December 10, 2024

EM And China 2025 Outlook: Bullish Or Bearish?

In This Report

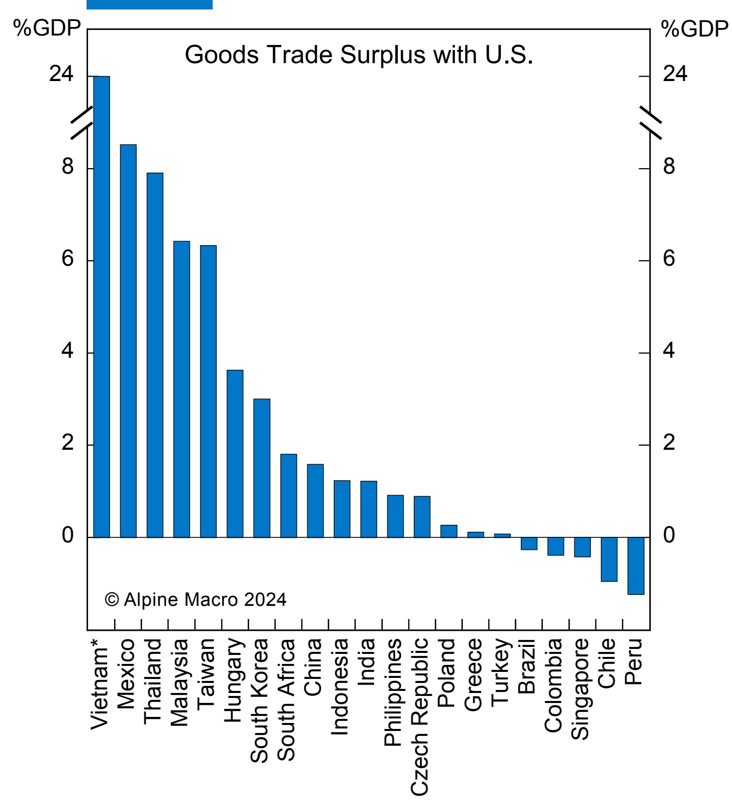
We discussed Alpine Macro's global outlook in yesterday's report titled "Boom Or Bust? An Investor's Playbook For 2025 & Beyond".[1] Regarding EM, the U.S. fiscal and trade policies under the new administration, along with China's reflation efforts, are pivotal. Beijing has once again signaled its intention to implement forceful measures to boost growth. Whether these statements will translate into substantial action remains to be seen, but one thing is more certain: the government has reached its pain threshold for economic weakness. Any additional external shock is likely to compel Beijing to adopt bolder measures.

The biggest headwind for EM assets in the near term is the strong U.S. dollar. However, it is worth noting that the dollar's bull market has been over a decade in the making, leaving it significantly overvalued compared to most other currencies. Moreover, a strong dollar is fundamentally at odds with President-elect Trump's goals of reducing the U.S. trade deficit and revitalizing domestic manufacturing. As a result, the dollar rally will eventually face strong economic and political resistance.

Trump Factor And EM Volatility

EM volatility is likely to spike in the first half of the new year, primarily driven by factors emanating from the U.S. The dollar may receive an additional boost from potential Trump policies. Domestically, his plans for deregulation and tax cuts could support the U.S. growth outlook and reduce the likelihood of deeper Fed rate cuts during the ongoing easing cycle. Externally, his tariff threats could weaken the currencies of affected countries.

Chart 1 EM Bilateral Balances With U.S.



*Data is truncated, the actual value is 24%GDP
Source: IMF DOTS

1 Alpine Macro *Global Strategy* "Boom Or Bust? An Investor's Playbook For 2025 & Beyond" (December 9, 2024).

While China will remain the primary target of Trump's trade war, other nations with significant trade surpluses with the U.S., such as Mexico, Thailand, Taiwan, Korea, and Vietnam, may also find themselves on his "hit list" (Chart 1).

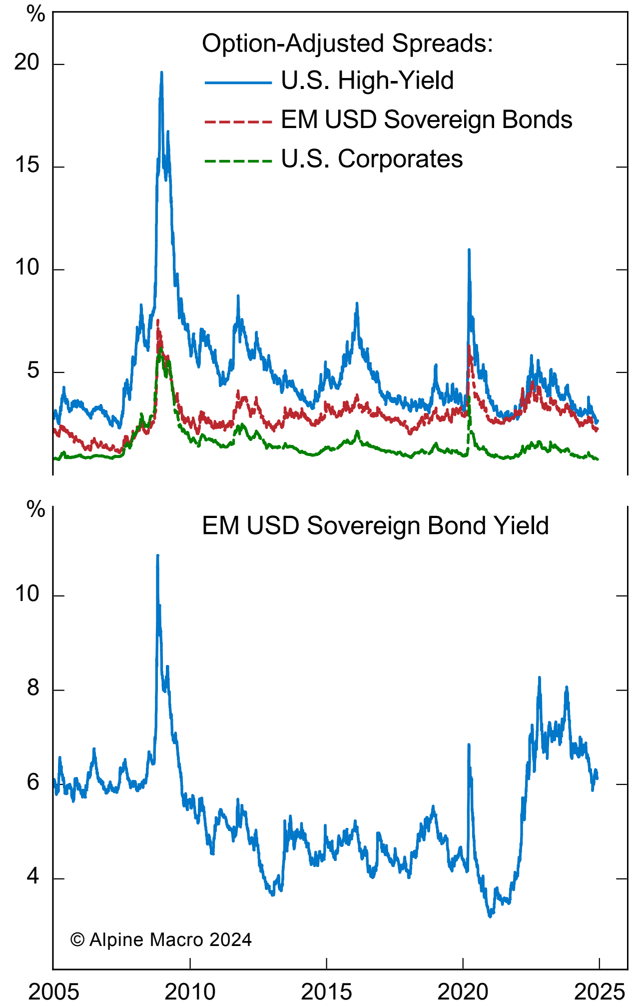
EM assets will also be vulnerable to potential contagion from any fallout on Wall Street. The U.S. stock market's bull run has become increasingly stretched since the presidential election, marked by overbought momentum, elevated valuations, optimistic sentiment, and bullish positioning. Some "Trump winner" assets, such as cryptocurrencies, have reached euphoric levels. While it is impossible to predict the timing of a correction, we believe the recent surge in the U.S. market appears unsustainable. Any negative surprises—whether economic, political, or geopolitical—could trigger a setback, potentially sending shockwaves through EM.

With this in mind, a few recommendations are warranted.

- Global equity markets are likely to be volatile in the coming months. Historically, EM has struggled during periods of turmoil on Wall Street, particularly in terms of absolute performance in dollar terms. The good news is that EM assets are far cheaper than their U.S. counterparts, and EM central banks are cutting rates. Overall, we maintain a benchmark weighting for EM equities in a global portfolio. We will discuss the Q1 2025 allocation strategy within EM at the start of the new year.

- Some EM local currency bond yields are highly attractive in both nominal and real terms from a long-term perspective and are likely to decline due to policy easing in these countries. However, in the near term, betting against the dollar remains risky. Within EM, some currency trades are appealing for both economic and geopolitical reasons, as outlined in an earlier report.[2] These include shorting the Mexican peso against the Brazilian *real*, shorting the Chinese yuan against the Japanese yen, and shorting the Thai baht against the Singapore dollar.

Chart 2 EM USD Bonds: Spreads Are Tight, But Yields Are Attractive



Source: ICE BofAML, Bloomberg Finance L.P.

2 Alpine Macro *EM & China Strategy* "Three EM Currency Trades, Regardless Of U.S. Election" (November 5, 2024).

MRB holds the same two opinions above and the one below

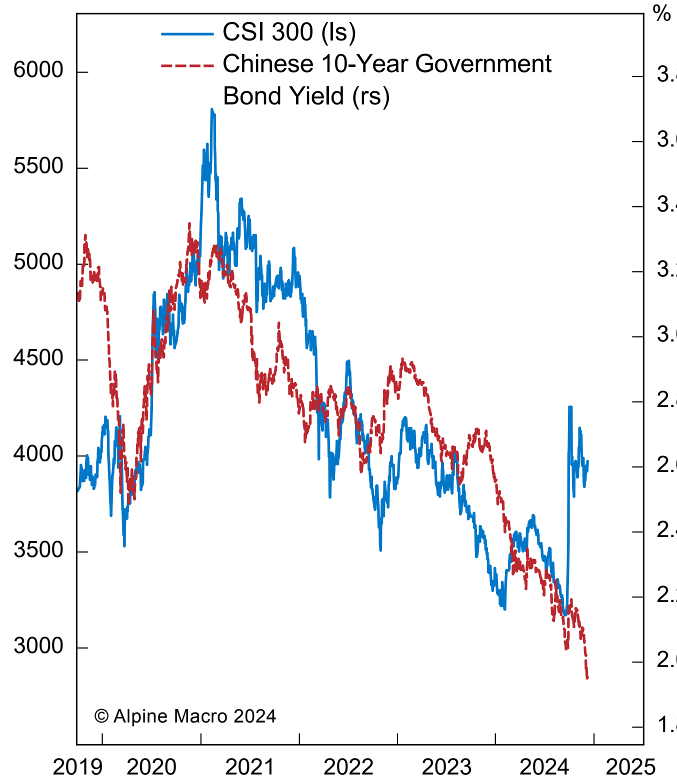
- EM dollar-denominated bond spreads are near the lower end of their historical range, leaving limited room for further compression (Chart 2). However, they remain more attractive than their U.S. corporate counterparts. The EM sovereign spread is only slightly lower than the U.S. junk bond spread but significantly higher than U.S. investment-grade bonds. With the EM dollar sovereign bond yield currently at 6.2%, which is very high by historical standards, these bonds are appealing from a total return perspective.

Will China Step Up Easing Efforts?

A key uncertainty for the EM outlook is Beijing's reflation effort. After an initial round of stimulus at the end of Q3, recent easing measures have been underwhelming (Chart 3). Yesterday's Politburo meeting rekindled expectations for more aggressive policy easing. The authorities pledged to strengthen "extraordinary" counter-cyclical measures, signaling an unprecedented policy stance. Looking forward, the Central Economic Work Conference later this week and the National People's Congress, typically held in March, will be key events to watch for insights into China's policy outlook. Despite escalating trade tensions during President Trump's first term, the Chinese economy and stock market performed remarkably well, underscoring the greater importance of Beijing's domestic policies over external factors.

Whether Beijing can implement decisive measures to boost domestic demand and fend off another trade war remains to be seen. What's more certain are the following:

Chart 3 China: Fading Reflation Momentum



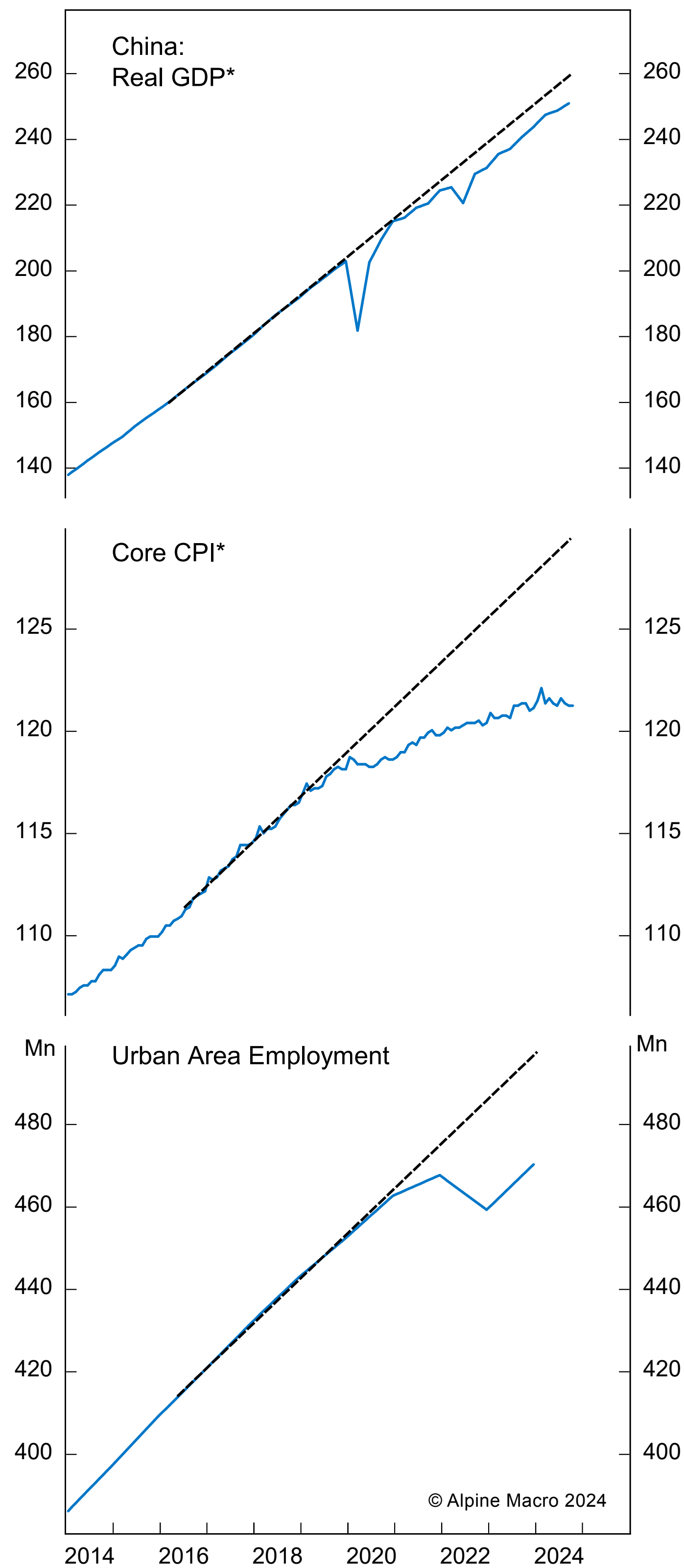
First, Beijing has likely made a pivotal shift in its economic ideology regarding policy stimulus. Previously, the authorities believed that the growth slowdown in recent years was an inevitable and necessary part of reorienting the economy toward higher value-added sectors. "Counter-cyclical measures" and "structural improvements" were essentially seen as mutually exclusive. This approach appears to have been abandoned since late September, which is also confirmed by the messages from this week's Politburo meeting. Beijing no longer views "massive policy stimulus" as inherently negative. Shedding this policy straitjacket marks a significant pragmatic shift.

Second, Beijing's pain threshold for economic weakness has been reached, meaning that further deceleration will be intolerable. Chinese GDP has yet to recover to pre-Covid trends, while a weak labor market and intensifying deflationary pressures point to a much larger output gap than GDP numbers suggest (Chart 4). Mass unemployment, particularly among the youth, has become an acute social problem. If the economy does not improve, this could lead to broader social and even political instability—a nightmare scenario for Beijing.

Third, Beijing has significant room to ease, particularly on the fiscal front. According to the latest official tally, China's total public sector debt, including both central and local governments and the "hidden liabilities" incurred by their financing vehicles, amounts to RMB 85 trillion, or 67.5% of GDP—among the lowest in major economies (Chart 5). Additionally, the Chinese government holds substantial financial assets, and its net financial worth, after accounting for liabilities, is positive, in sharp contrast to the net debtor status of most other major countries. This underscores ample room for fiscal easing with minimal side effects. The sharp decline in Chinese bond yields presents an excellent opportunity for Beijing to borrow and spend.

Finally, it has long been our view that China's growth problems in recent years are primarily self-imposed, and the economy is not destined to repeat Japan's decades-long stagnation.[3] This suggests that China's economic growth can respond positively to sufficient policy support. With many key economic variables, particularly consumer demand and the

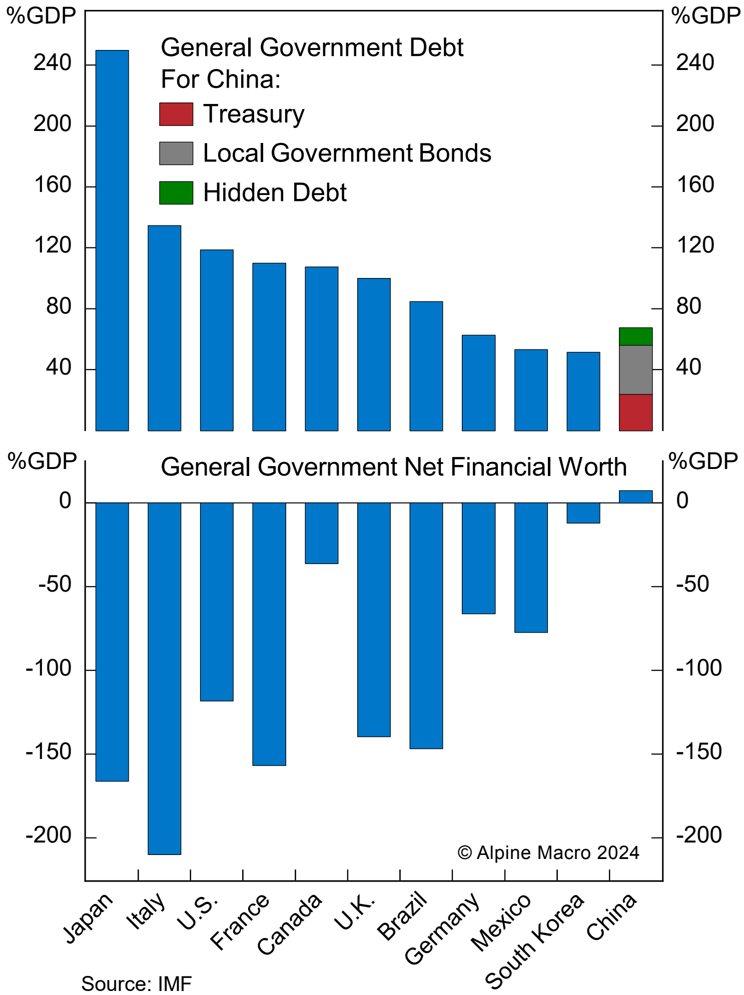
Chart 4 China: Widening Output Gap



*Series are rebased to Jan 2010=100

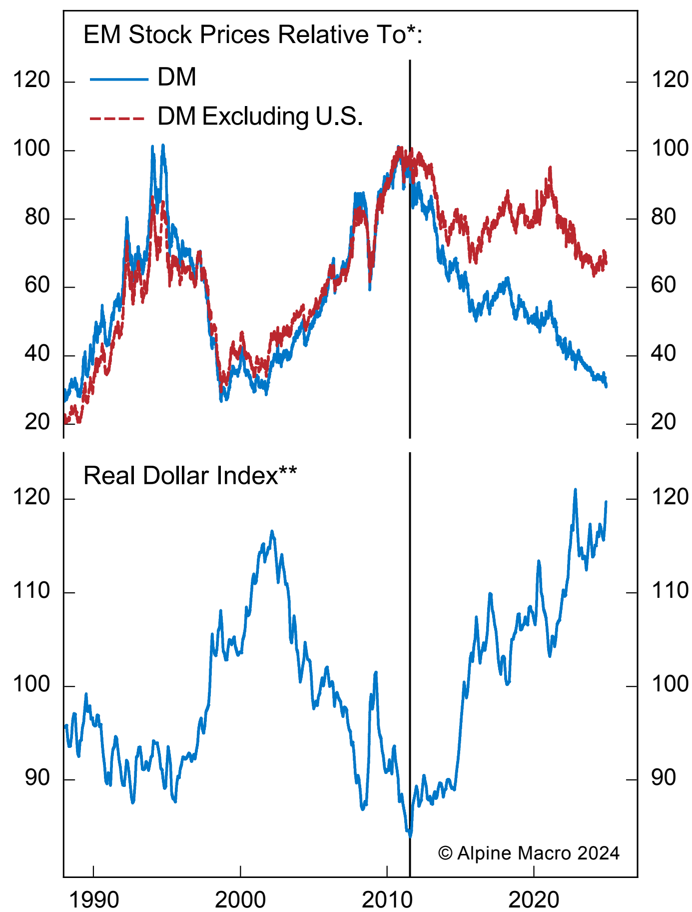
3 Alpine Macro *EM & China Strategy* "No, China Should Not Suffer A 'Balance Sheet Recession'!" (April 2, 2024).

Chart 5 China: A Lot Of Fiscal Room To Ease



Source: IMF

Chart 6 EM: Relative Performance And The Dollar



*Rebased to Oct 2010=100; source: MSCI
**Source: Federal Reserve

housing sector, at deeply depressed levels, it may not take much for them to recover. The sooner Beijing acts, the easier it will be to lift the economy out of its deflationary slump. Conversely, the economy will continue to struggle, if policymakers remain behind the curve.

In short, China's growth outlook critically depends on further policy easing, which remains uncertain. Our sense is that another external shock, such as tariffs imposed by Trump, could push Beijing into a more aggressive easing mode. Chinese stocks will likely continue to navigate the tug-of-war between policy measures and growth expectations. We see limited downside in stock prices, as we believe Beijing will not tolerate further economic deterioration. However, a sustained rally is unlikely to materialize without stronger policy catalysts.

EM Long-Term Underperformance: How Much Further To Go?

The EM/DM relative performance peaked in 2010, and EM has since underperformed DM by a whopping 70% (Chart 6). This is partly due to the spectacular bull market in U.S. stocks, while EM's

Chart 7 **EM: Widening Valuation Discount**

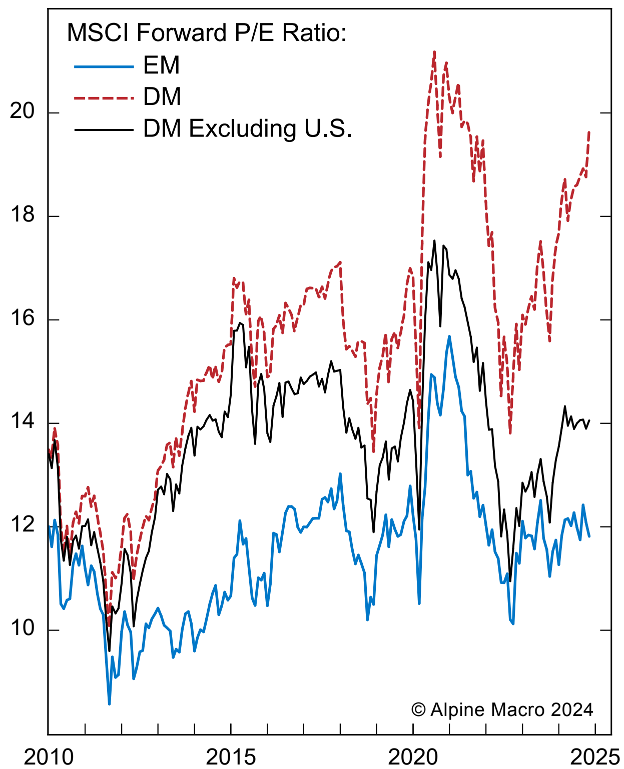
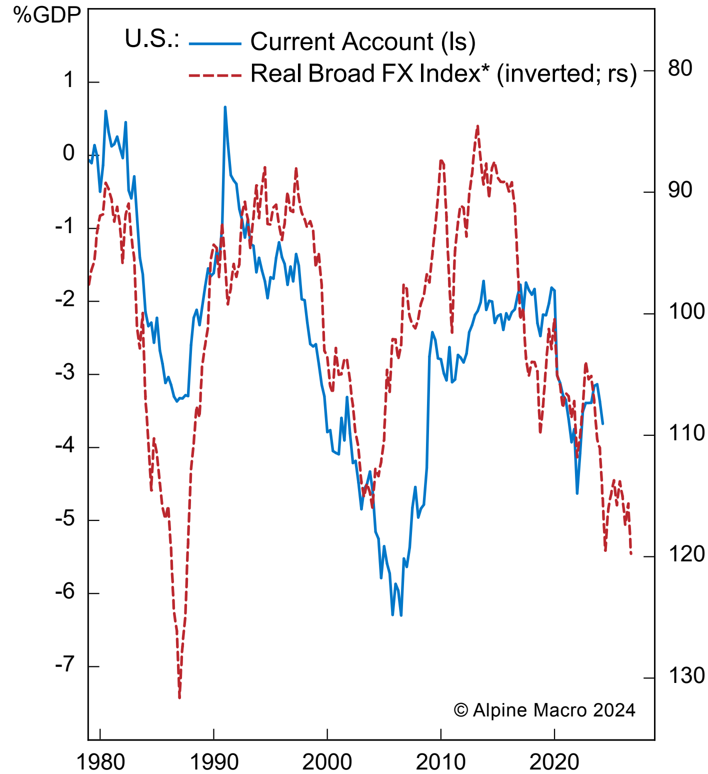


Chart 8 **U.S.: Dollar Trend And Current Account Balance**



*Advanced by 2 years; source: Federal Reserve

relative performance versus non-U.S. equities has been far less severe. After such a prolonged relative bear market, global investors' interest in EM assets has waned decisively, despite the ever-growing valuation gap (Chart 7).

Going into the first half of 2025, Alpine Macro still recommends an overweight position in U.S. stocks. Looking further ahead, will EM ever outperform? A few observations are in order.

First, the EM/DM relative performance has mirrored the dollar trend, as shown in the bottom panel of Chart 6. EM's poor performance since 2010 has coincided with a dramatic dollar bull market. A strong dollar directly translates into lower returns for EM assets when measured in common currency terms. Additionally, it complicates macroeconomic conditions in some EM countries, constrains monetary policy flexibility, and creates balance-of-payments difficulties.

While pinpointing an exact top is difficult, it is clear that the dollar bull market has become very stretched. It is highly overvalued, and any additional boost from Trump policies would push it further into overshoot territory. Since President Trump's first term, the U.S. has made no progress in bringing back manufacturing jobs and reducing the current account deficit, and further dollar overshoot would make achieving these top two trade policy priorities even more challenging in his second term (Chart 8). As such, we doubt the dollar's spectacular bull run has much further upside. EM assets will benefit when the dollar begins to weaken.

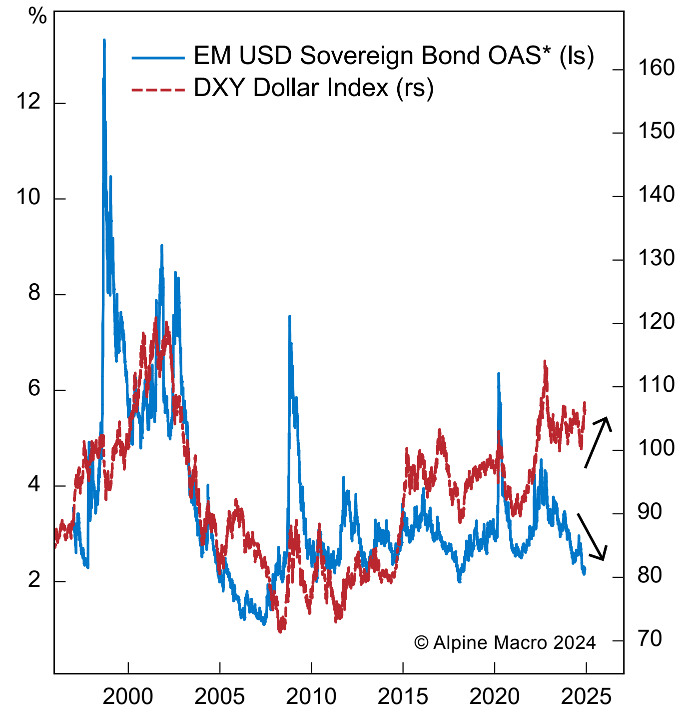
Second, overall EM countries have been very resilient in the past several years amid extreme external shocks induced by a global pandemic and an aggressive monetary tightening by the Fed. Historically, each Fed tightening cycle has resulted in some casualties in EM—the latest being the "taper tantrum" in 2013 when the Fed began to roll back QE measures.

In comparison, the most recent Fed rate hikes have not caused meaningful balance-of-payments pressure in any major EM countries. While EM exchange rates have broadly weakened against the "king dollar," the depreciation has been orderly, and no major EM central bank has significantly intervened to support their currencies. The fact that EM dollar bond spreads have remained near historical low levels despite the sharp dollar rally is also a market signal of improved macro stability among EM countries (Chart 9).

Even the Chinese economy has shown significant resilience, despite the deep slump in the housing sector, the wealth destruction caused by falling asset prices, and a lack of countercyclical support from the government. While the economy is certainly suffering, there has been no systemic stress in the financial sector. Moreover, the country has made very impressive progress in key sectors and technologies in recent years, despite mounting macro challenges and intense external pressure. This stands in stark contrast to the gloom and doom reflected in Chinese stock prices.

Finally, there is likely a developing long-term bull market in commodity prices, which will bode well for resource-rich EM assets. In fact, commodity prices, especially base metals, have been

Chart 9 EM Sovereign Spread: A Sign Of Macro Resilience



*Source: ICE BofAML

remarkably stable in recent years despite the strong dollar and the deep slump in Chinese housing construction-two of the most important macro factors for the commodity complex.

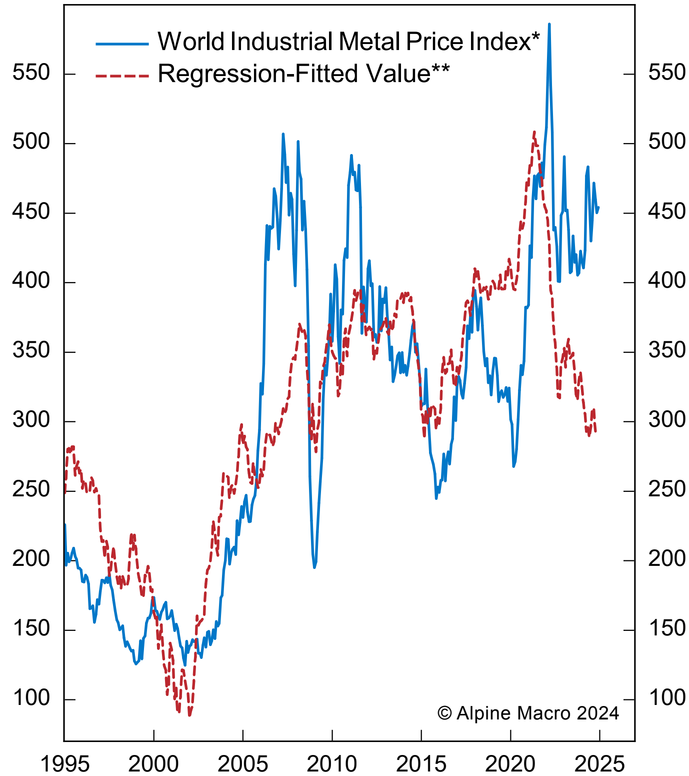
Chart 10 shows that industrial metal prices have diverged massively from the fitted line based on historical regression with the dollar and Chinese real estate activity. This divergence likely reflects changing long-term demand-supply balances. Supply may have been constrained due to a lack of capital spending in the mining sector. Meanwhile, demand may be strengthening from other large emerging countries such as India and Indonesia, as well as from new resource-intensive industries such as EVs, alternative energies, and data centers. Commodity prices could be supercharged if the dollar begins to roll over and China's business cycle improves.

All in all, financial markets typically follow big cycles and are subject to long-term mean reversion. The drastic underperformance of EM assets versus their DM counterparts appears very stretched. Continued undershoot is likely in the near term, but investors should be mindful of the structural changes in market dynamics. We believe the EM relative bear market is approaching its final stages.

Yan Wang, CFA

Chief Emerging Markets & China Strategist

Chart 10 Commodities: Diverging From U.S. Dollar And Chinese Housing



*Source: S&P GSCI
**Based on the historical correlation between industrial metal prices and factors of the U.S. dollar and Chinese home sales

Investment Recommendations

Strategic Positions (6 - 12 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Long Colombian 10-year Government Bond, Currency Unhedged	11/21/2023		3.7%	Long Colombian 10-year Government Bond, Currency Unhedged; stop point at -10%.
Long MSCI Greece Equity Index	11/21/2023		9.7%	Long MSCI Greece Equity Index in US$ terms; stop point at -10%.
Long Indian 10-year Government Bond, Currency Unhedged	06/04/2024		4.0%	Long Indian 10-year Government Bond, Currency Unhedged; stop point at -10%.
Long Malaysian Equities, Currency Unhedged	08/20/2024		-2.0%	Long MSCI Malaysia Equity Index in US$ terms; stop point at -10%.
Long ASEAN Equities, Currency Unhedged	09/17/2024		-6.5%	Long MSCI EM ASEAN Index in US$ terms; stop point at -10%.
Long BRL/MXN	09/23/2024		-5.5%	Long Brazilian Real versus Mexican Peso; stop point at -10%.
Short CNY/JPY	10/29/2024		2.8%	Short Chinese Yuan against Japanese Yen; stop point at -5%.

Tactical Investment Positions (3 - 6 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Short CZK/HUF	06/05/2023		0.7%	Short Czech Koruna versus Hungarian Forint; rolling stop point at -5%, or 0.1% from current level
Long MSCI China Equity Index	02/20/2024		23.5%	Long MSCI China Equity Index in US$ terms; rolling stop point at -10%, or -5.5% from current level.
Short COP/CLP	03/05/2024		7.3%	Short Colombian Peso versus Chilean Peso; rolling stop point at -5%, or -1.2% from current level.
Long CSI 300 Index	02/20/2024*		8.8%	Long China A-shares Index in US$ terms; stop point at -10%. *Trade opened on Feb 20, 2024, closed on Sep 13, 2024 and reopened on Sep 24, 2024.
Short CNY/USD	10/29/2024		2.0%	Short Chinese Yuan against US Dollar; stop point at -5%.
Short THB/SGD	11/05/2024		-1.2%	Short Thai Baht versus Singapore Dollar; stop point at -5%.

EM Equity Country Allocation				
Strong Overweight	**Overweight**	**Neutral**	**Underweight**	**Strong Underweight**
	Brazil Chile China Colombia Greece South Africa Indonesia Philippines Malaysia Thailand South Korea		India Czech Republic Hungary Mexico Peru Poland Taiwan Turkey	

EM Equity Sector Allocation	
Strong Overweight	**Overweight**
	Materials Health Care Consumer Discretionary Consumer Staples
Neutral	
Energy Communication Services Information Technology Financials	
Strong Underweight	**Underweight**
	Industrials Utilities

EM Local-Currency Government Bond Allocation		
Overweight	**Neutral**	**Underweight**
Indonesia Peru Brazil Colombia Chile India	Poland Hungary South Korea Malaysia Philippines South Africa Mexico	Czech Republic Thailand China Taiwan Turkey

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