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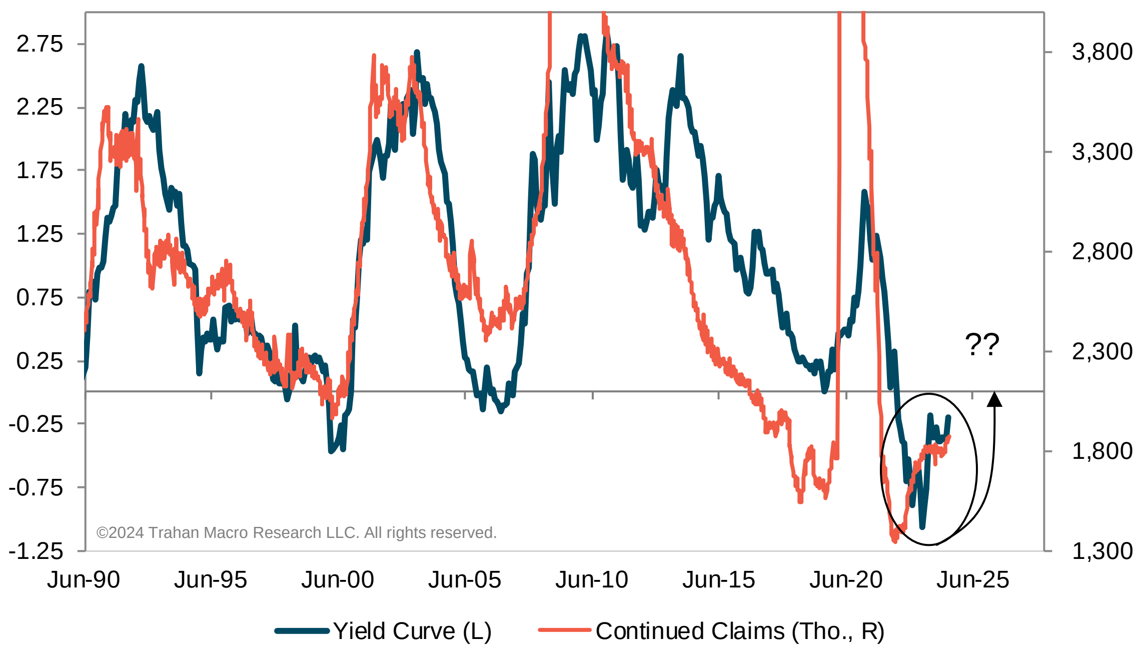
TRAHAN MACRO RESEARCH

August 15, 2024

Are The World's Weak Links A Problem For U.S. Equities?

These last few weeks have been a wild ride for financial markets. Given the context, there is nothing super surprising going on, apart perhaps from the timing. Indeed, a peak in the fed funds rate typically starts with a Fed-relief rally (Q4'23/H1'24) and an eventual shift toward defensive leadership (Utilities in Q2). The latter is generally a sign that the clock is ticking for the equity market. The next step in the process is what we have seen this summer – a change in the correlation between stocks and bond yields. The positive correlation seen in the past month is a sign that "bad economic news is bad stock market news" once again.

Yield Curve Steepening Typically Spells Trouble For The Consumer



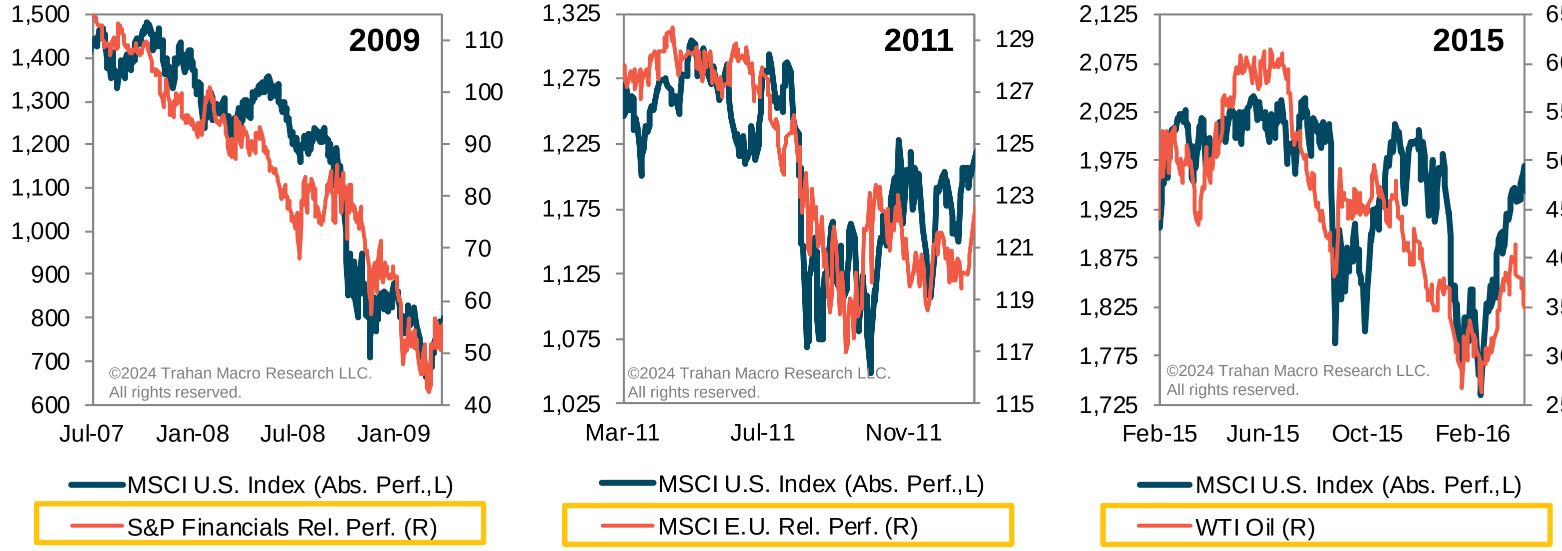
Yes, it took a weak labor report to get investors to finally worry about the risk of a recession. Employment is the driving force behind S&P 500 earnings, so the last few weeks are the markets prepping for an eventual downturn in the economy as well as company top lines. The Fed should be easing policy shortly as the gradual unwind of the yield curve inversion suggests. The chart above illustrates very well that the yield curve does not begin to steepen again until labor markets start to fall apart. This is also when volatility moves higher and problems for equities intensify.

While there are clearly domestic issues confronting U.S. equities, the S&P 500 is essentially a global benchmark considering that about 30% of its companies' revenues are generated abroad. This week we review some global episodes that ended up being a problem for U.S. stocks. We also explore where some of the weak spots may be in the rest of the world. A U.S. slowdown, after all, could very well be the catalyst that exposes some of the at-risk countries. It's a heavy topic for an August report, but it's important considering the issues at hand. Wishing you a great rest of your week. Francois

The Weakest Link For U.S. Equities Is Not ALWAYS Domestic

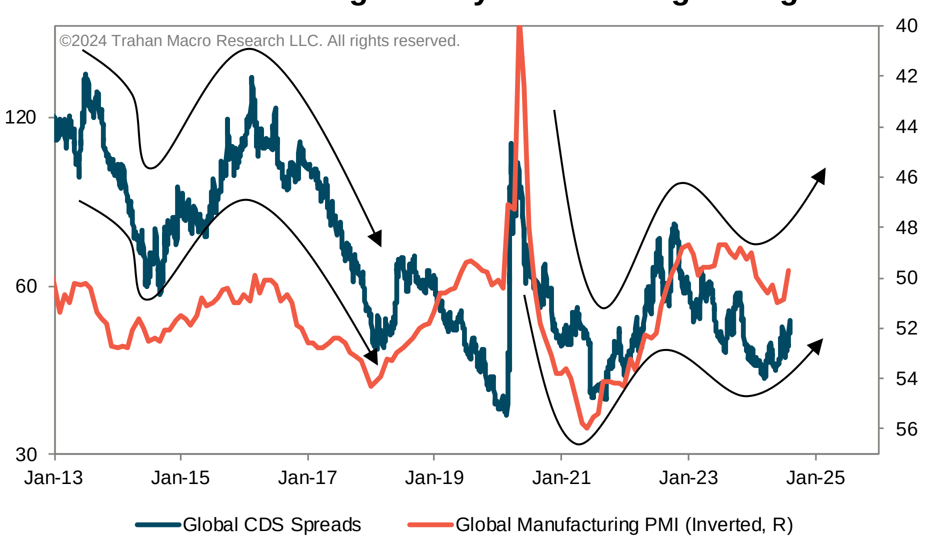
Most of what we have published in the last year on risks has been about the recession vs soft landing debate in the U.S. economy. The reality is that it's not as binary as that statement. There are other possible outcomes that are mostly unrelated to the U.S. outlook that could still prove problematic for the stock market. Indeed, history is littered with episodes that had little to do with U.S. economic conditions that still proved to be a problem for the S&P 500. In a world where financial markets are integrated and risks are synchronized by trade, there are a lot of potential problematic outcomes.

The Weakest Link In A Cycle Can Lead The Market Into And Out Of A Rough Patch

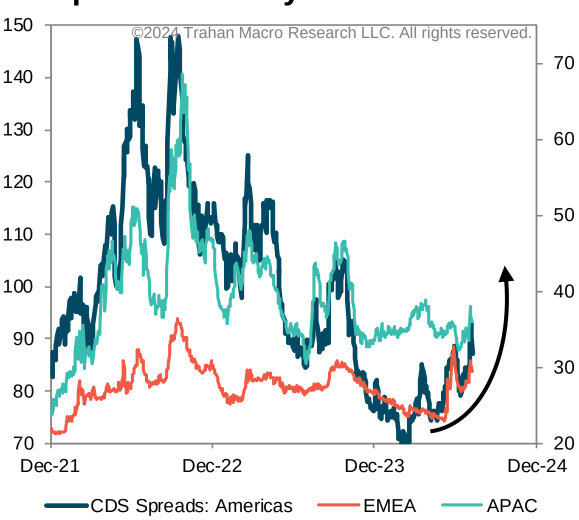


Surely, the Global Financial Crisis of 2008-09 was a U.S.-bred phenomenon. Still, the Asian Crisis in the 1990s had little to do with the domestic economy and yet it managed to take down the S&P 500, even if briefly. A year later, the Russian default had a similar effect, and this time it took down Long-Term Capital Management. In the wake of the GFC, events in Europe proved problematic at times as did the peak in China's investments in the mid-2010s and the pressure that put on energy prices. All of these events began abroad, yet they still had implications for U.S. equities. As the chart below illustrates, generally weaker economic prospects around the world (show here as the Global PMI) lead to a widening of risks (CDS Spreads). This dynamic is not uncommon in the wake of global tightening.

Global Manufacturing Activity Slows Along Rising Risks



Spreads Already Wider In 2024



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A Simple Framework For Quantifying Country Risk Around The World

It's not always easy identifying country risk. Surely, sometimes stories can bubble up in the media for years before they truly become problematic for U.S. equities. Remember Greece in the 2010s? On the following pages we highlight six metrics we find useful when assessing potential problems around the world. Note that these metrics are not always problematic, necessarily. They tend to flag problems when the world economy is losing steam and pressures are building, especially for those economies that are dependent on global trade for their economic performance.

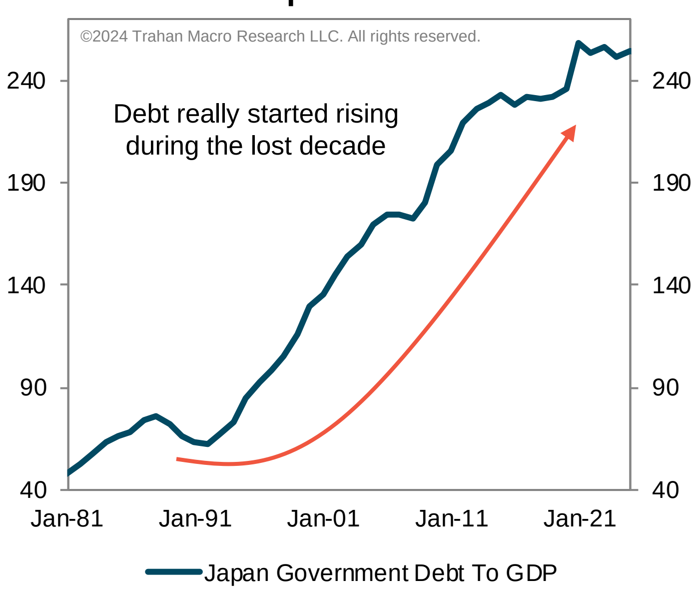
Six Metrics For Uncovering Country Risk

Macro Metrics	Micro Metrics
1. High Debt-To-GDP Ratio	4. High Dependence On Cyclicals
2. Risks Sensitive To The U.S. Dollar	5. Bankruptcy Risk Using Altman Z-Score
3. Dependence On Exporting To The U.S.	6. Quantitative Credit Grade Ratings

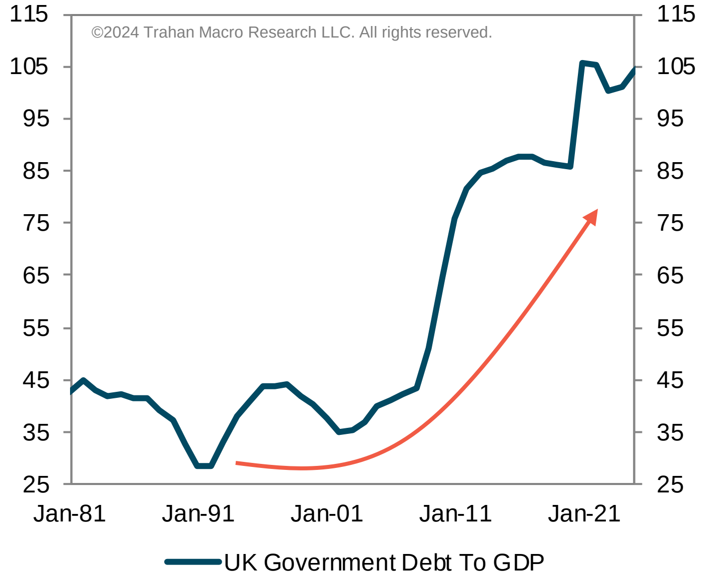
The first item on the list is the Debt-to-GDP ratio. Typically, investors don't pay too much attention to a company's debt while earnings are growing. Truth be told, it's not that different at the country level where debt is usually a non-event as long as the economy is expanding. Debt starts to gain more mindshare when the economy slows. We have seen debt impact smaller economies historically (Asian Crisis, Greece, etc.) but these events still had repercussions for U.S. stocks.

Today's public debt profile is rather unique in the modern era – most developed economies are laden with unsustainable levels of debt. This is not a small economy that poses some risks as Greece did in the 2010s. Now we're talking about major countries like Japan, the U.K., the U.S., and of course China that are not exactly on sound fiscal trajectories. To reiterate, none of this stuff matters when economic growth is strong, but debt often becomes a problem a few years after a monetary tightening cycle.

1. Japan Govt Debt



Other Countries Also At Risk



#2 & #3 Dollar Sensitivity And Dependence On Exporting To The U.S.

There is a clear inverse relationship between the U.S. dollar and the performance of the world economy. Some countries are more at risk than others when the USD is strong – in other words, when the world economy is under pressure. A simple correlation between country CDS spreads and the USD is a proxy for capturing debt service and sensitivity to the world economy.

2. Dollar Strength Translates To A Weak Global Economy

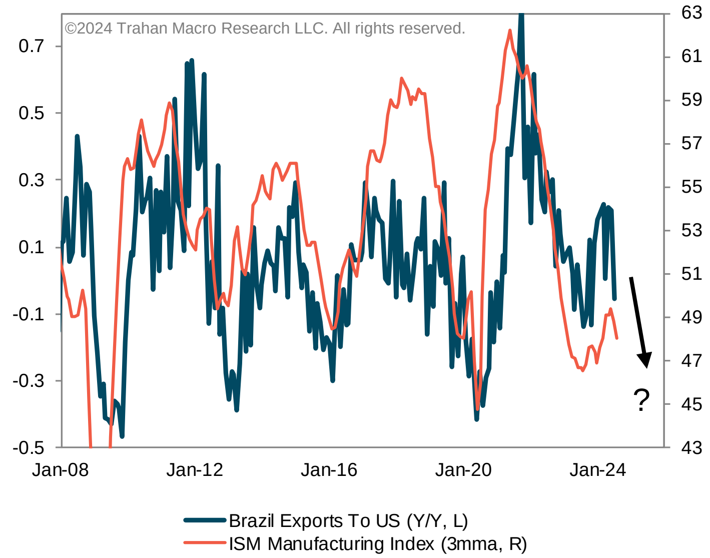
Correlation: CDS Spreads v USD	
Peru	74%
EM	64%
Mexico	61%
Indonesia	60%
China	60%
Chile	58%
Russia	56%
Vietnam	49%
Brazil	48%
Thailand	44%
Hong Kong	38%
S. Korea	33%
Australia	31%
Italy	30%
Spain	28%
Japan	23%
Eurozone	14%

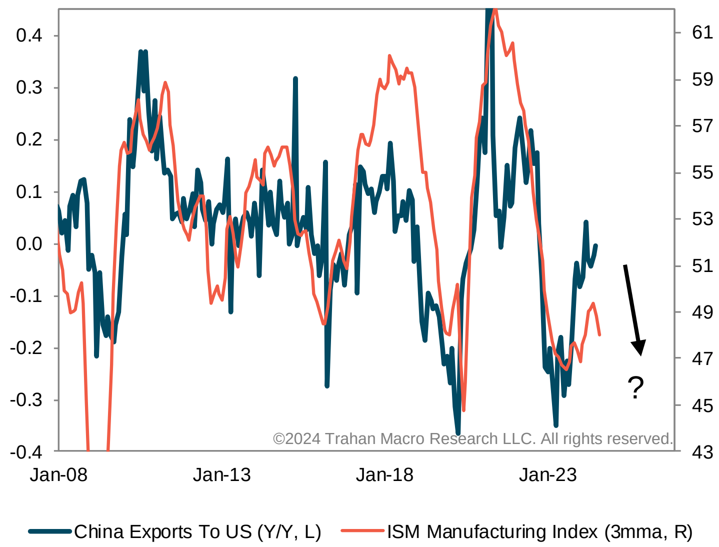
High

Low

Historically speaking, countries with a high dependence on exports for economic growth prove to be most at risk. Some of this is explained by the fact that many emerging markets have been poor stewards of fiscal policy. That said, some of it also stems from the fact that countries with structural issues often turn to trade as a source of growth. A slower global economy is often problematic for countries that depend on trade, especially if they have other structural issues in play. The two charts below illustrate just how levered countries like Brazil or China are to the ultimate source of demand around the world: the U.S. economy.

3. Countries With Structural Problems More Dependent On Trade For Growth





#4 Cyclical-Heavy Indices A Problem In A Global Downturn

Needless to say, in countries where the equity market is largely concentrated in defensive segments like Staples and Health Care – Switzerland, for example – are not that globally exposed, relatively speaking. It's a different story for those with markets concentrated in commodities and industrial cyclicals.

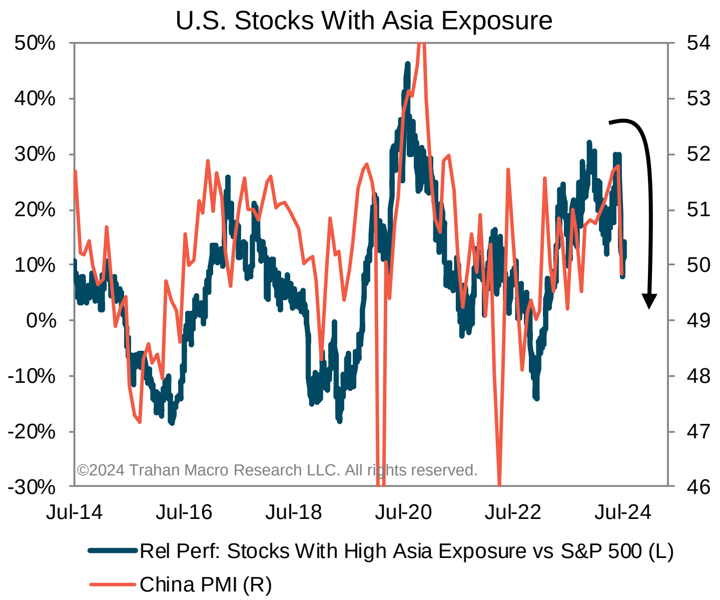
What Sectors Drive Global Indices?

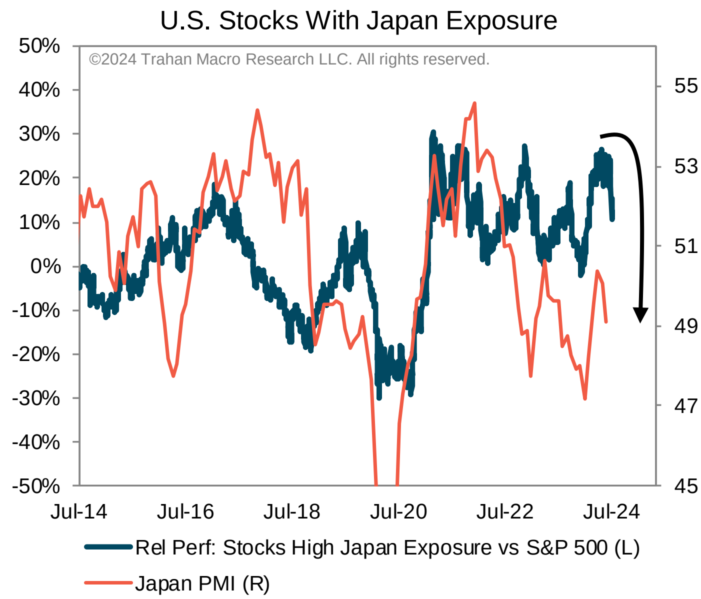
Country	Energy	Industrials	Materials	Cyclicals
Saudi Arabia	67%	7%	2%	**76%**
Canada	11%	19%	11%	**40%**
China	5%	26%	4%	**35%**
India	8%	20%	6%	**33%**
Brazil	14%	15%	3%	**32%**
United Kingdom	9%	18%	5%	**32%**
Australia	5%	9%	18%	**32%**
South Korea	1%	26%	2%	**29%**
Japan	1%	25%	2%	**27%**
Mexico	1%	10%	16%	**27%**
United Arab Emirates	9%	14%	1%	**24%**
France	5%	18%	0%	**23%**
Germany	0%	21%	1%	**22%**
Hong Kong	10%	9%	0%	**20%**
Italy	6%	8%	1%	**16%**
Taiwan	1%	12%	2%	**15%**
Spain	2%	12%	0%	**15%**
United States	3%	11%	1%	**15%**

These countries have the highest exposure to Industrial Cyclical sectors.

Generally, the most cyclical markets are in emerging markets and other trade-sensitive economies. Since these tend to be more dependent on exports, there is a tie-in to other factors we use here. These countries' economies slow disproportionally more than others in a global downturn, and their cyclical equity indices add even more pressure. We can also see the influence of the rest of the world on U.S. equities – especially those with large exposures to vulnerable markets. Composition of a country's equity market is just another way to manage risks at the end of the day.

Knowing Your Geographical Exposure Is Imperative





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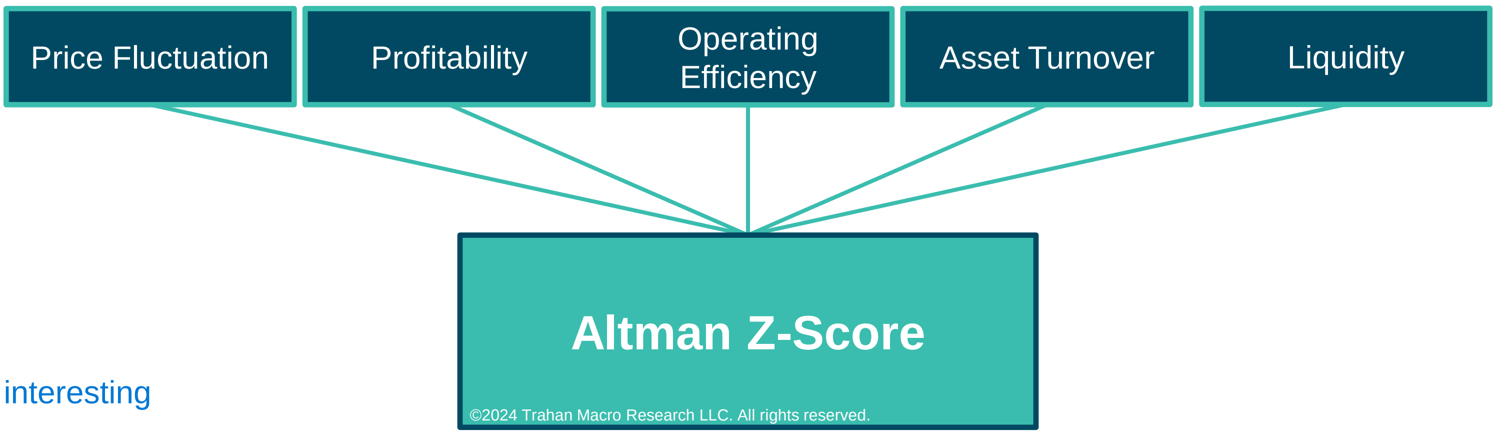
#5 Countries With Bankruptcy Risk Vulnerable In A Slowing Economy

We know that debt-laden economies are often at risk in a global downturn. Still, there are other financial risks that can create issues for a country. The health of the business is surely one of the most important variables to consider. At-risk companies had the biggest problems during the global financial crisis in 2008-09. One proxy to gauge the health of the business sector in a country is to use bankruptcy models like the Altman Z-Score. This model has been around for several decades, but enhancements since its origin, like Ohlson's O-Score, made only marginal gains on efficacy. Altman's simple 5-factor framework can prove helpful in assessing risky situations like these.

The Altman Z-Score: Quantitative Models To Assess Risk



v interesting

The process we undertake here is quite simple. We apply the Altman Z-Score to every company in a country's stock market and then roll that into a national score than can be used for international comparison. Interestingly, the U.S. and most other developed economies fared well on this screen. Surprisingly – and maybe this is our own bias – China also ranked well in this model. This could argue that the underlying companies are in better shape than the country's provinces. On the other hand, some developed economies like Belgium landed in the grey zone while Portugal screened as "in distress". This highlights the challenges at play for these country's companies. This model alone is not infallible, but it can prove helpful used in conjunction with other risk-monitoring tools. Note that this methodology can be applied to any equity index around the world.

The Altman Z-Score Applied At The Country Level

Safe Zone

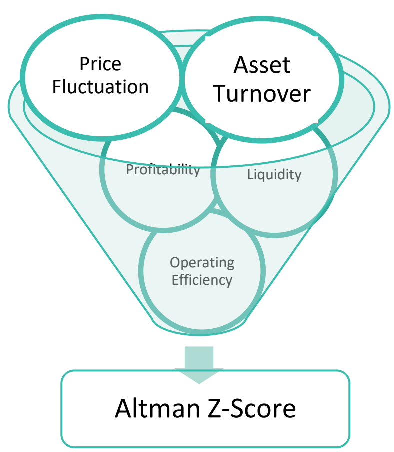
U.S.	Canada	Taiwan	Australia	S. Korea	Japan	China	France	U.K.	Mexico	Germany
10.48	9.49	7.36	6.78	6.16	5.55	5.43	5.08	4.31	3.92	3.42

Grey Zone

H.K.	S. Africa	Brazil	Chile	Belgium
3.38	3.20	2.69	2.31	2.29

Distress Zone

Portugal	Colombia	Oman	Costa Rica	Macau
1.65	1.47	1.27	1.08	0.93



We Used The Cap Weight Aggregate For All Companies

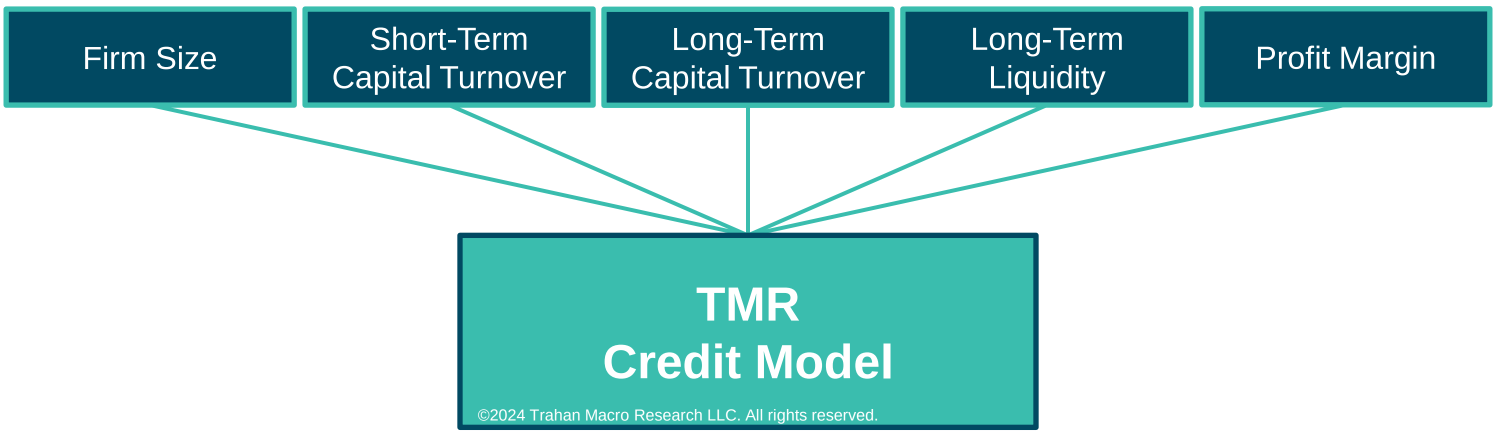
For Details Email Us At
quant@trahanmacroresearch.com

#6 Countries With Credit Risk A Potential Problem In Slowing Economy

A similar way to assess risk is to look at the credit risk of a country. Specifically, the credit risk embedded in a country's main equity index. We analyze this risk using the TMR Credit Model. We normally use this framework to compare a company's credit rating calculated by our model to the actual rating given by one of the major rating agencies. Any discrepancy between the actual and model ratings helps us gauge whether a stock is at risk of downgrades, and sometimes upgrades, of course. In this context, we are estimating a country's proxy credit score using an aggregate of a country's largest stocks.

This approach can be thought of as a micro way to analyze debt levels and the risks they entail for an economy. This is a not a perfect proxy of balance sheet risk, but it's a useful exercise in the context of a sluggish world economy.

TMR Credit Model Is A Real-Time Proxy Of How S&P Grades Companies



The table below lists the TMR model's credit ratings for world economies. It is essentially an aggregation of the credit score of all the companies in the country's main equity index. Now, some countries yield very different results from what we obtained with the Z-Score on the prior page. Note that Hong Kong appeared in the grey zone of the Z-Score but rates an AAA in this framework. We need to remain most mindful of the economies flagging risks in both models. Belgium and Portugal – both of which were flagged in the Z-Score model – are rated BBB in this framework, which is barely investment grade.

TMR Credit Rating Model At The Country Level

Hong Kong	S. Korea									
AAA	AAA									
Qatar	Japan	India	Chile	Peru	Taiwan	Colombia	Singapore	Egypt	Thailand	Philippines
AA	AA	AA	AA	AA	AA	AA	AA	AA	AA	AA
Saudi Arabia	China	Mexico	S. Africa	Canada	U.S.	Brazil	Argentina	U.K.	France	Germany
A	A	A	A	A	A	A	A	A	A	A
Belgium	Malaysia	Ireland	[illegible]	Norway	Portugal	Spain	Kuwait	Finland	UAE	Uruguay
BBB	BBB	BBB	[illegible]	BBB	BBB	BBB	BBB	BBB	BBB	BBB
Ukraine	Iceland	Monaco	Australia	Bahamas	Bahrain	Greece	Italy			
BB	BB	BB	BB	BB	BB	BB	BB			
Oman	Austria	Bermuda	Gibraltar	Nigeria	Costa Rica	Faroe Islands	Puerto Rico			
CCC	CCC	CCC	CCC	CCC	CCC	CCC	CCC			

Investment Grade

Junk

Investment Grade line

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Global Risk Monitor Summary

Below is the output of our six-factor screen. We did not list all countries below due space constraints, but the full list is available for any clients who are interested. One positive takeaway is that there is no country that scored poorly in all six categories. With that said, it's important to note that Italy was flagged in five of the six risk categories.

Which Countries/Equities Are At Risk In A Global Downturn?

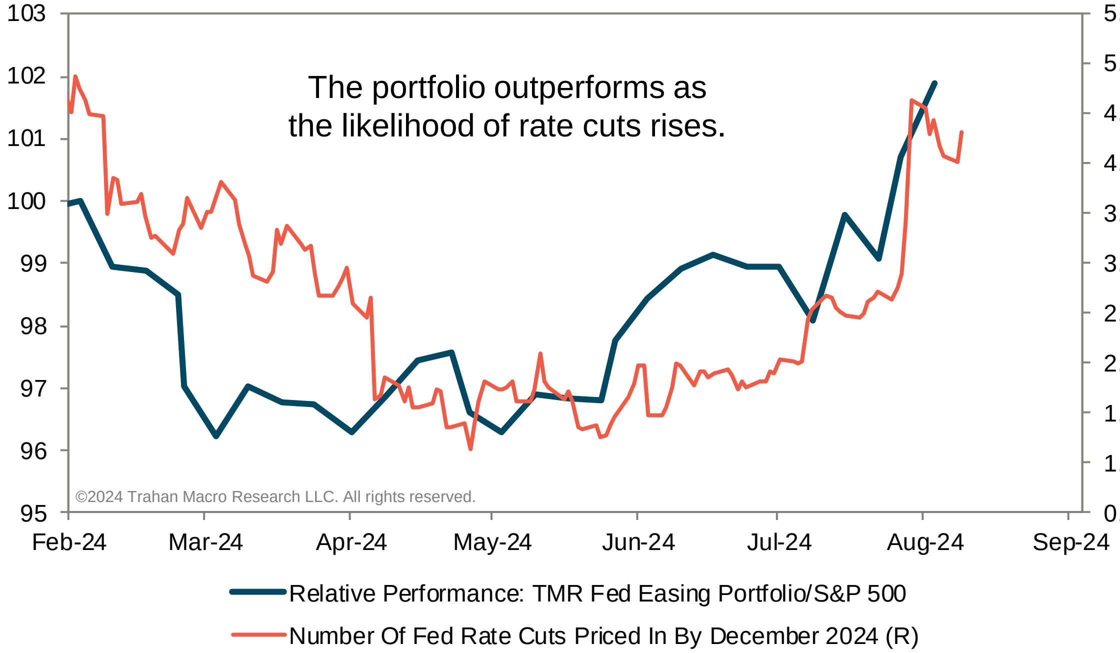
	Top-Down Metrics			Bottom-Up Metrics		
Country	**Exports To USA**	**Debt To GDP**	**USD Risk**	**Cyclical Exposure**	**Financial Strength**	**TMR Credit Rating**
Canada	Exports	108%	Rising CDS	40%		
S. Korea	Exports		Rising CDS	29%		
Japan	Exports	263%		27%		
China	Exports	88%	Rising CDS	35%		
India	Exports	87%	Rising CDS	33%		
Brazil	Exports		Rising CDS	32%	Altman Z	
Italy	Exports	135%	Rising CDS		Altman Z	Junk
Spain		96%	Rising CDS		Altman Z	
Portugal		118%		37%	Altman Z	
Costa Rica	Exports		Rising CDS		Altman Z	Junk
Greece		160%	Rising CDS	26%		Junk
Mexico	Exports		Rising CDS	27%		

This framework is not the only way to measure country risks around the world, but it does show which inputs could be most useful for any investor looking to develop their own model. There are myriad ways to use this information. We have always been fans of using it as a breadth indicator, but others view it as a snapshot of the problems at play in a given country. For instance, we see that Italy would score very poorly on the breadth approach. Meanwhile, Japan is highly exposed to one important issue – government debt. Note that we are using government debt for this work, so it doesn't catch the intricacies at play in a country like China where much of the debt is held by the provinces. Still, this can be an extremely helpful snapshot in the current context. This type of work does have a shelf life so if things deteriorate in the coming year as we expect, it should be reassessed at a later date.

A Stock Screen For The Fed Easing Cycle … Of 2024 And 2025?!?

We have highlighted this screen a number of times now but given the macro issues at play this one might be relevant for the next 12 to 18 months. We call this the “Fed Easing Portfolio” as it uses five factors that have proven to be consistent outperformers in easing cycles of the past. I don’t think anyone would be surprised to hear that the factors are somewhat defensive, and for the most part counter-cyclical. Needless to say, the portfolio has performed extremely well in the past month as investors have realized that weaker labor markets are finally going to usher in a Fed easing cycle.

The TMR Fed Easing Portfolio Built To Perform During Easing Cycles



The full screen is available for the S&P 500 as well as other common indices. Simply email quant@trahanmacroresearch.com for the full list. We will likely keep updating this one for the next year and probably longer. After all, the average Fed easing cycle has lasted about 18 months and some cycles have been even longer. Once you have the Excel file, feel free to tweak it as you see fit.

A Sample Listing Of The Five Factor Fed Easing Portfolio

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Lower Values Rank Better In All Categories

Universe: S&P 500
TMR Fed Easing Portfolio

Ticker	Name	Portfolio Rank	Profitability	Cyclicality	Sentiment	Governance	Operating Efficiency	Sector
MCD	McDonald's Corporation	1	1	1	1	1	1	Consumer Discretionary
VZ	Verizon Communications Inc.	1	4	1	2	1	1	Communication Services
BRK.B	Berkshire Hathaway Inc. Class B	1	8	3	2	1	1	Financials
AMT	American Tower Corporation	1	3	6	3	1	1	Real Estate
IBM	International Business Machines Co	1	7	1	9	1	1	Information Technology
MRK	Merck & Co., Inc.	1	2	1	2	2	1	Health Care
PG	Procter & Gamble Company	1	2	6	2	2	1	Consumer Staples
SBUX	Starbucks Corporation	1	5	3	5	2	1	Consumer Discretionary
NSC	Norfolk Southern Corporation	1	3	3	5	3	1	Industrials
SHW	Sherwin-Williams Company	1	3	6	6	3	1	Materials

For complete list, different benchmark, or monthly model updates:

Email quant@trahanmacroresearch.com or visit trahanmacroresearch.com/screens