Settling Sands: From Shifting to Settling Sands.

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The scorecard four months into the year has been a positive one for financial markets. Stocks and bonds gained ground across both developed and emerging markets ("EM") while many of last year's winners – such as commodities and the U.S. dollar – underperformed. These gains mask a large dispersion in performance derived from, I think, a global outlook that remains uncertain. A look at the many shifts in market narratives of late illustrates the extent of this uncertainty. At the turn of the year, market strength reflected prospects of easing inflation and a gradual deceleration in activity, which would allow major central banks to end their tightening cycles. The tide turned after surprisingly strong January data in the U.S. and Europe, bringing concerns of persistent price pressures and additional rate hikes to the forefront. Then, in early March, banking-sector turmoil marked a new inflection point, triggering a repricing lower in interest rates as recession fears increased.

I think the positive performance to date also masks some welcome, renewed visibility about critical factors driving markets today: the outlook for the U.S. Federal Reserve, China's recovery, and geopolitical risk. This trio of factors, which we dubbed the shifting sands in previous pieces, is gradually settling. Put together and seen through our investment clock framework, recent shifts in these factors point to a late-cycle investment environment, which favors defensive strategies. These include high carry strategies and places where differentiation should remain wide. Local EM rates is a compelling option to gain exposure to high carry – particularly in countries with stronger fundamentals and secular drivers such as Mexico (nearshoring, conservative fiscal stance). The high interest rates offered by many EM countries – Hungary, Brazil, Chile – also provide some cushion in the event of U.S. dollar strength. Early signs of a possible shift to a "reflation" regime of central bank easing are also appearing, reinforcing the appeal of bonds more broadly, including longer-duration ones as the curve bull steepens.

China's recovery has legs. China's normalization is advancing rapidly, as evidenced by the strong service-led rebound in first-quarter GDP, which puts the official 2023 growth target of around 5.0% well within reach. The jump in consumption is the bright spot as is infrastructure spending, whereas property is only stabilizing, and private investment remains sluggish. Even though Chinese stocks and bonds have underperformed so far in 2023, the recovery seems to have legs. With home sales picking up and signs that the worst of the crackdown on the private sector is behind, I think both housing and capex are likely to pick up. Moreover, pent-up demand and ample savings should keep consumption strong. Low inflation, importantly, provides room for the policy stance to stay accommodative.

China's ongoing rebound provides a welcome offset to the expected deceleration in developed economies. As the consumption-led recovery gains ground, its positive spillovers – through links such as tourism, trade, and investment – are likely to become more evident, keeping growth tilted in favor of emerging economies. China's compelling growth narrative should help anchor sentiment, as the focus stays on the strength of the recovery and its implications, rather than on the country's structural challenges such as worsening demographics and over-indebtedness.

Higher for longer U.S. rates? I believe peak Fed hawkishness is well behind, but the path for U.S. interest rates has once again come to the forefront following recent bank-sector jitters. The debate is two-fold, starting with how much further interest rates will increase. The good news is that markets see only limited scope for additional hikes – currently a May peak of 5.25% is priced in – as the specter of banks' tightening lending standards is effectively "finishing" the job for the Fed. The second question mark is if the Fed will quickly reverse gears by cutting rates starting as early as the third quarter, which is currently priced in – a view that is contrary to Fed guidance of higher-for-longer rates.

The Fed's upcoming actions will be critical for the relative performance of assets. When investors overestimated the willingness of policymakers to cut rates preemptively even though inflation remained a concern in February, financial markets had to readjust. If this happens again, the U.S. dollar could strengthen while so-called risky assets suffer as markets price out interest rate cuts. Such a "higher for longer" scenario would also boost the attractiveness of cash vis-à-vis risky assets.

Living with geopolitical risk: Commodity markets adjusted to living with the war. Prices for energy and food items fell back near or to below pre-war levels. Nowhere is that more evident than in Europe, which successfully diversified away from its reliance on Russian energy sources. Unseasonably warm weather and high LNG inventories led to a collapse in natural gas prices – good news for both inflation and for growth. Indeed, Europe is now expected to avoid recession, and stocks have outperformed this year in both the U.S. and emerging markets. From a market standpoint, I suspect Europe's story of improving terms-of-trade has largely played out.

Still, concerns about energy-price volatility are likely to remain muted until later in the year when winter approaches – particularly because the war doesn't seem any closer to a resolution. Neither side appears sufficiently strong to overwhelm the other. Moreover, it is not obvious that Russia or Ukraine see upside from reaching a compromise at this juncture, with the former's leadership seeing the conflict as existential and the latter seeking to reestablish its pre-2014 border. Critically for markets, the risk of more extreme scenarios – like nuclear weapons or attacking NATO territory – seems limited as a weakened Russia focuses on holding on to gains in Ukraine.

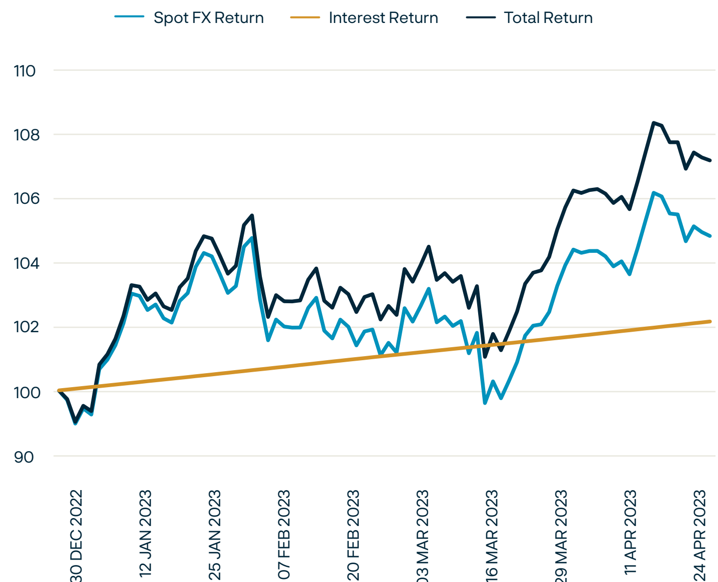
Sino-American tensions are another source of geopolitical friction. The relationship appears to be steadily deteriorating after the balloon incident. If the prospect of war remains a tail risk, emerging markets provide plenty of opportunities to leverage the intensifying great power competition. Some keep benefiting from the trend towards supply chain resilience and diversification, such as Mexico and Vietnam. Supply chain diversification extends to commodity producers. This is particularly acute in raw materials critical to the green transition, including lithium, copper, and cobalt which are often found in Latin America and Africa. Meanwhile, countries like India and Turkey are adopting a pragmatic approach, buying discounted Russian oil while keeping strong ties to the West and trade openness with China.

Differentiation and Carry

Exposure to high carry with a focus on quality is one of the takeaways from my analysis of the settling sands. Increased visibility that China's recovery has legs, a perception that the Fed's tightening cycle is approaching its end, and persistent yet manageable geopolitical risk are the factors driving markets. I believe these trends combined point to a late-cycle investment environment favoring carry strategies, with local EM rates offering a route to gain exposure. A basket of six higher-yielding EM currencies, for example, delivered total returns of 10% since the end of 2021 and 7% so far in 2023 (*see Exhibit 1 and 2*). Implied yields are higher than a year ago, providing, in my view, a cushion in case of any U.S. dollar strength. Real-effective exchange rates, which place many high-yielding EM currencies below their long-term historical averages, also suggest a valuation cushion.

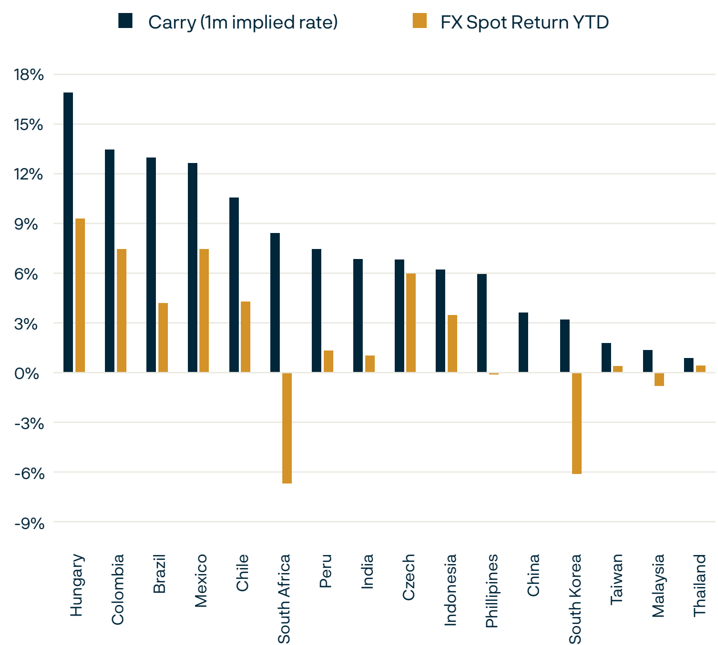
In sum, I see progress in settling key aspects of the debate about three factors driving global markets – China, the Fed, and geopolitics – with important implications for asset allocation. Incoming data confirms a rapid consumer-led recovery in China, and the focus is on how to best position to capitalize on its spillovers. A peak in U.S. rates is approaching, even if some question marks remain about economic growth and thus the timing of rate cuts. Geopolitical risk is likely here to stay and the world is adapting to this new reality; insofar as extreme scenarios remain remote, these tensions are creating investment opportunities, too. Against this backdrop, exposure to defensive and high carry strategies through local EM debt seem compelling.

Exhibit 1: High-Carry EM Currency Basket
(Dec 30, 2022 = 100, Total Return)



Source: Bloomberg *Equal-weighed basket of BRL, CLP, COP, HUF, MXN, ZAR

Exhibit 2: Carry and FX Return (As of April 24, 2023)



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