Shifting Dynamics

The place of Emerging Markets in the Investment Landscape

Overview

- **The post-Covid macro landscape is ending. The sharp reflation experienced since 2020, fuelled by abundant liquidity and the gradual reopening of economies, has run its course. For investors and policymakers alike, the "easy part" appears to be behind: Above-potential growth has tapered, supply-side inflation has peaked, excess savings have normalised (mostly in the US), and job market distortions have started to phase-out.**

- **But while the macroeconomic backdrop is resilient, this period has precipitated several structural shifts which policymakers cannot ignore. The significant rise of public indebtedness among developed economies will constrain the scope of future policy options. The US public debt, for instance, has surged over 120 percent of GDP during the pandemic, with projections indicating no imminent reversal. Annual fiscal deficits under the Biden administration, averaging 7.5% of GDP since 2021, have soared to levels not seen since World War II.**

- **Conversely, the debt trajectory of emerging economies was more moderated. Emerging markets' country risk is thus improving relative to developed economies, bolstered by robust growth fuelled by high commodity prices. Our comprehensive assessment of the current investment landscape leans favourably towards emerging economies. With financial conditions gradually easing in developed economies, we anticipate a narrowing of the risk premium between developed and emerging assets.**

Disrupted Macroeconomic Balances in Developed Economies

Textbook economics often suggest monetary policy should focus on taming inflation while fiscal policy should steer the country towards growing its economic output. Under this framework, monetary and fiscal policy is required to work in tandem to produce an effective policy-mix. However, the intricate reality of the political economy surrounding this equilibrium is notably complex.

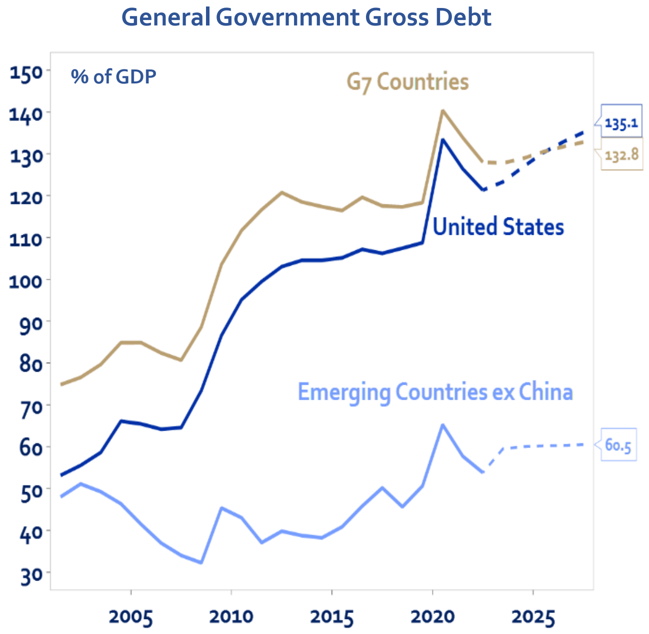
The aftermath of Covid, along with the ramifications of the Russia-Ukraine conflict on energy prices, have distorted voters' readiness to endorse fiscal prudence in their electoral decision-making. There is a prevailing sentiment among the public that any future economic shocks will be countered by the implementation of new social safety measures, thereby exerting pressure on policymakers to deliver more fiscal stimulus.

Consequently, consumers are also exhibiting reduced inclination towards maintaining substantial savings, leading to increased domestic demand and structural inflation. This trend is particularly marked in the US.

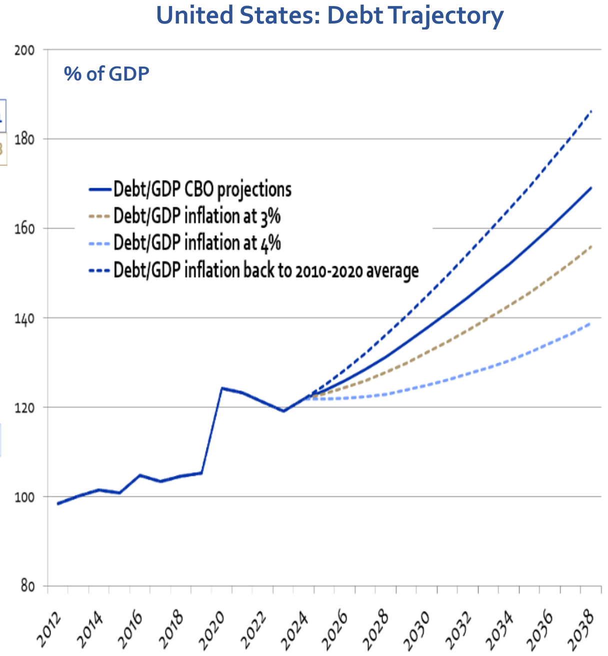
Recent fiscal spending initiatives across developed economies don't signal any short-term reversal of this trend, especially amidst the backdrop of a global election year (2024). Increased defense expenditures are anticipated to persist in the current confrontational environment. Financing the green transition necessitates significant infrastructure development and incentives, primarily achievable through state intervention. Moreover, escalating wealth inequalities exacerbate pro-social policies, skewing economic platform campaigns towards greater fiscal spending rather than pledges of budgetary restraint.

In this context, how can policymakers navigate the policy-mix as prescribed by conventional economic theory?

Willingness for fiscal adjustments is low



Source: H2O AM, Macrobond (2023)



Source: Congressional Budget Office (Mar. 2024), and Federal Reserve of St. Louis (Dec. 2023)

The Looming Risk of Fiscal Dominance

At the macroeconomic level, we observe no balance sheet imbalances among private agents, namely households and firms, despite the recent uptick in interest rates. As a result, the risk of a sudden recession is low.

But these favourable conditions did not occur naturally. Protective measures enacted during Covid resulted in a substantial transfer of debt from private entities to the public sector (see graph). Meanwhile, extensive liquidity injections, exemplified by quantitative easing measures, have predominantly aimed at restoring the private sector by upholding loose financing conditions throughout the recovery phase.

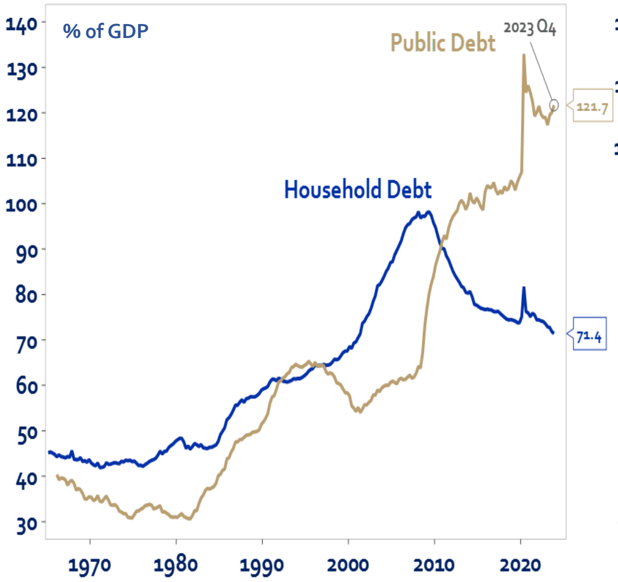
Today, monetary policymakers are tasked with steering the policy-mix whilst government officials show no appetite for fiscal adjustment, despite being burdened with unprecedented debt levels.

As such, there is growing contention surrounding the ability of prominent central banks such as the Federal Reserve, the European Central Bank, or the Bank of England to disregard the trajectories of public debt, given the pivotal role of interest rates and growth in the debt sustainability equation. Their capacity to conduct monetary policies independently from fiscal constraints is being called into question.

In this situation of fiscal dominance, the fiscal stance takes precedence over monetary policy. Ultimately, central banks' reaction function gradually shifts toward risk management to avert excessive macroeconomic downturns, potentially at the expense of inflation containment. This trend creates a growing divide between investors' perception, as reflected in market pricing, and economists' forecast regarding policy, as the objective of central banks becomes less normative.

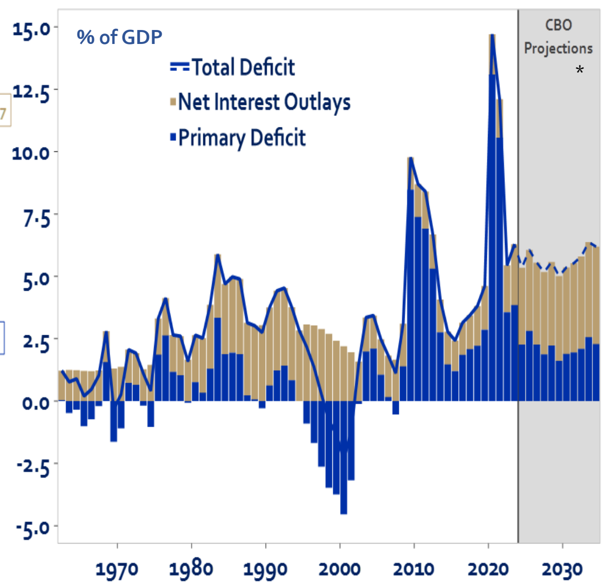
Rising debt and its servicing will increasingly interfere in the conduct of monetary policy

United States: Household vs. Public Debt



Source: H2O AM, Macrobond (Q4 2023)

United States: Public Deficit



Source: H2O AM, Macrobond (Q4 2023)

" Ultimately, central banks' reaction function gradually shifts toward risk management to avert excessive macroeconomic downturns, potentially at the expense of inflation containment "

*CBO : Congressional Budget Office

The concept of "fiscal dominance" describes the growing interference of fiscal considerations in the conduct of monetary policy, consequently undermining the efficacy of the latter. Historically, this phenomenon has been primarily observed in emerging countries marked by institutional fragility, navigating volatile economic phases characterised by boom-and-bust cycles.

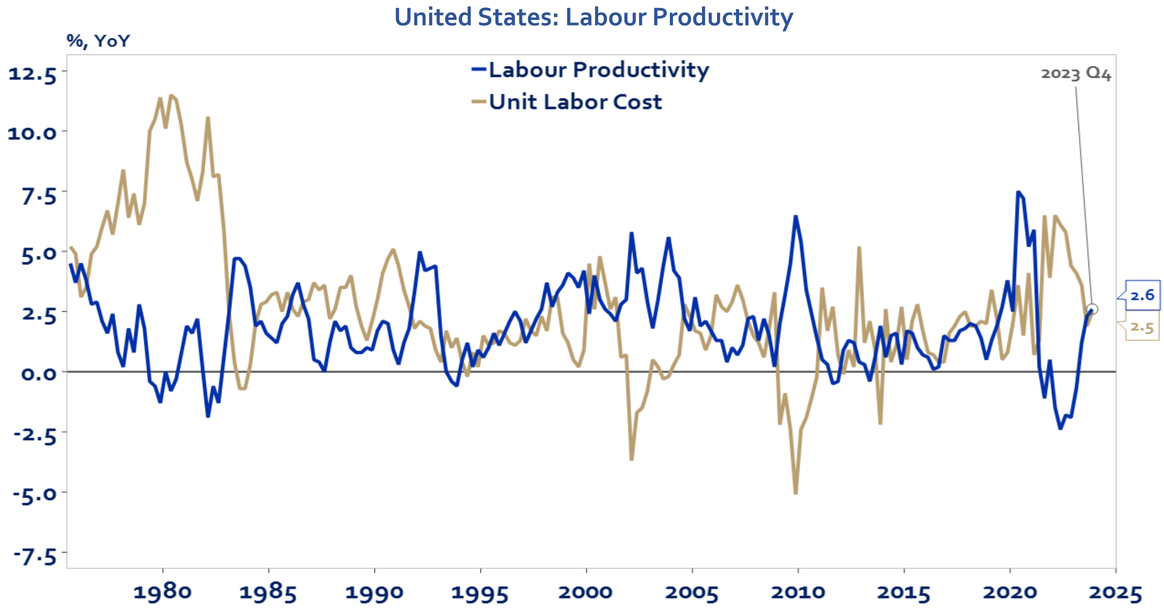
The outlined framework is applicable across most G7 economies, with Japan presenting a notable exception, marked by its unique economic dynamics. However, within the G7 cohort, distinct differences emerge.

EU countries face different debt challenges with Germany demonstrating a more conservative fiscal stance compared to its regional counterparts. Moreover, the Eurozone's potential GDP growth remains subdued and less innovation-driven compared to the United States. Given the region's below-potential growth outlook, the ongoing deceleration in wage growth, and the predominantly supply-driven source of pressure on inflation (i.e., food and energy prices), the European Central Bank is poised to encounter fewer obstacles in its cutting cycle compared to the Federal Reserve.

In contrast, the United Kingdom occupies a middle ground, exhibiting a more cyclical economic profile than the Eurozone, yet facing heightened vulnerabilities due to its large financing needs, including fiscal and current account deficits. Consequently, the UK must either attract capital inflows through higher interest rates or foster robust growth despite having reached large debt levels. Overall, **this leaves G7 monetary policies constrained by weak growth prospects and/or financing issues.**

The situation could still unfold favourably for the US if the ongoing, innovation-led productivity shock proves sustained. Productivity gains inherently carry disinflationary implications while supporting growth, potentially affording the Federal Reserve enough margin to cut rates

Productivity gains are disinflationary



Source: H2O AM, Macrobond (Q4 2023)

without heightened concerns over inflationary pressure. This envisaged 'Goldilocks' scenario mirrors the robust productivity surge witnessed in the 1990s, spurred by the advent of the web; this period was notably marked by robust growth devoid of significant inflationary or wage-related pressures. And while definitive confirmation of this trend remains premature, its materialisation would offer significant support for risk assets and the market at large. Although the immediate challenge of debt financing may not dissipate entirely, it could be deferred until the next economic downturn.

In any case, Emerging Markets are well placed

Numerous arguments support the rationale for central banks in developed economies to adopt an accommodative stance, whether to facilitate public debt financing or due to the non-inflationary nature of innovation-led growth.

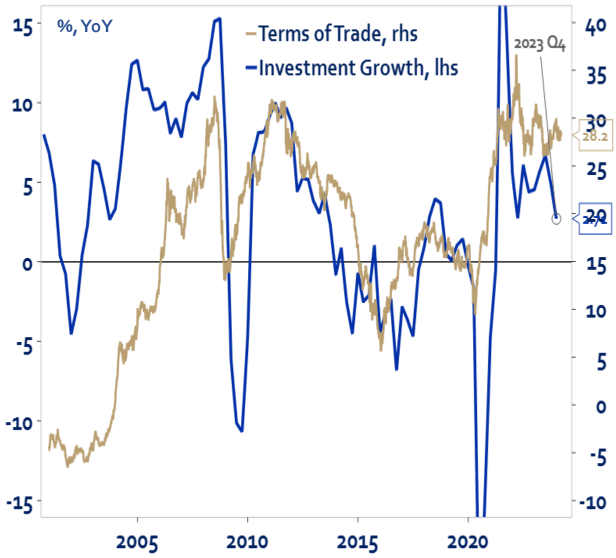
With financial conditions forecasted to ease, capital will naturally flow outward to the rest of the world as investors pursue more appealing opportunities. Poised to reap the rewards of several reinforcing factors, emerging countries are distinctly positioned to entice these flows amidst the current investment landscape.

Primarily, most emerging markets have avoided the aforementioned debt vulnerabilities, demonstrating heightened levels of fiscal and monetary restraint during Covid.

Among them, commodity-producing nations distinguish themselves thanks to their advantageous exposure to the prevailing cycle, which is conductive of nominal growth and carries constructive implications for commodity prices. In this context, cyclical emerging markets (i.e., Latam, central EU) should continue to see their terms of trade supported. And the resulting positive feedback loop, where strong revenues from commodity exports fuel domestic investment and consumption, should support growth.

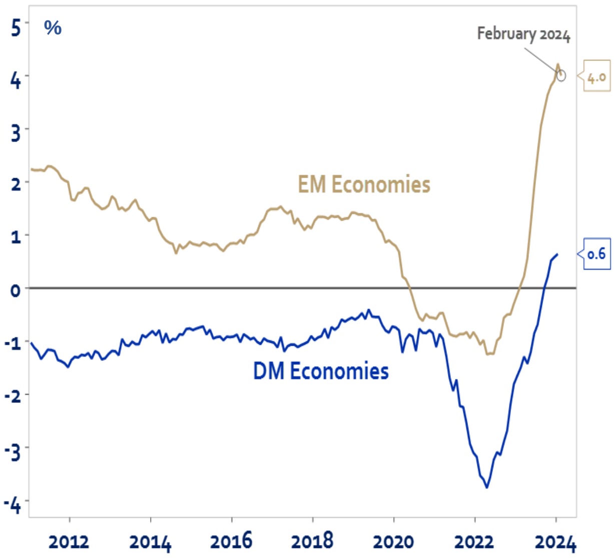
Emerging Assets should benefit from a series of reinforcing factors

EM Economies: Terms of Trade vs. Investment



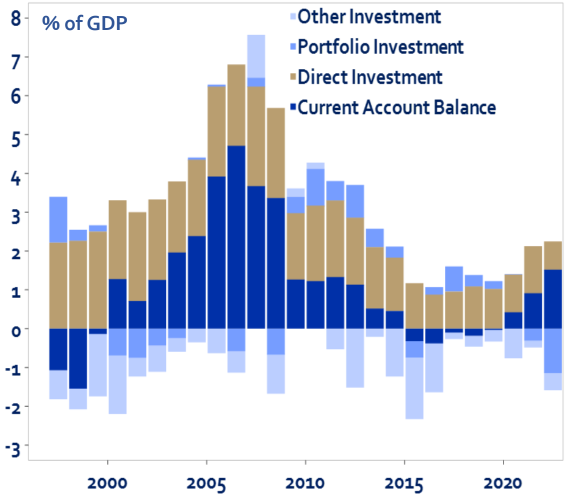
Source: H2O AM, Macrobond (Q4 2023)

Real Rates (Policy Rates vs. Core Inflation)



Source: H2O AM, Macrobond (Feb. 2024)

EM Economies: Balance of Payments



Source: H2O AM, Macrobond (2023)

Mexico : Investment

Source: H2O AM, Macrobond (Q4 2023)

After experiencing a decade-long downturn, emerging markets now exhibit an improved relative risk profile in the post-Covid landscape. This is further evidenced by the growing allure of the near / friendshoring trend among various countries, such as Mexico, which are attracting rising levels of foreign direct investment (FDI). The resulting productivity enhancements stemming from these new investments will improve the competitiveness of these nations and unlock untapped potential.

The gap in country risk premium between developed and emerging economies is now converging in favour of the latter, a trajectory that should eventually manifest in the relative outperformance of emerging currencies, bonds, and equities.

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