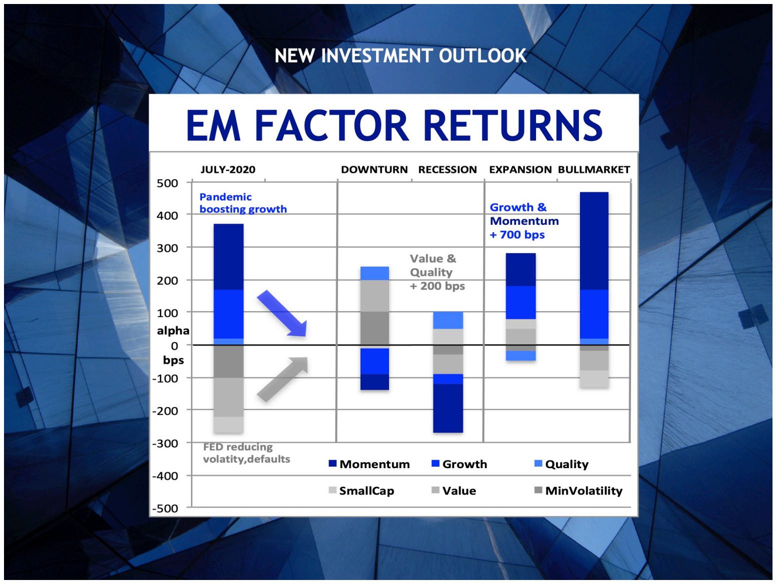
LATE GROWTH & EARLY COMMODITIES



Larry & Xin discuss changes in factor investing

Which factors worked best in the previous investment cycle? Where are the opportunities at the current juncture? How could a new cycle evolve differently?

Welcome to a new discussion between Larry and Xin, two prominent economists from the Keynesian tradition, offering a bi-weekly US-Chinese debate. Today, Larry shares his perspective from Washington with two charts and Xin comments from Beijing. Disclaimer: names are fictional but analysis should be realistic.

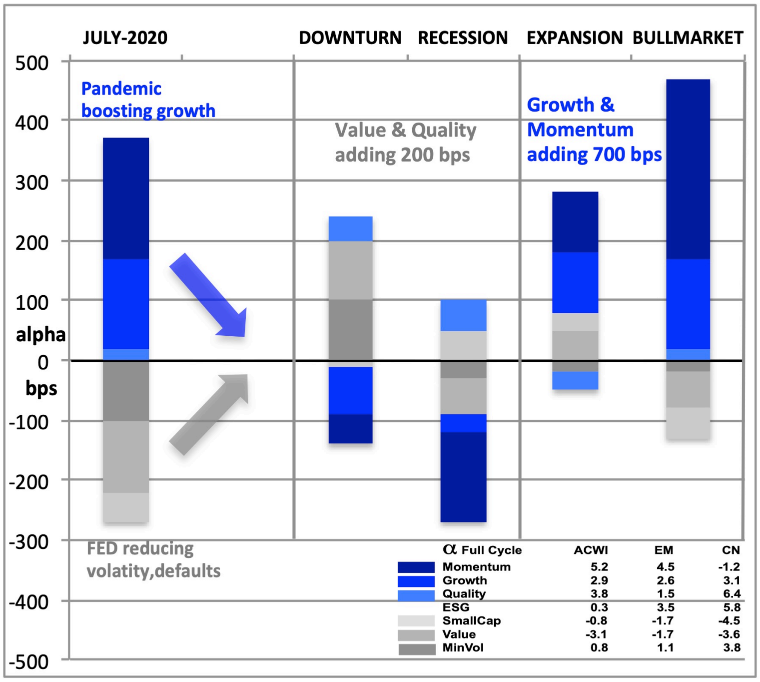
Larry: Good evening Xin, here in Washington we have observed quite an aggressive unholy crusade against China, as Jeffrey Sachs put it this week. Mr. Pompeo spelled out an aggressive approach, Mr. Trump has banned TikTok and WeChat, Mr. Azar is now visiting Taiwan, and high-level talks on August 15 could further escalate matters.

Xin: Warm greetings Larry, here in Beijing we hopefully have cooler heads prevailing with an intent to de-escalate matters and then engage with the new administration. Mr. Wang Yi has stated that China-US relations are facing the gravest challenge in four decades in a measured speech but also spelled out "clear red lines", esp. on Taiwan.

Larry: Yes, we could face quite some volatility over the next three months, both in geopolitics as well as market dynamics, where we are entering into a new cycle. It might be helpful for us to identify which factors worked best in our cycle since 2008 where we had a phenomenal 400% rally in the SPX while the US$ gained about 45%.

Xin: Right, I call it twin-growth cycle both for China and the US, whereas the previous cycle from 2000-2007 was more of a value cycle with rising commodities as the US$ lost over 40% and emerging markets outperformed the US markets. That started after a decade of EM crises, from Mexico to East Asia to Russia, with many cheap EM assets.

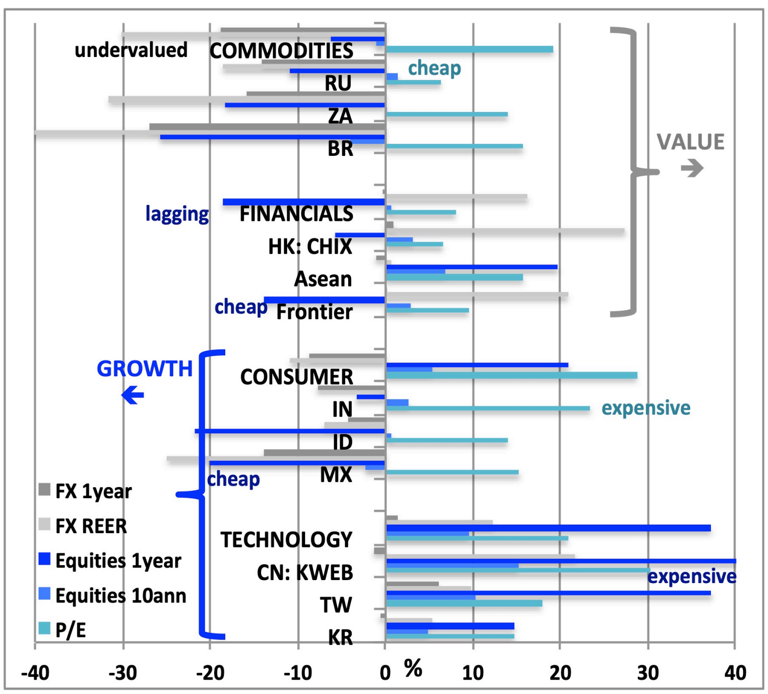
EM Factors: Late growth boost — Chart 11



α Full Cycle	ACWI	EM	CN
Momentum	5.2	4.5	-1.2
Growth	2.9	2.6	3.1
Quality	3.8	1.5	6.4
ESG	0.3	3.5	5.8
SmallCap	-0.8	-1.7	-4.5
Value	-3.1	-1.7	-3.6
MinVol	0.8	1.1	3.8

Sources: Based on 2008-2020 data, MSCI Emerging Markets, Style Analytics, IMF, BIS, EM Leaders

EM Sectors: Wide dichotomy — Chart 12



Sources: Data as of July 2020, MSCI Emerging Markets, Style Analytics, IMF, BIS, EM Leaders

Larry: Well, maybe 2020 will end up similar to 2001, with a big correction in growth and re-pricing of commodities and emerging markets equities as well as fixed-income. The pandemic has given us a late boost to growth stocks, as the five top US stocks (AAPL, MSFT, AMZN, GOOGL, FB) are up by 50% against a flat index. And the FED has opened the magic money Pandora's box that is tanking the dollar and boosting gold.

Xin: I wonder what that means for Chinese markets, which are a mix of old-economy and new-economy stocks. Our market has risen by 64% over the past four years, three times as much as overall emerging markets, and faster than the 54% rise in US stocks. My sense is that the US-Chinese decoupling could deflate the technology bubble and the momentum could turn back into industrials and commodities that are quite cheap.

Larry: Let us first look at the value and growth factors over the past cycle from 2008 to 2020, illustrated in chart 11. Value and quality factors added about 2% alpha during the downturn and recession in 2008/09 but did not add any alpha over the full cycle. Growth and momentum factors detracted during the recession but added over 7% of alpha during the full cycle in emerging markets, and also in developed markets.

Xin: That explains why quant-value shops hard a tough time over the past decade. But China was different, we had less returns from momentum and growth, but the largest alpha from quality and ESG factors, totaling over 6% during the cycle, where our local managers initially had less expertise but then extracted the largest alpha. And our stars Tencent and Alibaba crushed the small-cap competitors, which lost 5% of alpha.

Larry: Indeed, that was the decade of mega-cap growth for East-Asia and it was a lost decade for banks and commodities especially in Latin America. China's weight in the MSCI-EM increased from 6% in 2001 to 12% in 2008 to 41% today, while the weight for Latin America combined declined by one half to now only 9%. But China developed also a retail- and momentum-driven trading culture with higher volatility. Institutional investors extracted the largest alpha from quality, ESG, and min-vol factors in China.

Xin: But I am puzzled that the winning factors during a downturn have performed so poorly this year: Value and min-vol and quality and small-cap factors underperformed by about 3% this year. That's the time when they should outperform, unless we have not seen the worst of the recession yet and these factors make a late appearance?

Larry: Well the markets don't seem to expect that today, as they are priced for a V-shaped growth recovery and a continuing boom in the largest technology companies. But three developments could upset that apple cart: first, if the fiscal stimulus was halted in the US, we could see a massive wave of credit defaults and evictions and social unrest. Second, if the China bashing continues with de-listings from US exchanges plus reciprocal US bashing and restrictions for US companies in China, then we could see a de-coupling and selloff in technology stocks. And third, if we have a smooth sailing in November and the FED keeps the magic money flowing, then we most likely get a major depreciation of the US dollar coming which typically is strengthening commodities and emerging markets more generally … so we will see.

Xin: Let's just agree that the strong growth and momentum factors that we currently see in the markets are highly unusual for major downturn and recession periods. But looking beyond 2020 and assuming that we succeed with a vaccine in 2021, what opportunities do these factors present us for the next ten-year cycle?

Larry: As I see it, the FED is by far the most significant long-term fork in the road. The magic money will keep flowing for most of the next decade, unless we get some kind of regime change with a new monetary anchor, maybe a real asset, maybe a crypto asset, maybe a Chinese invention. So if we agree that magic money keeps flowing, then we concur that the dollar keeps depreciating, that the Euro will strengthen and that EM currencies will rise. That is good news for EM credit fundamentals, and good news for EM fixed-income markets, which we should study more carefully during our next discussion. And that is excellent news for EM equities, which are positively and strongly correlated both to EM currencies and to EM bond markets.

Xin: Yes, this seems to be the evolving consensus, albeit it is a little surprising after seeing institutional investors pulling out big amounts from emerging markets earlier this year. But let us analyze this opportunity with some more granularity by looking at specific countries, at major sectors, and at the dichotomy between value and growth.

Larry: Excellent, we have done just that in chart 12. We basically have two areas for value, namely commodities and financials. Russia, South Africa, and Brazil have the largest part of their indices in commodities, and their currencies are about 30% undervalued, looking at BIS data. Their equity markets are flat over the past decade and lost a modest 6% this year, and valuations are attractive, especially in Russia.

Xin: Interestingly, financials are the other value sector and they look even cheaper, with prices below book in many cases. Hong Kong, Asean, and the frontier countries have the majority of their indices in financials, but they have done very poorly this year with nearly 20% declines in their markets. The Chinese banks are a good example where analysts are worried about hidden NPLs and new credit losses, especially in the smaller regional banks. So the macro picture with credit troubles is not looking good.

Larry: On the growth side, we typically look first at consumer growth stocks that gain from urbanization and a growing middle class. But we have a mixed bag here, as Asian consumer stocks, especially in India, look overpriced with current P/E ratios pushing into the 30s. Latin America and Eastern Europe, on the other hand, look relatively reasonable if not cheap, especially Mexico, with an undervalued exchange rate.

Xin: Well, that leaves us with the star-growth performer in the technology area that is looking increasingly overextended after another 40% rally this year and P/E valuations for Chinese technology firms in the 30s, although momentum is still positive. China, Taiwan, and Korea have been the best performers over the past cycle, and we should expect at least some sector rotation to take place. When I look at the Chinese ratio of technology to banks (KWEB over CHIX), it has doubled over the past two years and now is even beyond its 2018 peak, which then resulted in a big correction.

Larry: That sums it up nicely: tough decisions coming in the markets, probably with a snap back of value factors, especially for commodities, combined with a weaker US$.

Xin: So a little patience is required, but for next year it looks good for the broader emerging markets, both for equities and fixed income, as we will discuss next time.