Observations from Across the Pond

Marquette regularly sends a senior member of our research team abroad as part of ongoing manager sourcing and due diligence efforts. These trips include update meetings with investment managers with whom Marquette has existing relationships as well as on-site visits with potential new manager recommendations. The cadence of these trips was severely impacted by the COVID-19 pandemic, but with international travel now almost back to normal, Marquette sent Senior Research Analyst Evan Frazier on a whirlwind tour of Europe earlier this summer. Over the course of almost a week, Evan met with eight investment management firms across three cities. In this newsletter, Evan shares the perspectives, as well as more anecdotal information, he gained while on the ground in Europe, including insights on the region's economy, the corporate landscape, and the unique set of opportunities and challenges currently facing international markets.

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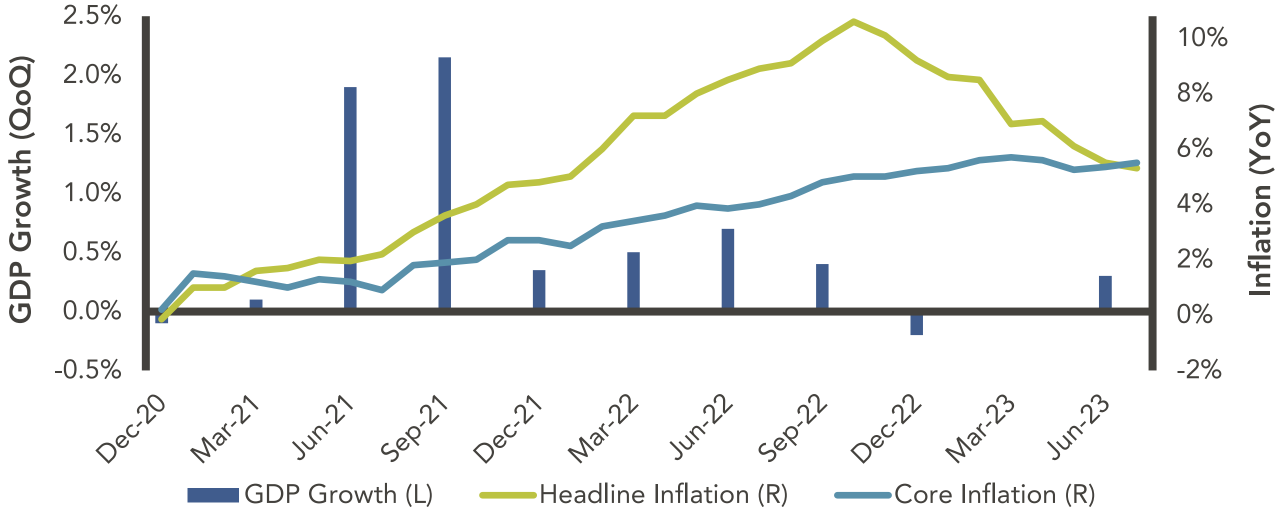
THE EUROPEAN ECONOMY: UNEVEN FOOTING

Both investment professionals and laypeople alike characterized the state of the European economy as somewhat gloomy during my trip. Indeed, while the euro area did manage to notch positive GDP growth in the second quarter, advancing 0.3% from the previous three months, other headwinds, including sticky inflationary pressures, continue to hamper the region. To that point, euro area consumer prices rose 5.3% on a year-over-year basis in July, which actually represents a significant moderation from the increases of over 10% last year. Despite this improvement, several analysts and portfolio managers remain cautious about the trajectory of price levels over the coming months. Core inflation, which excludes food and energy prices that tend to be more volatile, has continued to climb higher after a brief correction earlier in the year. According to the European Central Bank (ECB), both headline and core inflation are not expected to retreat below 2% until the end of 2025, and many of the investment managers with whom I spoke noted that their portfolio companies continue to aggressively push through price increases as a result. As seen in Exhibit 1 below, July marks the first time in over two years that the core figure surpassed the headline inflation rate in the euro area.

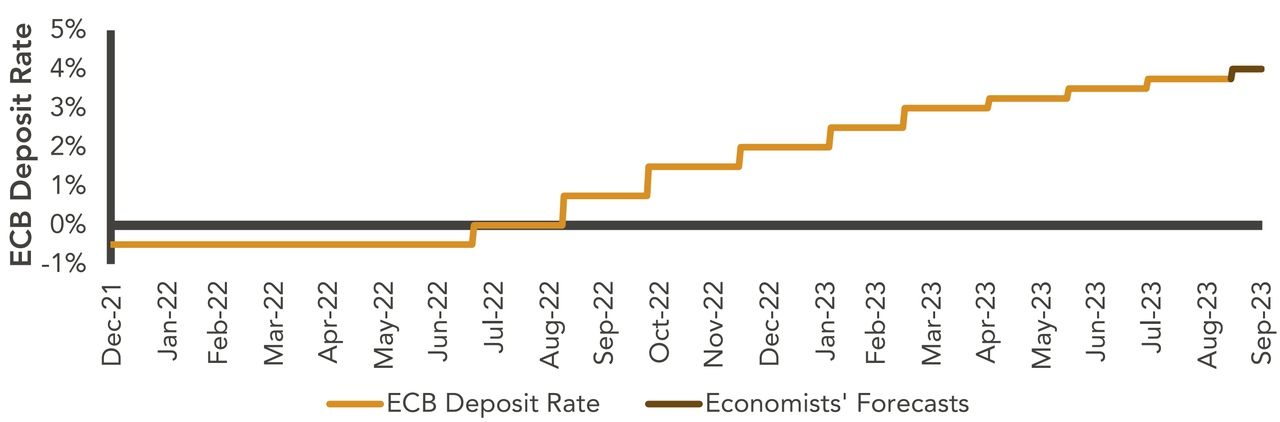
Exhibit 1: Despite positive GDP growth, core inflation remains stubbornly high in the euro area



Source: Bloomberg, Eurostat as of July 31, 2023

In addition to challenges for both consumers and businesses in the region, elevated core inflation also creates some uncertainty regarding the trajectory of interest rates over the coming months. The deposit rate in the euro area stands at 3.75% at present, with the ECB likely nearing the end of its aggressive hiking cycle that began roughly one year ago. Still, ECB President Christine Lagarde has stated in recent days that another hike could take place in September depending on underlying inflationary trends, and other officials have indicated that even if there is a pause next month "it would be premature to consider it automatically the end of the cycle." As shown in Exhibit 2 below, economists are currently anticipating a 25 basis point increase in the policy rate next month, and most of the investment professionals with whom I met concur with those forecasts.

Exhibit 2: Economists expect another 25 basis point hike from the ECB in September

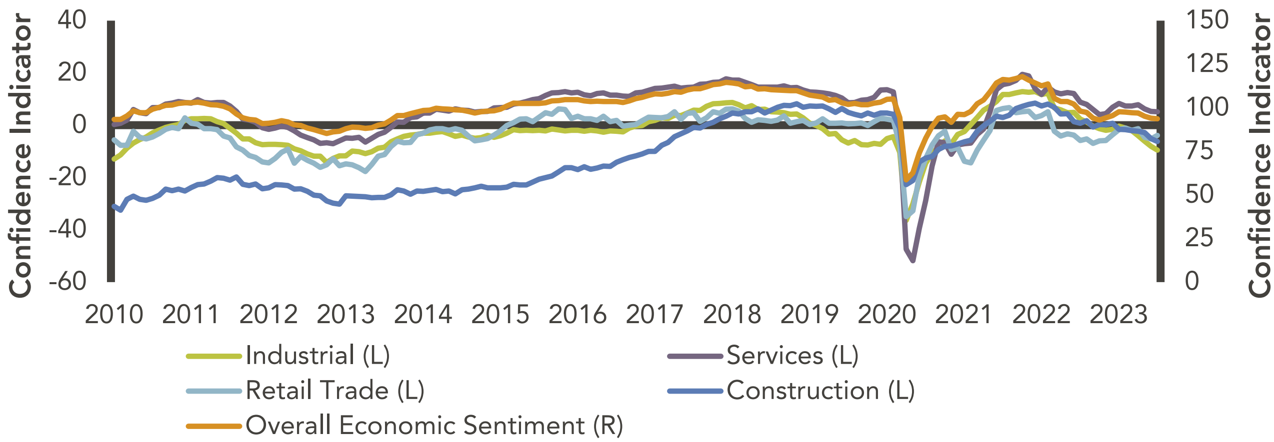


Source: Bloomberg as of July 31, 2023

Should the ECB raise its deposit rate to 4.0% or higher in the coming months, it may come at the expense of economic growth and confidence, which has already been waning. After reaching a post-pandemic peak in late 2021, confidence in the euro area industrial, services, retail, and construction spaces, as measured by the

European Commission, has dropped dramatically in recent months, as has the overall economic sentiment indicator for the region as a whole *(Exhibit 3)*. Additionally, the Eurozone Composite Purchasing Managers' Index dropped to 48.6 in July, the lowest reading for the metric since last year and, according to Bloomberg, worse than what forecasters had been anticipating. Any PMI figure below 50 represents a contraction. When I discussed the factors behind this slowdown with portfolio managers, many were quick to note that Germany has been particularly challenged of late. Indeed, despite emerging from a technical recession in the second quarter (Germany's GDP was flat after contracting in the two prior periods), the country continues to experience a slump in its key manufacturing sector and is, according to the International Monetary Fund, on pace to be the only Group of Seven nation to see a decline in output in 2023. Based on both formal and informal conversations I had throughout the week, low demand for credit among companies, production cuts, and a slowing services sector seem to be other key drivers behind the souring sentiment across the broader region.

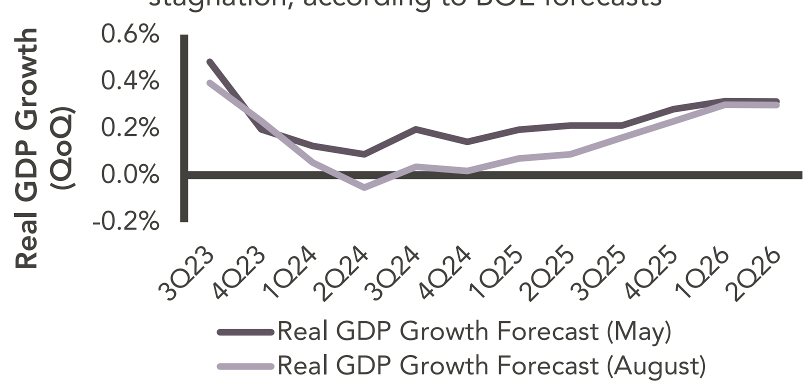
Exhibit 3: Economic confidence in the euro area has waned in recent months



Source: Bloomberg, European Commission as of July 31, 2023

In the United Kingdom, the economic picture is similarly bleak. The Bank of England (BOE) raised its key rate to a 15-year high of 5.25% earlier this month and markets currently expect up to 75 basis points of additional increases through the first quarter of 2024. This tightening has largely been in response to the UK's own inflation problem, with headline inflation near 8% — the highest among the Group of Seven nations. Despite recent rate hikes, the BOE expects price pressures, particularly those impacting the services sector, to remain at "elevated" levels for some time. Additionally, the BOE's own forecasts project that Britain's economy will stagnate over the next two years, with already-lackluster GDP growth estimates from just three months ago revised downward in August *(Exhibit 4)*. Portfolio managers and analysts with whom I spoke during my travels also cited the potential for higher unemployment, a higher cost of living, stalling productivity and wage growth, and long-term health issues that are currently impacting a significant portion of the UK workforce as additional

Exhibit 4: The UK is poised for a period of economic stagnation, according to BOE forecasts

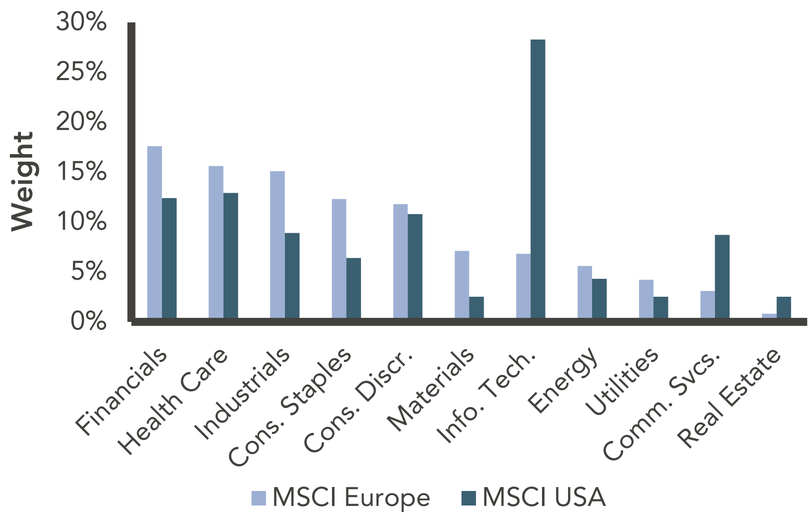


Source: Bloomberg, Bank of England as of July 31, 2023 challenges for the region's economic prospects. Finally, hearing both investment professionals and laypeople note that the current climate may present difficulties for Prime Minister Rishi Sunak's bid to win an election, which must be held by early 2025, was also noteworthy. Whether in the corporate boardroom or on the streets, fears appear to be mounting that Sunak's plans to stabilize the UK economy are seriously lacking.

EUROPEAN EQUITY MARKETS: DIFFERENTIATED CHARACTERISTICS AND PERFORMANCE

Speaking to portfolio managers and investment analysts provided a stark reminder of the extent to which the composition of the equity market in Europe differs from that of the United States. As shown in Exhibit 5, nearly half of the MSCI Europe index, which is comprised of large- and mid-cap businesses in 15 developed market countries across the continent, falls within the Financials, Industrials, and Consumer Staples sectors, relative to just over 25% of the MSCI USA index. Conversely, the Information Technology and Communication Services sectors, which represent over one-third of the MSCI USA index, constitute less than 10% of the European market. Naturally, the different composition of these indices will lead to very different valuation and growth outlooks. For instance, the MSCI Europe index currently trades at roughly 12.7x forward earnings and 1.9x book value, compared to 20.3x and 4.5x, respectively, for the MSCI USA index, since the European benchmark is more heavily exposed to sectors that are typically cheaper and grow more slowly. For the same reason, the European index boasts a higher dividend yield — 3.2% vs. 1.5% for the MSCI USA index. Perhaps unsurprisingly, the U.S. index has notched returns well in excess of the European benchmark in the last several years, and with lower volatility, given the recent success of more growth-oriented assets *(Exhibit 6)*. That said, the differences between the two equity markets allow investors to experience diversification benefits, as the correlation between these two indices has decreased in recent time. It is worth pointing out that each of the global equity managers with whom I met during the trip maintain significant exposures to both the United States and Europe, as they feel there are companies in both regions that present attractive investment opportunities on a go-forward basis.

Exhibit 5: Financials, Industrials, and Consumer Staples make up a significant percentage of the European equity market, while the U.S. is dominated by technology-oriented companies



Source: MSCI as of July 31, 2023

Exhibit 6: The MSCI USA index has delivered higher returns and lower volatility over the last decade

		3 YR	5 YR	10 YR
RETURN	MSCI Europe Index	11.1%	5.8%	5.9%
	MSCI USA Index	13.2%	12.1%	12.6%
STD DEV	MSCI Europe Index	19.9%	19.3%	16.2%
	MSCI USA Index	18.3%	19.1%	15.1%

Source: MSCI as of July 31, 2023

FLYING IN 2023: DELAYS FOR DAYS!

Some readers may have first-hand knowledge of what was by far the low point of my travels: excruciatingly long flight delays on both sides of the Atlantic. Beyond allowing me to become well acquainted with the layouts of various airports across the world, these experiences brought to life the current state of air travel, marked by staffing shortages and increased travel demand. According to Bloomberg, growth in demand for flights to Europe from the U.S. has outpaced pre-pandemic levels by roughly 20% since the start of the summer and airports across Europe have struggled to keep up. For instance, London's Heathrow Airport (the site of one of my long delays) saw nearly 40% of its flights depart behind schedule during the month of June. These figures, as well as my experiences while on the trip, will hopefully serve as reminders to readers who may be flying to Europe (or anywhere else, for that matter) in the near future to plan accordingly!

CONCLUSION

Despite the aforementioned travel hiccups, a week on the ground in Europe meeting with portfolio managers and analysts provided an invaluable reminder of the vital role the region plays in the global financial system, where Marquette clients have direct investment exposure. It showcased the differences in the opportunity sets when it comes to U.S. and European equity market investing, and underscored the fact that attractive international equity valuations have to be weighed against uncertain economic outlooks and high inflation. Lastly, the trip was a helpful reminder of why we get away from our desks and spend time with managers in person in their offices, wherever they may be. We look forward to keeping you all apprised of our future manager due diligence trips.

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About Marquette Associates

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