

H2O's Macro Insights

Emerging Markets Strike Back

Overview

- 1. The on-going growth cycle is strong, synchronised and well-balanced across all regions supportive for global trade and commodities;*
- 2. Developed markets' financial conditions should remain supportive for some time while Emerging Markets' lines of defence have improved*
- 3. While the whole asset class should be supported, several EM currencies stand out as their local policy-making has committed to maintaining the right balance to anchor investors' expectations and thus reduce the risk of sudden stop.*
- 4. Global investors' strategic positioning is light in EM after 10 years of poor performance. Supportive macro and valuations factors not seen in years and further development of the asset class will entice investors to reallocate assets to EM.*

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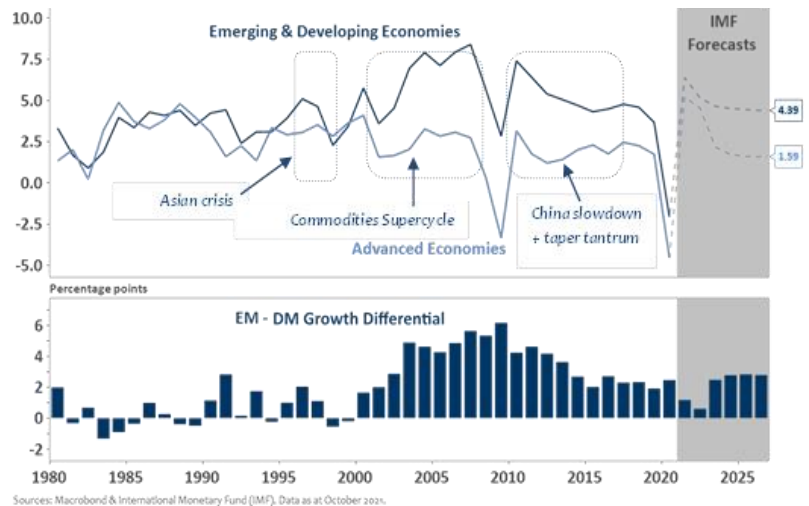


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Since the beginning of the 21st century, the world economy has become much more globalised: emerging countries exchange more with developed countries and among themselves. This structural deep interconnection is now expressing itself in a strong, global and synchronised recovery, the sort of growth the world had not experienced in decades. Such steep cycle will come in sharp contrast with the gradual recovery that followed the global financial crisis. Stable growth will be replaced by high variance in economic data. Central banks will have no choice but to act and often surprise investors when they could change just a few words in a statement in the past. Liquidity will not prove as readily available, with a fiscal drag starting next year in the US and central banks not in such an easy position to bail markets out in case of a shock due to inflation.

This context of higher inflation, higher rates, and higher volatility will, one day or the other, push investors out of the past decade success stories.

Elevated and synchronised global growth support EM



“
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As happened in the early 2000’s, the combination of macro and market volatility will force participants to find new investment solutions. As was the case then, emerging markets might well be one the answers.

The Covid shock proved a big reset for the world economy, with what could well be the deepest recession in human history over a single quarter. The ensuing reboot also re-synchronised business cycles among countries across the globe. China may have been the first country to exit restrictions in 2020, by end-2021 all countries in the world should be roughly back in full synch in this cycle.

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The question asked here is how will EM assets fare in the years ahead? The follow-up of the Trump years would rather support US assets outperformance. Early-cycle dynamics are always favourable to US assets. However, if strong growth were to continue going forward, the 21st century’s world economy would support strong EM performance through global exports, high commodity prices, and a pronounced domestic investment cycle.

Investing in emerging markets often comes down to getting just a few calls right:

- the Fed monetary policy relative to the rest of the world, and the resulting trajectory of the US dollar;
- the momentum of global and Chinese growth;
- and avoid major defaults and value traps.

The first two factors are key drivers for commodity prices. Not only commodities fuel most EM countries’ terms of trades, they also shape external accounts and financing needs. Export revenues also support domestic demand – investment and consumption – via wealth effects derived from improving exporters’ balance sheets that support employment and salaries. These are major ingredients to EM virtuous growth cycles.

Growth and commodities are also key components of the improvement of EM's balance sheets (i.e. country risk): the 2000's bull commodity cycle resulted in a rapid rise in foreign exchange reserves, via exports and capital inflows into EM. Stronger growth also significantly contributed to healing public debt ratios. So much that post GFC, EM was, incorrectly, perceived as structurally offering a better risk-reward than DM as public debt increased relatively less. This perception was quickly questioned when China started decelerating, triggering a decline in commodity prices while the Fed removed its ultra-dovish stance in May 2013 and announced an upcoming tapering.

This marked the beginning of a prolonged underperformance of EM local markets as investors struggled to acknowledge until 2015 as they remained focused on the previous paradigm (2000's super-cycle and saving gluts, and post-2008 sharp recovery).

Investors tend quite naturally to rely on their most recent experience to design future trends. The latest market/macro regime always carries more weight in investor sentiment. Psychologists call it "the end point bias" as per investors' inertia to acknowledge regime shifts. Markets are now experiencing a real-time illustration of this bias as investors ask themselves similar questions as in the last cycle, and remain sceptical about EM prospects as reflected in their 2021's poor performance: can EM assets really outperform if China does not return to double-digit growth and if the US maintains its leadership; are not debt overhangs capping EM potential growth and raising solvency concerns; may the Fed not end the party in tightening liquidity conditions to respond to the normalisation of the economic activity and inflationary pressure.

Whatever the prospect for commodity prices, EM assets now offer sufficient value, a high and rising risk premium and a solid growth outlook. Besides, improved external accounts and extremely light investor positioning make them a lot safer than many DM that have leveraged their way out of the Covid crisis. Investors are expected to gradually coalesce as value, carry and positioning are supportive while their hierarchy of preferences is gradually filtering through EM assets as they realise core US assets might not prove as safe as initially anticipated.

FOCUS ON 3 OF OUR PICKS

In the current cycle, EM currencies' strong lines of defense are not only resulting from their rising yields relative to G3 currencies but also their deviation from fair value. While the whole asset class should be supported from 2022 onward, differentiation still matters. Several EM currencies stand out by their high yields and cheapness but also because local policy-making has committed to maintaining the right balance to anchor investors' expectations and thus reduce the risk of sudden stop.

Brazilian Real

BRL's carry has moved from 0 to 8% in 2021 against the USD on the back of the CB's strong commitment to curb inflation. BRL deviates significantly from its long term average value. Strong commodity prices are tailwinds as they alleviate fiscal and growth concerns. Political risks are still distant and well flagged for October 2022's Presidential elections as the main contenders' track records (Lula and incumbent Bolsonaro) are well known.

Mexican Peso

MXN is investors' most common proxy for global EM risks thanks to its liquidity and proximity to the US economy. As such, it sometimes suffers from the "winner's curse" as positioning builds-up fast. In the current environment, MXN is well placed to benefit from inflows into EM from dedicated and crossover investors thanks to its stable institutional framework and its ability to leverage on robust US growth. Mexico's edge lies on its fiscal and monetary cautiousness.

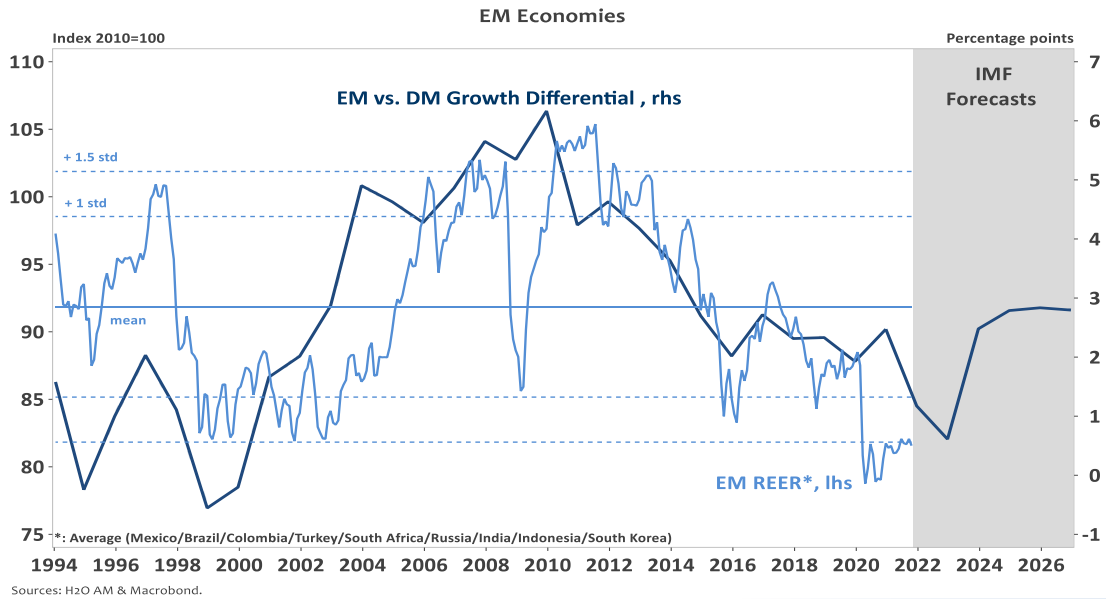
Russian Ruble

Russia's economy has strongly benefited from the rebound in the oil prices. Fiscal and external accounts are robust. Russia also implements the most orthodox policy mix in the EM scope (CB and Ministry of Finance). Carry in the Ruble has risen according over 8% against the USD. Those are strong anchors and balance the underlying geopolitical risks that are currently well factored-in. With a solid outlook for commodities, Rub still trades cheap versus fundamentals.

1 – THE ON-GOING GROWTH CYCLE IS SYNCHRONISED AND WELL-BALANCED ACROSS ALL REGIONS

In cycles of robust global growth in which there is no US striking leadership, EM economies benefit as a by-product of strong global demand first and, right after, from their own domestic momentum in investment and consumption. China might not be running double-digit growth, as in the 2000's, but it still plays its part in the global chain while reducing its structural imbalances (leveraged property markets, excess investments in some sectors). That should be taken as good news.

EM vs. DM growth differential to rebound in a context of above-par growth context



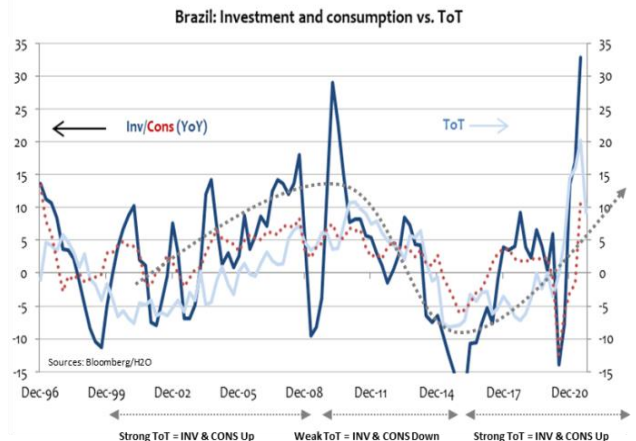
The US, Europe and EM will grow above par as ballooning liquidity and excess savings are soon to be spent. Following a delayed re-opening, EM economies are now catching up as global demand remains robust.

Contrary to the 2000's super-cycle, commodities are less China-dependent as demand is broad-based and supply is constrained in the short run by the lack of investment in capacity in recent years and the transition to a greener energy production. It is a demand and supply shock. This is key for EM domestic economies due to the positive externalities stemming from strong exports revenues (rising ToTs) thanks to the wealth effect – as illustrated by Brazil in the 2000's (consumption, investment, employment...).

ToTs are a proxy for global demand and the recent rise has occurred without China growing at double-digit speed. Demand is more balanced and we would expect this trend to be sustained over the coming years.

“ Strong commodities will fuel export revenues and support a domestic Capex cycle ”

Brazil: Terms of trade and domestic consumption



#2 – DM'S FINANCIAL CONDITIONS SHOULD REMAIN SUPPORTIVE FOR SOME TIME WHILE EM RISK PREMIUM RISES

DM central banks have less leeway to tighten rapidly as they face the risk of messaging investors well ahead of any change, and thus triggering abrupt reactions.

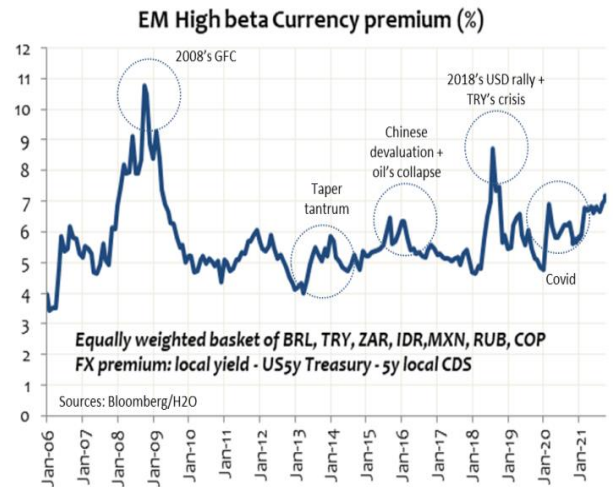
On the contrary, **EM central banks have acted quite decisively since the start of 2021 to move out of their ultra-loose bias adopted during Covid in order to react to the activity and inflation rebounds.** EM monetary authorities have fewer strings attached to their hands as inflation rates are more responsive to commodities, their currencies are undervalued and they do not fear jeopardising the stability of their domestic markets as they are under-owned and not overvalued.

Conversely, whilst the Fed and the ECB have acknowledged the normalisation in economic activity and the rise in inflation, they are far from turning harshly hawkish and remain concerned not to remove liquidity too fast to insure market stability. It might also be argued that they have become more politicised.

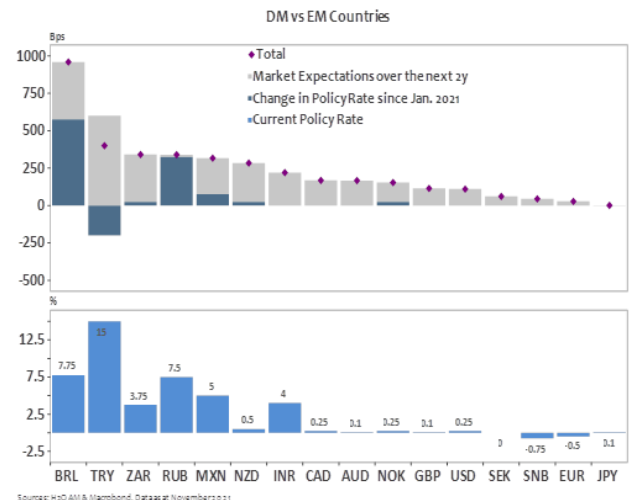
As a result, **monetary policy divergence between EM and DM have widened significantly** as illustrated by Russia, Brazil, Mexico, Chile, Colombia, Korea and Central Europe. The resulting increase in risk premium in favour of EM assets (relative to G3 FX carry) has been a key missing piece of the puzzle for investors to invest in EM over the past decade. Carry and strong growth are necessary ingredients in the EM outperformance recipe.

This provides a backstop should DM central banks reprice faster than currently expected. Short EM positions are harder to hold on to for long as carry becomes expensive. **The carry cushion also provides long investors with time to react, should expected capital inflows fail to materialise quickly,** thus keeping EM currencies undervalued for longer.

As EM balance sheets are in a much better position than during the 2013 taper tantrum, **being long EM is an attractive value proposition from a portfolio construction perspective** as it has become the only liquid investment corner with a decent yield, now that risk premiums have normalised across the DM world. 2021 was a good example of carry providing decent returns in the absence of capital gains.



“ EM Risk premia in EM have increased as Central banks have responded faster than DM CBs to inflation ”

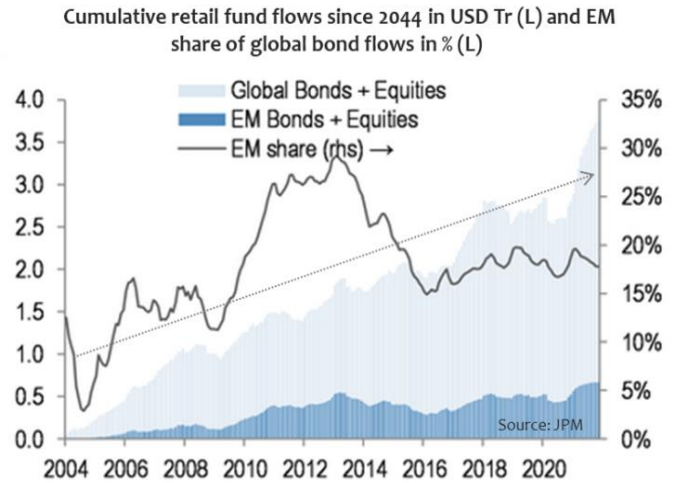


#3 – INVESTORS' STRATEGIC POSITIONING IN EM IS LIGHT AS IT REFLECTS 10 YEARS OF TRAUMA DUE TO POOR RELATIVE PERFORMANCE

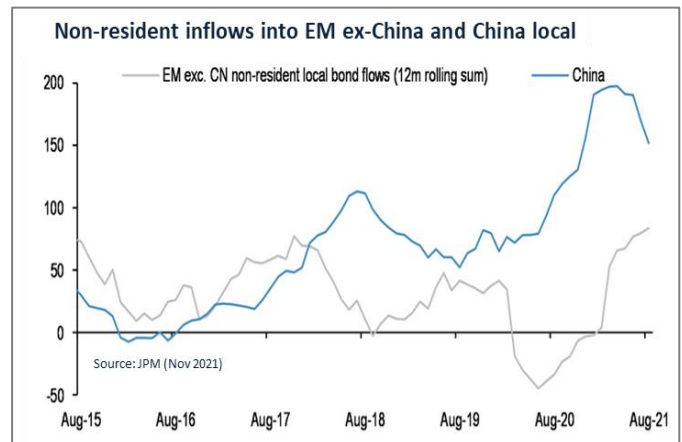
As of end October, EM equities returned +80% over the past 10 years, while the S&P 500 delivered +350% in dollar terms. EM local sovereign debt delivered +7.4% unhedged in USD while US Treasuries recorded +24.4% over the same period. In short, **global investors have lost patience (and money) after years of disappointing EM local asset returns.** This was reflected in the decreasing share of their investment dedicated to EM assets (less than 20%) while their assets rose in line with global liquidity. In addition, the opening up of the local Chinese government bond market has captured a significant share of the flows at the expense of others EM countries (see chart below).

The market capitalisation of the EM asset class has continued to expand as the stock of debt has been rising pre and post-covid.

The outlook for further deepening of EM debt markets remains robust as more EM economies are opening their debt markets to foreign investors. The post-covid fiscal situation will also entice local authorities to tap foreign savings (global Pension funds, SWFs etc...) to finance deficits and avoid crowding out the private sector (when local banks lend more to the government than to the private sector and caps investment and consumption). Over the medium run, EM ought to maintain a rising share of allocation in global investors' portfolio with excesses in down and up cycles. The on-going regime shift will entice foreigners to increase their allocations to EM to converge back to the historical trend as liquidity is ample and perspective a lot more supportive. Prospects of rising capital flows are also a major source of financing for EM's current accounts that are expected to turn slightly negative as growth and domestic demand pick up across countries. This will not be an issue as portfolio and direct investments will easily bridge those gaps unlike in the 2013-2020's cycle and more like in the 2000's.



“ **The conditions are met to get 2 to 3 years of carry and capital appreciation** ”



CONCLUSION

We are transitioning into a new global growth regime precipitated by the Covid-crisis. This shift has a major impact for EM assets. Investors' inertia to acknowledge a change from one regime to another always raises more questions than answers, at first as EM may not fit the post-Covid narrative focused on services and new technologies. At H2O, our top down and value process aims at identifying these regime shifts to position ourselves against the consensus with a medium-term time horizon. Hence, our strategic call to buy EM currencies and local duration in the post-Covid regime. EM's edge in that regime should be the revival of commodities.

We are still speculating on the length of the EM bull cycle but we have concluded for now that there is no strong rationale to end up with conclusions. For the time being, we think that the conditions are met to get 2 to 3 years of carry and capital appreciation until valuations and positioning become less attractive and require a new driver to prove attractive for longer. Investors will embrace another "end point bias". Let's bet it will be overly-bullish EM.

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