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Temperature Check

Global Matters Weekly

14 November 2022

– Richard Stutley, *CFA — Portfolio Manager*

I wanted to provide a quick update on the Euro-zone economy. It's good practice to step behind the headlines, which as we know are written with the aim of being interesting, rather than painting a complete picture of any topic. While we firmly believe that a good macroeconomic outcome is neither sufficient nor necessary for good investment returns (although it does help, particularly in the short term!), we nevertheless need to be aware of the macro when managing portfolios.

Consumption, which translated means day-to-day spending by individuals, rightly makes up the majority of total spending in the region – around 52% according to Eurostat[1]. Hence we're primarily interested in household finances (current and prospective) when taking the temperature of the Euro-zone economy.

Gross Domestic Product grew by 0.2% quarter-on-quarter in Q3, a bit below its 10-year average of 0.37% but well within the norm, with adjustment for the effects of the pandemic[2]. Hence real incomes continue to expand and coming into the start of this year households had approximately 12% excess savings tucked away[3]. From a debt perspective, household debt to disposable income is comfortably within its recent range and approximately 50% lower than around the time of the Great Financial Crisis[4].

That's the good news. Debt mostly in the form of mortgages is sensitive to rising interest rates and hence, as we look forward, today's good starting point begins to look less rosy. While the widening gap between US and Euro-zone short-term interest rates[5] may seem strange, one needs to understand that the transmission mechanism of central bank policy to the real economy is much weaker in the States, due to the predominance of 30-year fixed-rate mortgages far longer than anything generally seen in Europe. This means that rising interest rates will start eating into the disposable income of Euro-zone households much more quickly than their American cousins.

The Euro-zone looks like it is in for a tough time, made only slightly easier by the healthy state of household balance sheets

Unemployment in the Eurozone is low[6], and unlike in the US isn't flattered by a falling participation rate post-pandemic. According to data from the World Bank[7], one of the clearest signals from this inflationary period is that more Americans need to find their way back to the labour market – there are too few workers to deliver the goods and services the US needs. As with household debt, the employment picture looks set to deteriorate, with hiring intentions slowing and likely to turn negative resulting in a fall in new orders reported by companies[8].

The main issue the region faces isn't poor balance sheets, but huge distortions in the price of goods and services. Stripping out the effects of energy price rises only makes sense when prices fall back quickly. Power prices in the Euro-zone's industrial heartland Germany remain in a range some five times higher than their pre-pandemic level9. This has led to a huge redirecting of spending towards energy, and away from all other goods and services. On this basis, the outlook for many businesses is tough, and the redistribution of profits from energy producers via windfall taxes seems appropriate.

Overall, the Euro-zone looks like it is in for a tough time, made only slightly easier by the healthy state of household balance sheets. However, the significance of that conclusion shouldn't be overstated, to repeat what I said at the outset, we are macro-aware rather than macro-driven. Economies are self-righting over time and even bad policymaking can't upset them for long, the UK's recent experience being a case in point. Despite the weak macroeconomic outlook, we are neutral European equities, given signs of some good valuation opportunities emerging.

Sources: [1]Euro Area Household & NPISH Final Consumption Expenditure as a percentage of Euro Area Gross Domestic, as seen on Bloomberg Finance L.P., [2]Euro Area Gross Domestic Product Chained 2010 Prices QoQ, Eurostat, [3]Euro Area (17 Countries) Gross Household Saving Rate, Eurostat, [4]Eurozone Household Debt to Disposable Income Ratio, Bloomberg Finance L.P., [5]US Federal Funds Effective Rate less the ECB Main Refinancing Operations Announcement Rate., [6]Eurozone Annual Unemployment Rate (%), Bloomberg Finance L.P., [7]Euro area Labor force participation rate ages 15-64, World Bank Group, [8]S&P Global Flash Eurozone PMI, 24/10/2022, 9EXAA Germany Day Ahead Baseload Electricity Spot Price.

The **Marketplace**

- Global equities rose 6.7% last week
- Last week saw US midterm elections, key developments for Ukrainian forces, and a below-expectations Consumer Price Inflation (CPI) report that gave the market signs of a potential Federal Reserve (Fed) pivot
- Brent crude fell by 2.6% over the week to $96.0 a barrel
- Gold rose by 5.3% to $1771.2 per ounce

Market **Focus**

US

- US equities rose by 5.9% last week as headline CPI surprised to the downside at 0.4% month-on-month and 7.7% year-on-year versus 0.6% and 7.9% expected
- The monthly core CPI reading fell to 0.3% versus 0.5% expected, giving investors hope that the Fed wouldn't need to be as aggressive in future rate hikes, leading to a surge across all the major asset classes
- Weekly initial jobless claims rose to 225k versus 220k expected in the week ending 5 November

UK

- UK equities returned -0.3% last week
- Bank of England chief economist Huw Pill said that "there is more to come" on interest rates following their 75 basis points hike last week

Europe

- European equities rose 4.7% last week aided by the news that Russia had ordered its troops to leave the city of Kherson in Ukraine
- Euro-Area retail sales grew by 0.4% in September in line with expectations
- German industrial production rose by a faster-than-expected 0.6% in September

Asia/Rest of The World

- Global emerging market equities rose 5.7% over the week
- Japanese equities rose by 3.3% last week
- China's Producer Price Index fell in October for the first time in two years by 1.3% year-on-year, as strict COVID-19 restrictions combined with a sluggish property sector amid global recession risks hurt the economy. Meanwhile, consumer inflation in October came in at 2.1% year-on-year. The muted inflation figures suggest that the People's Bank of China policy divergence against its global peers will continue
- China's exports, as well as imports, contracted simultaneously for the first time since May 2020 as elevated global inflation and rising interest rates hurt overall demand
- Japan's produce prices inflation fell to 9.1% year-on-year in October, marking the slowest pace of growth since January

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Asset Class/Region	Currency	Currency returns			
		Week ending 11 Nov. 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	5.9%	3.2%	-15.4%	-13.2%
United Kingdom	GBP	-0.3%	3.2%	4.7%	5.2%
Continental Europe	EUR	4.7%	5.9%	-10.5%	-10.3%
Japan	JPY	3.3%	2.5%	1.8%	0.8%
Asia Pacific (ex Japan)	USD	7.8%	12.4%	-20.8%	-23.0%
Australia	AUD	4.0%	4.5%	0.2%	1.3%
Global	USD	6.7%	5.0%	-16.1%	-15.2%
Emerging markets equities					
Emerging Europe	USD	7.4%	12.4%	-73.8%	-76.7%
Emerging Asia	USD	7.6%	12.9%	-24.4%	-26.7%
Emerging Latin America	USD	-4.5%	0.2%	13.2%	10.2%
BRICs	USD	3.1%	11.3%	-26.1%	-31.8%
China	USD	6.0%	19.3%	-31.7%	-38.2%
MENA countries	USD	-0.2%	-1.4%	-1.9%	-5.6%
South Africa	USD	8.3%	14.8%	-4.0%	-6.8%
India	USD	3.2%	4.8%	-0.9%	-4.0%
Global emerging markets	USD	5.7%	10.4%	-22.1%	-24.9%
Bonds					
US Treasuries	USD	1.9%	1.3%	-12.7%	-12.7%
US Treasuries (inflation protected)	USD	1.7%	0.7%	-12.7%	-13.0%
US Corporate (investment grade)	USD	2.6%	2.3%	-17.7%	-17.9%
US High Yield	USD	1.2%	0.4%	-12.2%	-11.9%
UK Gilts	GBP	2.4%	1.9%	-22.0%	-22.6%
UK Corporate (investment grade)	GBP	2.1%	2.4%	-19.3%	-20.0%
Euro Government Bonds	EUR	1.0%	0.2%	-16.4%	-17.3%
Euro Corporate (investment grade)	EUR	1.3%	1.1%	-13.6%	-14.1%
Euro High Yield	EUR	2.4%	2.4%	-11.1%	-11.1%
Japanese Government	JPY	0.7%	0.1%	-3.8%	-4.0%
Australian Government	AUD	1.1%	0.7%	-9.1%	-8.3%
Global Government Bonds	USD	3.9%	3.3%	-18.1%	-18.6%
Global Bonds	USD	3.7%	3.2%	-18.3%	-18.9%
Global Convertible Bonds	USD	3.0%	2.8%	-20.3%	-23.6%
Emerging Market Bonds	USD	3.4%	3.6%	-27.9%	-28.7%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	5.6%	4.0%	-22.4%	-17.9%
Australian Property Securities	AUD	5.6%	4.0%	-20.8%	-15.9%
Asia Property Securities	USD	9.7%	12.8%	-13.2%	-17.5%
Global Property Securities	USD	7.4%	7.0%	-22.2%	-20.3%
Currencies					
Euro	USD	4.2%	4.6%	-9.2%	-9.7%
UK Pound Sterling	USD	4.1%	2.9%	-12.8%	-11.8%
Japanese Yen	USD	5.9%	7.1%	-17.1%	-17.8%
Australian Dollar	USD	3.9%	4.8%	-7.9%	-8.1%
South African Rand	USD	3.9%	6.4%	-7.7%	-11.4%
Swiss Franc	USD	5.8%	6.2%	-3.3%	-2.3%
Chinese Yuan	USD	1.1%	2.8%	-10.5%	-10.0%
Commodities & Alternatives					
Commodities	USD	-0.7%	4.0%	22.8%	20.2%
Agricultural Commodities	USD	-0.8%	1.6%	8.2%	10.9%
Oil	USD	-2.6%	1.2%	23.4%	15.8%
Gold	USD	5.3%	8.3%	-3.2%	-4.9%
Hedge funds	USD	-0.1%	-0.2%	-4.7%	-5.6%

Source: Bloomberg. Past performance is not indicative of future returns

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