Index House View

A summer of horizontal markets

As summer comes to an end, the macro picture does not seem any different from the one in June. Relative good health remains across developed economies and some emerging ones. One notable difference is the intensification of negative commentary in the news around "cracks" appearing in the US job market, plus the usual uncertainty in rates and inflation – nothing new under the sun.

It is our view that inflation, rates and unemployment in developed economies do not seem on the brink of a sudden change. To the contrary, we feel there is visibility on both inflation and rates remaining high and stable for the next 12 months. This interpretation makes us quite convinced we are still on time to allocate ample capital in fixed income instruments, enjoying a very favourable ratio of upside to downside in the next 2 to 3 years.

Will interest rates produce a recession among developed economies? Is the FED playbook still so old as to want to create a recession to cool down the US economy, to which Europe will follow? The short answer is yes. The medium answer is that there is no alternative for authorities to cool down the economy and bring down inflation. The long answer is that, despite a potential recession, the American household is not in dire straits, has non-negligible savings, is healthy enough to consume as usual and has plenty of job opportunities to choose from.

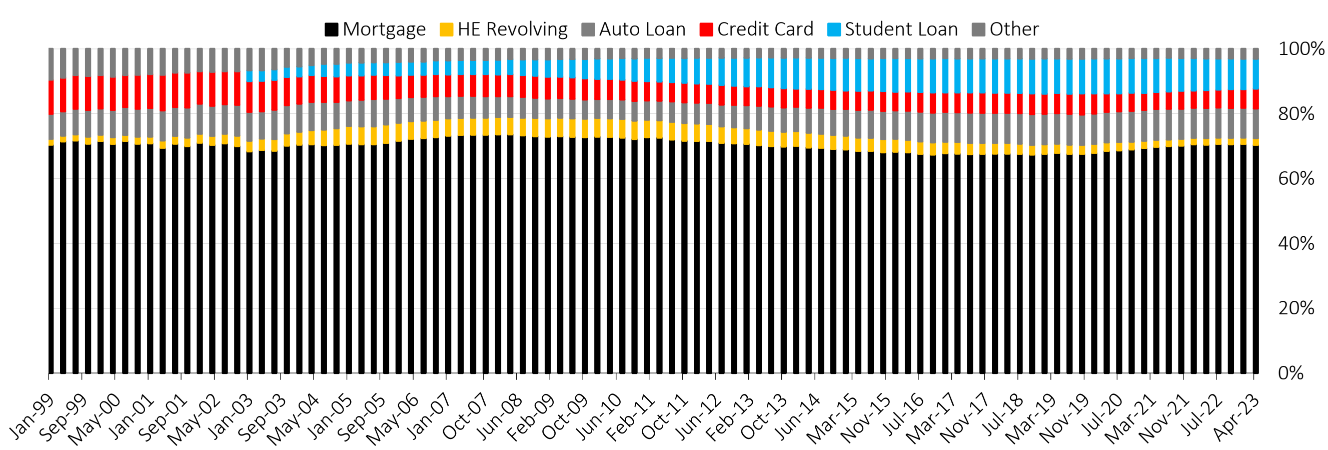
With this outlook, perhaps an exogenous element might trigger and then aggravate the severity of a potential recession. China comes in focus, the one country with an enormous internal market that fails to fulfill its potential and seems stuck in a middle income trap.

US households

We cannot find alarming anomalies in the American household's financial condition.

In fact, we see a pause in growth of household debt, which is a natural reaction to rising mortgage rates. The situation of the mortgage market is of course central for households, as mortgages count for a constant 70% of total household debt since 1999 and the ratio between total debt to disposable income has been reducing below the 90% since 2013 – a typical cycle of excess leverage, followed by a normalization.

Total debt balance and its composition – percentage

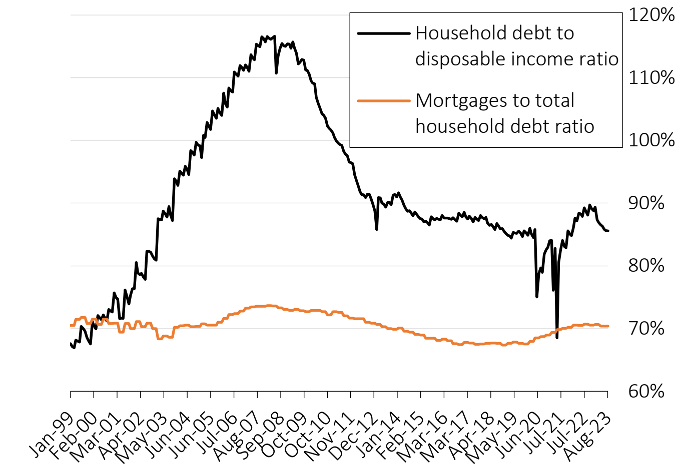


Source: Federal Reserve Bank of New York, New York Fed Consumer Credit Panel, Equifax

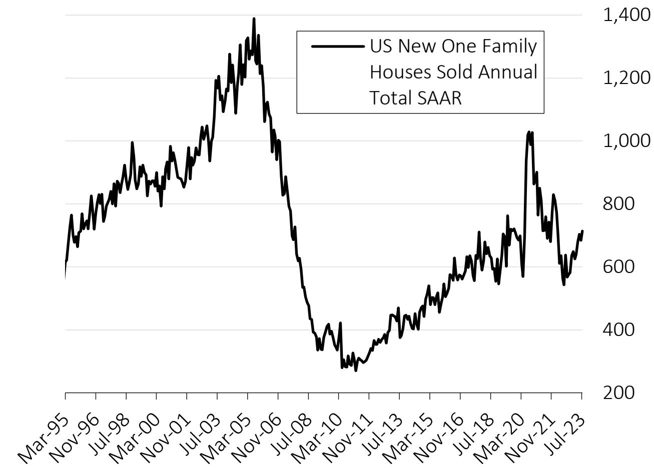
The three graphs below show not a precipitating, on-the-brink-of-default situation.

Yes, new mortgage rates are becoming prohibitive for even double income earners in the US to purchase homes, which reflects in a decreasing number of mortgage applications being filed (grey area on third graph). However, new home purchases are not decreasing when including non-mortgaged properties, which is a positive sign of domestic purchasing power. The 2023 home sales seem to be in trend with the trajectory set after the Global Financial Crisis, an event that effectively wiped out enormous amounts of debts which would have never been repaid.

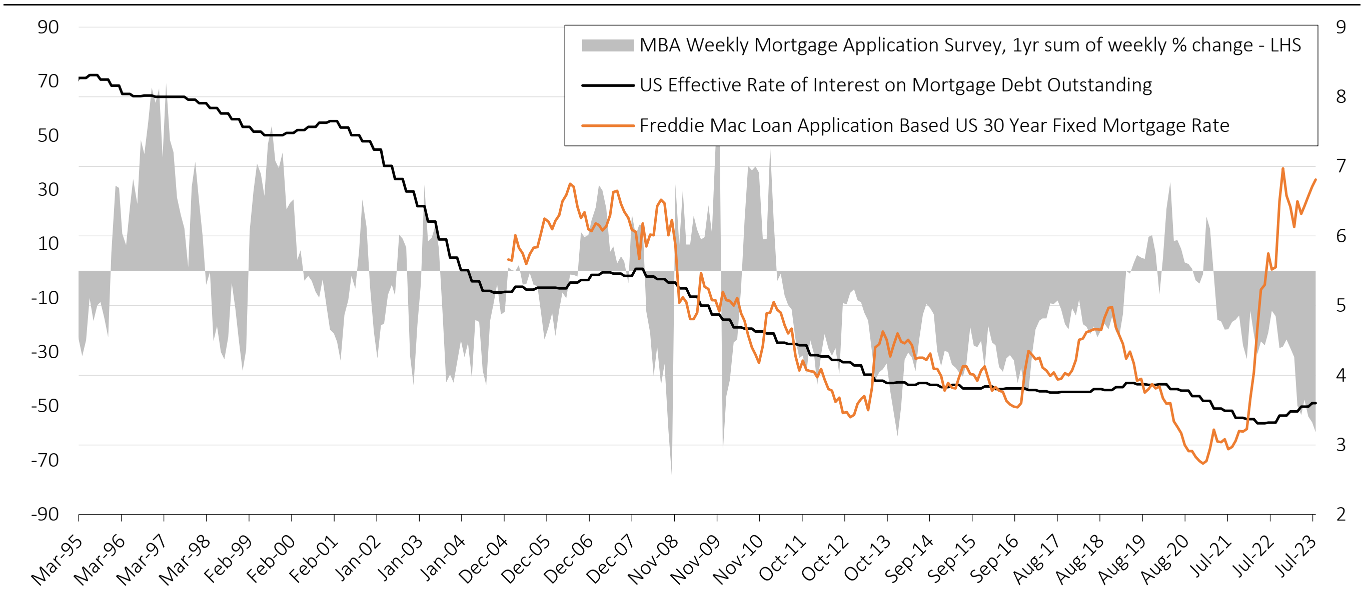
State of US household debt



New home sales



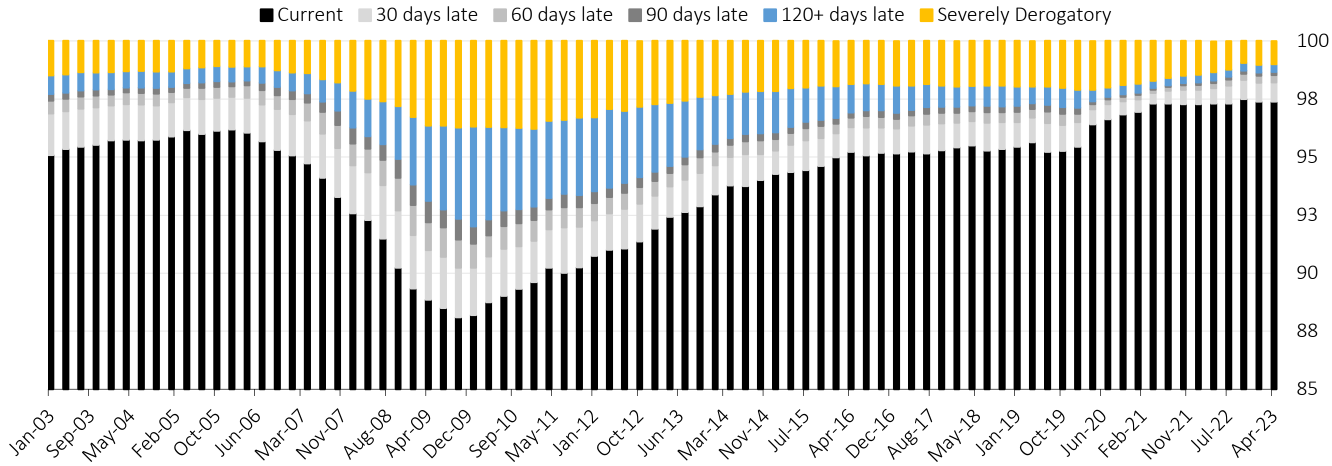
Mortgage rates and housing applications



Source: Federal Reserve Bank of New York, U.S. Census Bureau, Bureau of Economic Analysis, Freddie Mac Commitment Rates, Mortgage Bankers Association, Bloomberg, Index & Cie calculations

In addition, households have not become more delinquent than average in the last two years over their loans, with the share of fully-paid loans around 97% of total loans – see first graph on next page. This means that the effect of substantially higher rates is most likely stopping new mortgages being issued, rather than punishing the entire compartment – see the effective rate of interest on mortgage debt outstanding on the graph immediately above (named *Mortgage rates and housing applications*).

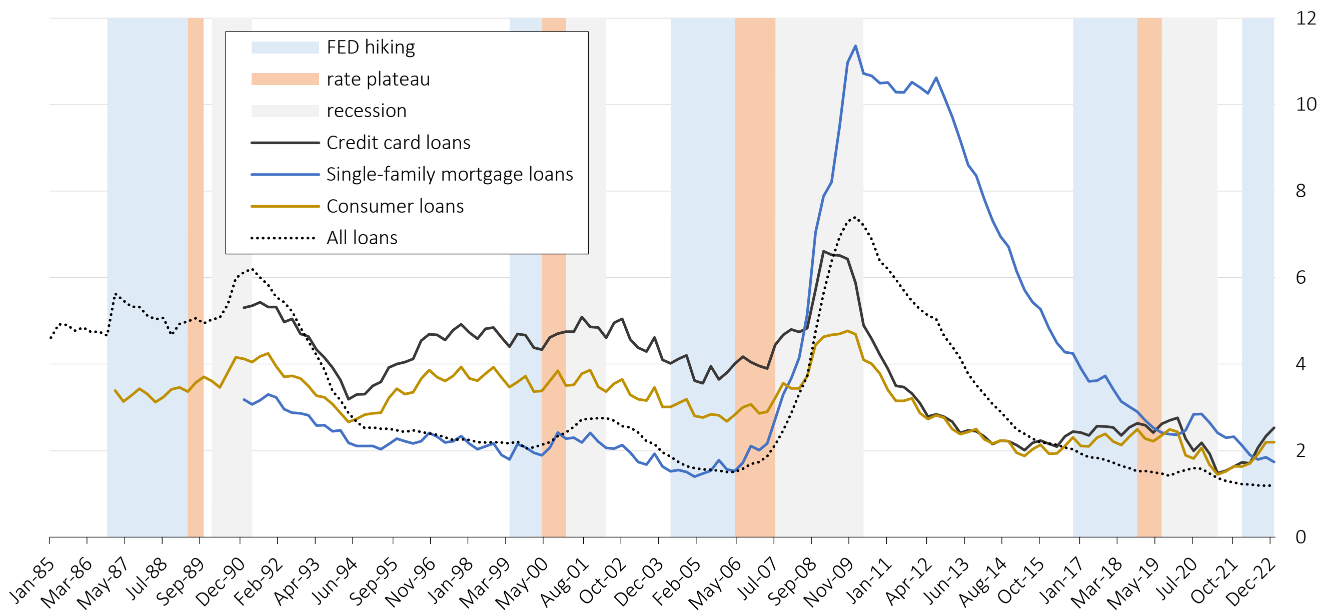
Total balance by delinquency status, all loan types – percentage



Source: Federal Reserve Bank of New York, New York Fed Consumer Credit Panel, Equifax

More generally, delinquencies rates across loan types are nowhere near alarming levels, when considering all US banks. Outside of the largest 100 banks by assets, the situation is only more alarming on credit cards, which represent only 6% of total outstanding loan balance.

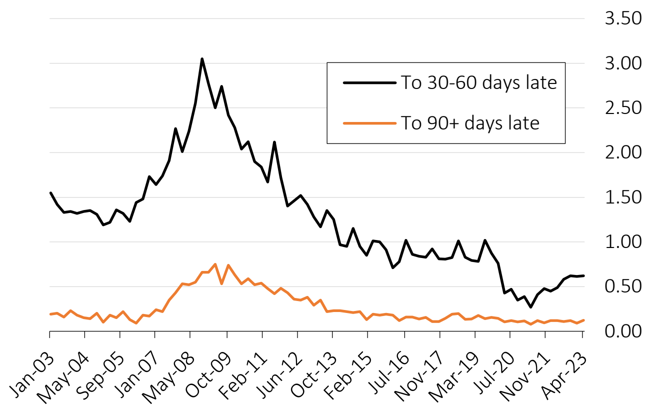
Delinquency rates across loan types – percentage, all banks



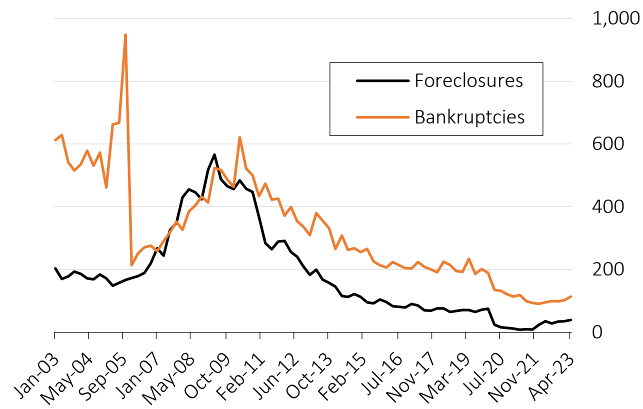
Source: Economic Research Division, Federal Reserve Bank of St. Louis

In the specific case of mortgages, transition rates are well below average over the past 20 years, along with as foreclosures and bankruptcies numbers.

Transition rates for current mortgage accounts



Number of consumers with new foreclosures and bankruptcies

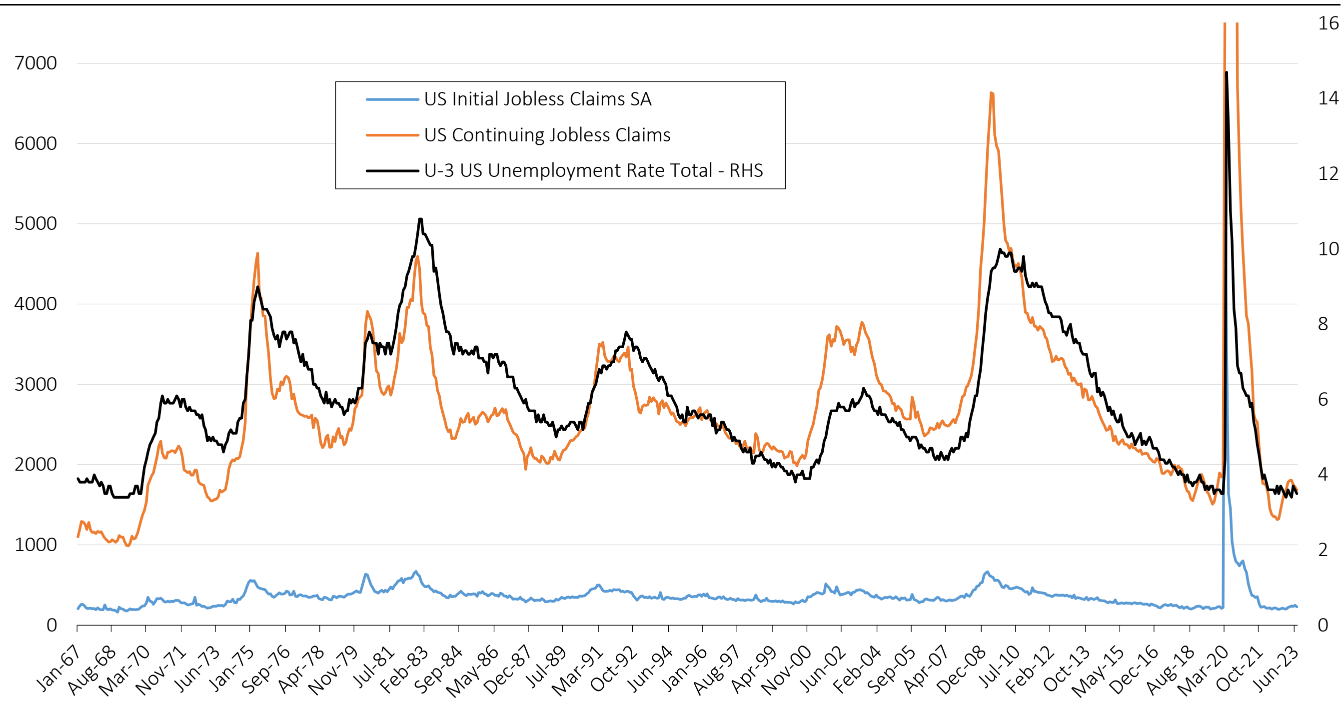


Source: Federal Reserve Bank of New York, New York Fed Consumer Credit Panel, Equifax

In essence, the average American household is not on the brink of insolvency, nor is it entering a period of clear financial constraint. In fact, the opposite is true: very little worrying signs can be read in the various graphs above.

A last comment on the job market. There are no cracks on the horizon suggesting an incoming storm.

Job market and unemployment – percentage and thousands



Source: US Department of Labor, Bureau of Labor Statistics, Bloomberg

If the American household does not seem constrained financially, it naturally follows that consumption is not about to dry up all of a sudden.

The gaze should then pass on to the second largest consumer market in the world, China.

INDEX & Cie

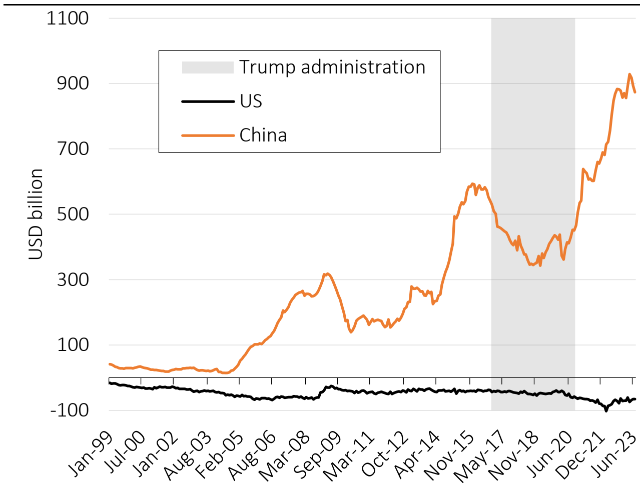
Stuck in the middle income trap

As mentioned plenty of times in our past newsletters, China is still a deeply export-dependent nation. This is not out of the ordinary for emerging economies that are transitioning from a low-income level into the middle-income bracket, but it is also a very common trap for economic development.

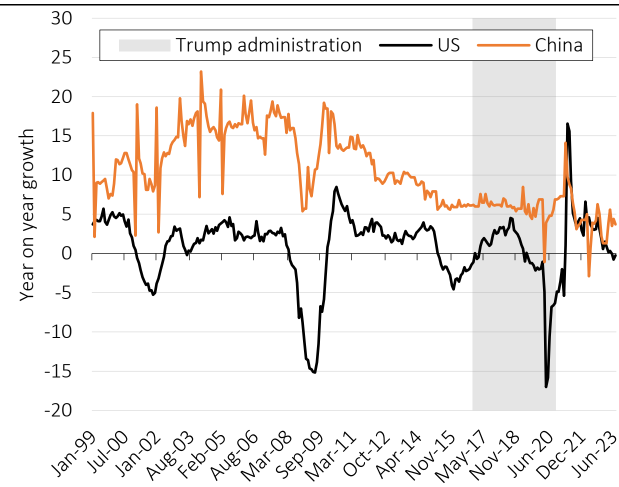
As of 2022, about 30% of the US$ 3.5 trillion worth of Chinese manufactured exports is high-tech components, a stable percentage since 2008. The trajectory is clear: from a strong development of both absolute amounts and percentage of medium- to high-tech components, this share seem to have stopped growing around 2004. The components are typically exported to high-income countries, which use them as inputs in high-tech machinery and products. It appears China has not managed to become a *user* of high-tech components, but remains a *supplier* of them. Worst of all, the share of China's exports to high-income countries has been gradually decreasing since 1996 (from 90% to 70% of total merchandise exports) versus an increase in share towards low- and middle-income economies (from 4% to 13%). In other words, Chinese exports are feeling the competition from other middle-income countries, so that the next best target economies to export to are low- to medium-income countries, which typically do not consumer high-tech components.

History shows that most countries fail to move away from manufacturing medium- to high-tech components and become users, or high-income countries.

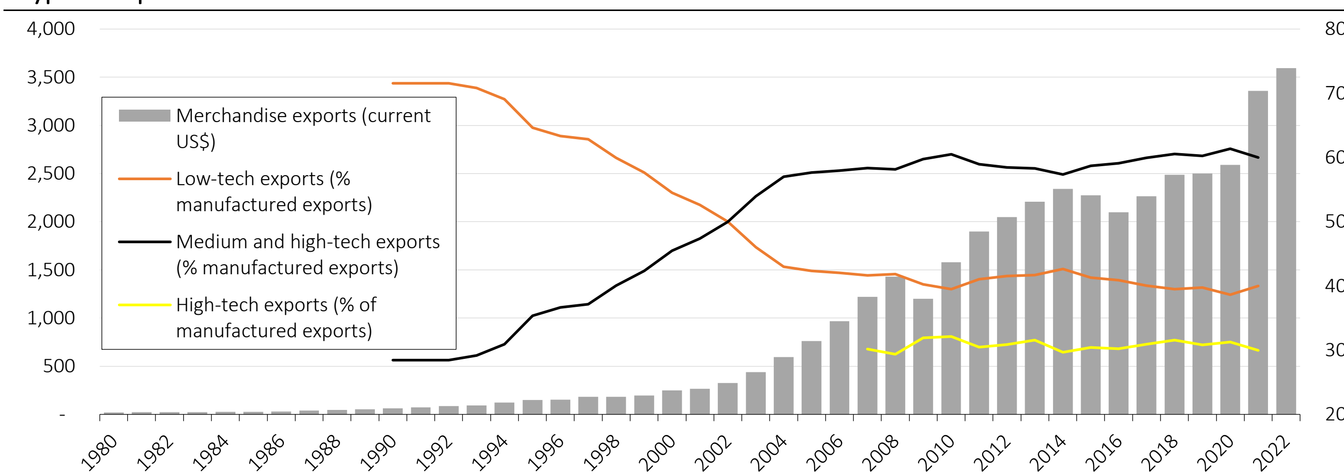
Trade balance



Industrial production



Type of exports

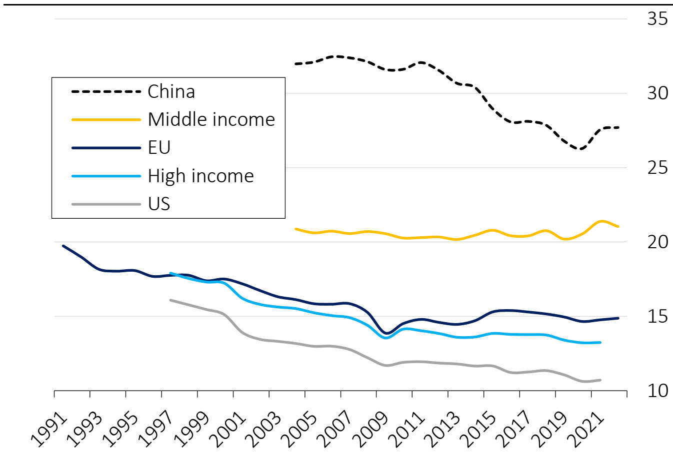


Source: US Census Bureau, World Bank, Bloomberg

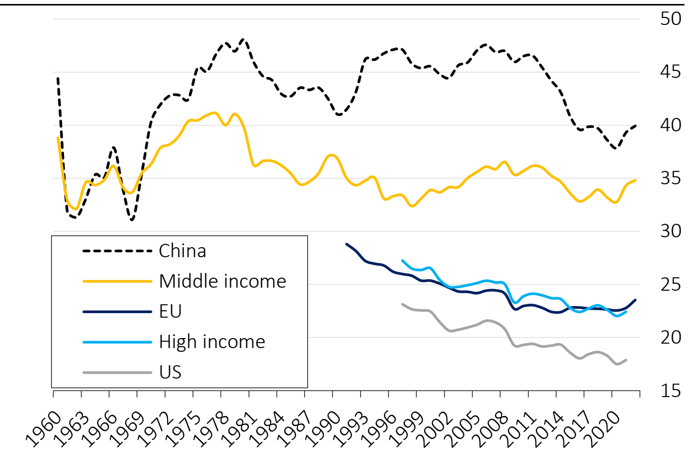
Like all stabilizing economies, China is experiencing a general cooling in economic growth – as shown by industrial production among other metrics. It is clear today that the economic structure of the past 20 years – in which repayments of government-issued debt can be satisfied with high economic growth – is no longer sustainable. As growth naturally slows down, there is less capital to service the enormous amounts of capital lent to build regional and urban infrastructure. The recent news on the local government financing vehicles and their quest to repay US$ 9 trillion of central government debt is exactly highlighting the challenge.

China is now facing major obstacles from the real estate sector, local government debt, slowing down internal consumption and deflation in effecting its transition from middle- to a high-income level. Past instances of such challenge identify the culprit in the political leadership failing to gradually sophisticate the legal infrastructure, industrial architecture, education system and banking regulation in the direction of creativity and technological advancement. Without creativity there is no gain in productivity and efficiency, without technology there is no economic advancement.

Value added, manufacturing – % of GDP



Value added, industry – % of GDP



Source: World Bank

The most preoccupying of these challenges is the disconnect between type of export and internal consumption. There is no way internal consumption can absorb the mountains of components that are destined to high-income countries, simply because Chinese businesses would not have a destination for them. With an eye on high-tech components, China does not have a sophisticated chip manufacturing industry, and has opted for buying rare-earth metals instead.

So, in a way, internal consumption will never be the answer to a decreasing international consumption of Chinese components, generated by natural competition from other middle-income countries or by unnatural Western sanctions against Chinese products.

When your trading partners shun you away, and your own people do not need to products you have constructed your industries around for decades, the only choice is to continue down the road of state intervention/nationalization. Since Mao's times the Communist Party has been strongly present in the Chinese economic fiber, de facto commanding the totality of it. Very few are the areas where Chinese entrepreneurship is free to create and risk capital. The example of Jack Ma of Alibaba and Ant Financial, the overnight shut down of the entire edutech sector in 2021 and the disappearance of vocally anti-Party entrepreneurs show the Party never lost its grip on the national economy. The entire tech sector, the only one where creativity paid out handsomely for years, is now getting gobbled into the state. No wonder that Kweichow Moutai, a manufacturer of Chinese spirits, is the second most valuable company in Chinese stock markets, right behind Tencent and way above Alibaba – at the time of writing.

Therefore, it is safe to assume the country faces really only one way forward: to increase the presence of the state into the economy. And this is exactly what is happening as we write.

Conclusion

As far as fears of recession are concerned, we do not see any sign of deterioration at a US household's level. The job market remains strong, without the paranoid – or perhaps simply media-catching – comments of a number of market participants.

We do fear that the current cooling of internal Chinese demand might spill over to the global economy. However, the stop-loss here is the Communist Party deepening its hold of the Chinese economy. The news on LGFVs and on rate cuts are a testament of such intervention, although far from being definitive measures in the short-term. Considering the magnitude of the challenge, China has a good five to seven years of internal restructuring to go through.

Will investors throw in the towel as the Chinese threat becomes more apparent? We do not need to answer this question, as remuneration from fixed income instruments offers liquidity, remuneration, diversification and limited downside.

Today, more so than at the beginning of 2023, we believe high-quality bonds present a unique opportunity to park capital and get reasonably remunerated. The upside/downside ratio remains favourable once the eventual recession hits, and authorities lower rates to help the recovery. From a floor of 4-6% gross annual return, capital gains can reach +20-30% over the next two to three years.

Our view on equities is that quality matters in any cycle. By placing any part of capital into high-quality companies the downside remains naturally limited to a -30-40%, while other parts of the market usually tank more substantially. We feel good about high-quality names, but bad timing can easily turn into months of negative mark-to-market values. We prefer to sit out current markets while waiting for more clarity in the macro picture.

Commodities have been enjoying a nice run thanks to inflation, so far. While we have no general view on all categories, we found out a potential supply-demand deficit can accumulate on copper in the coming years, based on the EV industry growth – up to 70kg of copper are used in every EV. An exposure to such metal would have to be made only with an investment horizon of 5 to 7 years, as commodity cycles rest exclusively on long-term supply-demand balance.

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