

Monthly Equity Market Topics

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In Brief

- China's Economic Stimulus: A Glimmer of Hope? What do the recent announcements mean for investors?
- Europe's Economic Puzzle: Seeking a Spark.
- USA, Performance Enhancing Drugs. The US continues to lead, and the rate cycle has turned.

China's Economic Stimulus: A Glimmer of Hope?

Last week, Chinese policy makers stepped up. The PBOC announced a series of liquidity measures, cutting lending rates and providing support for mortgages and asset prices to improve economic confidence. Crucially, this was followed by the Politburo announcement outlining countercyclical fiscal easing to “stop the decline and return to stability” in the housing market while providing income support to low- and middle-income consumers. Is this the equivalent of former European Central Bank (ECB) president Mario Draghi, during the depths of the European sovereign debt crisis, guaranteeing he would do whatever it took to protect the euro? Will China do whatever it takes?

While this is not the bazooka-style stimulus that China has undertaken in the past, the rhetoric from President Xi Jinping and government officials on down is encouraging and implies this may be the first salvo and that they are prepared to do more. The number of policies being announced across a multitude of dimensions indicates an acceptance of the gravity of the task at hand in arresting the economic slowdown and reviving consumer confidence.

The monetary measures are helpful, but they do not alleviate the oversupply of housing, the lack of demand for credit or the willingness to put capital to work. To reflate the economy, we believe fiscal stimulus is needed to drive consumption and demand. The Politburo announcement is probably the beginning of a new fiscal journey, with some new and untested policies. Previous stimulus programs have traditionally been concentrated on investment or housing. The one trillion yuan (USD \$142 billion) social benefits package will likely be implemented slowly and adjusted over time. On housing, the policies are aimed at reducing inventory and stabilizing prices, not new construction. Further details will be announced over the coming weeks and months, but for now, the market seems to believe this is the start of a concerted effort by policymakers to get the Chinese economy back on a growth path.



The measures announced to date are more supportive for the consumer, with limited impact on new housing and construction. If more consumer-focused stimulus is announced, we believe there will no doubt be a short-term boost to consumption, but the bigger question is whether this will reverse the deflationary mindset that has taken hold. The success of the stimulus will depend on its ability to boost confidence; encourage consumers to spend more and improve the property outlook.

Chinese equity markets have rallied on the back of this news, and there is likely to be a period of consolidation as the winners from these policies are identified. We expect it to be a long and bumpy road, but if this is only a first salvo and swift implementation follows, then there are still opportunities for investors to participate. China remains the second biggest country by GDP, so a stronger Chinese economy has ripple effects across global growth.

Europe's Economic Puzzle: Seeking a Spark

From an equity perspective, European economic growth remains a concern. Worryingly weak purchasing managers' indices for Germany, plus France's political logjam and surprisingly weak inflation data from France, Spain and Italy are all weighing on the eurozone's economy. A struggling France and Germany and inflation falling faster than anticipated could see the ECB accelerate its rate-cutting cycle. That could be positive for yield-sensitive sectors and higher-yielding stocks. A recovery in the Chinese economy would also be supportive for many European stocks. We have already witnessed metals and mining stocks, as well as luxury and other consumer stocks with high China exposure, react positively to last week's stimulus announcements.

European consumer sentiment remains subdued. Household savings rates are rising as consumption remains weak, but encouragingly, real wage growth persists. A decrease in borrowing costs could reinvigorate European consumers and, along with improvements out of China, be positive for growth in Europe and European cyclicals. Our preference would be for lower-beta, higher-quality cyclicals given the myriad geopolitical risks, but we think that this will be a bumpy journey.

USA, Performance Enhancing Drugs

The US economy is surpassing expectations, led by resilience in the service sector (which accounts for three-quarters of the economy) despite weaker manufacturing. Inflation is coming back under control, and with the initiation of rate cuts, policymakers are emphasizing maintaining growth and employment. This is not the stuff of which recessions are made, and the US Federal Reserve is cutting into strong earnings growth. We believe that conditions appear ripe for a melt up in US equities: ample liquidity, the bond market signaling all is well with the falling short term rates, the 10-year yield rising, and credit spreads remain tight. Last week, we saw a significant upward revision in Gross Domestic Income (GDI), driven by revisions in corporate and household incomes. Market commentators had been pointing to the gap (now closed) between GDP and GDI as a cause for concern as they are the opposite sides of the same coin (production versus income for that production). The result is that consumers are better off than the data had been suggesting for some time now, with more savings than thought, which explains their continued strength.



The question is why aren't companies hiring? What is driving the deterioration in the labor market and giving the Fed reason to ease aggressively (the market is anticipating 200 bps of cuts by the end of 2025)? Is the weak labor market data an aberration, like the many other data anomalies since the pandemic? Is this a digestion of post pandemic labor hoarding? Is it a function of a close election, with divergent policy outlooks keeping corporates on the sidelines until after the vote or is the economy deteriorating faster than we think? While we, like you, grapple with these questions, we are keeping a watch on leading indicators for unemployment and for any signs of a rebound in inflation. In addition, we are amid rapidly escalating tensions in the Middle East as well as broader geopolitical and trade tensions, all of which are causes for concern. Rather than trying to predict what are often binary outcomes, stay diversified in well-managed, high-quality companies that will endure.

Over the past quarter we have seen breadth return and a rotation from narrow tech/AI leadership to rate-sensitive sectors and cyclicals. Across sectors and market caps, momentum and quality continue to dominate performance. With interest rates expected to fall by 2% (implied rates, Bloomberg) by the end of next year, consumers and companies with floating rate and higher debt loads should benefit the most, boosting cyclicals and consumer stocks as well as stocks further down the cap spectrum, as we expect a broadening of earnings growth. From an asset allocation perspective, midcap stocks trade at undemanding multiples and, with their superior profitability and stronger balance sheets compared to the S&P 600 small-cap index, may be well-positioned to benefit in an environment of falling interest rates and a strong albeit slowing US economy. For example, one of the biggest exposures in the S&P 400 index is banks. A steeping yield curve and falling money market rates could help their profitability. Long-term bond yields falling from above 5% in late-2023 to around 4% today reduces the mark-to-market losses on their long-term bond holdings (an issue highlighted by SVB's failure). They have also had time to provision against commercial real estate (CRE) losses while the outlook for CRE in general (though office continues to have its struggles) improves. While rates are coming down, we expect them to remain structurally higher than the pre-COVID years. In our view, all this is positive for banks, but it is also creating a lot of dispersion and, therefore, stock picking opportunities.

Midcaps could benefit from exposure to a stable US economy while financial conditions ease. Small caps may also benefit from the same set of circumstances; however, midcaps will experience greater profitability, and financial strength is preferred, given the balance of risks. ▲

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