FORSTRONG GLOBAL

# ASK FORSTRONG
# SOFT LANDINGS AND HARD FACTS ABOUT THE COMING EMERGING MARKETS BOOM


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## Key Takeaways

- The most widely predicted recession in history will be a no-show in 2023. But investors should not hold their breath for a soft landing.

- A global race to reindustrialize — driven by decarbonization, reglobalization and remilitarization — is reversing the "secular stagnation" trend of the last decade and powering structurally higher growth and inflation.

- Emerging markets, particularly those with excess labour and commodity-exporting capabilities, are primed for a long period of outperformance.

## Ask Forstrong: Everyone is abandoning their recession forecasts. What happens next?

Bernard Baruch's famous line — that the main purpose of the stock market is to "make fools of as many men as possible" — strikes again in 2023. Everyone should have the received memo by now: the most anticipated recession in history will not show up this year after all. Global growth is humming along nicely, labour markets are still booming and the much-feared deep downturn in corporate earnings has yet to materialize. Resilience, rather than recession, has suddenly become today's watchword.

It's still summer and the living should be easy. Instead, most investors, positioned ultra-conservatively this year, are sweating through one of the most painful U-turns in the forecasting business ever. Only a few months ago, those who dared to dream of soft, velvety landings were on the same level as those who believe in fairytales and pixie dust. Now? To put it mildly, things have changed. Falling recession risk has been a particularly huge disappointment for the many that were predicting macro doom, especially the permabear blogs hopelessly addicted to catastrophizing (you know who you are).

But hold on. Just because recession has been postponed, does it automatically follow that a soft landing is now the most likely scenario? This is exactly what is happening. Investors are ditching their recession forecasts in droves and assuming a return to a world of benign inflation and continuing growth — in other words, the same environment that dominated the 2010s.

Yet the scenario that should be upgraded is the structurally higher inflation and growth one. Why? Because receding recession risks and reaccelerating growth are likely to feed into higher prices and create stickier inflation. Ironically, this also increases the chance of a hard landing further out into the future as central banks may have to continue tightening to counter inflationary forces. But that is a worry for another day.

## Global Race To Reindustrialize

Our investment team's central thesis since 2020 has been that the coronavirus crisis changed everything. The pandemic paved the way for bold policy breakthroughs around the world — a clear breakaway from austerity and deficit shaming. Both are now dead.

Looking ahead, the policy table has already been set. A global race to reindustrialize — driven by decarbonization, reglobalization and remilitarization — is underway. Public and private money is flooding into capital projects of all kinds, creating an investment boom in all corners of the world. And, a revival in aggregate demand is taking hold simply because the world underinvested in the productive capacity of the economy for years (what our investment team is calling the "revenge of the real economy"). Everywhere you look, companies, facing higher interest rates and labour costs, are spending money to lift productivity — in ways that extend far beyond betting the farm on AI and ChatGPT.

All of this is reversing the "secular stagnation" trend of the last decade and powering an environment of structurally higher volatility in growth and inflation. Of course, winners and losers will be created in this new macroeconomic environment. But, overwhelmingly, all roads point to emerging markets as clear winners. Consider the setup here. Most Western nations continue to struggle with a series of self-inflicted wounds: high sovereign debt levels, fragmentation into squabbling trade zones and, most notably, over-stimulating during the pandemic (and entirely missing the inflationary impulse afterward).

Meanwhile, emerging markets are leaning boldly into a new world order. In fact, deep cooperation is happening across many of these nations. Multi-lateral trade agreements are being swiftly signed. Settlement of bilateral trade in national currencies other than the US dollar is rapidly increasing. And, supply-chain diversion is powering a manufacturing revival and investment boom outside of China.

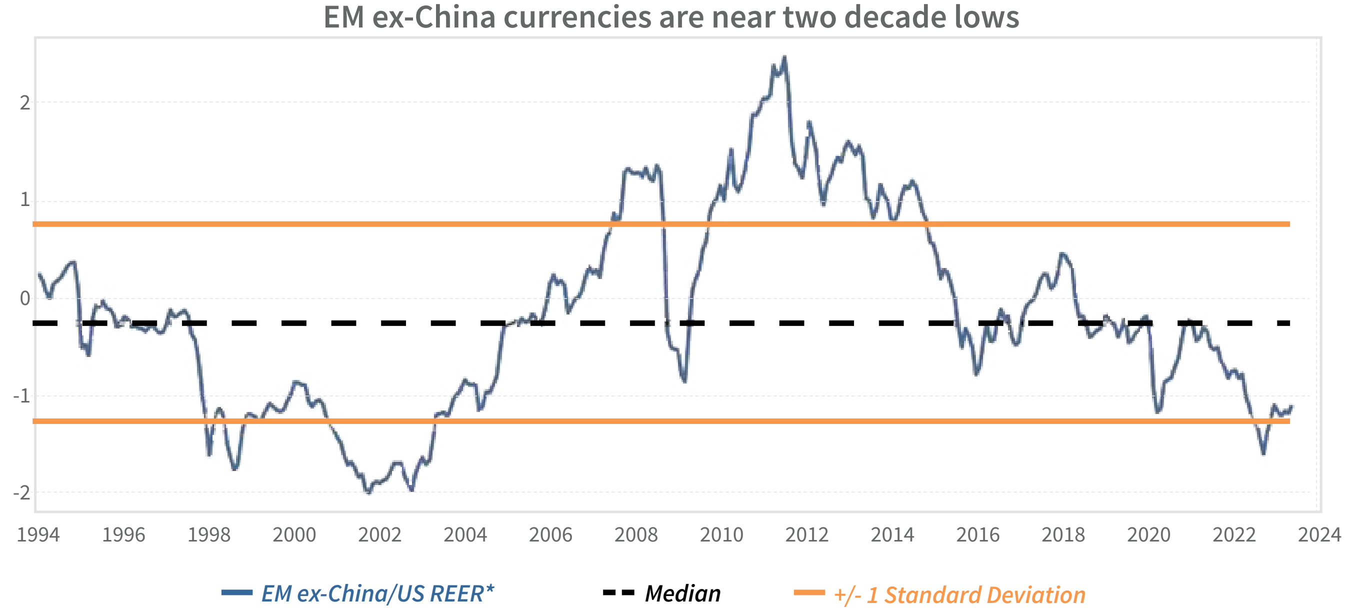
What's more, EM capital is moving in a way it has never done before. War and sanctions have buoyed commodity prices and profits for EM commodity exporters. During previous booms, the proceeds were always recycled back into Western markets. Not this time. Money is now heading back into domestic markets, funding all stripes of entrepreneurial dynamism. Countries that formerly grumbled about America's privileged currency status (and did nothing) are finally pushing back.

## EM Primed For Outperformance

Few saw this resilience coming. Most expected EM economies to be especially vulnerable to rising rates, based on the view that rate increases caused serial crises in the 1980s and 1990s. But this perspective extravagantly misses the big picture. EM economies entered the pandemic with repaired banking systems and heightened financial discipline after a decade-plus of deleveraging. During the pandemic, they borrowed less heavily for stimulus spending, and saw deficits rise on average by half as much as the US. In fact, excluding China, total EM government debt to GDP figures have fallen over the last year with improving fiscal deficits and higher nominal growth. External debt, often called the original sin in EM, has also declined dramatically. Only about 15% of EM government debt is now funded from foreign sources.

What's next? Starting points matter in macroeconomics. Stronger sovereign, corporate and household balance sheets have lowered external vulnerabilities. But also, after a long period of foreign disinterest in EM, local currency valuations are trading near the crisis-lows of the early 2000s.

Cheap currencies are the cheat code for national economies. In fact, low currency valuations have always been wonderful starting points for EM outperformance in the past. Heightened competitiveness boosts exports. Capital then follows higher growth. And so, a virtuous cycle begins.




*EM ex-China REER index constructed with market capitalization weightings. Presented as Z score.
Sources: Macrobond, BIS, WFE, World Bank, Forstrong Global Asset Management

Layered on top of all this, is an unfolding policy easing cycle. The absence of fiscal excesses and more proactivity toward combating inflation has kept prices more contained in EM compared to the developed world. In fact, for the first time, inflation levels in major EM economies are lower than major developed economies. Now, having lots of levers to pull —in the form of lower interest rates or higher fiscal spending — provides a huge comparative advantage.

Of course, trends in EM have never fit neatly into one storyline. The last EM boom in the 2000s was driven by China's rapid industrialization phase. This new phase extends far beyond China with far deeper participation. Importantly, India, long deficient in critical infrastructure, is now deep into a major capex boom, as evidenced by a steep rise in gross capital formation and surging private sector new project announcements. The global push to build a greener economy is increasing demand for raw materials, benefitting commodity-exporting countries like Brazil, Chile and South Africa. Countries where wages are low, populations are young and relatively skilled — such as Vietnam, Indonesia, and Mexico — are benefitting enormously from supply-chain diversification. Even the Gulf states, lured by Asia and eager to diversify their economies away from fossil fuels and restore national images (apparently soccer stars are the new safe asset for sovereign wealth funds), are witnessing a boom in cross-border trade and current account surpluses.

It should not be difficult to see what is happening here. Increased infrastructure investment and trade is integrating more of the world's developing economies into the global economy at an accelerated pace. So much for deglobalization. Excluding China, these countries comprise more than 3 billion people, where demographics are favourable, incomes are growing, and constructive dialogues are leading to a surge in commerce and economic partnership. To ignore this new reality is now an exceptionally risky position for long-term investors.

## Investment Implications

Investors are at a crossroads. With America's technology giants continuing to dazzle, one path is to assume that the investment leadership of the last decade continues. But history provides no support for that view. Winners of the last decade rarely go on to dominate the next one simply because everyone is already all-in on the trade — high valuations and high expectations naturally lead to low returns.

The other path is to assume that deep, structural macro changes in the global economy have occurred that will initiate new leadership. This will pull capital away from the over-owned and over-hyped US growth stocks into under-owned and under-loved emerging market assets.

What may surprise investors is that the latter path is already happening. Stock markets in

Brazil, Mexico, Taiwan and South Korea have all outperformed the US in 2023 (in US dollar terms). In fact, 7 of the top 10 performing equity markets this year are emerging countries. This is likely to continue. Despite better growth, lower debt and lower inflation, many EM stock markets are still trading at crisis-level valuations. That leaves plenty of room for re-rating.

But an index-based approach to EM is unlikely to be the right strategy. Passive investing in broad-based indices often means buying yesteryear's winners. Today, EM indices allocate far too much capital to digital economy heavyweights like Chinese consumer internet stocks and not nearly enough to real economy sectors like manufacturing, industrials and natural resources. Active management will be crucial to capture the pockets of opportunities within countries, sectors and themes.

Our investment team has such strong conviction in this thesis that Forstrong is launching a family of ETFs based on the view that international markets will dramatically outperform in the period ahead. The last decade's carnage in EM offers an excellent entry point at a time when momentum has begun to take hold. Given the potential returns, investors need to have a strategic allocation to this part of the world brimming with opportunity.

**Tyler Mordy, August 2023**