

Tales From the Emerging World

The Top Ten Trends of 2021

ACTIVE FUNDAMENTAL EQUITY | GLOBAL EMERGING MARKETS TEAM | MACRO INSIGHT | 2021

From early in the pandemic our sense was that Covid-19 was less likely to “change everything” than to bring more—much, much more—of the same. And so it has, deepening trends that were already underway, most notably expanding the role of government in the economy, and the adoption of digital technology. As these trends develop, the result could well be a radical shift in the profile of global market winners and losers. In many ways, our top ten trends of 2021 look like a mirror image of 2020.

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SURGING ECONOMY, SOGGY MARKETS

In 2020 the global economy contracted by 4 percent, the worst downturn since World War II. Yet stocks rose 14 percent worldwide.¹ Why this unprecedented market boom in a recession? Three main reasons. Early on, governments and central banks rolled out unexpectedly massive amounts of stimulus to keep businesses alive. Investors quickly came to see the pandemic as a passing storm, not the kind of long-term shock generated by financial crises. As people sheltered at home, they spent less, saved more, and a good chunk of that added savings went into the markets.² Hence, the strange spectacle of a historic market rally amid the historic economic bust.

What now? Consensus forecasts show that analysts expect both the economy and markets to surge in 2021, but the forces that lifted markets last year are unsustainable. Stimulus campaigns are likely to continue, but not anywhere near the record pace of spending and money printing seen in 2020. The passing of the pandemic is already factored into valuations, which are back to record highs. With vaccines rolling out, and governments reluctant to reimpose lockdowns, savings are likely to come down as people venture back

¹ MSIM, Bloomberg, Factset, Haver. Data as of January 2021.

² Federal Reserve Board, Haver. As of December 2020.



out to barber shops and gyms. The result could be that this year plays out as the opposite of last year, with markets moving sideways amid the economic recovery.

INFLATION BOTTOMS

Consumer price inflation has been still for so long, policymakers have come to assume it's dead, not just sleeping. But the forces that restrained consumer prices are giving way, one by one. Growth in the global working-age population turned negative around 2005, and a declining labor supply tends to increase wages.³ Growth in global trade started to slump after the crisis of 2008, reducing competition.⁴ Declining productivity is raising business costs, adding to the upward pressure on consumer prices.

That was the situation when the pandemic hit. Policymakers began printing and borrowing money at a record pace, confident they could do so without

reviving inflation. It's been dead for decades, no? We think it's just sleeping, and is likely to be awakened by our "Four D's." **Depopulation, deglobalization and declining productivity** are all putting upward pressure on consumer prices, and in this environment, **rapidly rising debt** could be the jolt that reawakens the beast.

HEDGED BY HOUSES

The housing boom in the gloom of 2020 was as unsettling to many as the stock market boom, but there is one big difference. Home prices are more likely to rise from here. For one, inflationary expectations are rising, and investors are turning to assets that are seen as good hedges against inflation. Those include gold, silver and bitcoin, and real estate.

The housing boom was strikingly broad, lifting prices in virtually every developed country at its peak, and in the United States pushing the median price of existing

homes above \$300,000 for the first time.⁵ Real estate price dynamics vary widely by country, of course, but there are reasons to believe the boom can last into 2021.

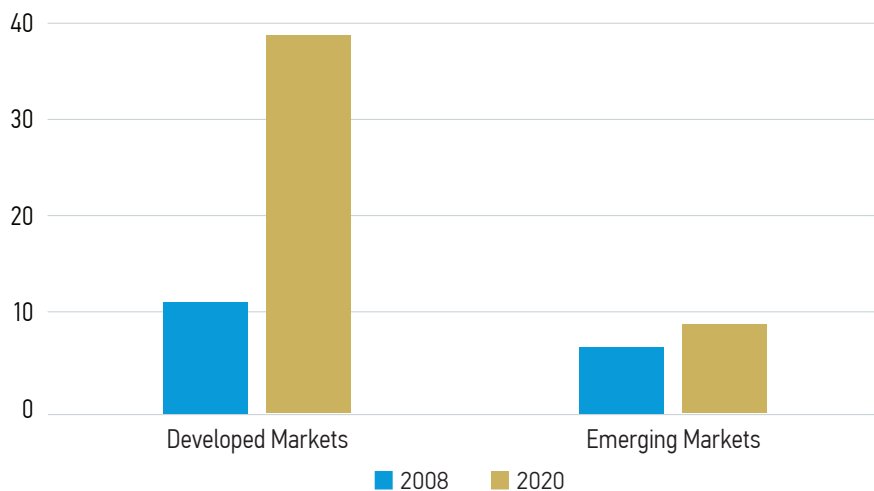
Ninety percent of the world's central banks have dropped short-term rates to record lows, which has in turn pushed 30-year mortgage rates to record lows—under 3 percent in the U.S., even less in Europe.⁶ While a likely rise in long-term interest rates could also push up mortgage rates, they are likely to remain near historic lows this year.

On the supply side, home construction cratered after the global financial crisis of 2008, leaving inventories lean when the virus hit. In the United States, the stock of existing single-family homes available for sale is at an all time low, relative to the adult population.⁷ And the demand pressure from young families fed up with cramped spaces is likely to linger even after the pandemic dies down.

DISPLAY 1

Stimulus Is Not Likely to Continue at a Record Pace

Total Government and Central Bank Stimulus Estimates in Response to Crisis (% of GDP)



Source: MSIM, IMF, UBS. Includes on-budget government stimulus data from IMF, off-budget government stimulus (corporate loan guarantees) from UBS and central bank stimulus from UBS. Developed markets aggregate is calculated using median of New Zealand, Australia, South Korea, Japan, Czech Republic, Switzerland, UK, Eurozone, Canada, US. Emerging markets aggregate is calculated using median of Colombia, South Africa, Turkey, Brazil, Mexico, China, India, Vietnam, Philippines, Indonesia.

EASY MONEY DRIES UP

Since the early 1980s, when central banks began to win the war on consumer price inflation, they have gradually lowered the average short-term rate from a peak of 13 percent to 2 percent at the start of 2020.⁸ And they cut that rate in half during the pandemic.

If you let people borrow virtually for free, they are going to borrow money to make more. The result of increasingly loose monetary policy was a stunning run of asset price inflation. In 1980, the total value of global financial assets including stocks and bonds, was equivalent to 110 percent of global GDP; by 2019 that figure was 390 percent.⁹ It's even higher now, after the bull run of 2020.

If and when the return of consumer price inflation compels central banks to tighten again, the run is likely to falter. That tightening is less likely to come first in the form of higher rates than in the form of

³ United Nations as of December 31, 2018.

⁴ MSIM, World Bank, Haver Analytics. IMF forecasts.

⁵ MSIM, Haver. Data as of November 2020.

⁶ NDR as of October 2020; Citi, ECB, Federal Home Loan Mortgage Corporation as of September 2020.

⁷ Applied Global Macro Research as of October 1, 2020.

⁸ MSIM, Bloomberg, Factset, Haver. Data as of December 31, 2020.

⁹ BIS, WFE IMF, McKinsey.

reduced intervention in the credit markets. The \$8 trillion in assets central banks purchased last year was more than twice the previous record, set in 2008, and 40 times what they purchased in 2019.¹⁰ Even a partial return to normal could have a sobering effect on markets.

THE POST-DOLLAR WORLD

Before the United States, only five countries had held the world's reserve currency going back to the 15th century: Portugal, Spain, the Netherlands, France and Britain. Those reigns lasted 94 years on average;¹¹ the U.S. dollar is now 100 years old. Advanced age alone was reason enough to wonder about the dollar's future, when the pandemic hit.

As the United States rolled out trillions in new spending to keep the economy alive, its debts to the rest of the world spiked to 67 percent of its economic output—way above the 50 percent threshold that has often signaled a coming crisis.¹² In the past, financial empires, holders of the coveted reserve currency, often faltered when the rest of the world lost confidence that they could pay their bills.

Up to now, U.S. policymakers considered the dollar impregnable, for lack of serious rivals. Trust in the Euro was undermined by doubts about Europe's fractious multinational government. Trust in the renminbi was undermined by the interventions of a one-party state. The big surprise of 2020 was the emergence of a stateless cryptocurrency as a plausible alternative.¹³

The hottest investment of the year was Bitcoin, which gained ground both as

store of value (a digital option to gold) and a medium of exchange (a digital option to the dollar), with large online payments platforms announcing they would accept payment in Bitcoin. Skeptics still abound, but millennials are nearly ten times more likely to own cryptocurrency than boomers, and younger generations will choose the reserve currency that challenges the dollar.¹⁴ It may well be digital.

A COMMODITY REVIVAL¹⁵

Commodity prices have declined steadily in real terms since records began, in the 1850s,¹⁶ but that long decline is punctuated by boom decades. We may be entering one now.

As government spending threatens to revive inflation and weaken the dollar, those forces could help to revive commodity prices, after a down decade. Going back at least to 1980, a declining dollar tends to boost prices for global commodities, from copper to wheat.¹⁷ And so it was that as the dollar began to weaken last year, commodity prices began to climb.

While money printing has driven up the valuations for all manner of assets from stocks to bonds and Bitcoin, commodities are an exception. In relative terms, they look hugely attractive, and have fallen to record low shares of both U.S. and emerging stock markets.⁸ Moreover, the weak prices during the 2010s led to light investment and supply cuts in everything from oil fields to copper mines. Couple tight supply with rising demand in a post-pandemic recovery, and you have the recipe for a revival in commodity prices.

THE EMERGING MARKET COMEBACK

When commodity prices rise, the many emerging economies that depend on commodity exports tend to do well. That is the first of our top four reasons to expect a comeback for emerging markets, which just suffered their worst decade for returns since records begin in the 1930s.¹⁸

Exports and manufacturing are both shrinking as a share of the global economy, which makes it increasingly difficult for emerging nations to follow the old export manufacturing path to prosperity. But a select few are still expanding their share of global exports, led by Vietnam and some of its neighbors in Southeast Asia, and Poland and some of its neighbors in Eastern Europe.¹⁹

Emerging countries tend to press tough reform only when their backs are to the wall, and few crises have pressed harder than the global pandemic. Compared to developed countries, emerging countries can't afford as much stimulus to ease the pain of lockdowns, and have little choice but to tighten their belts in ways that could raise productivity and growth in the future, if not now. The result is a widely overlooked wave of market-oriented reform from India and Indonesia to Brazil, Saudi Arabia and Egypt.

The pandemic is accelerating the adoption of digital technology everywhere, but this revolution is unfolding even faster in emerging countries than developed ones, and delivering a commensurately larger boost to economic growth.²⁰

Today the United States accounts for 25 percent of the global economy and 56 percent of global stock market capitalization; meanwhile, emerging markets account for 36 percent of global

¹⁰ MSIM, Bloomberg, Factset, Haver. Data as of December 2020.

¹¹ EconomicReason.com, JP Morgan, HKMA, Erste Group.

¹² International Monetary Fund (IMF) - "External Liabilities and Crises." U.S. data as of 2Q20.

¹³ Cryptocurrency (notably, Bitcoin) operates as a decentralized, peer-to-peer financial exchange and value storage that is used like money. It is not backed by any government. Federal, state or foreign governments may restrict the use and exchange of cryptocurrency. Cryptocurrency may experience very high volatility. The Global Emerging Markets strategies do not invest in cryptocurrency.

¹⁴ Forbes, July 2020.

¹⁵ The commodities markets may fluctuate widely based on a variety of uncontrollable factors such as inflation, weather, political unrest, acts of terrorism, new technologies and even rumors. Investors in commodities should be able to bear a total loss of their investment. The Global Emerging Markets strategies do not invest directly in commodities.

¹⁶ MSIM, Bloomberg, Factset, Global Insight. Data as of December 31, 2020. Index includes all industrial metals, industrial non-food agricultural commodities and food.

¹⁷ CRB Commodity Index, MSIM, Bloomberg, Factset, Haver. As of December 31, 2020.

¹⁸ MSIM, Bloomberg, Factset, Haver. Data as of December 31, 2019.

¹⁹ United Nations Conference on Trade and Development. As of 2019.

²⁰ MSIM, IMF, Statista. Data as of November 2020.

GDP, and just 12 percent of global stock market capitalization.¹⁰ The valuation gap between the U.S. and emerging markets too is at record wide levels.⁸ And with the growth prospects of emerging economies rising relative to the United States, these extreme balances are likely to shift back toward balance.

THE DIGITAL REVOLUTION

The pandemic, as we all know by now, is forcing people to work, play, study and shop online, a huge boon to e-life in all its forms. But where is this transformation most likely to boost economies and markets?

To a surprising degree, less-developed countries are already prematurely well developed as internet societies, in part because their citizens are far less well served by landlines and bricks and mortar stores, banks, hospitals and schools. When they adopt digital services, they are leaving nothing familiar or beloved behind. Of the world's 30 most digitized economies (by digital revenue as a share of GDP), sixteen are found among the emerging markets, led by China, South Korea, Indonesia and Colombia.²⁰

In this group of 30, digital revenue is growing barely faster than nominal GDP in the developed countries, but much faster

in the emerging markets.²⁰ On average, in the emerging markets, digital revenue is growing by 11 percent a year—or 4 points faster than nominal GDP.²⁰ Though digital technologies are lowering the cost of launching and operating business everywhere, this process is fastest where the adoption of digital services is most rapid: the emerging markets. By countering the global decline in productivity, this digital boost is likely to support the emerging market comeback.

THE RISE OF THE CHALLENGERS

Over the last decade, for the most part, investors were drawn to just two countries, the United States and China, and one kind of company, tech giants. That is already starting to change. Monthly active user growth for giant, well-known social media platforms has slowed to single digits, from 40 percent or better early in the last decade.²¹ E-commerce giants in both countries have made huge gains in recent years, but the market cap of smaller, popular rivals is growing faster.²² It is very possible that some of the challengers will catch up.

The lesson of the past is that tech giants often enable their successors: IBM made Microsoft possible, and today, many internet giants are platforms on which startups thrive. From South Asia to

South America, regional challengers are rising up in e-commerce and social media, succeeding by catering more attentively to local taste than the American or Chinese giants can.

NEW MEDIA HABITS

It's no secret that the pandemic has been good for online entertainment. As movie theatres shut their doors, total subscriptions for two popular streaming services rose from 230 million to 315 million in 2020.²³ The big question is whether this shift online will slow down or continue when the pandemic passes.

One answer comes from the fate of older forms of home entertainment, which are equally safe from virus-carrying crowds. All else equal, there is no reason that traditional TV channels should not have thrived under lockdown, too.

Instead, among Americans, the long-term decline in the number of traditional TV viewers actually picked up speed in 2020, falling 16 percent.²⁴ And that decline would have been even steeper but for the surge in TV news viewers drawn to the bitter 2020 presidential campaign. So all else is not equal. Digital entertainment is killing the traditional forms, and that shift is likely to continue when the pandemic passes.

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²¹ Company data.

²² The Economist, Reuters, as of December 31, 2020.

²³ Bloomberg as of 3Q20.

²⁴ UBS, Nielsen NNTV as of November 2020.

²⁵ Assets under management as of September 30, 2020. Morgan Stanley Investment Management ("MSIM") is the asset management business of Morgan Stanley. Assets are managed by teams representing different MSIM legal entities; portfolio management teams are primarily located in New York, Philadelphia, London, Amsterdam, Hong Kong, Singapore, Tokyo and Mumbai offices. Figure represents Morgan Stanley Investment Management's total assets under management/supervision.

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