FRANKLIN TEMPLETON

Perspective from
Templeton Global Macro

Templeton Global Macro Insights
Opportunities for diversification outside the United States

August 2023

Summary

- The cyclical factors that have supported the US dollar are eroding, while structural factors remain a challenge, in our view.
- Emerging markets in general have shown resolve and robust policy responses during the pandemic and its aftermath, improving their economic fundamentals.
- Beyond emerging markets, we think a sea change in Japan remains an exciting prospect.
- We believe there are therefore a number of attractive options globally to diversify away from a weakening US dollar.
- Risks to our outlook remain, including currency volatility and the possibilities of financial shocks or geopolitical events.

The US dollar: no rosy outlook here

In our view, **the highs the US dollar attained in 2022 represent the peak of the current cycle**. Currencies exhibit volatility and episodic reversals even during the course of a cycle, so even though the dollar has broadly moved sideways thus far in 2023, our view remains that the cyclical supports to the dollar's strength are waning. In particular, we anticipate that the imminent end of the US Federal Reserve interest-rate hiking cycle, along with slowing growth, will remove some of the underpinnings of the currency, so that looking forward we expect both growth and interest-rate differentials to work against the dollar. As some foreign capital that flowed into the United States over past years consequently gets repatriated or deployed elsewhere, likely accompanied by some domestic US capital flowing abroad to chase better returns, the dollar is expected to weaken further. Structurally, the dollar also faces well-known negative factors, chiefly a high level of government debt to GDP (gross domestic product) and a structural trade account deficit. Without cyclical factors to buoy the greenback, those factors are likely to come more to the fore.

We'd note that none of this has a bearing on the dollar's status as the world's primary reserve currency, nor do we believe that status to be in jeopardy. Reserve currencies can and do exhibit cycles, just as other currencies do. Indeed, the dollar was arguably a more important reserve currency in the early 2000s than today, but it still depreciated then. Reserve status and currency valuations encompass different considerations.

Emerging markets: proving their mettle

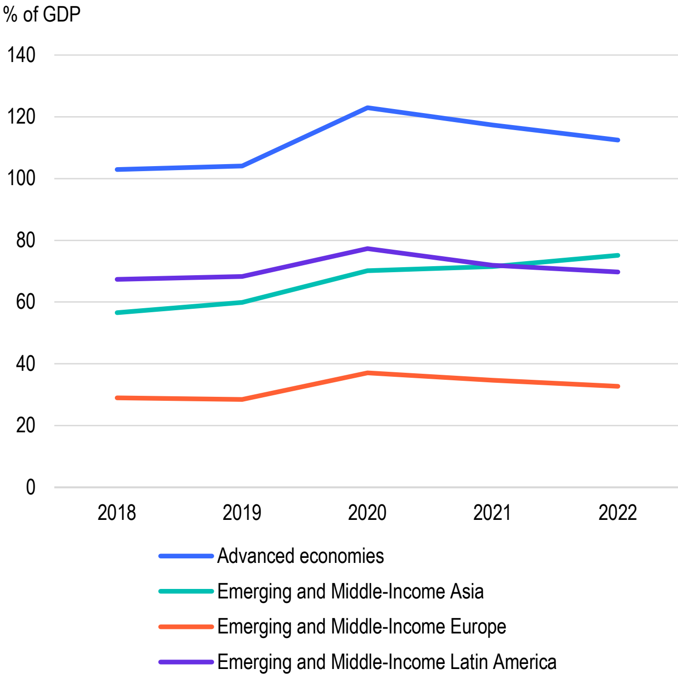
Although the asset class is not homogeneous and selection within it remains key, there are some broad themes in emerging markets. A notable one is that many of these countries exhibited strong resolve in their policy responses during the COVID-19 pandemic. In particular, fiscal responses were generally moderate—there was no debt binge—and monetary policies were responsible in terms of responding to emerging inflationary pressures. This is especially notable when comparing these policy responses to those in developed markets, specifically the large increases in already-high debt levels seen in the United States and other advanced economies.

While there have been cyclical timing differences between regions, **inflation has generally peaked, and interest-rate cycles are following suit**. Latin America generally saw inflation surge before other regions, but also saw policymakers react swiftly, with the result that inflation in several countries has either stabilized or shifted into a downtrend, and we have already seen some central banks in the region start to reduce rates. The inflation cycle in Asia—where growth was dampened by longer COVID lockdowns—was later and lower than elsewhere among emerging markets, but central banks there too responded when necessary, and thus stable or downward trends in inflation have also already started to become evident in the region.

Emerging Markets Have Not Been on a Debt Binge

Exhibit 1: Gross Government Debt

2018–2022



Source: International Monetary Fund (IMF). As of December 31, 2022. There is no assurance that any estimate, forecast or projection will be realized.

Within emerging markets, **emerging Asia is still a bright spot for growth globally**. Although there has been some disappointment over the extent of the Chinese growth rebound to date—likely due to both over-optimistic expectations, as well as some underwhelming outcomes—there has been recovery. And notably, as part of this recovery and its services spending component, Chinese tourists have started to travel abroad once more. This has had a positive effect on other countries in the region. While longer-term concerns persist over the ultimate success of China's government-led growth model, the immediate cyclical recovery—including the ability of the authorities to pull levers such as those needed to stabilize the property market—appears intact. Emerging Asia as a whole is projected by the IMF to have growth outcomes of over 5% this year and next, well above the rest of the world.

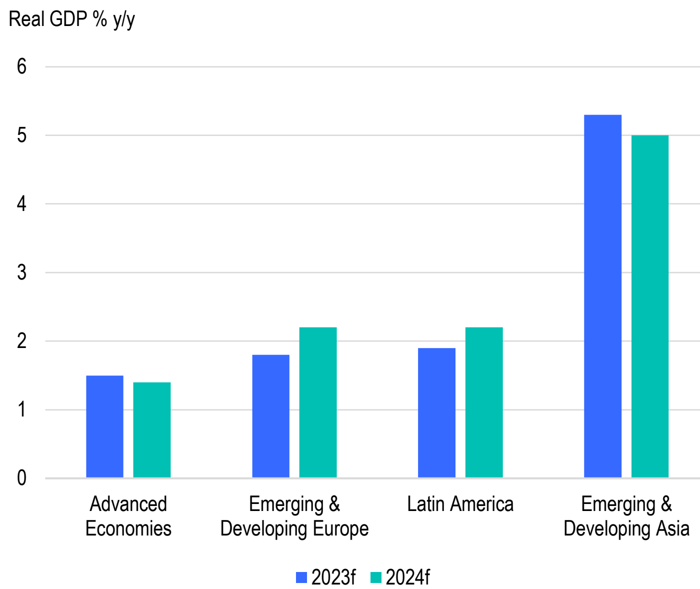
Global shifts in supply chains are an important consideration for emerging markets. Strategic alliances have given increasing momentum to the concept of **reshoring**, more specifically in terms of **"nearshoring" and "friendshoring."** The old globalization model of offshoring meant that companies tended to relocate production to wherever costs were lowest. As geopolitical tensions intensify, concerns have increased about various issues, including the reliability of supply, as well as the physical location of production technology. This has resulted in issues other than just cost factoring into decisions about where to locate production.

Nearshoring refers to production facilities being situated in a location of geographic proximity—for example, US manufacturers with facilities in Mexico. This can help reduce risks associated with physically moving goods (for instance, it is easier to find a new truck than a new ship in the case of a transport issue). Friendshoring, meanwhile, refers to the reallocation of various parts of the supply chain to strategic allies where geopolitical risks are reduced, whether this means placing production facilities in a friendly country or sourcing critical raw materials or other inputs from one.

Emerging Asia Forecast to Outperform on Growth

Exhibit 2: Real GDP 2023 and 2024 (forecast % year-over-year)

2023-2024f



Source: IMF. There is no assurance that any estimate, forecast or projection will be realized.

While there is not yet much obvious impact in the data, anecdotal evidence is starting to build, principally through company announcements of decisions about where to locate new production. While this will not necessarily represent capital physically leaving one country for another (although that might happen), it will represent lost opportunities for certain countries who may or may not be able to make those up through their own alliances. In our view, China is likely to be a net loser to countries who are closer (physically or in geopolitical alignment) to Western countries. The positive effects are likely to come to a wide range of countries for various reasons—including, we believe, much of Asia (including Japan) and even all of North America, from Mexico through the United States to Canada. Specifically, countries within this bracket that have environments friendly to foreign direct investment are likely to benefit significantly from these shifts. In our view, such beneficiaries could include countries such as India, Indonesia and Japan.

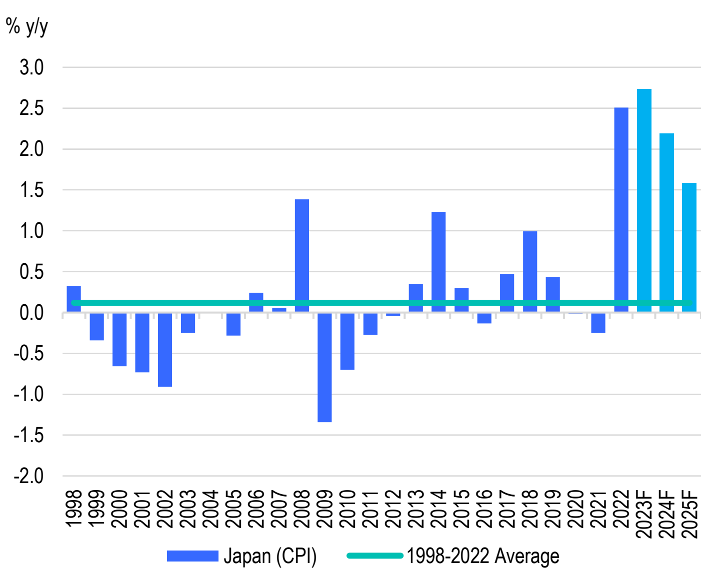
Japan: undergoing a sea change

The economic environment in Japan is changing meaningfully compared with the past couple of decades. The slow growth/very low inflation environment that had characterized the country has now given way to more sustained growth and inflation. Its demographics have been an issue for some years, with the aging population top of mind. A demographic cliff for the labor market was averted over the past decade as Japan successfully maneuvered to significantly increase the participation of women in the workforce, though it appears the aging population dynamic has now overwhelmed even this increased participation. As that has been happening and the labor market has been tightening in response, pressure on wages—and then on inflation—has become more entrenched. Indeed, Japan's annual headline inflation rate has been at or above 3% since August 2022, while "core" inflation (i.e., inflation excluding fresh food and energy) has exceeded 4% for the past few months, its highest levels since 1981.

As inflation rises, and we assume that at some point interest rates would react, the investment opportunity set for a domestic Japanese investor changes. In a deflationary or very low inflationary environment, there is an incentive to hoard cash. As inflation rises, and especially if wages also increase, Japanese consumers may switch their behavior more to consumption and away from saving. For businesses who may have been hoarding cash to date, inflation is a disincentive to hold cash on their balance sheets and an incentive to deploy it into investment. In turn, both these factors support economic growth, and should help entrench a growth-inflation dynamic more favorable than the one that has been in existence for the past couple of decades.

Over Two Decades of Japanese Inflation vs. Current and Future

Exhibit 3: Consumer Price Index (actual and forecasted)



Source: Bank of Japan, IMF. Note: data adjusted for 3% consumption tax on 2/3 of CPI (April 2014–March 2015). There is no assurance that any estimate, forecast or projection will be realized.

Another consequence of Japan's weak demographics and resulting labor shortages is that its ability to automate and develop robotics has become quite high. This technological advantage, along with Japan's strategic geopolitical alliances (especially in the context of uncertainty around China and Taiwan), should, in our view, mean that Japan will also be a beneficiary of the reshoring dynamic discussed earlier.

Conclusion: attractive diversification opportunities

The above discussion leads to the conclusion that not only is the US dollar (and dollar-based assets) likely to become less attractive, but that there are some compelling investment cases elsewhere.

Many emerging markets have improved their fundamentals through solid policy responses to COVID. Naturally, this asset class is generally subject to higher volatility (economic and political) than advanced markets, with higher yields intended to compensate for those risks. Selection in this asset class always remains key, and we carefully monitor individual countries to assess their fundamentals and idiosyncratic risks. We particularly like specific countries in emerging Asia and Latin America.

Outside emerging markets, Japan is an exciting prospect to us as the economic fundamentals of the past two decades morph into a more favorable environment, which we expect to be supported by further investment impetus from reshoring.

As always, risks remain. These include currency volatility, as well as the shocks that might arise from factors such as financial crises or geopolitical events.

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