Quarterly International Economic Commentary

Executive Summary

International equity markets were rangebound during the second quarter as markets digested volatile rate expectations and economic uncertainty. The MSCI EAFE Index returned -0.1% during the quarter.

Value led again modestly this quarter. Sector performance favored Health Care and Financials over Consumer Discretionary and Materials. Continued uncertainty in the economic outlook still weighs on many cyclical segments of the market.

Composite PMIs broke above 50 for Europe this spring but remained below last year's mid-year peak. Services PMI has exhibited seasonal weakness after the second quarter, risking composite PMIs moving back into contractionary territory. Manufacturing PMI in Europe has remained a laggard with two years at contractionary levels, and Japan moved back <50 after one brief move above 50 in May. In many markets, Services PMIs are contributing supporting Composites above 50, while manufacturing activity remains on the weaker side.

Consumer sentiment improved during the first half of the year in many markets. Unfortunately, these remain at statistically weak levels in Europe, though improving. China sentiment remains weak, and manufacturing surveys reflect continued near term weakness in sales.

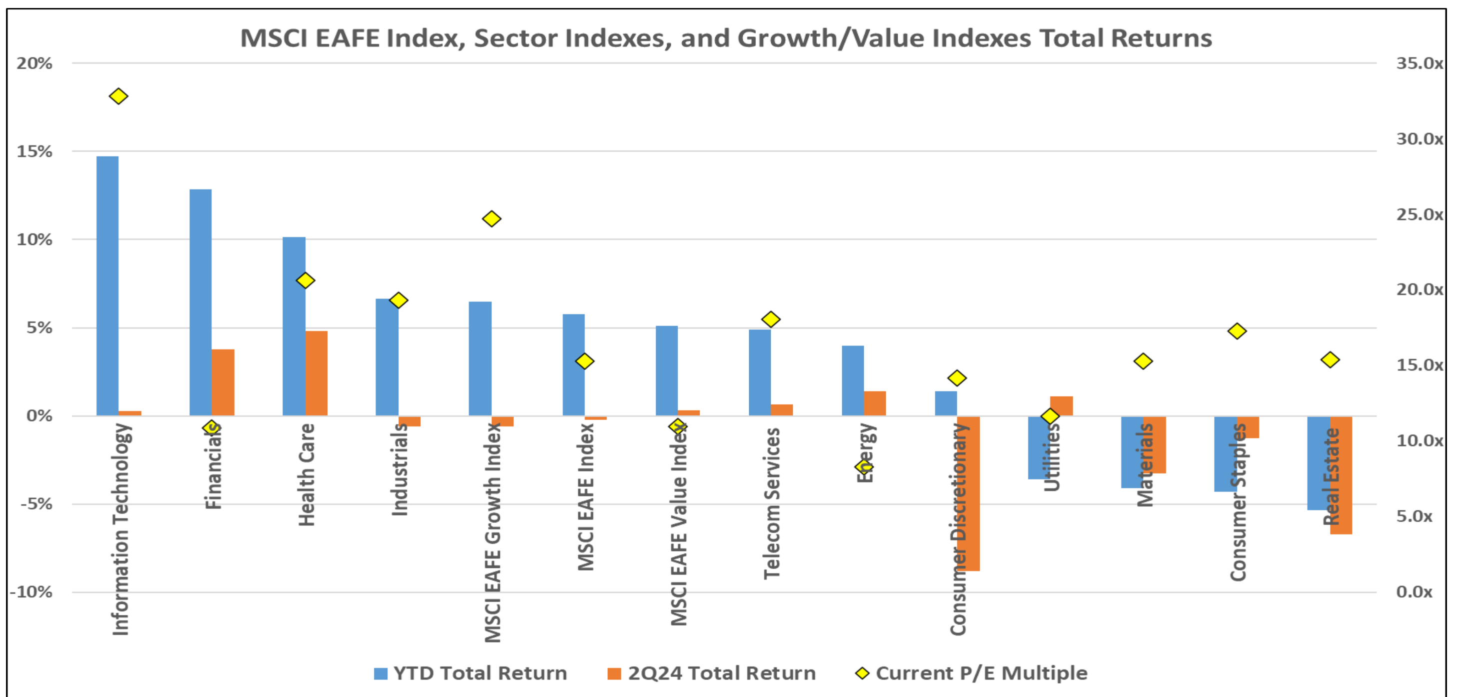
Central banks across the globe have started cutting rates (e.g. People's Bank of China, Bank of England, European Central Bank, Riksbank Bank, Bank of Canada, Swiss National Bank, et al) with few exceptions (e.g. Japan), as central bankers shift from inflation mandates towards protecting jobs and supporting economic growth.

Probabilities of recession have remained below 50% for all major markets, as measured by economic consensus. Recently, we have seen these move up from some forecasters – particularly, for the United States. Base case estimates still predict non-recessionary growth in 2024, despite a recent wave of some weaker data, reflected in a negative economic surprise index.

Economic and Capital Markets Commentary

The international markets largely consolidated during the second quarter. The MSCI EAFE was *down* 0.1% during the quarter, and the value index, represented by the MSCI EAFE Value Index, outperformed its corresponding growth index by ~90 basis points. Equity markets in April digested the higher rate outlook that developed during the prior quarter, pressuring present values of longer-duration business models relative to more value-oriented companies with a higher proportion of cash flows in earlier time periods. During the last two months, a 300 basis points spread in performance narrowed as global short rates peaked and trended lower later in the quarter.

The two sectors that led the index during the quarter were Financials and Health Care. While Information Technology remains the best-performing sector year-to-date, the sector was not very additive to the index during the second quarter. Multiples for the sector remain buoyant at 33x FY24 EPS, whereas Energy only assigns one-quarter of the value to their earnings for equity pricing (~8x). During the second quarter, the Consumer Discretionary sector experienced the most violent reversal, dropping from being the second-best performer in the first quarter to the worst performer in the second quarter. I hate to read too much into market behavior. Still, the significant underperformance by discretionary companies relative to non-discretionary could reflect concerns around pockets of weakness and sustainability of discretionary consumption.

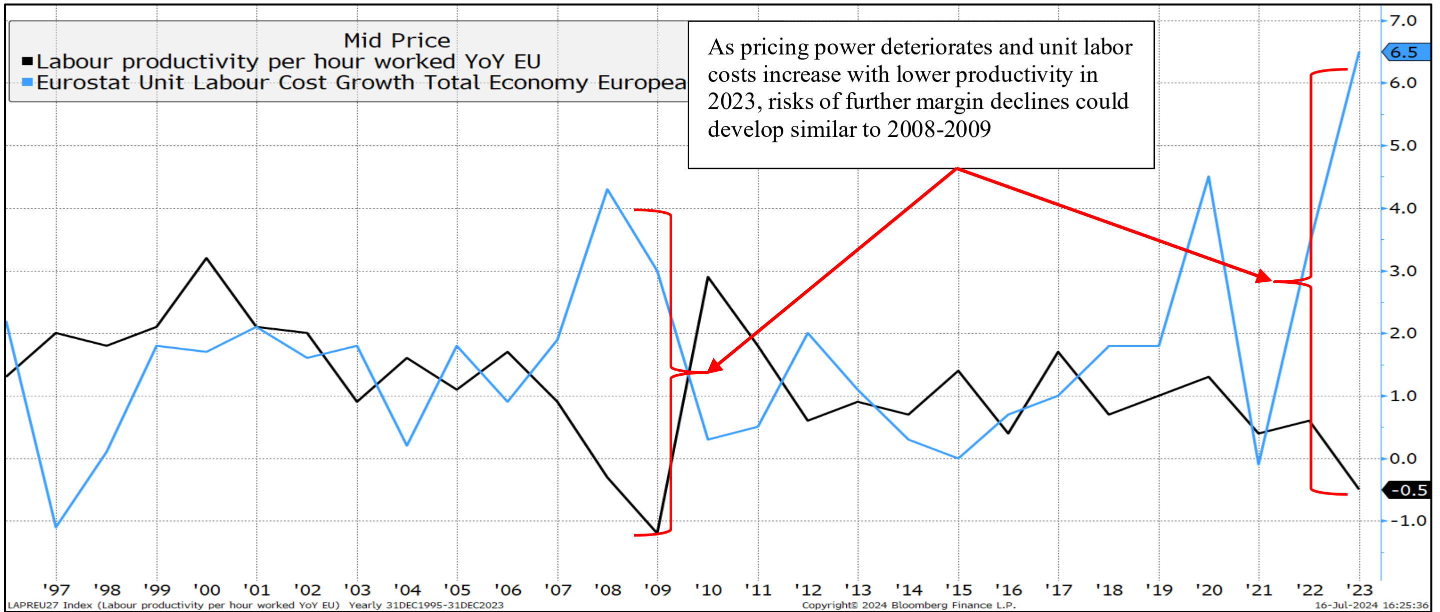


Source: Bloomberg LP

As disinflation progresses, annual inflation rates have moved towards more manageable levels. The European Central Bank and Bank of England have moved reference rates lower to spur economic activity through lower real interest rates. Interest rate sensitivity in construction has acted as a headwind to economic growth over the last few quarters. While exports have decreased, imports have also declined to offset the negative impact on real GDP growth. Government spending has had an elevated effect on economic growth, while household consumption has proven resilient. Both have contributed to maintaining positive real annual economic growth in Europe and the United Kingdom.

Unit labor costs (ULCs) are rising at the highest levels in over two decades, and though unemployment has risen slightly in the U.K., unemployment in the E.U. has remained at record low levels. While nominal wage increases now exceed inflation and should support household consumption, premature monetary accommodation could risk the persistence of wage inflation and structural challenges in a labor market with little economic slack. Productivity no longer offsets these accelerating labor costs after cratering in 2023, marking the first time since 2009 that productivity in the European Union turned negative. Labor productivity must exceed labor cost inflation to preserve the corporate profit share in the absence of any offsetting unit price increases.

Consumer confidence has recovered from record low levels in 2022, when inflation peaked, but remains historically low, reflecting stress on households. Manufacturing has also remained vulnerable, as the Manufacturing PMI survey has improved but remains in contractionary territory (<50). The Composite PMI moved above 50, led by seasonal strength in the Services series. My concern is that the series will drop back into contractionary territory as the Services PMI rolls over during the late summer and fall, tempering some enthusiasm for economic expansion. Time will tell whether the policy decisions ease pressure on rate-sensitive activity to support growth, relieving dependency upon government spending and household resiliency, or premature action will drive further increases in labor costs and, potentially, prices for a new inflationary wave.



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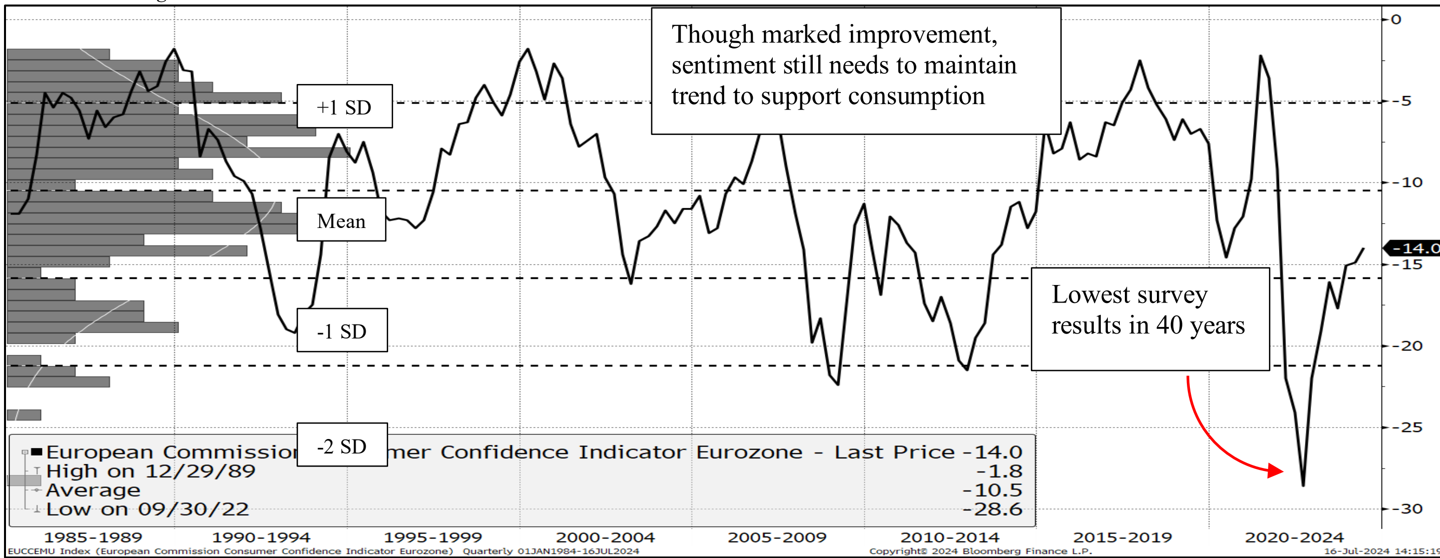

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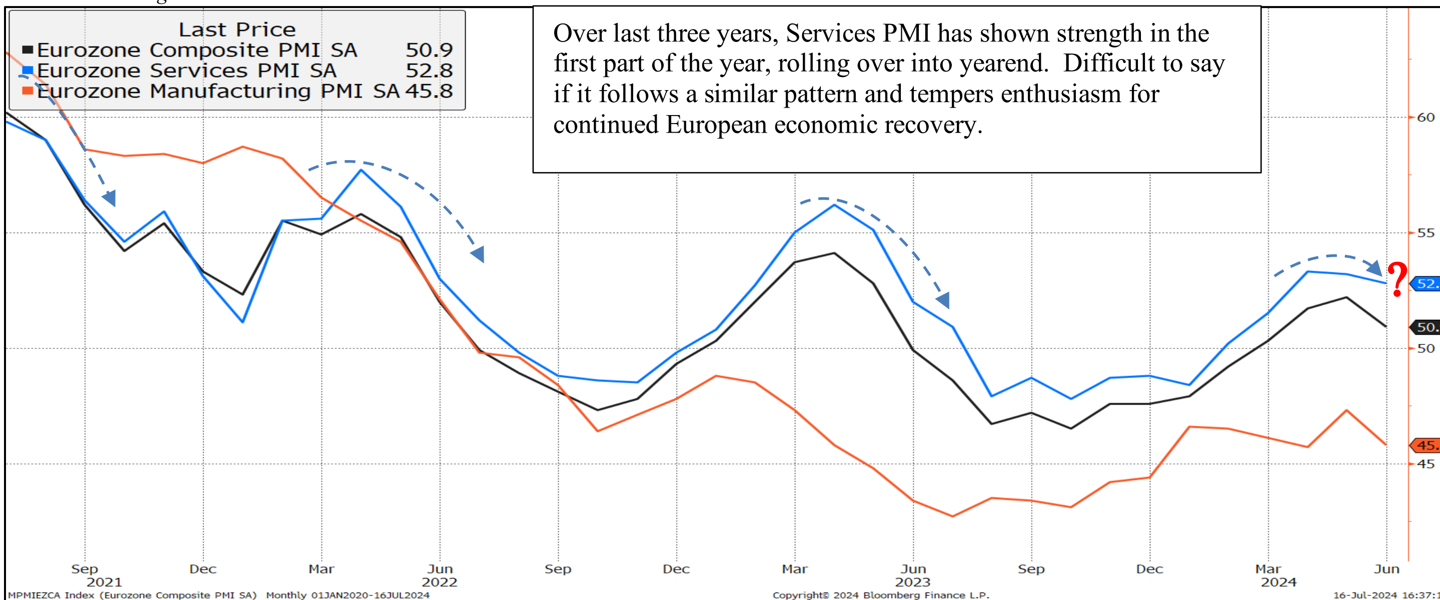
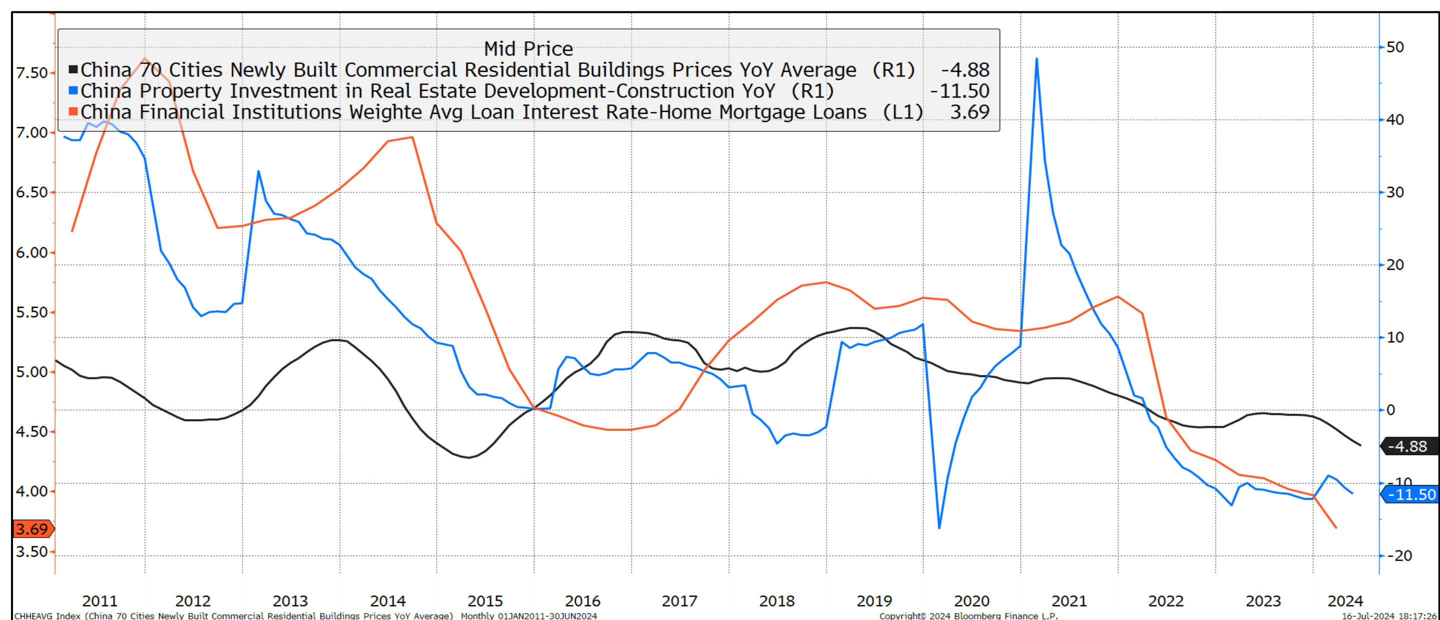


Source: Bloomberg LP

Japan appears to be navigating the turmoil relatively smoothly. The Bank of Japan has been more reluctant to raise rates meaningfully despite the plunging value of the Yen on real rate differentials and carry trades. They did raise rates again last week, which prompted a sudden adjustment in domestic currency values, as investors clamored to sell USD assets, including investments in US listed technology companies, to unwind Yen-funded carry trades. Core inflation, excluding food and energy, peaked at only a 2.8% annualized rate last December and has trended down to 1.7% in May. Japan utilized fewer governmental financial resources to prop up real GDP growth, with public demand detracting from growth over the last two quarters. Household consumption has also been less contributory, with private household consumption recording negative annual growth for the previous three quarters. Imports also declined over the last four quarters, driving up net exports' contribution to economic growth as exports continued to recover despite weaker domestic demand. After the weakness in annual GDP growth during the first and second quarters, economic growth is expected to accelerate into 2025.

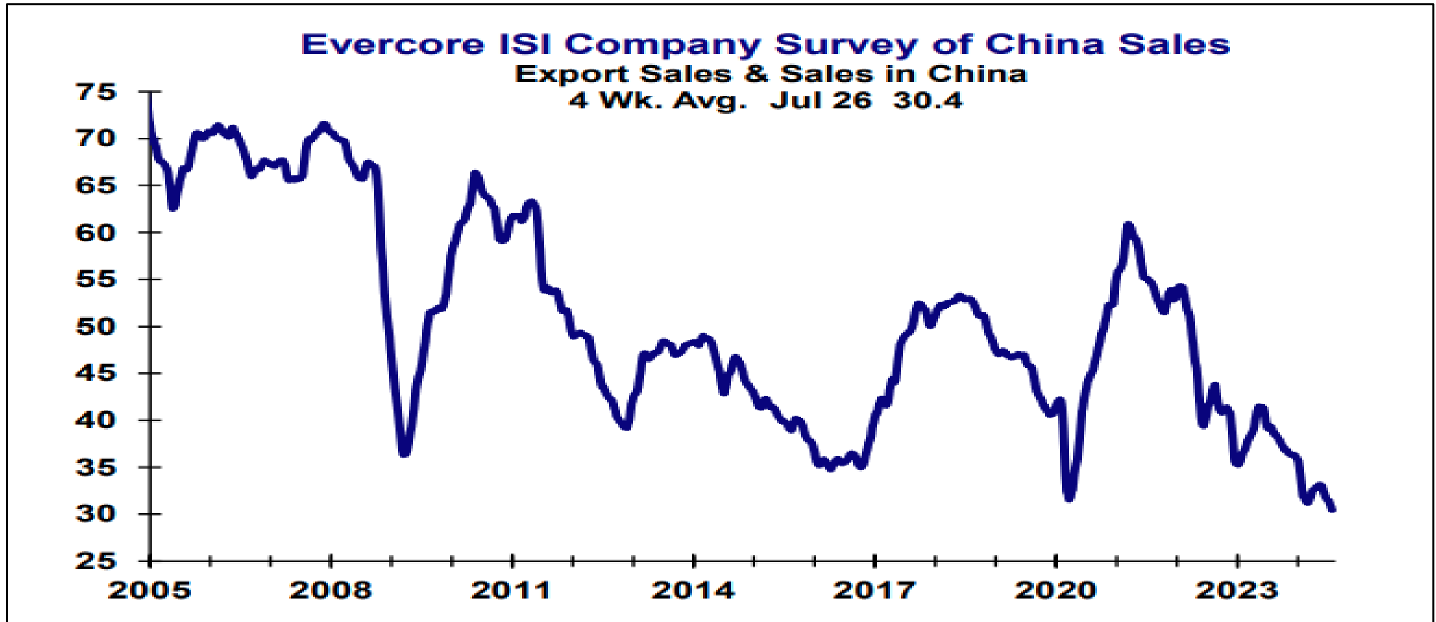
China remains an enigma of sorts. A large portion of their economy continues to drag on the total property development. As we have pointed out in prior reports, Chinese citizen has large portions of their household net worth tied to the value of underlying residential assets. Unfortunately, these prices continue to slip, with property investment falling another 10% in June – the twenty-sixth consecutive month of year-over-year declines in real estate activity. Residential prices declined nearly 5% annually in June, marking a new record in the duration of declines, also, at twenty-six months. Since the start of 2022, the PBOC has lowered reference rates five times to try to entice residential mortgage borrowers. Rates are now at 20-year lows. Reference rates in China moved below comparable U.S. during this time, a phenomenon only seen prior to the Great Financial Crisis. Domestic consumers remain very weak, with warnings from Western companies' revenue noting declines in some discretionary purchases. Nominal value of retail sales grew only 2.0% in June, which is 1.5 standard deviations below the mean for the last thirty years. Weak property markets and consumers weigh on domestic growth.



Source: Bloomberg LP

China maintained a 4.7% real GDP growth during the prior quarter. While providing some efforts to stabilize property markets, the CCP has allocated a greater portion of government resources towards expansion of the supply side through a massive expansion – and subsidization – of industrial policy. Despite weak domestic demand, the greater supplies have supported economic growth through greater net exports. Chinese companies have become price disrupters in many markets (e.g., EVs, solar panels), leading to some retaliatory action by trade partners. While past decades were marked by excessive real estate and infrastructure development, creating idle assets and ultimately leading to capital destruction, leadership shifted towards a more aggressive industrial policy that could follow a similar pattern. Their intent would be to capture market share while undermining stability in established markets. This approach has led to a wave of protectionist responses from Europe and the United States, which could temper

potential gains from exports and sour access to some of the largest markets. Weaknesses continue to be noted in company surveys of prospective sales to China.



Source: Evercore ISI

A risk for China is the large amount of debt issued by state and local governments through the local government funding vehicles (LGFV). These vehicles allowed local municipalities to sidestep borrowing limits set by the central government to fund development projects. A study last year found that only one-fifth of the 2,900 LGFVs had sufficient cash to satisfy short-term funding obligations and debt service, and another study by the IMF concluded that 80-90% of LGFV annual spending came from issuing new financing. The size of off-the-books debt is estimated between $7 and $10 trillion (or 45-67% of annual GDP), and property sales are no longer available to support the cash flows. Challenges with recovering any residual value are also proving to be very challenging for investors who funded the debt in these entities. Lower recovery rates could impact future borrowing costs, and both Fitch Ratings and Moody's Investor Services have lowered their outlook on China's credit to negative, largely driven by concerns for local debt. While China has been a significant engine for global growth over the last few decades, credit concerns appear to be mounting. These risks have been mounting, but they have been able to navigate less challenging episodes in the past. Time will tell if the burden is now too large and becomes a prelude to a financial crisis. At this time, economists expect China to continue to grow real GDP at ~4.5% a.r. over the next six quarters with only a 15% probability of recession (For perspective, economists assign 20-30% probability for most European nations and 30% probability for the United States).

Geopolitical risks persist… Russia is still attacking Ukraine. Israel maintains its offensive response to Hamas attacks and, recently, is taking direct, kinetic action against Hezbollah. China continues to expand its military – both regarding technology and total assets. With their expanding capabilities, China has increased saber-rattling in the South China Sea and Taiwan. Iran continues to operate behind its proxies but, fortunately, did not escalate after Israel's response. This year is also a massive year for national elections, with a record >2bn voters heading to polls in 50 countries. Results so far show changes in leadership in many countries, as uncertainty is the winner and incumbents the losers. A broad process underway could reshape international order with further shifts towards anti-globalization and nationalism. Shifts in India, France, the United Kingdom, the European Union, Taiwan, and, yes, Iran demonstrates unease amongst voters with incumbent parties. Even exit polls in Venezuela had 70% for the challenger, but not surprisingly, Maduro "won" again, though he is facing international protest.

Mason D King, CFA
August 8, 2024

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