Fisher Investments Australasia®

MARKET PERSPECTIVES
REVIEW & OUTLOOK

SECOND QUARTER
2023

SECOND QUARTER 2023 REVIEW & OUTLOOK

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SECOND QUARTER 2023 REVIEW & OUTLOOK
EXECUTIVE SUMMARY

1 August 2023

PORTFOLIO THEMES

- We believe a new bull market cycle is underway. Equities that fell the most during the downturn likely continue to lead in the early stages of the recovery.
- Excessive pessimism tied to inflation, Fed policy fears and narrow market breadth likely sets the stage for continued positive surprises in the second half of 2023.
- In a slow-growth economy with widespread recession fears, high-quality, all-weather growth equities should benefit nicely.

MARKET OUTLOOK

- **A New Bull Market is Underway:** Global equity markets' significant rebound since last October's low, coupled with better than expected economic data, lead us to believe we are in a new bull market cycle.
- **Ongoing Investor Fears Support New Bull:** Excessively dour sentiment, driven by fears of inflation, global recession, narrow market breadth and a variety of other factors has significantly lowered investor expectations, creating space for the new bull market to continue.
- **Political Drivers are a Tailwind for Global Markets:** The combination of the third year of a US president's term, which has historically had the highest frequency of positive returns of the four-year cycle, and calmer global politics in 2023 provides a positive environment for the new bull market.

Global markets finished positive in Q2, rising 6.2% to put 2023's first half gains at 13.9%.[i] Emerging Markets (EM) ended Q2 slightly positive, returning 0.9% while up a modest 4.9% thus far in the year.[ii] Despite better than expected economic data and a rather impressive bounce off October 2022's market low, this bull market features a classic "wall of worry"—a barrage of investor fears that tamps down sentiment as equities climb higher. Nearly nine months from equities' low, today's wide gulf between sentiment and reality reflects a classic early bull market feature. Ultimately, as we enter 2023's back half, we expect investor fears to continue fading away as we believe the new bull market has ample room to grow and surprise to the upside.

June's end closes a nearly picture-perfect example of the nine-month "Midterm Miracle" we have detailed in past Reviews. This period near US midterms is history's most consistently positive, up 91.7% of the time and averaging 19.6% gains.[iii] On cue, the S&P 500 surged 25.7% from last 30 September through June.[iv] The Midterm Miracle might be ending now, but the positive momentum will likely continue. Since reliable data began in 1925, returns in the second half of presidents' third years have been positive 75% of history, albeit with lower returns than the first half, averaging 5.5%, as the gridlock powering the Miracle keeps legislative risk low.[v] US political drivers remain at equities' backs into the fourth year—up 83.3% of the time with an average 11.4% return.[vi] Not only does gridlock reign, but sitting politicians have little motivation to pursue divisive legislation on the campaign trail—especially when they can fundraise on existing topical issues instead.

Despite the economic and political tailwinds behind this bull market, several pundits argue the current market environment is fundamentally unstable, propped up by AI-fueled enthusiasm for giant Tech equities while everything else seemingly underperforms. They say this narrow market breadth makes the rally weak—set to fall again when Tech stops leading. We think this is backward. Rapidly falling market breadth is quite bullish and its presence now is a typical feature of a new market cycle.

Consider why large, growth-oriented companies are leading. First and foremost, this is a phenomenon we call the Bounce Effect: the tendency for the downturn's worst-performing categories of equities to perform best as the market recovers. This has been playing out well since this bull market began last October. Despite strong fundamentals, large growth equities fell hard in 2022's bear market. Now they are rebounding significantly. Beyond this, many economists continue forecasting recession or at best, sluggish growth. That fuels fears of a low-growth world hampering companies dependent on booming demand—like smaller, value firms. Therefore, investors want to own companies capable of churning out earnings in a slower global economy. These are true growth equities. Their rise is a simple, logical result of tight supply and high demand. Hence, we think narrow breadth is a false fear. And false fears are bullish—bricks in the wall of worry.

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i Source: FactSet, as of 30/06/2023. MSCI ACWI Index returns with net dividends, 31/03/2023 – 30/06/2023 and 31/12/2022 – 30/06/2023.

ii Source: FactSet, as of 30/06/2023. MSCI EM Index returns with net dividends, 31/03/2023 – 30/06/2023 and 31/12/2022 – 30/06/2023.

iii Source: Global Financial Data, Inc., as of 28/09/2022. Average S&P 500 total return and frequency of gains from 30 September of midterm years through 30 June of the following, 1926 – 2021.

iv Source: FactSet, as of 30/06/2023. S&P 500 total return, 30/09/2022 – 30/06/2023.

v Source: Global Financial Data, Inc., as of 22/06/2023. S&P 500 average total return and frequency of positive total return in the second half of presidents' third years, 1927 – 2019.

vi Source: Global Financial Data, Inc., as of 08/02/2023. S&P 500 frequency of positive returns and average total return in presidential election years, 1928 – 2020.

UK equities' struggles appear tied to sentiment more than fundamentals. Several fears, from stubbornly high inflation to recession worries, have taken turns weighing on sentiment. However, we don't think reality is as poor as perceived. Producer prices are close to a zero percent inflation rate, and broad money supply has contracted in five of the past seven months. These developments suggest inflation should broadly keep easing, regardless of whether the BoE hikes or not, and 13 straight BoE hikes haven't halted GDP growth. That so many remain dour towards British equities despite this resilience is bullish, in our view.[vii]

In continental Europe, more recent data suggest the eurozone's economic backdrop is mixed. The eurozone composite PMI, which aggregates services and manufacturing, fell to 49.9 in late Q2—right below the level dividing expansion and contraction. However, by sector, services showed growth (52.0) while manufacturing stayed in contraction (43.4).[viii] This split has persisted throughout the year, and while heavy industry's weakness weighs on growth, services comprise the majority of output in the eurozone—so the latter's prospects have more sway on the region's economy. Germany is an example where reality is not as poor as feared, in our view. Since late 2021, economists have been predicting a German recession, and that oft-forecast downturn appeared to manifest in revised GDP data. Q1 GDP was revised down from flat to -0.3% q/q.[ix] Following Q4 2022's -0.5% q/q dip, the two straight quarterly dips meet one popular definition of recession. Some argue German equities outperformance since last September has been disconnected from fundamentals—and now they point to technical recession and other alleged headwinds (e.g., ongoing ECB rate hikes) to claim the outlook is negative. In our view, forward-looking equities have moved on from these developments, as recession discussion didn't prevent Italy, Spain, France and even Germany from outperforming in late Q2.[x]

In EM, China's decline weighed on markets for the quarter as disappointing economic data and concerns about local government debt created big headwinds. May's official manufacturing purchasing managers' index (PMI) fell to 48.8 from 49.2, while China's services PMI eased to 53.8 from 55.1. This fanned long-running fears China is heading for a hard landing. But in our view, China was always likely to decelerate after its reopening growth spurt, in line with its ongoing GDP slowdown from early-2000s' double-digit rates.

Long-running concerns that China's estimated $9 trillion in allegedly distressed local government financing vehicles (LGFVs) would imperil growth also reappeared—often the case when the economy slows and hard-landing fears escalate. However, as with property market concerns last year, we see the Chinese government doing what it takes to alleviate material dislocations. In our view, MSCI China's decline this year is mainly sentiment driven. With its economic outlook not appreciably worse (or better) than before its year-to-date January high, we think the sentiment reset just lowers expectations for Chinese growth going forward, leaving room for upside surprise heading into 2023's second half.

Meanwhile, MSCI Taiwan and Korea didn't follow China down—both outperformed in the quarter and year to date.[xi] While both nations have strong economic ties to China, often causing Chinese growth concerns to spill over, it seems Tech's global rebound has been a stronger force during the quarter.

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vii Source: S&P Global, as of 05/07/2023.

viii Source: FactSet, as of 01/06/2023.

ix Source: FactSet, as of 05/07/2023. MSCI Italy Index, MSCI Spain Index, MSCI France Index, MSCI Germany Index returns with net dividends, in USD, 31/05/2023 – 30/06/2023.

x Source: FactSet, as of 05/07/2023. MSCI EM return with net dividends, 31/12/2022 – 30/06/2023.

xi Source: FactSet, as of 02/06/2023.

On the sentiment front, pundits also argue the US Fed's June rate-hike pause was premature, potentially forcing it to tighten even more this year. Many bemoan wobbling economic data in China and call the UK the "sick man" of a Europe doomed for recession. Germany's microscopic downturn overshadows growth across most of the bloc. To us this is classic Pessimism of Disbelief—everyone touts bad news while downplaying good. Despite perceptions and geopolitical concerns, the reality is China is still growing, adding to global demand. Most eurozone countries are expanding—Germany's contraction is nowhere near what economists envisioned mere months ago.[xii]

Pundits can't shake the certainty that rate hikes must doom equities. Many argue the bull market can't be a sure thing until the Fed is fully done hiking or even starts cutting. But what they miss is that the S&P 500 is now up slightly since the Fed started raising rates in March 2022 and up 23.5% since the Fed upped its tightening pace last June.[xiii] Equities are seemingly clearly signaling that rate hikes aren't bearish. This skepticism is markets' fuel.

The world isn't without risk, and we are always watching for signs of trouble. Yet today's often-cited negatives look like more bricks in the wall of worry—too small or well-known to deliver a huge negative shock. Those that could be bigger look quite unlikely to materialise. Meanwhile, global growth, an earnings recovery and global gridlock give equities plenty of bullish fundamentals to weigh.

xii Source: FactSet, as of 05/07/2023. MSCI Taiwan and MSCI Korea return with net dividends, 30/04/2023 – 30/06/2023 and 31/12/2022 – 30/06/2023.

xiii Source: FactSet, as of 30/06/2023. S&P 500 total return, 17/03/2022 – 30/06/2023 and 16/06/2022 – 30/06/2023.

GLOBAL UPDATE AND MARKET OUTLOOK

1 August 2023

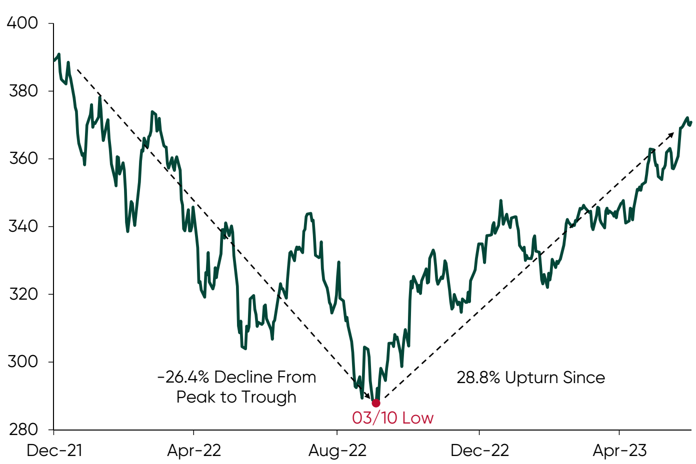
MARKET RECAP

THE BULLS ARE OFF AND RUNNING

Few appreciate it, but last year's nine-month long bear market is over.

In our view, it officially ended in October 2022 amid broad pessimism, near-universal recession expectations, still-hot inflation, fast global central bank hikes, inverted yield curves and sour earnings. But as we wrote then, pessimism primes markets for recovery. In the nine months since, the young global bull market has climbed 28.8%.[xiv] (Exhibit 1) Looking forward, we expect political gridlock and better than expected corporate and economic fundamentals to remain a tailwind for equities in the second half of the year—and into 2024.

EXHIBIT 1: MSCI ACWI INFLECTION POINT



Source: FactSet, as of 06/07/2023. MSCI ACWI Index Return Level with net dividends, 31/12/2021 – 30/06/2023.

ON SENTIMENT'S EVOLUTION

"Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." We have often cited this legendary quote from Sir John Templeton—the best sentiment depiction of a bull market's evolution. Here is an update.

Sentiment has seemingly warmed from last year's more intense pessimism—perhaps with one foot in skepticism and one in pessimism. NYSE short interest topped $1 trillion in June, nearly matching levels from April 2022 despite the rally.[xv] Bears claim the worst lies ahead, pointing to the same negatives they fretted early last year—and after the bear market's low. These old fears are revisited repeatedly, but surprise moves markets most and well-known worries lack surprise.

BREADTH AND PESSIMISM IN TODAY'S MARKET

Those who do acknowledge the bull market don't seem to expect much. They call it a figment of overly bullish imagination created by a few very large equities pumped up by enthusiasm over artificial intelligence (AI). They argue equities' sharp rise will reverse when reality proves AI frothy. While we agree AI is a bit overhyped, bears' logic has problems: For one, past periods of fast-falling breadth haven't foretold bear markets. Two, Big Tech leadership isn't all about AI.

MEASURING BREADTH

Breadth can be measured in varied ways. In the early 1900s, analysts cited "advance/decline" lines—the number of rising equities versus falling—as indicators of a move's strength and resilience. Today many define breadth as the percentage of equities beating the broader market. Others count how many top their trailing 200-day average price.

xiv Source: FactSet, as of 30/06/2023. MSCI ACWI Index return with net dividends, 03/10/2022 – 30/06/2023.

xv "Equities Tumble as Short Interest Grows," Staff, Yahoo! Finance, 22/06/2023.

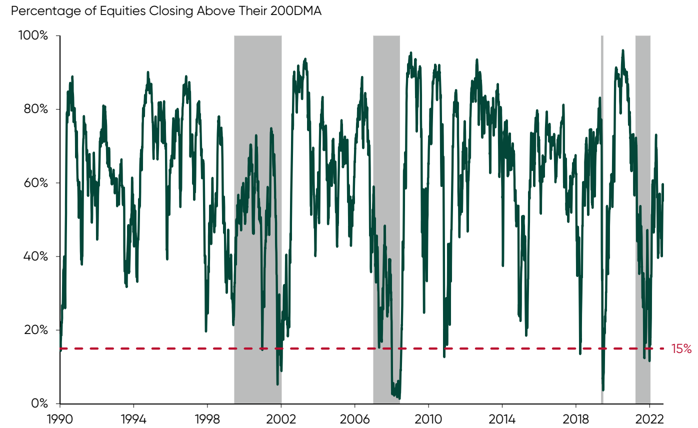
Breadth did narrow in the year's first half. At January's end, over 62% of S&P 500 equities beat the index over the prior year. By May's close, just 32% did. That is this breadth measure's fastest plunge since reliable data start in 1965.[xvi] Similarly, the percentage of S&P 500 constituents topping their 200-day moving average fell below 15% last June and September—only the eighth and ninth times the share was that low since 1990.

But historically, fast declines to narrow breadth haven't foretold bear markets. The percentage of S&P 500 outperformers has had three other swoons approaching January to May's—in 1969, 1984 and 2003. The first came in a bear market, but long into it. A new bull market began under five months later. A year from that relative breadth low, the S&P 500 was up 17.1%.[xvii] The other two came in early *bull markets*—in 1984, three long bullish years before equities peaked, and 2003, just months into a five-year bull market.

As for the low share of S&P 500 outperformers, many of the other instances also fell late in bear markets and corrections—the forward-looking implications were generally positive, not negative. Besides, this measure of breadth is already rebounding. (Exhibit 2)

Crucially, few see fast-falling breadth's reality: Headlines are full of *narrow breadth is bad* arguments. None note the actual history—a positive surprise hiding in plain view. False fears are always bullish, keeping expectations in check.

EXHIBIT 2: BREADTH BY PERCENT CLOSING OVER 200-DAY MOVING AVERAGE



Source: FactSet. 5-day moving average of percentage of S&P 500 constituents closing above their 200-day moving average, 01/10/1990 – 09/06/2023.

A low-breadth bull market makes sense today. While many credit AI for Tech's upturn, other factors are involved. For one, last year's bear market hit big Tech firms hardest. As we have written, bear market laggards typically lead in bull markets. This "bounce effect" likely explains much of what pundits deem AI froth. Beyond this, slow overall economic growth favours Tech and growth generally, given their better ability to deliver sales growth than value in that environment.

THE WALL OF WORRY IS HIGH

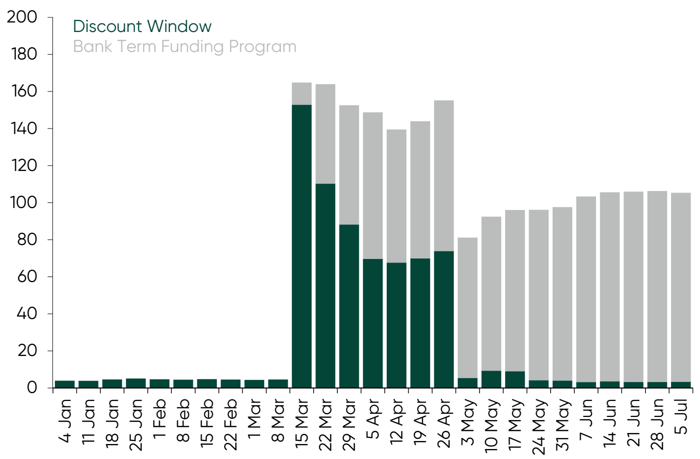
Bull markets proverbially climb a wall of worry—rising despite fears that keep investors' expectations low. Concerns over market breadth is a brick in the wall. So is AI froth. But these are two of many. Since last October, investors have feared rate hikes, inflation, the debt ceiling, regional banks, China's faltering recovery, the Ukraine war, OPEC+ production cuts and more. We will touch on many in this Review, but overall, from markets' perspective, these are either too old or false fears.

xvi Source: Clarifi, as of 09/06/2023. S&P 500 breadth, defined as the percentage of constituents leading the index.

xvii Source: FactSet, as of 11/07/2023.

The recent batch of US regional bank failures is a big brick in this bull market's wall of worry. It bridged Q1 and Q2, from Silicon Valley Bank's March failure through First Republic's travails and sale to JPMorgan Chase in May. In between, headlines painted a dire picture akin to 2008. However, First Republic seemingly ended the saga. While lending has slowed—as we expected—it remains healthy at 5.8% y/y as of 28 June.[xviii] Emergency bank borrowing from the Fed has flattened, and new borrowings from the Discount Window—its traditional crisis facility—have plummeted. (Exhibit 3) As for the Bank Term Funding Program created early this year, use is up, but this doesn't seem like a sign of systemic stress to us, given friendly collateral terms and offer rates banks can lock in for a year. The KBW Regional Bank Index—a gauge of tiny US Financials—rebounded since post-First Republic lows in early May. While more small banks could fail or face profit headwinds and industry consolidation might loom, we think systemic crisis fears have, rightly, evaporated.

EXHIBIT 3: EMERGENCY FED LENDING HAS FLATLINED



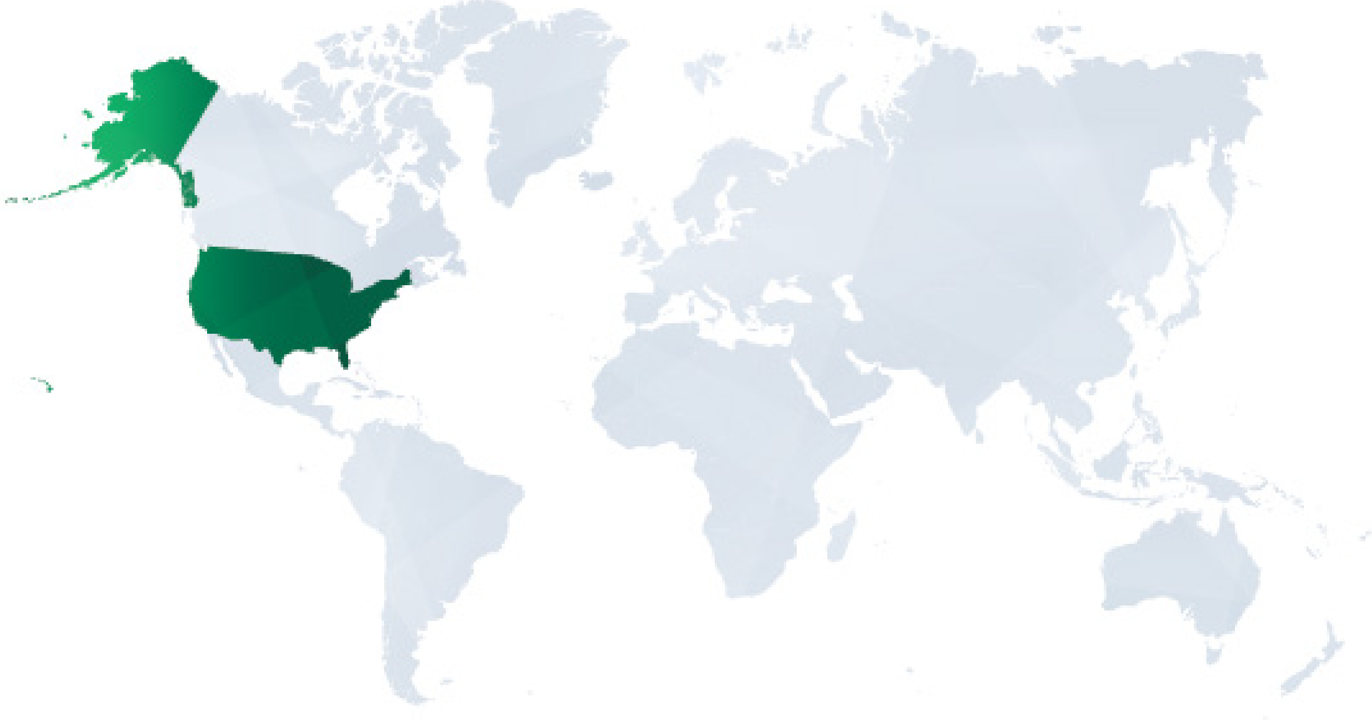
Source: Federal Reserve Bank of St. Louis, as of 12/07/2023. In Billions USD.

INFLATION AND INTEREST RATES AROUND THE WORLD

Of all the drags on sentiment since early 2022, none has dug in quite like inflation. Companies might be coping relatively well, with robust profit margins and sharply positive returns from last October's low, but people are weary. The US inflation rate has slowed markedly since June 2022's peak, but many only noticed this month and complain core prices are still rising too fast. People see more stubborn prices in the UK and Europe, worrying stickier inflation there necessitates even more rate hikes, rendering a recession that infects the world. Yet on both sides of the Atlantic, we see many encouraging signs. Sentiment has fallen too far, vastly underrating improvements and creating a big inflation wall of worry. We will provide more detailed inflation commentary in the US and Global ex-US sections below.

xviii Source: Federal Reserve Bank of St. Louis, as of 07/11/2023.

UNITED STATES **COMMENTARY**



A TEXTBOOK MIDTERM MIRACLE

Our political commentary is intentionally non-partisan. We favour no politician nor any party, assessing developments solely for potential market impact.

Our Q3 2022 Review & Outlook detailed the bullish impact of US midterm elections, which routinely reduce the president's legislative influence, blocking contentious bills. This gridlock renders a noisy but inactive legislature, which buoys equities. Legislation creates winners and losers, which can create a difficult environment for corporations to navigate.

The nine months surrounding the November vote—the Midterm Miracle window—are the most consistently positive nine-month stretch in US equity market history, rising in 92% of periods since 1925 and averaging 19.6% returns.[xix]

This period was a classic example. Equities began rising in mid-October, a few weeks before the vote and just after the midterm Q4 started. They finished it up 7.6% in Q4. The positivity carried right into Q1 and Q2, which rose 7.5% and 8.7%. The overall gain was 25.7%, a nicely above-average Midterm Miracle return.[xx] In contrast to pre-midterm political angst, post-midterm gridlock is helping fuel a new bull market.

xix Source: Global Financial Data, Inc., as of 10/07/2023. S&P 500 average total return and frequency of positivity from 1 October of midterm years to 30 June of the following, 1926 – 2023.

xx Source: FactSet, as of 11/07/2023. S&P 500 total return, Q4 2022, Q1 2023 and Q2 2023.

WHAT TO EXPECT IN THE SECOND HALF

Third years' second halves aren't as consistently positive or strong as the first, but gains tend to continue. As Exhibit 4 shows, equities rose in 75% of them, averaging 5.5% gains. Moreover, outside the Great Depression and 1987's crash—neither of which resemble today—down stretches were mild.

EXHIBIT 4: THE THIRD YEAR BY HALVES

Third Year	First Half	Second Half
1927	12.2%	22.2%
1931	-0.7%	-43.5%
1935	10.0%	33.9%
1939	-15.9%	17.9%
1943	29.7%	-3.0%
1947	1.9%	3.3%
1951	6.4%	17.1%
1955	16.4%	12.9%
1959	7.6%	4.0%
1963	11.7%	9.8%
1967	14.7%	8.1%
1971	9.9%	4.0%
1975	41.9%	-3.3%
1979	9.9%	7.7%
1983	22.2%	0.2%
1987	27.4%	-17.4%
1991	14.3%	14.2%
1995	20.2%	14.4%
1999	12.4%	7.7%
2003	11.8%	15.1%
2007	7.0%	-1.4%
2011	6.0%	-3.7%
2015	1.2%	0.2%
2019	18.5%	10.9%
2023	16.9%	?
Average	12.5%	5.5%
Median	11.8%	7.7%
Frequency of Positivity	92.0%	75.0%

Source: Global Financial Data, Inc., as of 12/07/2023. S&P 500 total return in the first and second half of presidents' third years in office.

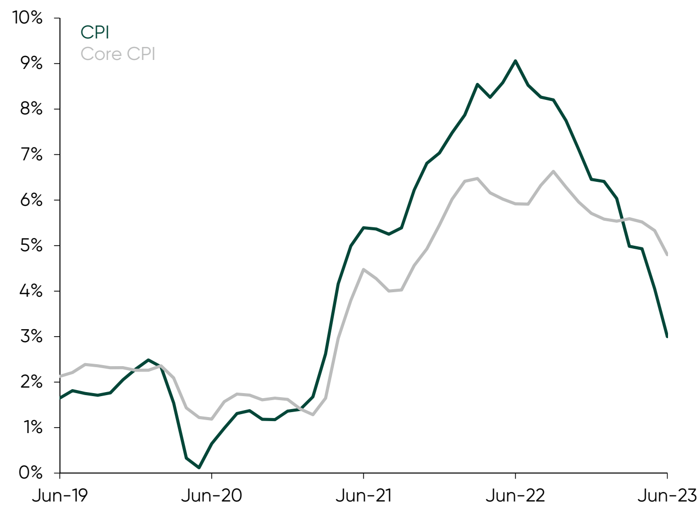
The back half segues into year four, also historically good for markets. Since 1925, US markets climbed in 83.3% of presidential election years, averaging 11.4%. Not only does gridlock persist, but most candidates seeking re-election avoid big legislation as the election approaches. They fear roiling voters—particularly centrists. Besides, during a campaign, wedge issues are more useful for raising money and motivating their base than passed legislation. This is a predictable pattern in politics, knowing that politicians' chief motivation is retaining office.

With the field taking shape, chatter about next year's US presidential election are moving to the media forefront, but in our view, it is much too early to give significant thought to the potential market impact. There are far too many unknowns, and the number of politicians running could grow even larger before primaries start narrowing the field. The election isn't a second-half 2023 market issue, in our view. We will have more to say on it next year.

US INFLATION'S UNDERRATED IMPROVEMENT

Even at June's 3.0% y/y, the headline Consumer Price Index (CPI) inflation rate remains higher than Americans enjoyed in the 2010s.[xxi] Yet it is also a third of last June's 9.1% y/y peak. (Exhibit 5) Core CPI, which excludes food and energy, has also eased, though at a slower pace.

EXHIBIT 5: WELL PAST INFLATION'S PEAK



Source: FactSet, as of 12/07/2023. Headline and Core CPI, year-over-year percent change, June 2019 – June 2023.

With headline inflation now undershooting core, higher core CPI has taken center stage. While core goods inflation is quite normal now, at 1.3% y/y, core services remain elevated at 6.2%.[xxii] Many economists argue higher wages are keeping service prices elevated, straining households and likely forcing the Fed to resume hiking rates after June's pause.

xxi Source: FactSet, as of 12/07/2023.

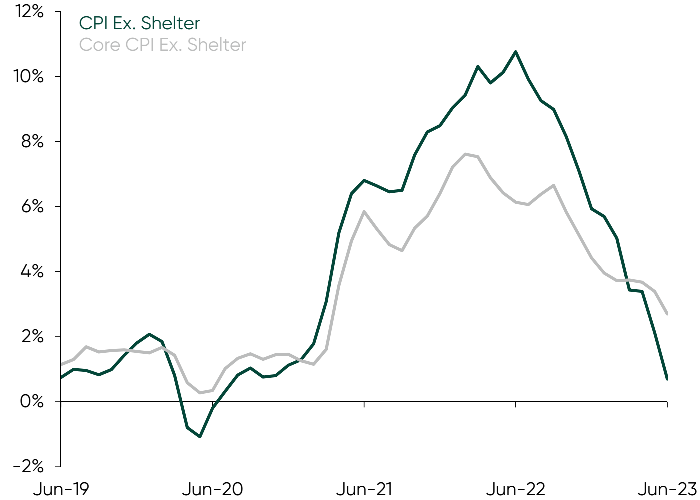
xxii Source: FactSet, as of 12/07/2023. Year-over-year percent changes in the Commodities Less Food and Energy Commodities and Services Less Energy Services US CPI aggregates, June 2023.

Central banks will do what they do—they are unpredictable, a key lesson many have failed to learn these last two years. But, still, fears rest on flawed logic. In the late 1960s, Nobel laureate Milton Friedman famously dismantled the widely held view that wage growth causes inflation. He showed wages trail consumer price inflation since employers factor in living costs when recruiting. From the BLS's wage data to the Atlanta Fed's wage growth tracker, data overwhelmingly show pay growth lags inflation. Ironically, a May Fed study echoed these findings. Inflation is about too much money chasing too few goods and services. With money supply down after 2020's spike and supply chain issues gone, the fundamental drivers behind recently high inflation have eased substantially.

So why are core services prices stubbornly high? Shelter. This category is over one-third of total CPI and over half of core services. Its biggest component is Owners' Equivalent Rent, which no one actually pays. It is the hypothetical amount a homeowner would pay to rent their home—the Labor Department's means of folding home prices into inflation, which is philosophically questionable. Inflation is meant to tally commonly consumed goods and services. Real estate, an investible asset, doesn't seem to qualify.

So when looking at inflation now we think it is important to also look at CPI excluding shelter. Headline CPI minus shelter hit 2.1% y/y in May, completing the return to prepandemic rates, before slowing to 0.7% in June.[xxiii] Core CPI excluding shelter, at 2.7% y/y, is below its long-term average of 3.6%.[xxiv] If not for an imaginary cost's skew, US inflation would be at prepandemic rates now. (Exhibit 6)

EXHIBIT 6: WITHOUT SHELTER, INFLATION IS BACK TO NORMAL



Source: FactSet, as of 12/07/2023. Headline and Core CPI Ex. Shelter, year-over-year percent change, June 2019 – June 2023.

Soon the main CPI measures should reflect this. Shelter tends to lag home prices by about 15 months, and home prices leveled off (and in some areas began falling) a year ago. We think equities already reflect this, but more visible inflation improvement should help sentiment. Slowing inflation also points to more stable long rates.

THE FED SLOWS DOWN

As for short rates, again, central banks are unpredictable. But this rate hike cycle looks close to done. After slowing its rate hike pace to a quarter point in March and April, the US Fed paused in June. This doesn't preclude more hikes, as we saw in the US in late July. Australia's and Canada's central banks resumed hiking after brief recent pauses. The BoE returned to half-point hikes in June following an earlier slowdown. Still, market expectations suggest rates won't go much higher. With inflation moderating, this seems rational.

xxiiiIbid. Year-over-year percent change in the All Items Less Shelter US CPI aggregate, May and June 2023.

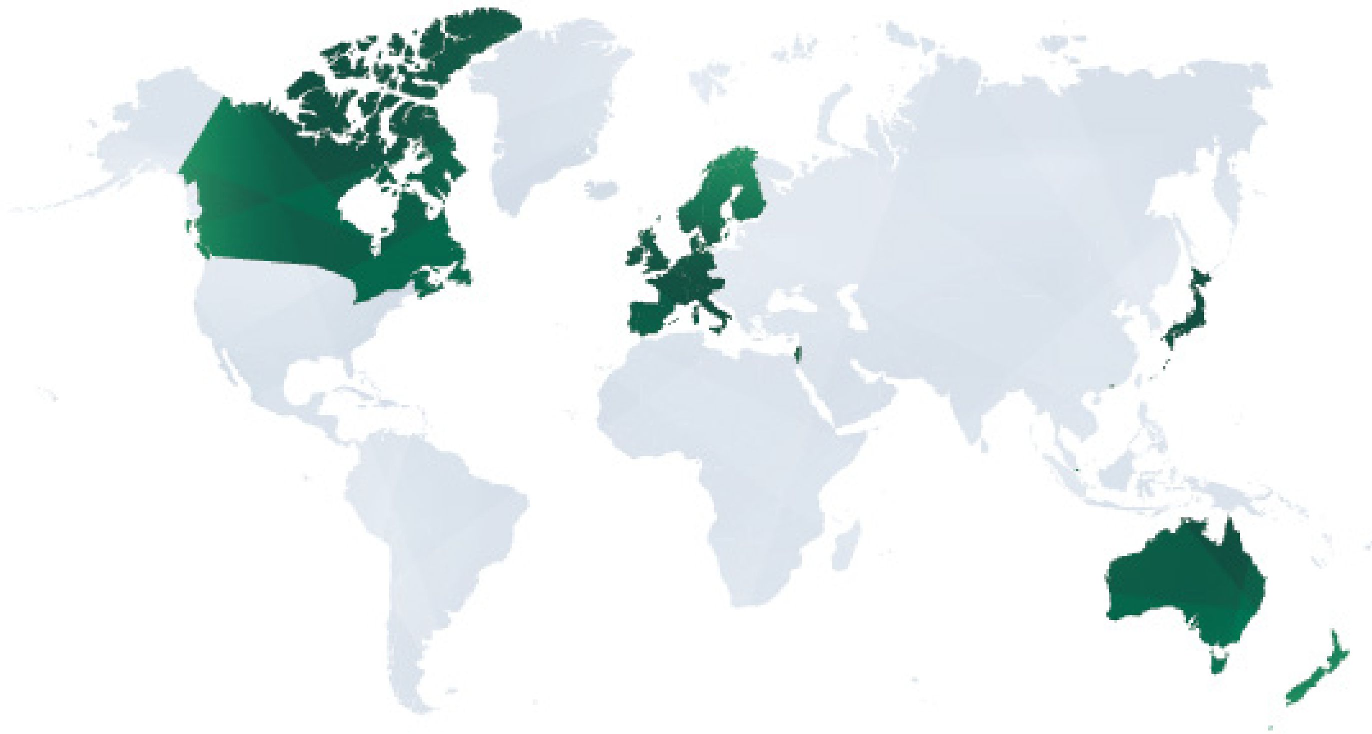
xxivIbid. Year-over-year percent change in the All Items Less Food, Energy and Shelter US CPI aggregate, June 2023. Long-term average rate, January 1968 – May 2023.

Markets don't need a rate pause or cuts, as many argue today. Pundits who focus on this are worrying unnecessarily, considering there is ample evidence equities already overcame rate hikes. The S&P 500 is up nicely since June 2022, despite most of the Fed's rate hikes (and their biggest moves) occurring since then. The ECB started hiking last July. Eurozone markets? Up double digits since then in euros and dollars.

If all of these rate hikes didn't prevent markets from rising over the last year, it seems pretty clear rate hikes aren't driving markets. It is also clear equities aren't waiting for pauses or rate cuts. They are doing what they always do, pricing in expected earnings over the next 3 – 30 months. Those will hinge on far more than interest rates.

Central bankers aren't as powerful as people think. Furthermore, they themselves don't know what they will do next, as is abundantly clear from the many times they have defied their own forecasts and guidance. If central bankers can't know their next move, certainly no one else can. Fixating on what everyone fixates on is a pointless activity in markets.

GLOBAL DEVELOPED EX-US **COMMENTARY**



INFLATION IN THE UK AND EUROPE

Inflation in the UK and most of Europe hasn't eased as much as in the US. This shouldn't surprise, considering US inflation led Europe by several months on the way up. Where US CPI peaked in June 2022, most of Europe and the UK didn't peak until late last year. French and Austrian inflation kept accelerating through early 2023. Now all are easing and should keep doing so, albeit in fits and starts, but their delayed progress has extended inflation and rate hike fears, weighing on sentiment and some overseas markets—most notably, the UK.

Britain's headline inflation rate hit 7.9% y/y in May and 7.3% in June when using the Office for National Statistics' headline measure, CPI-H (which unlike CPI, includes an estimate of owner-occupiers' housing costs).[xxv] While that continued its gradual decline from October's 9.6% high, core CPI-H accelerated to 6.5%, a new high in May—and decelerated just slightly, to 6.4%, in June.[xxvi] Now there is a hot political debate over whether wage hikes or corporate margin-padding is responsible. The Bank of England (BoE) blames both sides, urging workers to tolerate stagnant pay and warning companies not to boost profit margins. The angst has weighed on sentiment. After hitting a new all-time high in mid-February when measured in pounds, UK equities hit correction territory in price terms in early July.[xxvii]

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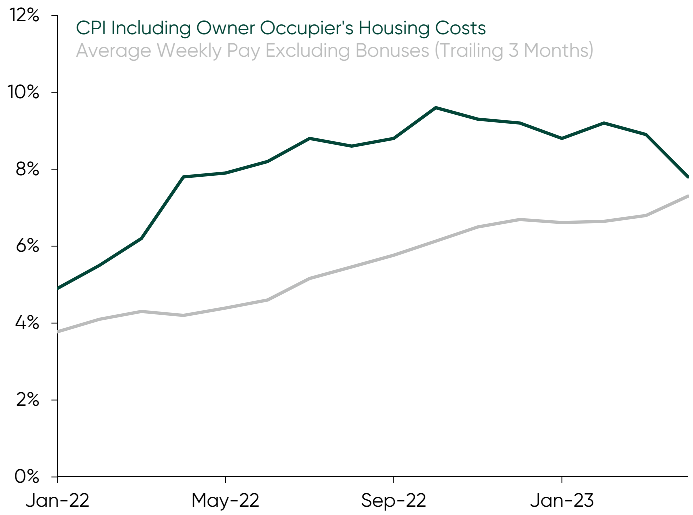
xxv Ibid. Year-over-year percent change in UK CPI Including Owner-Occupiers' Housing Costs (CPI-H), May and June 2023.

xxvi Ibid. Year-over-year percent changes in UK CPI-H, October 2022, and UK CPI-H Less Food and Energy, May and June 2023.

xxvii Source: FactSet, as of 10/07/2023. Statement based on MSCI UK IMI price returns in GBP.

As in the US, there is little to no evidence UK wages are driving inflation. Rather, they aren't keeping up with it: Wage growth has lagged prices. As Exhibit 7 shows, the wage growth rate has trailed the inflation rate since 2022 began, and while headline inflation peaked last October, wage growth is still trying to catch up.

EXHIBIT 7: WAGES LAG INFLATION



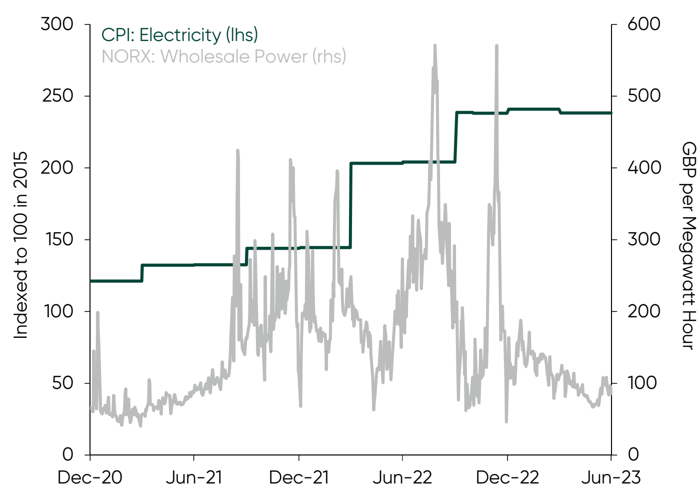
Source: FactSet, as of 11/07/2023. HICP and Average Weekly Pay Excluding Bonuses, year-over-year growth rate (percent), January 2022 – April 2023, latest wage data available.

As a result, real pay is negative. But even adjusting pay for inflation doesn't tell the full story, as it doesn't include the effect of the government's decision to freeze income tax bands until 2026. This, coupled with several benefits thresholds' not being indexed to inflation, has hit households with a stealth tax hike and added to the number of people caught in the 60% tax trap. Not only are nominal wage increases subject to higher income tax rates, but they have also propelled over a million households into higher investment taxes, further increasing the burden. Meanwhile, mortgages that are about to exit their fixed-rate periods will expose more households to today's higher rates. Data overwhelmingly show households are scrimping, not bidding prices higher.

This also argues against price gouging, which "works" only if demand supports it. Moreover, UK corporate profit margins aren't running away. Private non-financial corporations' net rate of return held steady at 9.8% in Q4 2022 (the latest available), matching Q3's rate.[xxviii] Given household budgets have only tightened since then, we doubt margins ballooned in 2023's first half.

We see a much simpler culprit for the UK's relatively slower improvement: Government interference with energy prices. The UK has twin price caps. The first is Ofgem's regulatory cap, which initially reset every six months (now every three), setting a ceiling for average annual costs for households on the default tariff. Given the inherent volatility in energy commodity markets, the ceiling became a price target for suppliers, forcing big stairstep increases on UK households as oil and gas prices increased last year. This led to the government's Energy Price Guarantee, whereby the government pays all costs over £2,500 annually. While possibly helpful to some when annual household energy rates exceeded £2,500, it has mostly hidden a steep fall in wholesale power prices over the past several months. Ofgem's cap started falling in April 2023, but it remained above £2,500, so this initial reduction didn't flow through to the inflation rate. The only force dragging energy price inflation lower was the base effect.

EXHIBIT 8: HOUSEHOLD ENERGY PRICE INFLATION VERSUS WHOLESALE POWER PRICES



Source: FactSet, as of 19/07/2023. Daily NORX Wholesale Power Price-GBP per Megawatt Hour and Monthly CPI Electricity Level, indexed to 100 in 2015, 31/12/2020 – 30/06/2023.

xxviii Source: Office for National Statistics, as of 29/06/2023.

The regulatory cap finally fell below £2,500 in July (while the Energy Price Guarantee rises to £3,000). From there, presuming natural gas and wholesale electricity prices remain low, improvement should quickly register in CPI. Not just in the energy components, but up and down the inflation basket, as businesses' energy cost pressures ease.

Other disinflationary forces abound in the UK. Broad money supply fell month-over-month in six of the past eight months through May, bringing the year-over-year growth rate to just 0.7%.[xxix] Plunging Producer Price Inflation (PPI) shows goods inflationary pressures have largely faded: Input costs fell -2.7% y/y in June, while output costs eased to 0.1%, down fast from April's 5.2%.[xxx] PPI doesn't lead CPI, as many suppose, but it clearly shows disinflationary forces have taken root.

Something else UK fears miss: Britain isn't much of an outlier. Exhibit 9 shows June's inflation rates across Europe, with the caveat that some of these are preliminary rather than final readings. German inflation accelerated in June, with the core rate jumping from 5.1% y/y to 6.1%, a fresh high. But German inflation doesn't inspire the same angst as Britain's. Dutch core inflation is also higher and reaccelerated sharply in April and May before a modest June cooldown. Irish core inflation reaccelerated in June, while Belgium, Austria and Sweden have higher core inflation rates than Britain. Seemingly, there is scant European inflation dread overall. Nor should there be, considering lending and money supply growth have slowed, pointing to price stability ahead.

EXHIBIT 9: EUROPEAN INFLATION AT A GLANCE

	Peak CPI	Current CPI	Current Core CPI
UK	9.6%	7.3%	6.4%
Eurozone	10.6%	5.5%	5.5%
Germany	11.6%	6.8%	6.1%
France	7.3%	5.3%	4.4%
Spain	10.7%	1.6%	3.8%
Italy	12.6%	6.7%	4.9%
Netherlands	17.1%	6.4%	7.1%
Belgium	13.1%	1.6%	6.5%
Ireland	9.4%	4.8%	5.1%
Austria	11.6%	7.8%	7.7%
Portugal	10.6%	4.7%	6.4%
Finland	9.1%	4.1%	4.5%
Sweden	10.8%	6.3%	7.2%
Norway	8.4%	6.8%	6.5%
Denmark	11.4%	2.4%	4.7%

Source: FactSet and Eurostat, as of 19/07/2023. Headline and Core (excluding food, energy, alcohol and tobacco) CPI inflation rates. Current data are for June 2023 except for Spain's Core CPI, which is May 2023. Peak data are for July 2022 (Spain), September 2022 (The Netherlands), October 2022 (UK, eurozone, Germany, Belgium, Ireland, Portugal, Norway and Denmark), November 2022 (Italy and Finland), December 2022 (Sweden), January 2023 (Austria) and February 2023 (France).

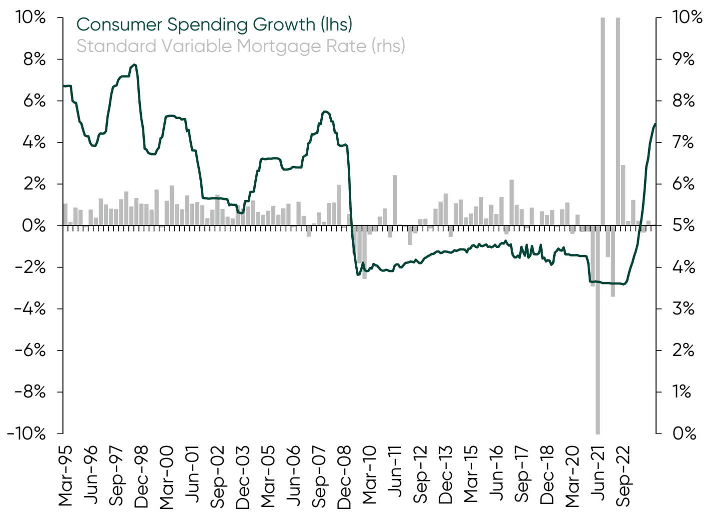
Inflation is a global phenomenon. So is disinflation. With the US previewing the rest of the world and disinflationary forces pretty broad, inflation should keep coming down across the developed world, including the UK. As it does, there should be less upward pressure on long rates, helping ease concerns about heightening mortgage payments hammering consumer spending and ushering in the long-feared recession. Chancellor of the Exchequer Jeremy Hunt's mortgage relief measures, announced in June, should also help on this front—albeit incrementally. Under the new programme, borrowers will have the option to temporarily switch their mortgages to interest-only or switch to a new mortgage deal entirely without incurring penalties, affordability checks or a credit score reduction. Those whose fixed-rate deals are ending can also lock in a new deal up to six months ahead of time. While these can't fully offset the impact of market movement, they do add more wiggle room, which should help sentiment if nothing else.

xxix Source: Bank of England, as of 29/06/2023. M4 excluding intermediate OFCs, May 2023.

xxx Source: Office for National Statistics, as of 19/07/2023.

Mortgage fears are likely a big culprit for UK equities' 2023 correction—not just because of the associated economic fears, but because it has been over 15 years since mortgage rates were last this high. Recency bias has made society anchor to the previous decades' generationally low rates as "normal." Yet as Exhibit 10 shows, higher rates were the norm. If higher rates didn't prevent consumer spending growth throughout the 1990s, we doubt they alone are sufficient to flip the UK economy into recession now. As investors gradually fathom this, UK equities should resume their climb up this young bull market's wall of worry.

EXHIBIT 10: HIGH MORTGAGE RATES DON'T STOP CONSUMER SPENDING



Source: FactSet, as of 12/07/2023. Quarter-over-quarter real household spending growth and month-end weighted-average standard variable mortgage rate, January 1995 – May 2023. Secondary Y-axis truncated to reduce skew from lockdown-era results.

Mortgage fears were just one extension of how the rise in long rates hit sentiment this spring and early summer. When 10-year Gilt yields crossed above 4.6% in late June, they eclipsed the highs of last autumn's pension crisis, which brought down Liz Truss's government. As inflation eases and the BoE dials down its tightening pace, the upward pressure on long rates should wane, relaxing fears about public finances and corporate debt. In the meantime, though, we think the latest spike provides two timely reminders. One, note that this time, pensions haven't had to fire-sale Gilts to meet margin calls—the pensions crisis isn't repeating. In addition to building larger liquidity buffers, funds have faced a gradual decline rather than a sudden spike, giving them more time to reposition as and when needed to fend off margin calls.

Two, note that gilt yields have hit new highs despite having a more nominally pro-austerity government in power—a powerful reminder that markets don't move on politicians' personalities or have pre-set reactions to a particular set of policies. Prime Minister Rishi Sunak and Hunt scrapped most of Truss and former Chancellor Kwasi Kwarteng's agenda, opting for the aforementioned stealth tax rises instead of the modest cuts Truss and Kwarteng championed. Similar to David Cameron and George Osborne, they have also slowed the projected rate of spending increases—policies advertised as "austerity" a decade ago—and have focused rhetorically on trimming the public deficit. These are all the policies pundits argued were necessary to rein in interest rates last autumn, but rates are now up at new highs anyway. Global market forces and inflation sentiment simply had a much larger influence, as they often do.

ON THE EUROZONE "RECESSION"

Is the eurozone in recession? Many headlines declared it so after Eurostat announced on 8 June that Q1 eurozone GDP contracted -0.1% q/q—a downward revision from its initial estimate of 0.1% growth. That contraction, combined with Q4 2022's -0.1% quarterly dip, meets one popular definition of recession, seemingly validating long-predicted downturn forecasts. However, in late July, Eurostat revised that -0.1% Q1 contraction to a flat quarterly reading (and annualised growth of 0.1%). While the question of whether Continent is in recession or not is still unanswered, we don't think this is a key swing factor for equities, which long ago pre-priced eurozone economic weakness to a large extent.

Many define recession as two or more consecutive quarterly GDP contractions, but the Centre for Economic Policy Research's Euro Area Business Cycle Network (EABCN)—the eurozone's official recession arbiter—considers broader criteria, including private consumption, investment, trade and employment. Even if Q1 growth hadn't been revised up, two tiny quarterly contractions of -0.1% are as mild as mild could be and may not qualify as recession based on the EABCN's review. Also consider that in every official recession, Germany and France, the region's largest economies, both contracted—and though German GDP slipped in Q4 and Q1, French GDP rose in Q1 after a very slight Q4 2022 contraction. Since 13 of 20 eurozone nations grew the past two quarters, we think it would be inaccurate to say the whole monetary bloc is in recession even if the consecutive contractions stood.[xxxi]

A closer look at recent detractors reveals some noteworthy nuances. Take Ireland, which comprises about 4% of eurozone GDP thanks to the sizable contributions from multinationals (e.g., large American pharmaceuticals and tech firms) who redomiciled to the Emerald Isle for tax benefits.[xxxii] Since GDP includes profits of foreign businesses, these multinationals have a big impact on Irish GDP—which influences eurozone output. This was a major factor in Q1's shifting results: The eurozone's downwardly revised Q1 reading accompanied a big downward revision to Irish GDP, which stemmed from a large reported decline in March's pharmaceutical production. This drop didn't reflect actual domestic production, but rather production elsewhere that was booked in Ireland, where the companies hold the relevant patents. But five weeks later, those March figures were revised higher (to a smaller contraction), paring the decline in Irish GDP (revised to -2.8% q/q from -4.6%) and leading to the eurozone's upward revision.[xxxiii] Economists are aware of Ireland's quirks, which is why the country's statistical agency uses a measure called modified domestic demand (MDD) to track the domestic economy—and this metric rose 0.1% q/q in Q1 following a flat Q4.[xxxiv]

ON GERMANY

Germany, the eurozone's biggest economy, did contract over the past two quarters (-0.3% q/q in Q1, extending Q4's -0.5% decline), and the results under the hood were a mixed bag.[xxxv] Real household consumption expenditures slipped -1.3%, and weakness was broad-based.[xxxvi] Households spent less on food and beverages, clothing, furniture and cars—which the German Federal Statistics Office attributed to persistence of elevated inflation. But on a gross value added basis, manufacturing rose 2.0% q/q, perhaps indicating some economic green shoots after the sector contracted in three of four quarters last year.[xxxvii]

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xxxi Source: Eurostat, as of 27/07/2023.

xxxii Source: Eurostat, as of 23/07/2023.

xxxiii Source: Central Statistics Office, as of 27/07/2023.

xxxiv Ibid.

xxxv Source: Destatis, as of 25/05/2023.

xxxvi Ibid.

xxxvii Ibid.

That said, the German economy's soft patch isn't a surprise. Economists have forecast a deep German recession since December 2021. Those calls intensified after Russia's invasion of Ukraine, as many projected soaring energy prices would roil Germany's industry-heavy economy. High prices did weigh on German industry and households, but they haven't sent the broad economy into a deep downturn. Perhaps German GDP struggles to grow this year. But a muddled pattern of tepid growth and mild contraction is a more benign outcome than last year's projected major recession—and that better-than-anticipated outcome can positively surprise investors, boosting markets.

MARKETS MOVED FIRST

This appears to have been the case. We think equities behaved like the leading indicators they are, moving ahead of the economic data. Since eurozone markets bottomed in late September last year, they are up 31.7% in euros (used to eliminate currency skew from the strong USD) through 30 June—ahead of the EAFE's 17.7% return over the same period.[xxxviii] This rebound started *before* Q4 began, when GDP contracted. In our view, markets aren't missing anything. Rather, we think they pre-priced the economic weakness the data now show—and have moved on.

The latest economic figures suggest eurozone growth remained muddled throughout Q2. For example, though eurozone services PMI readings have exceeded 50 this year—indicating expansion—manufacturing remains mired in contraction. It is possible eurozone GDP contracts again. But in our view, little here is new. Surprises move markets most, and at this point, a mild dip wouldn't shock. Note, the IMF has turned more pessimistic on Germany's economic prospects, updating its 2023 forecast for a -0.3% annual contraction—worse than its April estimate of -0.1%.[xxxix] This estimate is consistent with findings from recent sentiment surveys, indicating eurozone sentiment remains dour, especially relative to other developed economies. In our view, that establishes a low bar for reality to clear—a bullish development.

A NEW DAWN FOR THE LAND OF THE RISING SUN?

Japan is a rare recipient of investor enthusiasm this year tied to several minor factors. For example, the Tokyo exchange encouraged buybacks to boost price-to-book ratios, and the last decade's slow-moving corporate governance reforms, which gave shareholders more influence, have finally started bearing some fruit. Those developments—plus relatively stronger economic performance—spurred high-profile investors to tout Japan's prospects.

Alongside these positives, the Nikkei 225 and TOPIX hit 33-year highs (in yen) in May.[xl] Though still off their all-time highs, Japanese equities' run-up this year sparked optimism the country's long-running economic stagnation and chronic deflation are ending.

xxxviii Source: FactSet, as of 24/07/2023. MSCI EMU Index and MSCI EAFE Index returns with net dividends, in euros, 29/09/2022 – 30/06/2023. For reference, in USD, eurozone stocks returned 47.1% to the EAFE's 31.5% over the same period.

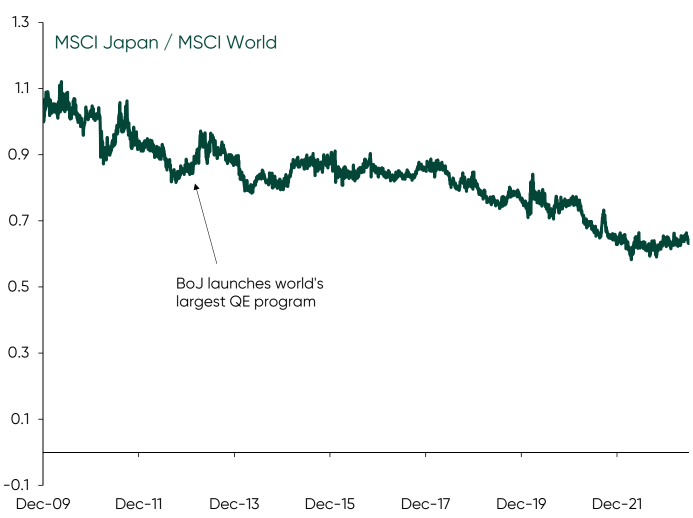
xxxix Source: IMF, as of 27/07/2023.

xl Source: FactSet, as of 10/07/2023. Statement based on Nikkei 225 and TOPIX price indexes, in Japanese yen, 01/01/1970 – 30/06/2023.

But we think much of this enthusiasm is overstated—reminiscent of 2013's short-lived outperformance. Then, global investors cheered the late Shinzo Abe's return to the premiership, hopeful his "Abenomics" programme would revitalise the country's economy, particularly via structural reforms. But the few reforms that passed were incremental and took time to generate results, disappointing investors hoping for a quick fix—and Japanese equities' spurt of outperformance didn't last.

Some say it is different now because prior reforms are starting to breed more shareholder-friendly corporate actions. Perhaps, but this is also well known, and improvement likely fades into the long-term structural backdrop just as Japan's chronic headwinds did. Additionally, PM Abe didn't complete his reform agenda, forgoing labour market changes in favour of national defense-related measures—a position current Prime Minister Fumio Kishida has continued with. And as previously mentioned, the Bank of Japan continues the misguided monetary policy that hampered lending and Japanese markets in the 2010s. It is hard to see Japan's economy suddenly surging.

EXHIBIT 11: JAPAN LAGGED DESPITE MAMMOTH QE PROGRAMME



Source: FactSet, as of 12/07/2023. Japan is underperforming when the line is falling. Indexed to 1 at 31/12/2009.

Japanese growth benefited from a reopening-related boost in the first half, and we think that will eventually fade into more normal rates. But slower prepandemic growth rates still add to the global economy. Japan's globally competitive multinationals are less dependent on domestic demand and more likely to benefit from improving global demand.

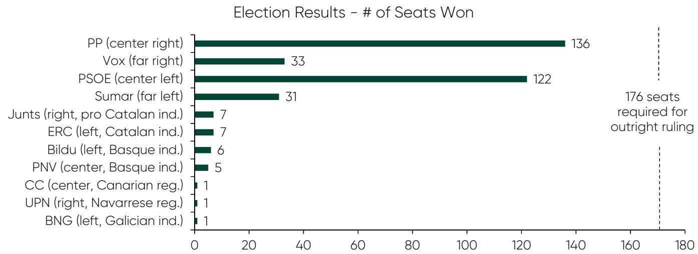
VOLATILITY IN SPANISH POLITICS, FOR NOW

Spain went to the polls in late July, five months ahead of schedule, as Prime Minister Pedro Sánchez and his center-left Socialist Workers' Party (PSOE) sought to limit the damage from a resurgent center-right Popular Party (PP). Voters gave neither side a clear path to a majority, raising uncertainty for the time being—but also pointing to gridlock in the longer term, which should become clear to markets as uncertainty falls.

When Prime Minister Sánchez called a snap election after the PSOE suffered in May's local elections, most pundits penciled in a win for Alberto Nuñez Feijoo's PP. At the time, the PP had a comfortable polling lead that most presumed would land them a coalition government with the more right-wing, populist Vox party. But Prime Minister Sánchez took the risk anyway, hoping the PSOE and its more populist left-wing allies, Sumar (formerly known as Podemos) could retain enough seats to leave the right-wing bloc shy of a majority—giving him a chance to reform a government with support from small regional parties.

That chance is still alive. The PP won a plurality in the 23 July vote, taking seats in the 350-seat chamber—47 more seats than it won at 2019's election. But Vox lost 19 seats, winning just 33. That gives the right-wing bloc (which also includes the Navarrese People's Union, a tiny regional party) 170 seats, 6 short of a majority. Complicating matters, the PSOE gained 2 seats—winning 122—while Sumar won 31. If Prime Minister Sánchez can successfully organise all the left-leaning regional parties, his alliance would have 172 seats, which is closer but still shy of the 176 needed. This leaves hardline Catalan separatist party Junts, which won seven seats and whose leader, Carlos Puigdemont, is a fugitive living in exile in Belgium.

EXHIBIT 12: SPANISH ELECTION RESULTS



Source: Spanish Government via The Guardian, as of 25/07/2023.

Party leaders have nearly a month until the new Parliament sits on 17 August, giving them a few weeks for preliminary negotiations. Then, King Felipe VI will sit down with the leaders, determine which is likeliest to be able to win a confidence vote, and invite them to form a government. From there, the nominee gets several weeks more to hash out a coalition. If the new cabinet doesn't win an absolute majority on the first try, it can aim for a minority government in the second vote. Round two requires only a simple majority, making it possible for a minority administration to win if enough MPs abstain.

How this all shakes out is unclear—hence the near-term uncertainty. The PP's alliance with Vox will be a stumbling block for smaller parties, and their stance against regional separatism seemingly makes Junts an unlikely ally, to say the least. It also seems unlikely that enough left-leaning parties would abstain from a second-round vote to land them in office, but stranger things have happened.

On the flipside, it isn't clear Prime Minister Sánchez can pull together all the disparate parties and interests necessary to get a left-wing alliance in office, especially with Junts signaling its support will be expensive. Among its demands: amnesty for exiled Catalan politicians who have lived as fugitives since the illegal 2017 independence referendum and a new legal, binding vote on Catalan self-determination. Prime Minister Sánchez has repeatedly disavowed a new independence vote, and his past concessions to Catalan separatists are partly behind the PSOE's polling struggles. This suggests an alliance won't come easily, if at all. Adding to the drama, prosecutors asked Spain's Supreme Court to issue a European arrest warrant for Carles Puigdemont following an EU court's dismissal of his appeal for continued immunity due to his status as a Member of the European Parliament. If he were jailed, it would likely complicate the picture further.

If neither side can form a government, then Spain will likely head to new elections later this year. As we write, both main parties have downplayed this possibility as they start negotiating with potential coalition partners. Yet if Junts or any other small party doesn't make the math add up, one side will have to agree to abstain to let the other form a minority government. At the moment, this seems like a very tall order.

So the make-up of Spain's next government is quite unclear, and therefore, uncertainty is high for now. But regardless of the outcome, gridlock looks like the ultimate winner. Whether or not there is a second election, the next government will almost surely be a multiparty hodge-podge and potentially a minority administration. Even ideologically aligned coalitions tend to get very little done after squabbling over legislation. Major initiatives often get sanded down into something too watered-down for hardline MPs' tastes. Thus, few major changes tend to pass, which gives businesses more clarity—fostering risk-taking and investment. So while uncertainty could be a headwind in the near term, perhaps bringing more short-term volatility, that likely fades into the tailwind of gridlock over time.

THE RESERVE BANK OF AUSTRALIA'S NEW GOVERNOR

The RBA offers a timely lesson in central banks' unpredictability, too. With Governor Philip Lowe's first seven-year term coming to a close, Prime Minister Anthony Albanese elected not to reappoint him for another term. Lowe's popularity has taken a hit these last two years tied to on-again-off-again rate hikes and changing forward guidance that kept observers guessing all year.

In mid-July, after weeks of speculation, Albanese appointed Deputy Governor Michele Bullock to replace Lowe. Pundits have long speculated she was amongst a cadre of potential nominees he was weighing, so it came as little surprise when he tapped Bullock for the post. And many argue this is a vote for consistency on Albanese's part, as Bullock is a long-term RBA staff member.

Deputy Governor Bullock has served on the RBA's policymaking board for 15 months, during which she has assisted in Lowe's tightening campaign, which most project forward. But as per an official review's recommendations, the RBA is about to form a dedicated monetary policy board (MPB). Until now, the RBA board has overseen both monetary policy and overall corporate governance, stretching it rather thin. These functions will now split in two. One committee will oversee the currency and governance matters, while the other will set monetary policy.

And who constitutes this board is mostly unknown. It will include Deputy Governor Bullock, whoever succeeds her as Deputy Governor, and Treasurer Jim Chalmers—plus six external members with expertise in "macroeconomics, the financial system, labour markets, or the supply side of the economy."[xli] Most observers presume this means the MPB will need six new members, given the old board's external members tend to be from the business community and, the review hints, simply vote for what the Governor tells them to. The RBA review recommends the MPB should be "able to robustly challenge the views of others and bring an independent perspective."[xlii] The hiring process isn't set yet, but the review says the RBA should advertise the positions, with the Treasury Secretary, RBA Governor and an unspecified third party reviewing the submissions and recommending candidates to the Treasurer.

So who is setting policy isn't clear. Their backgrounds and potential biases aren't clear. Monetary officials' behavior can't be forecast, as it often sways on unknowable interpretations of data. But if the board itself is unknown, then anyone forecasting the direction of policy is just speculating.

xli "Review of the Reserve Bank of Australia," Australian Government, March 2023.

xlii Ibid.

EMERGING MARKETS COMMENTARY

SENTIMENT IN EM

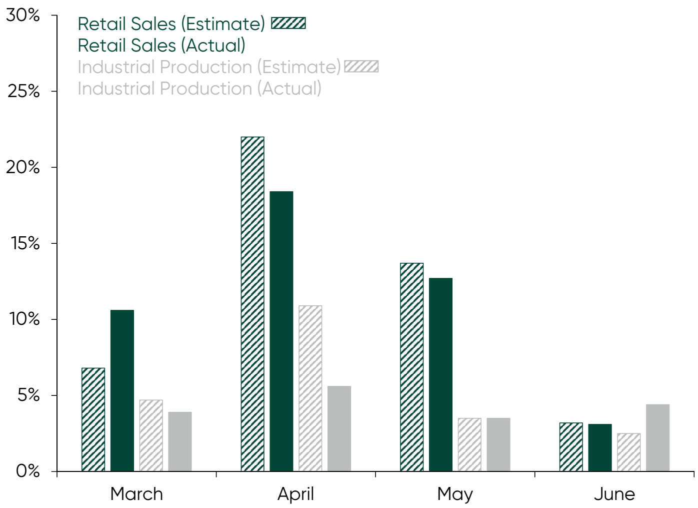
We track economic conditions worldwide. That said, dreary as sentiment is toward Europe, it is even worse toward China, which seems to be unfairly influencing people's views of Asian economies. Entering 2023, the world cheered China potentially booming as COVID restrictions finally ended. Now fear is back, centering on an allegedly faltering economic recovery. Yet conditions are simply returning to prepandemic trends, no bad thing. Better still, the broader region continues making big, underappreciated global economic contributions.

ON CHINA

China made headlines last quarter for several reasons, from regulations on local artificial intelligence (AI) products to trade disputes with the West—among other heated geopolitical issues. As important as these might be, they distract from China's main influence on global markets: its contribution to global economic growth. If Chinese growth looks set to beat expectations over the next 3 – 30 months, adding more than expected to global GDP, that is enough to give markets another tailwind.

Expectations for China's economy were high entering Q2. Fiscal and monetary stimulus was kicking in, the weather was warming up, and people were free to shop and travel. The stage seemed set for a newly reopened economy to recover quickly. Yet hope got a bit too lofty, and China's economic data didn't quite meet it—see widely watched retail sales and industrial production. (Exhibit 13)

EXHIBIT 13: HOW THE LATEST CHINESE DATA SQUARED WITH ESTIMATES

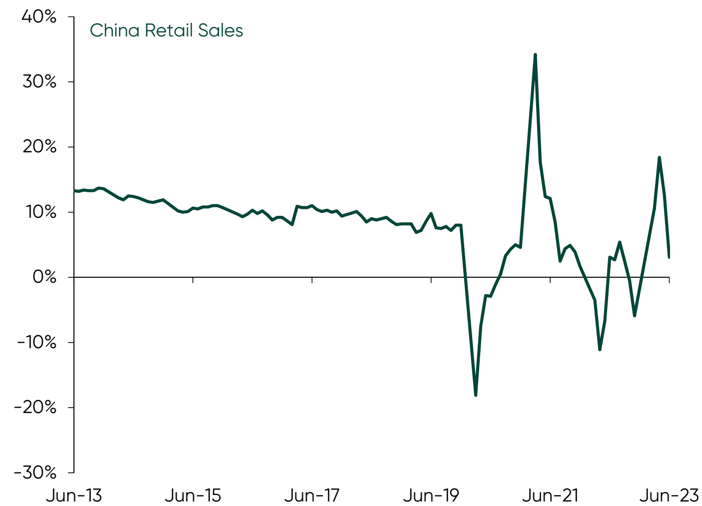


Source: FactSet, as of 18/07/2023. Actual and FactSet estimates of Chinese retail sales and industrial production, year-over-year percent change, 31/03/2023 – 30/06/2023.

Retail sales illustrate the trend. After March's sales beat expectations, many extrapolated red-hot growth forward. Yet April and May's growth, while faster than March's, missed forecasts. We suspect complicated year-over-year comparisons played a role here. April and May 2022 were when Shanghai and other major metro areas were locked down. Analysts rightly factored in a low base. But perhaps they underestimated how society had already learned to adapt to restrictions two years into the pandemic. Perhaps it was because the growth rates in those quarters had their own upward base-effect skew from 2021's initial reopening boost. Regardless, the miss discouraged those with high hopes for China's economy.

Tepid data drove fears of China lapsing into an unprecedented economic malaise, with high debt, prolonged property market weakness and poor demographics hindering growth. We disagree. It looks to us like China is returning to longer-term economic trends. Go back to retail sales, which were steadily slowing before the pandemic. (Exhibit 14)

EXHIBIT 14: A LONGER LOOK AT CHINESE RETAIL SALES



Source: FactSet, as of 17/07/2023. Monthly Chinese retail sales, percent year-over-year change, 31/05/2013 – 30/06/2023.

Slower growth would also match the government's long-term goal of transitioning away from heavy industry and export-driven growth to a model buttressed by domestic demand and services—akin to major Western economies. Note, too, a decelerating China still contributes mightily to the global economy: Last year's 3.0% annual real growth added nearly $490 billion to global GDP when measured in constant 2015 US dollars.[xliii]

xliii Source: The World Bank, as of 10/07/2023. Statement based on 2022 Chinese GDP (constant 2015 USD) and 2022 annual growth.

CHINA'S LOCAL GOVERNMENT DEBT LOOKS MANAGEABLE

Chinese debt fears have arisen again, with attention this time centered on local government debts, which many believe are large—and could trigger a hard landing. This, among other factors, has likely added to near-term uncertainty for broad Chinese markets, particularly state-owned enterprises. But, from a global perspective, the issue is an isolated, widely known extension of China's real-estate issues, and the economic effects are likely much smaller than most fear—particularly because the central government has the ability to step in with fiscal aid if needed.

The current debt concern features local government financing vehicles (LGFVs), off-balance sheet obligations China's local governments use to skirt debt issuance restrictions and fund infrastructure and real estate projects. Because LGFVs are off-balance sheet, their size is opaque. Public estimates vary from $9 to $13 trillion, which would be around half China's 2022 GDP.[xliv]

Ballooning LGFVs are an outgrowth of real estate weakness. Before its downturn, when China's local governments were short of tax revenue—like they were after 2020's lockdowns crushed economic activity—they turned to selling long-term leases for land to property developers, seemingly buoyed by insatiable appetite for housing and investment homes. But after 2021's Chinese property developers' travails, the market cooled. In their place, LGFVs—which traditionally sold debt to fund public infrastructure projects—stepped in last year, going on a land (lease) buying spree. China's government then sought to crack down, which caused net issuance to dry up. Thus, many fear this potentially hurts the local governments' ability to roll over existing debt while a record level of LGFVs are coming due. Not to mention China's ailing property markets and rolling lockdowns have drained local government resources the last couple years. This has some localities warning they may not be able to meet their LGFV obligations, leading to calls for financial assistance from the central government. In our view, uncertainty over the problem's size—and the response—is a headwind for broader Chinese markets. But it mostly seems to affect Real Estate and Banks, as we will discuss.

At a broader level, major spillover into global financial markets or Emerging Markets broadly looks unlikely. While frantic headlines suggest this is a crisis brewing, with local defaults causing an economic downturn, how the government handled property developers' debt crisis is instructive. Though selective defaults (on offshore bonds) were allowed, officials directed state-run banks to otherwise prop up the sector. Instead of the long-feared hard landing, GDP grew 8.1% y/y in 2021 and 3.3% last year.[xlv]

A similar situation appears to be developing now. Besides supporting real estate, China's biggest banks have started offering 25-year loans to LGFVs, with some waiving interest and principal payments for their first four years. Skeptics say this just shifts problems to banks, which now face ballooning non-performing loans. However, keep in mind that state-run Chinese banks are government-backed. The central government could use them as a conduit to aid imperiled local governments, a possibility valuations suggest markets are well aware of. Chinese banks currently trade at a price-to-book ratio of 0.4, a substantial discount the All-Country World Index's 1.0.[xlvi] (Exhibit 15) This is the trade off, in some sense, for banks' implicit state guarantees. To the extent an LGFV plan may require it, it is worth remembering China's government has recapitalised banks in the past when needed.

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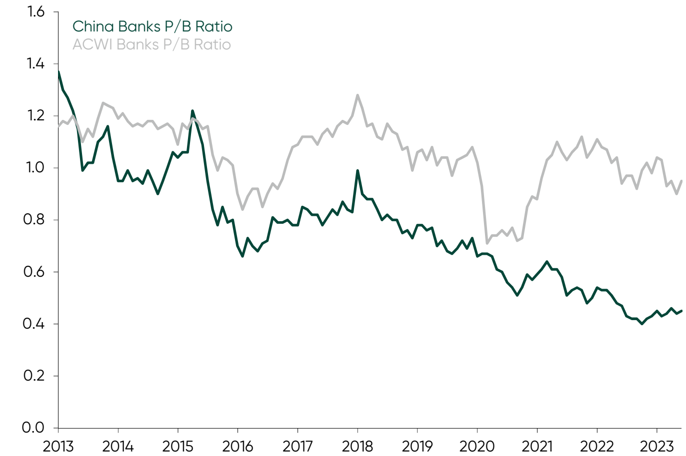
xliv "China Banks Offer 25-Year Loans to LGFVs to Avert Credit Crunch," Staff, Bloomberg, 03/07/2023. "China's Banks Bear Brunt of Concerns Around Growth and Debt," Staff, Reuters, 07/07/2023. Figures converted from yuan to dollars.

xlv Source: FactSet, as of 14/07/2023.

xlvi Source: FactSet, as of 14/07/2023. MSCI China Banks and MSCI ACWI Banks price-to-book ratios, 13/07/2023. Price to book is a ratio comparing a stocks' price to the company's reported net assets per share.

EXHIBIT 15: CHINESE BANKS' DISCOUNT TO THE ALL-COUNTRY WORLD'S



Source: FactSet, as of 14/07/2023. MSCI China Banks and All Country World Index (ACWI) Banks trailing 12-month price-to-book ratio, January 2013 – June 2023.

Conversely, it appears Chinese banks' (potential loan) loss could be LGFVs' gain. LGFV credit spreads—a measure of market's perceived default risk—have narrowed this year.[xlvii] While this could change, it is also worth noting that no LGFV has defaulted on its public bonds so far, though some have restructured their terms.

In the meantime, property developers and, now, local governments may have trouble borrowing, but the central government doesn't. The yield on 10-year China government bonds is 2.7%, while yields on equivalent-maturity offshore bonds—traded globally—hover just above that.[xlviii] This doesn't seem like too high a price to avoid a hard landing—and meet the government's stated policy objective to maintain social harmony—in our view.

It also points to how debt problems in China generally resolve: Losses weaker hands can't absorb are—sooner or later—borne by institutions strong enough to withstand them. Sometimes there are many intermediate steps in between to help sort it all out. Besides bank support, an additional step being considered is simply loosening restrictions on local government debt issuance that caused the LGFV environment in the first place.

Although the central government appears reluctant to pull out the fiscal stops—e.g., massive public works spending—there is seemingly more recognition greater household consumption is necessary to drive sustainable growth. In China, consumer spending makes up less than 40% of GDP compared to over 60% in most of the developed world.[xlix] This has been a long-running government goal: transitioning from investment and manufacturing-led growth to consumption and innovation-driven expansion.

In that vein, the government announced targeted measures to boost household consumption on 18 July. In addition to previously announced property developer loan relief, export support and electric vehicle tax breaks, its latest 11-point package—coordinated across 13 government agencies—plans to boost consumption by promoting home renovation and improving household credit access to buy appliances, electronics and home furnishings. On the supply side, policies seek to expand rural production of those goods, "optimise the consumption environment" with "15-minute cities" (providing residents' daily necessities within walking distance), encourage youth employment and wage growth, reform state-owned enterprises to raise their competitiveness and attract foreign investment.[l]

With the ability and intention to support growth, we don't think it holds much water to argue hard landing is imminent. In our view, spending will continue and local government investment alone wasn't propping up GDP. Therefore, despite some fears, this doesn't look like a Chinese economic calamity in the making. To us, it is one more false fear in the wall of worry global equities are climbing.

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xlvii "Investors Slash China Local Government Bond Tenors to Shortest On Record," Staff, Bloomberg, 14/07/2023.

xlviii Source: FactSet, 14/07/2023, and FTSE Russell, 30/06/2023.

xlix "China Signals Willingness for More Fiscal Stimulus," Chris Taylor, Radio Free Asia, 13/07/2023.

l "China Vows to 'Restore and Expand' Consumption to Boost Growth," Clement Tan, CNBC, 18/07/2023.

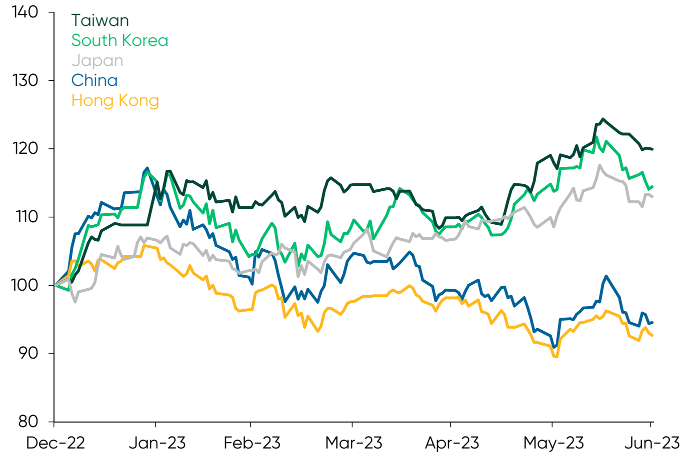
BEYOND CHINA

China's neighbours offer another way to see how reality simply beating expectations suffices for equities. MSCI China fell -9.7% in Q2 as several issues weighed on sentiment, from disappointing growth to regulatory headwinds, extending a slide that began in January.[li] Even that full-quarter return masks some of the pain, as the MSCI China fell -5.2% in April and -8.4% in May before rebounding modestly in June.[lii]

Initially, big regional trading partners fell in sympathy. But from around late April onward, fellow Emerging Markets Korea and Taiwan—and developed market Japan—detached from China and Hong Kong, rising as the latter two continued falling. (Exhibit 16)

Why is harder to know than what, but while Taiwan, Korea and Japan trade heavily with China, their companies aren't intertwined with the Mainland like Hong Kong's are. Hence, they didn't import this year's resurgent regulatory and property market concerns. That leaves economic growth and trade as larger influences, suggesting their markets quickly digested talk of a wobbling Chinese recovery and moved on. Disappointment that China's reopening didn't immediately boost trade seems priced in now.

EXHIBIT 16: ASIAN MARKETS LEAVE CHINA BEHIND



Source: FactSet, as of 07/07/2023. MSCI China, Hong Kong, Korea, Taiwan and Japan Index returns with net dividends, 31/12/2022 – 30/06/2023. Indexed to 100 at 31/12/2022.

Local economic figures further demonstrate Chinese headwinds aren't preventing Asia from contributing to global growth. Taiwan is a semiconductor powerhouse, with its exports considered a bellwether for electronics demand—hence their 2023 slide gets lots of attention. Less noticed? Taiwanese GDP stabilising from 2022's intermittent weakness despite exports' detraction, as private spending rose three straight quarters through Q1 2023—adding to global and regional demand.[liii]

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li Source: FactSet, as of 06/07/2023. MSCI China Index returns with net dividends, in USD, 31/03/2023 – 30/06/2023.

lii Ibid. MSCI China Index returns with net dividends, in USD, 31/03/2023 – 30/04/2023 and 30/04/2023 – 31/05/2023.

liii Ibid.

South Korea—also an important link in global tech supply chain—narrowly posted positive 0.3% q/q growth in Q1.[liv] Export weakness, particularly to China, has been easing. But here, too, domestic demand is doing the heavy lifting as private consumption expenditures rose in three of the past four quarters.[lv] Another sign of Korea's ongoing economic development: chatter of index provider MSCI upgrading Korean equities from EM to developed markets. Korea is an advanced and increasingly wealthy country, meeting many of the criteria of developed markets. It boasts some of the biggest and most familiar electronics companies in the world, but some legacy capital controls keep it classified as EM. Korea didn't get upgraded this year, but some observers think it may in the not-too-distant future, once the government implements some capital market changes.

Even Hong Kong, which shared China's prolonged COVID restrictions, is showing economic green shoots: GDP rose 2.7% y/y in Q1, snapping four straight quarters of contraction.[lvi] Retail sales have risen on a year-over-year basis for six straight months through May, thanks to the return of inbound tourism.[lvii]

INDIA'S GROWTH ADDS, TOO

India is also expanding nicely, as GDP rose 6.1% y/y in Q1, accelerating from Q4 2022's revised 4.5% rate.[lviii] More recently, services and manufacturing purchasing managers indexes (PMIs) have pointed to ongoing expansion in Q2.[lix] Inflation has also cooled more quickly than expected—down to 4.3% y/y in May from April 2022's 7.8%—easing some pressures on consumers.[lx] Like China, India adds to global demand—and as Asia's third-largest economy, it is an increasingly attractive market for global firms to sell into.

TWIN GREEK ELECTIONS IN Q2 AND RECLASSIFICATION HYPE

Amid three bailouts, two defaults, the installation of capital controls, a deep economic downturn, rising populism, reclassification from developed market to Emerging and ever-present fear it would ditch the euro, Greek elections triggered heavy investor angst from 2009 – 2019. But in Q2, two Greek parliamentary elections went off with nary a ripple in the press, save for occasional speculation that Prime Minister Kyriakos Mitsotakis' re-election may be a prelude to a move back to developed market status and credit raters upgrading the country. Those elections did deliver PM Mitsotakis another round at the helm of Greek government, but we think the hype over reclassification is overdone.

In late 2009, Greece's government announced its budget deficit was much larger than thought, and its 10-year bond yield started soaring—the first domino to fall in the eurozone's sovereign debt crisis. By mid-2010, eurozone officials and the ECB were cobbling together a bailout for the country, which mandated an austerity programme. But the country's troubles didn't go away. In 2012, Greece received another bailout and defaulted twice, and concerns surrounding the country's finances prompted index provider MSCI to reclassify Greece from developed to Emerging Market in June 2013.

liv Ibid.

lv Ibid.

lvi Ibid.

lvii Ibid.

lviii Ibid.

lix Ibid., as of 07/07/2023. India manufacturing and services PMIs, March 2023 – June 2023.

lx Source: FactSet, as of 06/07/2023.

In part due to default and in part due to austerity, Greece's economy collapsed, shedding a third of GDP over the succeeding five years. Part of the problem was that Greece, as a member of the euro, didn't control its own monetary policy or currency. Policy was therefore dictated more by German or French needs than Greek, and Greece couldn't do what many nations do in a debt crisis—print money to inflate the debt away. Furthermore, if Greece defaulted, many feared it would force the country out of the euro (a "Grexit"), potentially causing the euro currency to splinter—a shock many feared would drive a new financial crisis.

The drama reached a fever pitch in 2015, when populist leftist, and former PM, Alexis Tsipras and his upstart Syriza party won big in a snap election on the promise of rejecting austerity measures imposed by creditors—which stirred "Grexit" fears. That culminated in a July referendum, in which Greek voters rejected international bailout terms. However, former PM Tsipras surprised many and overrode the referendum. The country didn't exit the euro. Instead, former PM Tsipras moderated and compromised. Greece received more bailout money and remained in the common currency bloc. The leftist administration then enacted austerity and pushed privatisation plans forward—significant economic reforms that helped move the country out of its economic crisis.

PM Mitsotakis and his center-right New Democracy party came to power in 2019's election, and Mr. Tsipras became opposition leader. Amid the pandemic, Greek travails rarely stole the spotlight. But also, reforms have continued. Since taking office, the Mitsotakis government has cut corporate taxes, passed pension reform and pushed even further on privatisation deals. Greece repaid some IMF bailout loans two years earlier than estimated, and the Hellenic Republic found healthy demand in debt markets—it sold a 30-year bond in March 2021, the first since the global financial crisis. As Exhibit 17 shows, Greek spreads over Germany have long since retraced the debt crisis's spikes.

EXHIBIT 17: GREEK 10-YEAR SPREAD VERSUS GERMANY

Source: FactSet, as of 14/07/2023. Greece 10-year yield minus Germany 10-year yield, 31/12/2008 – 13/07/2023.

2023'S FIRST ELECTION

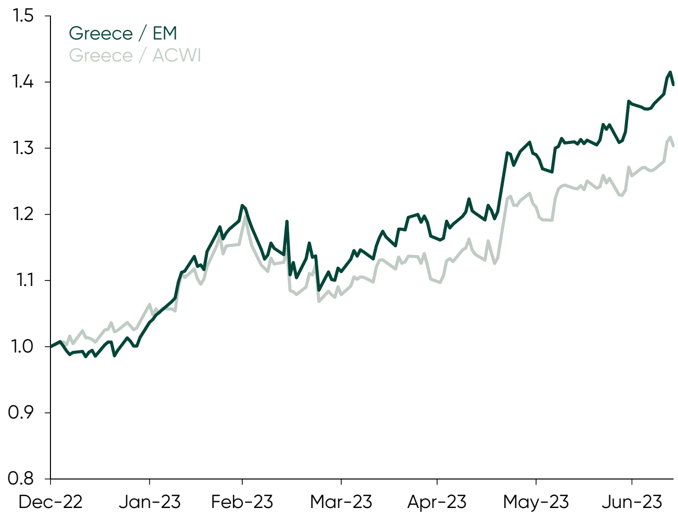
In 21 May's vote, PM Mitsotakis sought a mandate to continue his reforms and push the country toward a bond-rating upgrade to investment grade from junk. The government has many targets on this front, from reducing red tape to maintaining a budget surplus, in hopes of turning Greece into a European financial center and returning to developed market status. He didn't initially get it. While New Democracy outperformed expectations, garnering a plurality of the vote at 40.8%, the majority PM Mitsotakis sought eluded him.

But instead of trying to form a strong coalition and move policy forward that way, PM Mitsotakis simply called for new elections, set for 25 June. The reason: A new electoral system was set to take effect at the next election, under a law passed in January 2020. This new system (which actually resembles a system used for most of modern Greece's democratic history) is called a reinforced proportional system. Under it, the party getting the most votes will receive bonus seats based on the share they took.

It works on a sliding scale. The Greek parliament has 300 seats. If the top party takes 25% of the vote, it gets 20 bonus seats, with the remaining 280 divided proportionally. Every additional 0.5% of the vote adds one bonus seat to the top party's take, with a maximum of 50 bonus seats at 40% of the vote. That was PM Mitsotakis' motivation: If New Democracy could simply repeat 21 May's results a month later, it would hand the party a majority based on the new mathematics. And, that worked: In the end, New Democracy took 40.56% of the vote, handing it 158 seats (after factoring in the 50-seat bonus).

Predictably, his success has added to a frenzy over Greek assets. Year to date, the MSCI Greece is up 51.7%, with outperformance versus both EM and the MSCI All-Country World Index jumping at May's election and continuing to the present, with many citing the prospects for reclassification as a sign gains will continue. (Exhibit 18)

EXHIBIT 18: GREEK OUTPERFORMANCE IN 2023



Source: FactSet, as of 14/07/2023. MSCI Greece divided by MSCI ACWI and MSCI EM, all with net dividends in USD, 31/12/2022 – 13/07/2023. When the lines rise, Greece is outperforming. Indexed to 1 at 31/12/2022.

To us, this looks like a classic example of investors getting overexcited regarding an election's outcome. Yes, PM Mitsotakis did get a majority. And yes, he might follow through with more reforms. They may even win back developed-world status. But reclassification isn't a market driver—it usually follows returns and enthusiasm versus leading them. Hence, a rationale to own Greece today should be based on an assessment of the country's likely economic and political drivers and how those compare to rather lofty sentiment today—not whether MSCI will shift their classification.

TURKISH POLITICS

In Turkey, incumbent President Recep Tayyip Erdogan won May's presidential election, defeating opposition leader Kemal Kilicdaroglu in a runoff vote. After President Erdogan survived his stiffest challenge in 20 years atop Turkish politics, many thought he would enact reforms aimed at reversing unorthodox economic policies and instilling stability and investor confidence. Some moves and talk cheered investors on this possibility—particularly the appointment of "market friendly" Western-educated, former Wall Street officials. But in our view, excitement around political change doesn't automatically translate into results, and there is risk in buying into reform on personality grounds.

Upon his win, President Erdogan appointed Mehmet Simsek as finance minister and Hafize Gaye Erkan as governor of the Central Bank of the Republic of Turkey (CBRT). The former—who served as Turkey's finance minister from 2007 – 2009—is an internationally respected economist, having worked at Merrill Lynch in London as an EMEA strategist. The latter was a US bank analyst and co-CEO of First Republic Bank until 2021. Many viewed these appointments as a pivot from President Erdogan's unorthodox views—which include the belief that high interest rates cause inflation—to more traditional economic policies. That stirred excitement that "market friendly" changes to tackle long-running economic issues were being brought forward, queuing high expectations for Mr. Erkan's first meeting as CBRT governor.

But a radical shift didn't occur. The CBRT hiked its interest rate to 15% from 8.5% at this meeting—big, but short of the quadrupling some observers projected. Other decisions suggest the CBRT is pursuing incremental, not sweeping, measures. For example, Turkish banks must hold lira-denominated bonds amounting to a certain percentage of their foreign exchange deposits (called a securities maintenance ratio, which aims to prop up the lira's value). Rather than scrap this requirement and allow market forces to take hold, the CBRT lowered the ratio from 10% to 5%. While either move would likely have sent the lira reeling, Governor Erkan could have curtailed uncertainty by ending the measure—but didn't.

In response to the CBRT's late-June announcements, the lira fell to a record low against the US dollar. That isn't a shock. A weak lira is typical, not an anomaly, and interventions like these are unsustainable. Looking more broadly, Turkey's currency has weakened year to date and fell relative to the dollar for better part of the past decade. (Exhibit 19) To us, markets have long recognised Turkey's economic issues—and some policy tweaks aren't going to reverse those overnight.

EXHIBIT 19: THE LIRA OVER THE PAST 20 YEARS

Source: FactSet, as of 18/07/2023. USD per Turkish lira, monthly, July 2003 – June 2023.

Optimism that Turkey is moving towards economic normalcy still persists, especially since the country's relations with the West seem to be warming—e.g., President Erdogan approved Sweden's NATO application after being its most vocal opponent. However, we suggest keeping expectations in check, as President Erdogan has a well-documented history of reversing course on the purported "market friendly" option. Back in 2016, he named Murat Cetinkaya as CBRT governor—a decision that eased worries of waning central bank independence since Mr. Cetinkaya wasn't an outsider choice (he came from within the CBRT's ranks). But President Erdogan unexpectedly ousted Mr. Cetinkaya in 2019 because he resisted President Erdogan's call to cut interest rates—a move consistent with the president's short leash. Over the past five years, President Erdogan fired three central bank governors, a finance minister for publicly opposing CBRT rate cuts and even ousted the head of the state statistics agency for reporting record-high inflation.

Moreover, speculative hope doesn't translate into action. In early July, President Erdogan's ruling AK Party proposed to increase the corporate tax rate from 20% to 25% (and from 25% to 30% for financial institutions). Higher taxes aren't consistent with the typical "pro-business" reform expected from the new government. At its second meeting under Governor Erkan in mid-July, the CBRT hiked its policy rate by 250 basis points to 17.5%, which was still less than the consensus expected—spurring questions about the new economic team's ability to assert its independence. In our view, this is a reminder to wait and see what politicians do once in power. Presuming policy reform merely because it fits a political personality demonstrates extreme bias. If expectations remain high about a shift to normal economic policy, even just mild progress could disappoint investors hoping for bigger changes.

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