DIAMOND HILL

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Markets Hit the Summer Doldrums

Aug 2023

With much of the world on summer holiday, global stocks slid in August, declining -2.8% in USD terms as measured by the MSCI ACWI Index, bringing YTD gains to +15.2% — a move some may see as a return to reality given the ongoing challenging macroeconomic backdrop, including inflation, high global interest rates and persistent geopolitical uncertainty.

Many eyes were on China as the country struggles to escape its post-pandemic economic malaise. As prices officially reached deflationary territory, its market declined -9.0% in August, dragging YTD returns into negative territory (-4.5%). To date, the government has been reluctant to unleash fiscal stimulus, preferring monetary measures, including some rate cuts, which it enacted in August in a bid to spur lending and, with it, consumption. However, given the country's property market remains challenged, such measures may struggle to gain much traction among a population whose primary sense of wealth comes from its property holdings. The People's Bank of China injected roughly $104 billion in short-term liquidity into the country's banking system during the month — its largest such move since March — which potentially counteracts ongoing attempts to stem the yuan's decline. Meanwhile China's securities regulator announced reforms aimed at boosting capital markets investments. However, with the lack of consumer demand seemingly the primary issue, such measures' efficacy remains an open question.

Regionally, Europe declined least in August (-4.0%), bringing YTD returns to +13.1%. Germany's economic state remains of primary concern as industrial production has fallen, hampering exports and weighing on overall economic activity, which has declined or stagnated for the last three quarters. France (-3.9%) and the UK (-4.0%) also declined in August, with the latter particularly mired in high inflation and languishing economic activity. The Bank of England raised rates another 25 basis points in August to 5.25% — which remains above the European Central Bank's (ECB) 3.75%, though ECB President Christine Lagarde has maintained a hawkish tone, warning at the annual Jackson Hole, WY gathering of central bank heads that inflationary pressures could remain higher than normal amid ongoing global political and economic shocks.

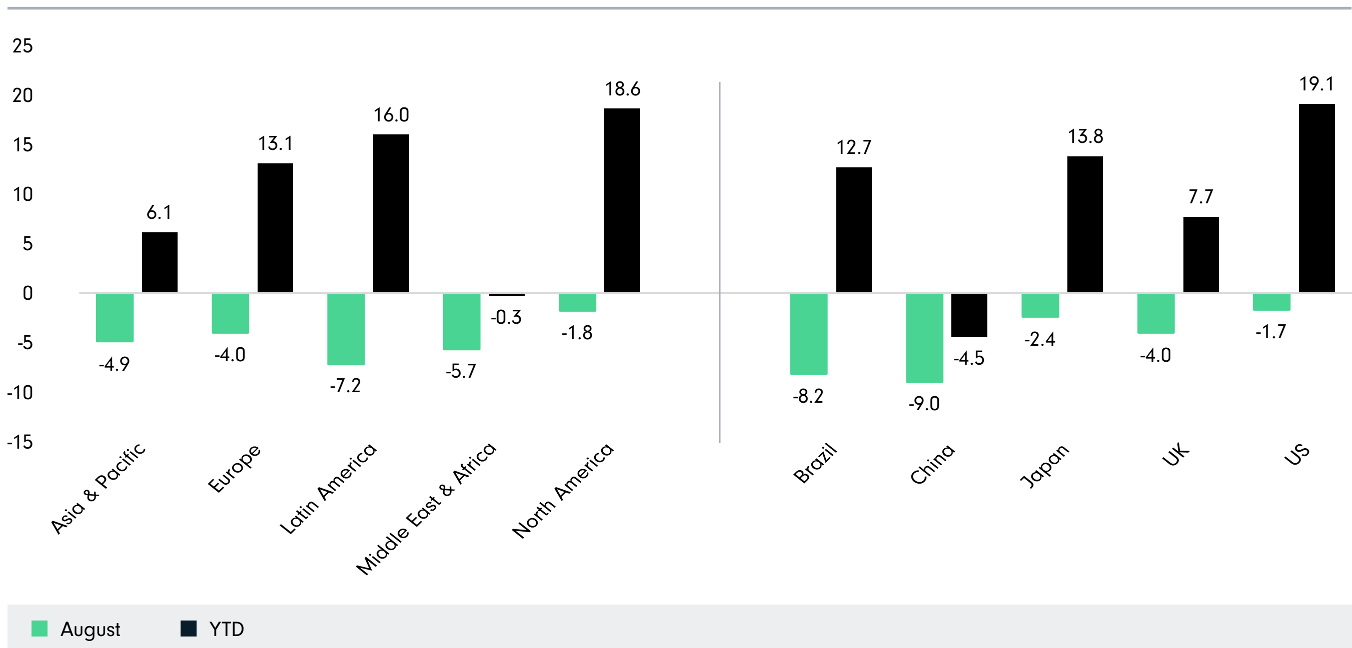
US Federal Reserve head Jerome Powell was also hawkish, indicating the Fed will hike rates further if needed and will keep rates high until inflation is tamed — though the Fed is not expected to raise rates in September. Meanwhile, quantitative tightening in the form of balance sheet-unwinding continues, with the Fed balance sheet now roughly $1 trillion smaller than it was — though to date it has sold off bonds with relatively little market reaction. However, given the combination of increased bond supply (amid the balance-sheet reduction) and higher Japanese rates (Japan has been a primary source of demand for US bonds as domestic rates have been historically low but are now rising), many expect the US yield curve to steepen in the period ahead.

Ratings agency Fitch cited the combination of worsening fiscal conditions (a growing projected budget deficit) and governance as the primary drivers behind its early August downgrade of US debt — from a AAA rating to AA+. Whether the downgrade has much impact on the outlook from here remains to be seen — particularly given US debt markets remain the world's deepest and most liquid.

Elsewhere, emerging markets (-6.1%) and the Middle East and Africa (-5.7%) were down sharply in August amid a spate of regional challenges. Brazil's President Lula announced a $76 billion public spending package — and Brazil's congress approved the necessary loosening of spending rules to enable it — in a bid to spur growth. However, markets weren't particularly enthusiastic, declining -8.2% in August and moderating YTD gains to +12.7%. South Africa's market led the way down in the Middle East and Africa, declining -12.3%, even as its fellow BRICS (Brazil, Russia, India, China, South Africa) members met and decided to extend invitations to six additional countries in an attempt to counter the global influence of developed-country blocs like the G7.

Stocks in countries across the Asia Pacific region were also negative in August, led down by New Zealand (-9.3%) and the Philippines (-9.2%) on an absolute basis, though the largest detractor was China, given its massive size and market influence. Korea and Taiwan were also in negative territory, sliding -7.6% and -4.4%, respectively, while Japan (-2.4%) and India (-1.9%) turned in more moderate declines.

Exhibit 1 — August and YTD Returns for Major Markets (USD) (%)



Source: FactSet, as of 31 Aug 2023.

From a sector perspective, only energy was in the black, adding a modest +0.6% to YTD gains of 10.0%. Consumer discretionary (-6.6%), communication services (-6.6%), materials (-5.8%) and financials (-5.0%) led the way down, though all sectors with the sole exception of real estate (-1.4%) remain in positive territory for the year.

Markets took a decent breather in August — though whether primarily due to thinner trading volumes as many concluded summer holidays or to genuine underlying woes remains to be seen. Most of the year's issues have remained consistent, inflation prime among the economic considerations, though geopolitical uncertainty remains likewise high. Fortunately, an environment in which markets are consolidating gains can afford opportunities to value-oriented investors who have done the groundwork ahead of time and who are accordingly prepared to capitalize when valuations moderate and introduce attractive entry points.

MSCI ACWI Index measures the performance of large- and mid-cap stocks in developed and emerging markets. The index is unmanaged, market capitalization weighted, include net reinvested dividends, does not reflect fees or expenses (which would lower the return) and is not available for direct investment. Index data source: MSCI, Inc. See diamond-hill.com/disclosures for a full copy of the disclaimer.

Investment Grade is a bond quality rating of AAA, AA, A or BBB.

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