lows experienced during 2020, but they still are well below pre-COVID levels (2013-2019). Fortunately, the improved consumer confidence has allowed for optimism that the consumer will begin to contribute more to real GDP growth, as exhibited by retail trade volumes in the following chart.



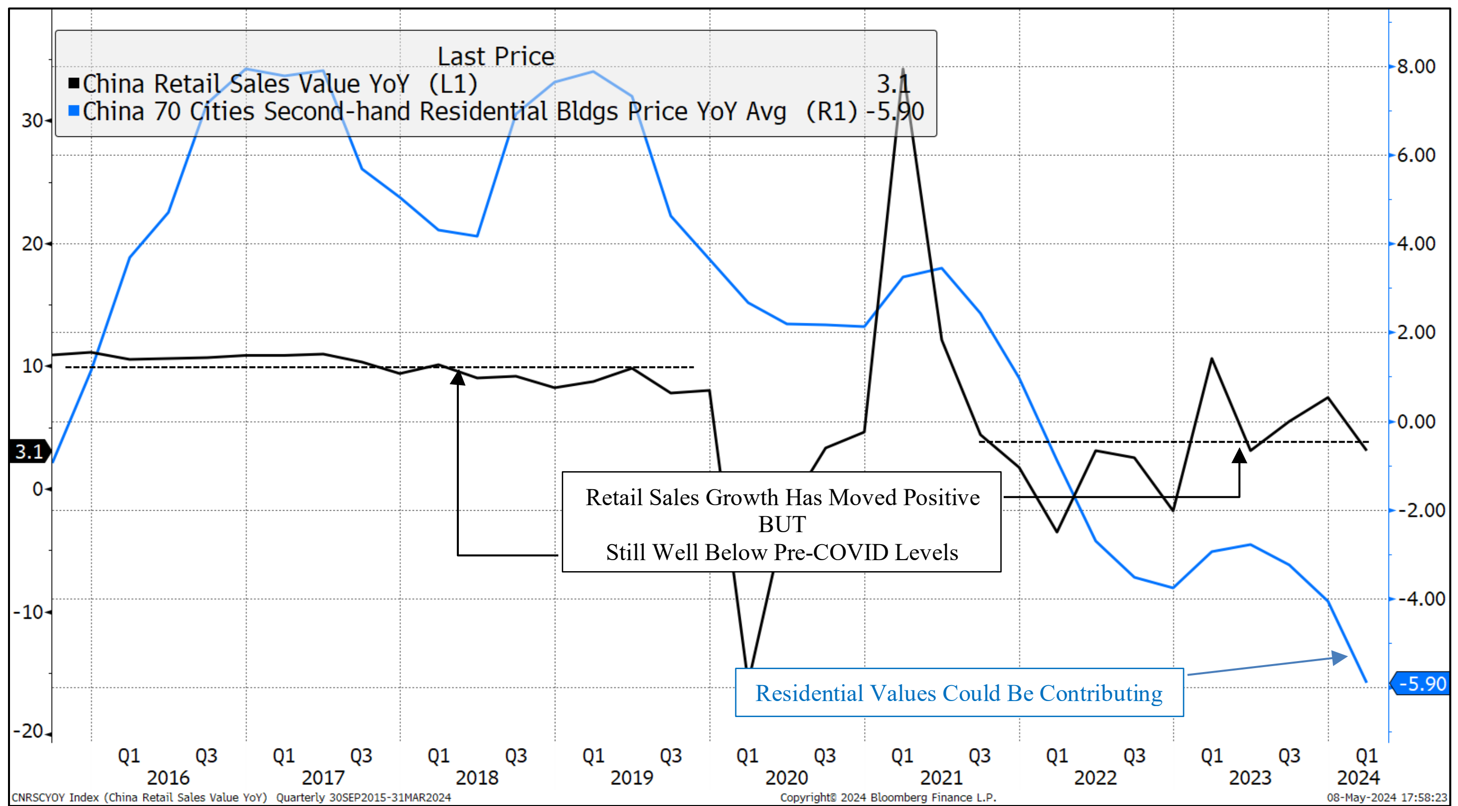
Source: Bloomberg LP

China and the United States will continue to have a large bearing on support for continued global economic growth and impact the sustainability of growth in other developed countries. While consumers in Europe and Japan have remained relatively disciplined after the pandemic, consumers in the United States enjoyed a surge in consumption driven by extraordinary excess savings. This excess personal savings has largely been exhausted, and the consumer has turned to lower savings rates and increased dependency upon credit to support their spending habits. The cumulative pressure of inflation has overshadowed nominal wage growth over the last three years, and cracks have developed in delinquencies in credit cards, automobile loans, and other personal credit. While the consumer still contributes positively to GDP growth, persistently high rates on elevated borrowing could lead to a reversal for the largest contributor to U.S. GDP later in the year. Some commentary from companies, such as Walmart and McDonalds, have noted trade-down behavior resulting from pressure on consumers. Strong government spending and fixed investment (promoted by massive fiscal programs) has supported strong growth numbers in 2023.



Source: Bloomberg LP

Chinese consumers may also be under pressure, as their real estate markets have continued to deteriorate, which, as noted in prior reviews, contributes to 70% of the citizen's net worth. Well publicized failures of property developers, poor incentive systems for local and provincial subsidies, and excessive expansion resulting in vacant, "ghost" cities have undermined confidence in real estate values and creditworthiness in China's system. While the CCP has responded by trying to pivot to large subsidies for manufacturing capacity, their approach to disrupting global market equilibrium in order to displace industry in other countries is not tolerated as openly as a decade ago. They have faced a deterioration in foreign direct investment (FDI) not ever seen. Consistent with the FDI flows, foreign companies are moving aggressively to source from other countries. The pressure on real estate and the consumer has been offset by this subsidized expansion in an attempt to achieve stated growth targets, though it may not be a prudent use of capital resources as their debt-to-GDP ratios skyrocket. While consumption is not as large a contributor to their GDP, the weak and volatile consumption trends and persistent real estate meltdown belie the strong economy that they attempt to exhibit to the world. As the second largest global economy, further deterioration could unseat any prospects for global growth. To be clear, we are not forecasting such an event but remain cautious of the underpinnings of their growth plan with these major headwinds.



Source: Bloomberg LP

Geopolitical risks persist, and we sound like a skipping record. The trade between Russia, Iran, and China continues to draw scrutiny, as China attempts to undermine sanctions despite its dependency upon Western economies. Russia resumes advancement into Ukraine, as the war of attrition takes its toll on the smaller nation. Israel continues to pursue its “pressure cooker” protocols for rooting out Hamas terrorists, but their tactics have resulted in waning support due to the losses of civilian life. Hamas cheers the IDF’s public relations challenges, though they have been known to historically use civilians as human shields, with strategic locations established near hospitals and schools. Additionally, little discussion seems to focus on attempts to kill Israeli civilians due to the success of the Iron Dome defense against thousands of missiles and rockets fired toward their cities by Hamas and Hezbollah. Israel has also proven their offensive capabilities in their response to Iran’s unsuccessful barrage of drones and ballistic missiles, wiping out missile defense systems near the Natanz nuclear facility. Fortunately, Iran denied the success of this response, and escalation didn’t result from the tit-for-tat. Regardless, the same geopolitical tensions exist in Europe, the Middle East, and increasingly, Asia as existed last quarter. While we pray for peaceful resolutions to these conflicts, we remain cognizant of the potential for further escalation and any resulting impact on global trade and economic decoupling.

Mason D King, CFA
May 9, 2024

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