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ECONOMIC COMMENTARY

Breakfast with Dave

October 25, 2022

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MORNING MACRO/MARKET MUSINGS

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HOW TO INVEST AROUND EXCESS SUPPLY POINTING TO A DISINFLATIONARY FUTURE

- This recovery in supply, combined with the Fed's fight against overall demand, is setting the stage for a deceleration in inflation and is a key theme of ours for 2023

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MARKET CLOSINGS

Monday, October 24th, 2022 (note: India and Singapore's markets were closed)

Equities

United States	Levels	% change
S&P 500	**3,797.3**	**1.2**
Energy	670.5	0.5
Materials	452.2	-0.6
Industrials	760.1	1.4
Consumer Discretionary	1,129.8	0.5
Consumer Staples	731.1	1.8
Health Care	1,502.3	1.9
Financials	542.1	1.3
Information Technology	2,208.4	1.4
Communication Services	171.0	0.9
Utilities	324.2	0.8
Real Estate	217.2	-0.1
Dow Jones Industrial Average	**31,499.6**	**1.3**
Dow Transports	**13,066.2**	**2.9**
Dow Utilities	**872.1**	**0.9**
Transports/Utilities Ratio	15.0	2.0
NASDAQ	**10,952.6**	**0.9**
Russell 2000	**1,748.4**	**0.4**
VIX	**29.9**	**0.5**

International	Levels	% change
TSX	18,918.4	0.3
Euro STOXX 600	401.8	1.4
DAX	12,931.5	1.6
CAC 40	6,131.4	1.6
FTSE MIB	21,983.0	1.9
IBEX 35	7,680.5	1.8
FTSE 100	7,014.0	0.6
Nikkei 225	3,020.1	0.6
MSCI Asia-Pac Ex. Japan	927.2	-4.4
Hang Seng	15,180.7	-6.4
Shanghai	2,977.6	-2.0
KOSPI	2,236.2	1.0
Straits Times	2,970.0	-
TAIEX	12,857.0	0.3
Sensex	59,307.0	-

Currencies

International	Levels	% change
U.S. Dollar Index (DXY)	111.99	0.0
Canadian dollar ($C/$US)	1.37	0.5
Euro ($US/€)	0.99	0.1
Sterling ($US/£)	1.13	-0.2
Swiss franc ($US/CHF)	1.00	-0.3
Japanese yen (¥/$US)	148.92	0.9
Australian dollar ($US/AUD)	0.63	-1.1
New Zealand dollar ($US/NZD)	0.57	-1.0

Bonds

United States	Levels	Basis points
Treasury curve (10/2)	**-26.22**	-0.66
2-Year T-Note Yield	**4.50**	3.23
5-Year T-Note Yield	**4.36**	2.15
10-Year T-Note Yield	**4.24**	2.57
30-Year T-Bond Yield	**4.38**	4.49
10-Year TIPS Break-Even	**2.58**	3.87
High-Yield Spread	**483.04**	-6.36
Investment-Grade Spread	**162.62**	-2.88

International	Levels	Basis points
10-Year GOC Yield	3.57	-4.10
10-Year Bund Yield	2.33	-8.60
France-Bund Spread	53.00	-2.40
Italy-Bund Spread	225.00	-7.50
Spain-Bund Spread	108.90	-2.70
Portugal-Bund Spread	99.60	-3.40
Greece-Bund Spread	250.50	-11.90
10-Year Gilt Yield	3.74	-30.89
10-Year JGB Yield	0.25	-0.10

Commodities

International	Levels	% change
CRB Commodity Price Index	271.82	-0.2
Gold (London Fixing)	1,649.78	-0.5
Silver	19.23	-1.0
Bitcoin	19,382.19	1.0
Crude Oil (WTI)	84.58	-0.6
Natural Gas	5.20	4.8
Copper (COMEX)	3.43	-2.6
Nickel	211.28	1.3
Bloomberg Industrial Metals Index	145.45	-0.3

EQUITY MOMENTUM MODEL

5-Day Moving Average of Daily Score: 0/10 (Negative Momentum)

Category	…50-day moving average?	…200-day moving average?	Score by category (where Y = 1)
Price: Is the S&P 500 above its…	N	N	0
Earnings: Are next four quarter S&P 500 earnings above their…	N	N	0
Risk Appetite: Is the ratio of S&P 500 high beta to low volatility stocks above its…	N	N	0
Financial Conditions: Are financial conditions below (i.e. more accommodative) their…	N	N	0
Credit: Are high yield bonds (total return basis) above their…	N	N	0
Daily Score			0

Note: a score of greater than 6 indicates positive momentum, between 4 to 6 is neutral, and less than 4 is negative momentum

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Webcast with Dave Featuring Special Guest

Byron Wien

October 25, 2022 @ 4:00 pm EST

Learn more

MORNING MACRO/MARKET MUSINGS

HIGHLIGHTS

- Little action overnight in global stock markets
- Bond markets see a reprieve as the DXY dollar index consolidates
- Coming off the 34th 400+ point surge in the Dow this year…
- … as many as we had from 2002 to 2019 combined
- Goldman Sachs CEO says he sees recession coming
- Amazon's union drive hits a wall
- A glut in gas comes our way
- U.S. data flow has been very weak — but investors don't seem to notice
- Chicago Fed survey points to contraction in housing and consumption
- Risks rise from the Asian currency war
- Keep an eye on the BoJ this week…
- … as the 2-year JGB is sniffing out a policy tweak

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COMMENTARY

Yesterday's Market Recap

i) Stocks rallied for a second straight day; ii) Treasury yields were slightly higher across the curve; iii) the VIX remained stubbornly elevated

- Stocks built on Friday's large advance — the S&P 500 rose +1.2%
- 9 of 11 sectors were higher, led by particular strength in Health Care (+1.9%), Consumer Staples (+1.8%), and Tech (+1.4%)
- Treasury yields were 2 to 4 basis points higher across the curve
- Despite the rally in equities, the VIX (29.9) was little changed — continuing to hover near the closely watched 30 level
- The Japanese yen (-0.9%) resumed its weakening trend after authorities stepped in to halt further declines on Friday
- Our Equity Momentum Model remains red (negative momentum)

Bottom line: Big Tech earnings are on deck with Microsoft and Alphabet reporting today. This will be key — one way or another — in terms of determining the market's direction over the near-term. While the current rally may well be extended further, we continue to view it within an overall downtrend — our expectation remains that we will see lower lows ahead.

While We Were Sleeping

U.S. equity futures are down around 0.4% in the early going. The Euro Stoxx 50 is down 0.3%, while the FTSE 100 is down -0.7%. Asian markets were mixed yet again: Japan's Nikkei 225 (+1.0%), Thailand (+0.6%), and Singapore (+0.5%); but Taiwan (-1.5%), Hong Kong (-0.1%), and Korea (-0.1%) all closed in the red, while China's Shanghai Composite was flat.

Bond markets are enjoying a rare rally, with 10-year yields slipping anywhere from 3 to 9 basis points across Europe, and by 6 basis points in the U.S., to 4.18%. Japan, however, is seeing its 10-year JGB rate press right against the 0.25% ceiling and the 2-year on the verge of breaking above zero for the first time since 2015. **The BoJ meets later this week, and if you think what happened in the U.K. debt markets and the fallout on the rest of the world was important,**

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any tweak in Japan would be infinitely larger (as the central bank confronts a three-decade-high 3% inflation rate and a three-decade-low yen).

CHART 1: Japan's 2-Year Yield Is Close to Positive Territory for the First Time Since 2015

Source: Bloomberg, Rosenberg Research

As it stands, the volume of global bonds trading below a zero yield has plunged to under $1 trillion from over $18 trillion at the end of 2020. The other risk beyond any shift in BoJ policy is the new policy out of China, sanctioning an ever-weaker yuan (today's setting at Rmb7.1668 is a clear break from the Rmb7.11 level that had acted as support in the prior month) — this is a dead-weight drag on the rest of the continent (as it has forced the likes of the Korean won down to a 13-year low). Remember 2015/2016?

The DXY dollar index is flat at 112 on the news. Bitcoin has softened 0.6% overnight to $19,265; Brent crude is off 1.5% to $91.86 per barrel; and gold is down 0.6% to $1,640 per ounce.

The data calendar was light, but Goldman Sachs CEO David Solomon joined JPMorgan's Jamie Dimon in declaring that the U.S. and European economies are shifting into recessions. The lone data point so far today was the German Ifo business confidence index — coming in at an uninspiring 84.3 in October (little-changed from September's depressed reading, though a tad better than consensus estimates).

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The good news for bonds is coming from some fresh disinflation signs, as Tesla is cutting prices in China between 5% and 9% in response to fledgling domestic demand, and what do you know, but the widely publicized unionization drive at Amazon just hit a brick wall in New York and California. I also suggest a read of ***Another Gas Glut Could Be on Horizon*** on page B11 of today's WSJ.

I must say, it's rather fascinating to see the stock market rally with each set of negative economic data. **The S&P global "flash" PMI data for the United States slumped to 47.3 in October from 49.5 in September (manufacturing and services combined) and has been in sub-50 contraction mode now for four months running. Prices receded further, but the bond market doesn't seem to be paying attention, at least for now.** If bad news really was good news, then the bad news would be pushing the Fed to the sidelines immediately, but that isn't happening. And Treasuries would be rallying, and that clearly isn't happening, either. If it's about reflationary growth ahead, how come the commodity markets haven't figured this out? Why is it that copper closed with a 2.6% slide yesterday, silver was off 1.0%, and oil was down 0.6%? More questions than answers.

Another question is about the gap between the Atlanta Fed Nowcast U.S. real GDP growth estimate of +2.9% annualized for Q3 and the St. Louis Fed comparable at +1.3% (though real private final sales in the Atlanta model are down to a near-stagnant +0.2% annualized).

Let's look at the latest data flow:

- Retail sales volumes (September): -0.4% and down in four of the past five months.
- Housing starts (September): -8.1% and down in two of the past three months
- Existing home sales (September): -1.5%, down for eight consecutive months, and the lowest since May 2020
- NAHB index (October): -8 points to 38, lowest since May 2020
- Philly Fed Index (October): -8.7 reading, negative in four of the past five months
- New York Fed Empire Index (October): -9.1 in October, negative for three months in a row and in five of the past six

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The economy is extremely weak, and the lags from what the Fed has done since March have yet to percolate.

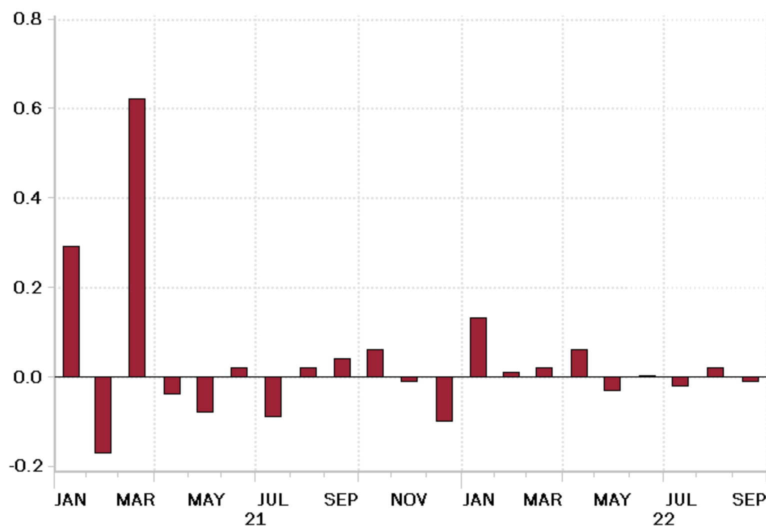
This was the 34th session in which the Dow has surged at least +400 points this year, whippy moves that happen in bear markets and only attest to the acute volatility. In the decade-long 2010-2019 bull market, we saw 21 such moves. Twenty-one in a ten-year span. And here we have had thirty-four in barely ten months. That tells you something about bull markets and bear markets when it comes to dramatic short-covering rallies — in bull markets, there are no shorts to squeeze. And dare I say that even with these 34 spikes, the Dow has still lost 4,839 points so far this year. The prosecution rests.

Chicago Fed Reveals Soft Underbelly to Consumer Spending & Housing

What is quite noteworthy coming out of the Chicago Fed National Activity Index yesterday (underpinned by fractional increases out of employment and production/income) was the deterioration we are seeing in the personal consumption/housing segment… which has basically been flat or in contraction mode in four of the past five months.

CHART 2: Personal Consumption & Housing

United States: *Chicago Fed National Activity Index*
(index; >0 denotes net increase)



Source: Haver Analytics, Rosenberg Research

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The Case for Bonds

I hear this all the time — about how the Treasury market is experiencing its worst showing this year since 1937 and is to be avoided. But the comparisons to the stock market are way off base. **Let me explain the difference between the equity market and the Treasury market.** In the latter, you certainly can experience total return losses in real-time as the price of bonds declines, as has been the case now for over two years, but you can always just clip the yield and know full well that these bonds will mature at par. **No matter the life of the bond, you know exactly what you are getting paid at the time of maturity. That is the certainty of the situation, as difficult as it is when we go through these yield spasms.** Before this cycle, when there was no yield cushion at the 0.5% trough on the 10-year T-note, there was never one time when it lost you money over a five-year interval. This has happened in the stock market no fewer than three times in just the past two decades. Treasuries, always and everywhere, are a ballast and a stabilizer in the portfolio.

Yes, yes, there is inflation risk and duration risk in Treasuries, but they are unique in their payment safety characteristics. They are the only assets where security and certainty of payment are assured and guaranteed. The Treasury strip is the benchmark risk-free asset for funding actuarial liabilities. It is the only investment vehicle with no default risk, no call risk, and hence, no reinvestment risk. It's the only thing you can buy where you know exactly how much money you will have at a future specified period of time. That is the unique characteristic not shared by any other asset class — not equities, not real estate, not commodities, and certainly not crypto.

The stock market has no such guarantee of payment as Treasuries. Equities are indeed a wealth-builder, but timing is always of the essence. It can take years to get back to breaking even in fundamental bear markets. **The S&P 500 peaked in 1929 and didn't make it back to that level until 1954. Admittedly, that is an extreme example. But we saw a peak in November 1968, and it wasn't re-attained until March 1972. The S&P 500 peaked in January 1973 and was still at that level in July 1980 (seven years later!). The market peaked in November 1980 and didn't see that level again until November 1982. The cycle high we saw in March 2000 wasn't breached until May 2007, and the bubble high in October 2007 wasn't seen again until March 2013. In fundamental bear markets, it takes an average and median of 4 years to get back to even if you bought at the peak. With Treasuries, you don't have that worry unless you decide to bail ahead of the time of expiry.**

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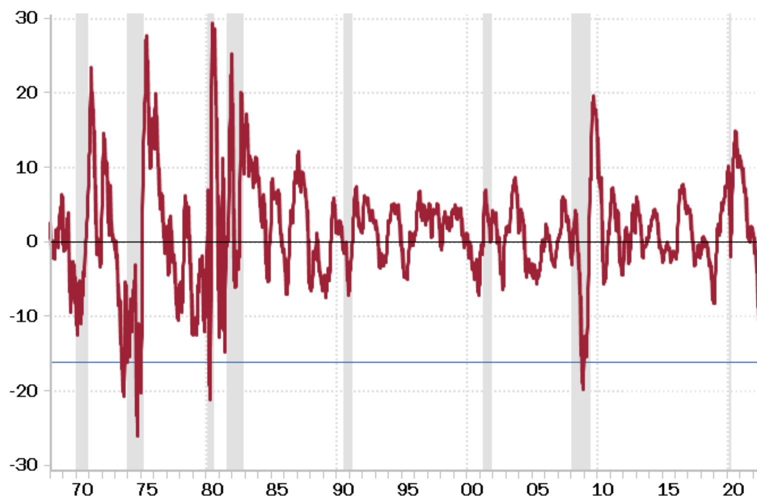
Without crying over the spilled milk in the bond market, the historical record shows that you stand a 92% chance of garnering a positive net return when the 10-year T-note hits the 4% mark, as it recently did.

Recession Coming — Ironclad!

First, the FIBER "spot" leading indicator, as of October 21st, has declined for ten weeks running and fell to the lowest level since April 3rd, 2020, when the economy was in pandemic-panic and lockdown mode. The "smoothed" leading index has dropped for eight straight weeks, and to a negative reading we only saw in November 2008, April 1980, and October 1974. All recessions. And all I read and hear about is how, outside of housing, the economy is so resilient. There is so much chatter about how airports are jammed, as if this $170 billion segment means everything to a $17 trillion aggregate consumer spending pie.

CHART 3: FIBER Weekly Leading Index Growth Rate
United States
(percent)



Shading indicates recession
Source: Haver Analytics, Rosenberg Research

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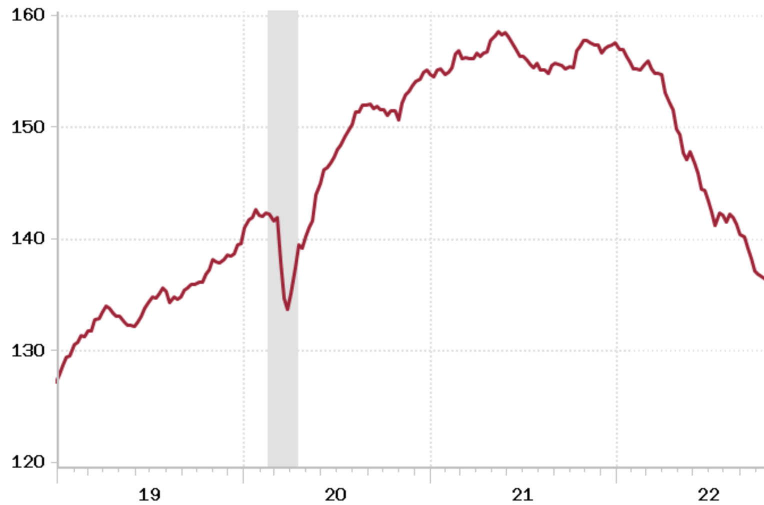
CHART 4: FIBER Weekly Leading Index

United States
(index)



Shading indicates recession
Source: Haver Analytics, Rosenberg Research

It seems lost on this band of stock market promoters and hucksters that U.S. retail sales volumes are down in four of the past five months and at a -3.3% annual rate over this timeframe. When I barked out this statistic a few weeks ago in a CNBC interview, it seemed as though my good friend Sara Eisen had just heard it for the first time (of course, Brian Moynihan, she asserted, must be more accurate than the actual aggregate data!). At the same time, the New York Fed's Weekly Economic Index has also contracted for three months running, and dropped to the weakest level since March 13th, 2021, when Jay Powell was still playing the role of the country's social worker instead of today's economic executioner. Why do I feel that I am reliving the summer and fall of 2007?

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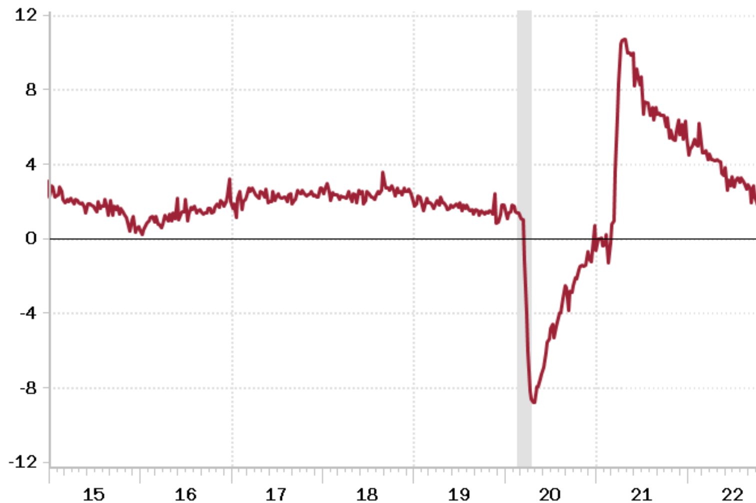
CHART 5: Weekly Economic Index (Lewis, Mertens & Stock)
United States: *FRB New York*
(index; scaled to year-over-year GDP growth)



Shading indicates recession
Source: Haver Analytics, Rosenberg Research

WHO IS DOING THE SELLING?

Believe it or not, it has been the foreign central banks, as they have been forced to sell Treasury securities out of their cache of foreign exchange reserves to defend their ever-sagging currencies. They have collectively sold a record $240 billion so far this year, with 43% coming out of Japan with the yen heading to three-decade lows of ¥150, and another 39% of the bond-selling has come out of the PBOC. This is why the traditional inverse relationship between the trade-weighted dollar index and Treasury yields has broken down. A rising dollar should curb import costs and inflation, and therefore act as a drag on yields — but that happens in more normal circumstances, when central banks aren't engaged in such heavy FX intervention.

Since last March, the correlation between dollar-yen and the 10-year T-note yield has exploded to 95%, roughly triple the average over the prior thirty years! So, when we see the yen finally strengthen, that will signal the break we need to see in the Treasury market. And the BoJ has already said that even with inflation at a three-decade high of 3% it has no intention of tightening monetary policy (the core is actually running at half that pace at

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1.5%). Out of the blue, the yen's influence on bond yields is now the strongest of anything else out there, followed closely by Fed policy. This is why the end to the Powell rate-hike cycle is so key — it will take pressure off the U.S. dollar, and thereby take pressure off these overseas currencies, especially the yen (and also the yuan) and put a lid on all these foreign central bank bond-selling activities.

CHART 6: Yen Relative to 10-Year T-Note

Global
(red line; Japanese yen; ¥ per $; LHS)
(blue line; 10-year T-note yield; percent; RHS)

Source: Haver Analytics, Rosenberg Research

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CHART 7: Foreign Holdings of U.S. Treasury Securities

United States
($ billions)

Shading indicates recession
Source: Haver Analytics, Rosenberg Research

CHART 8: Japan: Holdings of U.S. Treasury Securities

United States
($ billions)

Shading indicates recession
Source: Haver Analytics, Rosenberg Research

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If I had told you at the start of the year that the U.S. economy was heading into a recession, the dollar would be surging, the stock market would be in a bear phase, and commodity prices would sag sharply; would anyone have believed that this would be the sharpest run-up in Treasury yields in a generation? Not to mention that the fiscal deficit has plunged 50% this year, and on the back of an 8% reduction in spending (and that decline in expenditures comes even with the Fed-induced +28% surge in debt-servicing costs). But all of this has been thwarted by the dumping of Treasuries by central banks — and this is a by-product of Fed tightening insofar as it has caused the greenback to surge, and while deflating the goods part of the CPI here at home, it has forced these other central banks to sell U.S. bonds to prevent a total freefall in their currencies. **So… this bear market in Treasury securities ends once the bull market in the U.S. dollar ends… and that, in turn, will rest on the Federal Reserve finally stopping to catch its breath. Maybe the fact that it frontloaded so much of this rate action means this fateful day comes sooner, rather than later.**

HOW TO INVEST AROUND EXCESS SUPPLY POINTING TO A DISINFLATIONARY FUTURE

We continue to believe that, heading into next year, the current narrative surrounding inflationary pressures will shift towards disinflation. In recent months, we have highlighted how the supply side of the economy is picking-up in its recovery — thanks to a collapse in production bottlenecks such as supplier delivery times, increased labor supply (via a higher participation rate), and the fact that previous levels of unsustainable consumer demand have pulled back. **This recovery in supply, combined with the Fed's fight against overall demand, is setting the stage for a deceleration in inflation and is a key theme of ours for 2023**. For investors, the implications are that the playbook that was in place will need to be reassessed given the expected turnaround in CPI — as in a good environment for bonds, and long duration assets (such as growth stocks; particularly those that command reasonable valuations, though many may still require time before cheapening to more attractive levels).

To visualize what we have been describing, we decided to create a proxy for available supply using the year-over-year change in supplier delivery delays from the ISM PMI surveys and the labor force participation rate; as well as the spread between the year-over-year percent change in industrial production less real retail sales growth. Readings were converted to a z-score basis

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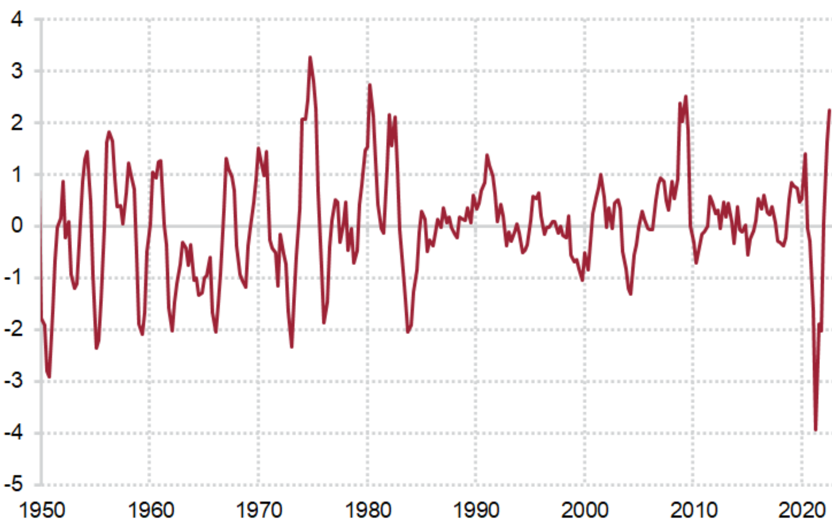
to aid in creating an aggregate index, using the average across each component. For aggregate demand, we simply took the YoY percent change in real GDP (also converted to a z-score). The spread between our aggregate supply and demand series represents the "balance" of the overall economy**. Looking at the chart below, we can see that after a historic negative spread as of Q2 2021 — indicating severe excess demand — things have shifted quickly to an extreme excess supply reading at +2.2 (a reading greater than zero denotes excess supply), something not seen since 2008/09, 1982, 1980, and 1974!**

CHART 9: Excess Supply Backdrop Points to Disinflationary Future

United States: *Spread of supply less demand proxy*
(index; >0 denotes excess supply)



Note: supply proxy includes supplier delivery delays, labor force participation rate and spread between industrial production and real retail sales growth; demand proxy uses real GDP growth
Source: Haver Analytics, Rosenberg Research

Historically, based on our series back to 1950, such elevated readings do not tend to last for long. In fact, going back to prior months when the index peaked out around current levels, we looked at how inflation (focusing on core CPI) shifted over the ensuing year. **The median change, summarized in the first table below, has been a 3.3 percentage point slowing in the year-over-year growth in core CPI. On this basis, it implies that the current +6.6% reading, as of September, should move closer to +3% by the end of Q3 next year**. So, for investors, what context does history provide in terms of asset allocation in times when inflation slows? Given expectations of a recessionary backdrop, we analyzed prior periods of both a deceleration in CPI and GDP. The results are presented in the second table below.

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TABLE 1: Median Change in Core CPI Growth Following Prior Peaks

United States

	YoY Core CPI (%)	1-Yr Fwd YoY Core CPI (%)
Jun-09	1.7	0.9
Dec-08	1.8	1.8
Sep-82	5.9	3.5
Mar-82	8.8	4.7
Jun-80	13.6	9.4
Dec-74	11.1	6.7
Median	**7.4**	**4.1**

Source: Haver Analytics, Rosenberg Research

TABLE 2: Historical Asset Class Performance During Periods of Slowing GDP & Inflation

United States

Equities (%)				Bonds (bps)	
S&P 500	1.6	Dow Jones	2.7	2-Year T-Note Yield	-91
Energy	-8.8	NASDAQ	6.0	5-Year T-Note Yield	-80
Materials	-1.4	Russell 2000	3.4	10-Year T-Note Yield	-67
Industrials	0.4			30-Year T-Bond Yield	-58
Consumer Discretionary	6.9			10-Year TIPS Breakeven	-38
Consumer Staples	2.0			High-Yield Spread	221
Health Care	4.2			Investment-Grade Spread	57
Financials	-2.0				
Information Technology	5.3				
Communication Services	4.6				
Utilities	-3.1				
Real Estate	-3.6				

Commodities (%)		Currencies (%)	
CRB Commodity Price Index	-11.4	U.S. Dollar Index	1.5
Gold	7.3	Canadian dollar	-5.9
WTI Crude Oil	-21.6	Euro	-0.7
Copper	-11.8	Sterling	-3.3
		Swiss franc	3.8
		Japanese yen	3.0
		Australian dollar	-4.7
		New Zealand dollar	-3.5

Source: Haver Analytics, Rosenberg Research

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Based on this analysis, as Treasury yields compress, investors can obtain 5% to 10% total returns from the long-end of the curve (10-year+) compared to roughly 2% for the S&P 500. Additionally, high yield and investment grade bonds underperform, as measured by the widening in spreads. In terms of individual sector exposures within equities — cyclical areas including energy, materials, industrials, and financials all underperform, while defensive sectors such as consumer staples and health care are much better off.

Interestingly, though perhaps rather unsurprisingly, sectors that we associate with long duration growth exposure — consumer discretionary, tech, and communication services (which include companies like Apple, Google, Microsoft, Facebook, and Amazon) are the big winners. Ditto for the overall Nasdaq. However, given the historically strong negative correlation with real interest rates and the performance of growth over value in general, we would advise waiting for the official Fed pause and pivot before considering increasing exposure to these areas (or, at the very least, focusing on those whose valuations can be justified with attractive PEG ratios until the change in monetary policy occurs). Beyond the stock market, the flight to safety and defensive qualities of the U.S. dollar traditionally provide a haven in this environment alongside the Swiss franc and Japanese yen. This dollar strength translates to weakness in commodity markets, but the flight to safety provides a tailwind to precious metals with gold a big winner in this market backdrop.

Bottom line, if we are correct in the belief that 2023 will be a story of disinflation and a further slowing in GDP, then history suggests an environment where bonds, defensive/safe haven assets, and long duration growth stocks outperform.

WHICH ECONOMIES ARE BEST PREPARED TO WITHSTAND RISING RATES?

After enjoying decades of low borrowing costs, courtesy of the global savings glut, governments are now under pressure across the globe. Some have been entirely shut out of financial markets (Russia, Pakistan, and Sri Lanka come to mind), while others are facing the highest interest rates in decades. The combination of elevated debt levels, rising interest rates, and weak economic growth increases the odds of sovereign defaults which, in turn, have potential to spill over to an already-weakened private sector via ties between

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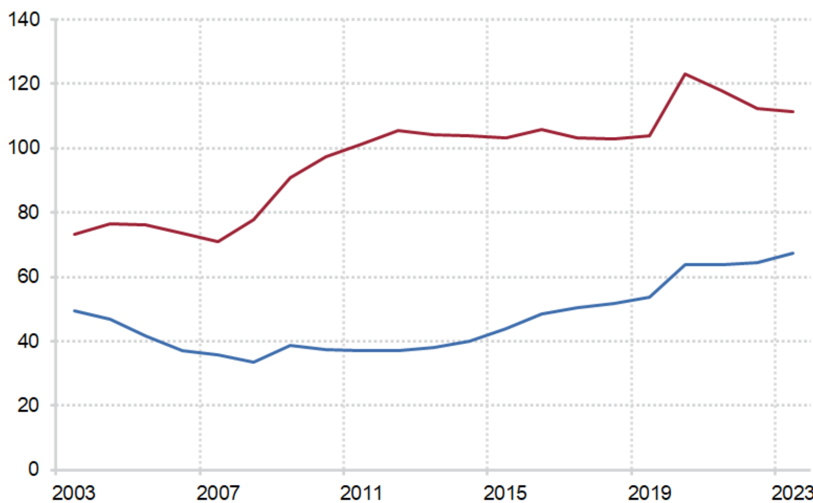
government and banks. As such, investors would do well to be discerning, focusing on economies that have manageable public debt, good current account positions, healthy foreign currency reserves, and a relatively weak sovereign-bank nexus. As we show in this report, countries like Thailand, Taiwan, and Malaysia screen well on those measures.

COVID-19 Debt Legacy

One of the legacies of the COVID-19 pandemic, namely the sharp increase in government debt, is now threatening to derail the global economy. According to the IMF's latest World Economic Outlook, **advanced economies have seen their gross debt climb from roughly 104% of GDP in 2019 to over 112% in 2022 — i.e., up about 8.5 percentage points. Emerging Markets have seen an even faster increase, up 10.5 percentage points over that period to reach 64.5% of GDP in 2022.**

CHART 10: Government Debt is High

Global: *General government gross debt as a share of GDP*
(red line; Advanced economies; percent)
(blue line; Emerging Markets; percent)



Source: IMF, Rosenberg Research

Among advanced economies, Japan and New Zealand have led the charge in terms of debt accumulation (amid the fight against COVID-19), both seeing a greater than 20 percentage point increase in the gross debt-to-GDP ratio. Others, including the U.S., Canada, and major Eurozone economies, have also seen double digit increases over the last three years. In Emerging Markets, Sri Lanka sticks out with a near-48 percentage point increase to 130% of GDP (no wonder that country is now in default), while Bolivia, the Philippines, and Thailand all saw a more

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than 20 percentage point increase. Also seeing double digit increases over that period were China, Tunisia, Malaysia, Korea, South Africa, and Indonesia.

TABLE 3: General Government Gross Debt

Global
(percent)

Advanced Economies	Share of GDP in 2022	Change 2019-22, percentage points
Japan	263.9	27.6
Greece	177.6	-8.0
Italy	147.2	13.1
Singapore	141.1	12.9
United States	122.1	13.3
Portugal	114.7	-1.9
Spain	113.6	15.3
France	111.8	14.4
Belgium	103.9	6.2
Canada	102.2	15.0
Cyprus	93.6	2.5
United Kingdom	87.0	3.1
Austria	78.5	8.0
Germany	71.1	12.2
Iceland	68.2	2.0
Finland	66.7	7.1
Australia	56.7	10.0
New Zealand	56.6	24.8
Netherlands	48.3	-0.3
Ireland	47.0	-10.1
Norway	40.3	-0.6
Switzerland	40.3	0.6
Sweden	33.5	-1.4
Denmark	31.8	-1.9
Luxembourg	25.4	3.1

Emerging Markets	Share of GDP in 2022	Change 2019-22, percentage points
Sri Lanka	130.5	47.9
Egypt	89.2	9.1
Tunisia	88.8	19.7
Brazil	88.2	0.3
India	83.4	8.3
Bolivia	82.6	23.3
Pakistan	77.8	0.2
China	76.9	19.7
Argentina	76.0	-12.8
Hungary	74.8	9.3
Croatia	72.6	1.4
Malaysia	69.6	12.5
South Africa	68.0	11.8
Thailand	61.5	20.4
Colombia	61.1	8.7
Philippines	59.3	22.3
Mexico	56.8	3.5
Korea	54.1	12.0
Romania	49.7	12.9
Poland	48.7	3.1
Indonesia	40.9	10.3
Vietnam	40.2	-1.1
Türkiye	37.5	4.9
Chile	36.2	7.9
Taiwan	24.1	-8.7

Source: IMF, Rosenberg Research

Inflation, Rising Bond Yields, & Debt Servicing Costs

This debt accumulation was, of course, made possible by a low interest rate environment, courtesy of a global savings glut, and loose monetary policy by central banks — particularly in advanced economies. **But now it's time to pay the piper.**

This year's inflation shock has prompted a U-turn in central bank policy, pushing up interest rates across the yield curve in most countries, leading to higher borrowing costs for governments. For instance, 10-year government bond yields have shot up since the start of the year by about 3.5

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percentage points (ppts) in Greece, Italy, and the U.K. (although the latter two are partly due to the uncertain political climate). In Emerging Markets, 10-year yields have shot up as well: Mexico (+2.3 ppts), Korea (+2.1 ppts), South Africa (+1.5 ppts), and Brazil (+1.2 ppts). **The surge in bond yields, coupled with earlier debt accumulation, translate to significant increases in debt servicing costs for many countries** (see table below).

The Eurozone's GIPS economies are the worst affected, given the relatively large size of their government debt and surge in bond yields — although the U.S. and the U.K are not far behind. The debt service shock is less acute in Emerging Markets given their relatively lower government debt levels, although still significant, at around 1% of GDP in places like Korea, Brazil, South Africa, and India.

TABLE 4: Debt Servicing Costs Have Risen in Most Countries

Global
(percent)

	Change in 10-year government bond yield so far this year	Corresponding increase in debt servicing as share of GDP*
Greece	3.7	6.6
Italy	3.6	5.2
Portugal	3.0	3.4
Spain	3.0	3.4
United States	2.6	3.2
United Kingdom	2.9	2.5
Canada	2.1	2.2
Germany	2.6	1.8
Australia	2.4	1.4
Mexico	2.4	1.3
New Zealand	2.3	1.3
Ireland	2.7	1.3
Korea	2.1	1.1
South Africa	1.6	1.1
Brazil	1.2	1.1
India	1.0	0.9
Thailand	1.3	0.8
Sweden	2.0	0.7
Malaysia	0.9	0.6
Switzerland	1.4	0.6
Japan	0.2	0.5
Indonesia	1.1	0.5
China	-0.1	0.0

* Assuming weighted average maturity of debt is 10 years
Source: Bloomberg, Rosenberg Research

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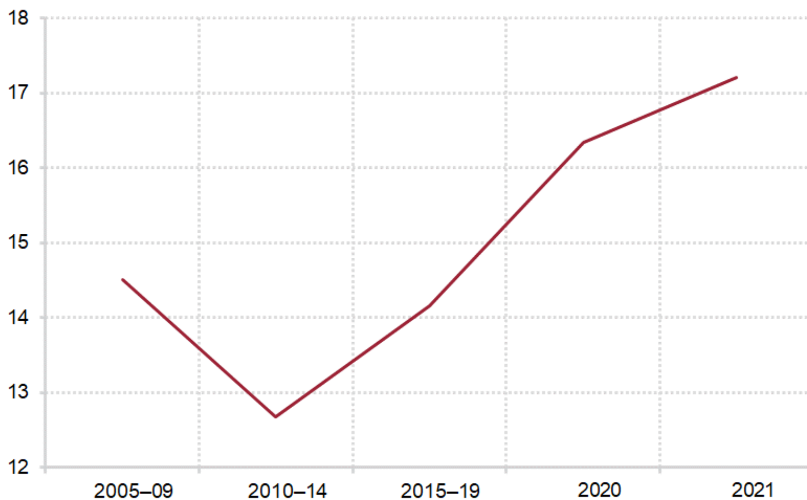
Some Complicating Factors

This is not to say that Emerging Markets are in the clear. The strong U.S. dollar represents a major risk to that group, given that nearly 16% of public debt is denominated in foreign currencies (compared to just 3% in advanced economies). Any trouble with public finances has potential to spill over to the private sector given the deepening ties between the sovereign and banking sectors. Note that banks in Emerging Markets now hold more than 17% of their government's sovereign debt, up from roughly 14% before the pandemic. This stronger sovereign-bank nexus, as we saw during the Eurozone's sovereign debt crisis, can threaten the stability of the economy and financial system.

CHART 11: EM Sovereign-Bank Nexus Is Getting Stronger

Emerging Markets: *Banks' domestic sovereign debt exposure*
(percent)



Source: IMF, Rosenberg Research

Another complication for Emerging Markets is capital flight. Countries with high shares of non-resident holdings of government debt are more vulnerable than others — here we're thinking of places like Indonesia (where foreigners hold as much as 40% of government debt) and Turkey (where foreigners hold about a third of government debt). It's true that several advanced economies have even higher shares of foreign ownership (e.g., Ireland, Portugal, Spain, Germany). But they are also better able to cope with capital flight than Emerging Markets thanks, in part, to their ease of access to financial markets, and also because they are backed by powerful central banks who can help cushion the blow of rising bond yields — the European

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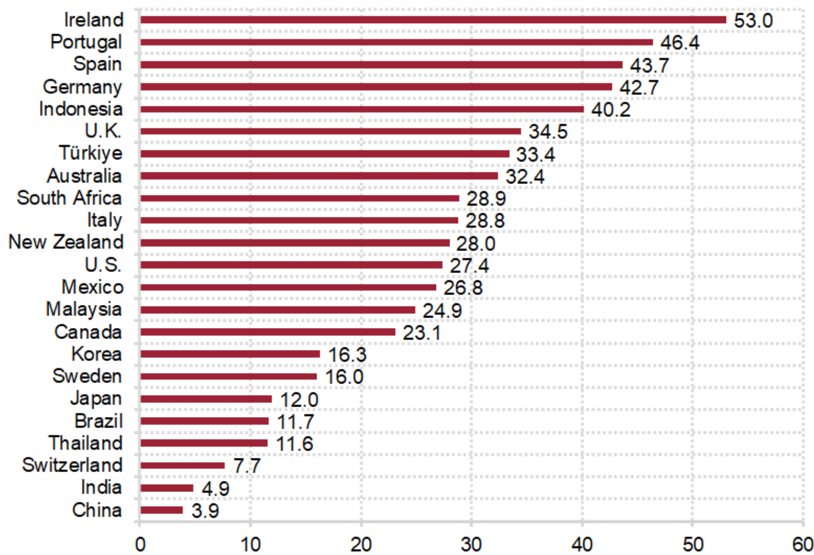
Central Bank's new "Transmission Protection Instrument" and the Bank of England's recent interventions are examples.

CHART 12: Some More Vulnerable Than Others to Pullback from Foreign Investors

Global: *Share of nonresident holdings of general government debt*
(percent)



Source: IMF, Rosenberg Research

In light of those challenges, investors would do well to be discerning, and focus on economies that have manageable public debt levels, good current account positions, healthy foreign currency reserves, and a relatively weak sovereign-bank nexus. Countries such as Thailand, Taiwan, and Malaysia screen well on those measures.

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TABLE 5: FX Reserves, Current Account, & Sovereign-Bank Nexus

Global
(percent)

	FX reserves as a share of GDP	Current account as a share of GDP	Banks' sovereign debt holdings as a share of total assets
Pakistan	1.7	-4.6	44.2
Bolivia	2.0	-1.4	na
Sri Lanka	2.3	-3.4	na
Egypt	5.6	-3.6	41.7
Türkiye	7.5	-5.7	15.8
Indonesia	9.1	2.2	14.2
Chile	10.9	-6.7	6.8
Mexico	12.5	-1.2	21.7
South Africa	12.7	1.2	13.6
India	13.6	-3.5	29.4
Brazil	14.8	-1.5	25.6
Tunisia	15.4	-9.1	15.9
Hungary	16.4	-6.7	16.9
China	16.5	1.8	12.0
Poland	18.5	-4.0	16.9
Philippines	20.0	-4.4	17.0
Malaysia	21.8	1.6	11.5
Korea	22.7	3.2	na
Thailand	33.7	-0.5	10.2
Taiwan	65.3	14.8	na

Source: IMF, Rosenberg Research

Bottom Line

The combination of high government debt and rising borrowing costs suggests that fiscal policy, unlike in the last two global recessions, is not in a position to cushion the blow of the upcoming economic downturn. No wonder the IMF is now expecting world real GDP growth of just 2.7% in 2023, the worst since the 2020 COVID-19 recession. **But things could be even worse than what the IMF is currently expecting if the dollar and bond yields continue their uptrend, capital flight gathers steam, and the deep ties between the sovereign and banking sectors prompt spillovers from government to the private sector. As such, investors would do well to be discerning, and focus on countries like Thailand, Taiwan, and Malaysia that have manageable public debt levels, good current account positions, healthy foreign currency reserves, and a relatively weak sovereign-bank nexus.**

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Dave's Big Picture Investment Themes

The Year of the Tiger has shown its typical unpredictability with a new supply-side shock hitting the global economy from the Russian invasion of Ukraine alongside recurring lockdowns in China as the pandemic spreads. Investing around supply chain issues, Cold War 2.0, climate change, food and energy security, as well as post-COVID-19 health care requirements are crucial for any long-term portfolio strategy. We did a refresh to include the implications of this latest global commodity shock:

- Long Treasury bonds (the entire Fed cycle is priced in; moving away from peak growth and peak inflation)
- Gold (benefitting from negative real rates; hedge against heightened geopolitical uncertainty)
- Pharma/Biotech/MedTech (long COVID-19 and mental illness coming out of the pandemic)
- Farmland, agri-business in stable areas on the planet, water infrastructure (security of supplies)
- Industrial REITs/Rails/ Warehousing (onshoring theme as globalization partly reverses)
- Defense stocks, cyber-security (heightened geopolitical tensions and screen well on a relative basis)
- Alternative investments (expected lower returns in public markets)
- Home office technologies (an increasingly flexible workplace)
- Online retailing, delivery services and industrial REITs (growing share of consumer spending on e-commerce)
- Robotic technologies (labor cost saving strategies)
- Green commodities (for example: copper, graphite, nickel, lithium, cobalt, aluminum, silver, & uranium)
- For the near-term, a barbell approach with the oil companies (huge cash-flow providers and balance sheets are in great shape)
- Screening for best-in-class ESG companies (ESG investing principles are here to stay), carbon credits
- Post-Russian energy transition opportunities: hydrogen, LNG, shale oil, uranium
- Electric vehicle market (the gas price shock has accelerated this process)
- Manufactured/Pre-fab homes (fall-out from affordability constraints in the single-family sector)
- Entertainment/travel (the post-pandemic "bucket list")

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Weekly

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