The Sizemore Income Letter

July 2021

Inflation Today, Deflation Tomorrow?

By Charles Lewis Sizemore, CFA

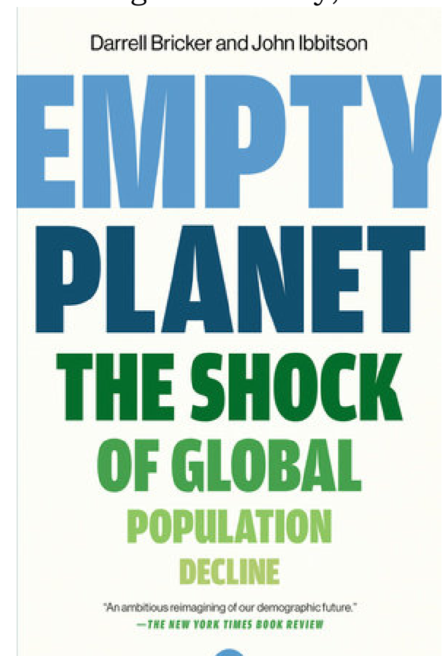
We have a lot to cover this week, but before we get into it, I want to take a step back and take a look at the big picture.

After working with Harry Dent for years, I can't *not* pay attention to demographic trends. This is just part of my DNA now. Once you understand demographic trends, you see the world through a different lens.

At any rate, over the past week I read two books I'd recommend for anyone wanting to better understand the world. The first is *Empty Planet: The Shock of Global Population Decline* by Darrell Bricker and John Ibbitson. The second is *The Great Demographic Reversal*, by Charles Goodhart and Manoj Pradhan. *Empty Planet* is a little more digestible and a little less academic, so if you're going to start with one, I might nudge you that direction.

If you spend any time at all reading the news, you'll be familiar with a certain narrative. Overpopulation and excessive use of fossil fuels is creating a pending disaster. Global warming, rising sea levels… We're looking at a bleak future on a dying planet.

Now, I don't minimize the problems we face. After recently taking a long road trip through rural Peru, I've seen what a mess people can make of things. Personally, I've love to live in a cleaner, less polluted world.



But for the big picture, it's not overpopulation we have to worry about. It's actually the opposite. In the not too distant future, we're actually looking at a *falling* global population. Today, Japan, South Korea, Italy, Spain and large swaths of Eastern Europe are already losing population. China will be joining them soon. And by the middle of this century – roughly 30 years from now – we're likely to hit peak population of the planet, at which time the total global population starts to decline.

Think that sounds impossible?

Consider that India – yes, India, perpetually overpopulated India – now has a birthrate of about 2.2 babies per woman, putting it at ever so slightly above the replacement rate… and falling fast.

The migrant caravans at our southern border might seem like a crisis today. But those that fear the United States will be overrun with migrants haven't looked at the data. Most of Latin America is now breeding at below the replacement rate. Mexico has a birthrate of 2.3 babies per woman, and Latin America as a region is right at the 2.1 replacement-rate level. In Brazil, the number is at European levels at just 1.7. And importantly, the trend is moving lower. The number continues to drop year after year, and this was *before* the disruption of the COVID pandemic.

No one really knows why birthrates have collapsed. A lot of it is attributed to higher levels of education for women, which keeps them in school longer during what might normally be fertile years. A lot of it is due to urbanization. Children are expensive in the modern world. And some of it is simply preference. We live in a world of entertainment and leisure options that prior generations could have never fathomed. Having a large family makes a beach vacation in Mexico prohibitively expensive.

But for whatever the reason or reasons, this is happening.

You might think a shrinking population is a good thing. And in many ways, it is. Fewer people means more space for the rest of us, less competition for resources, etc.

But economically, it's a disaster.

I don't need to whip out charts and graphs to prove the point. Think about it for five seconds, and you'll get it. How can Apple continue to sell new iPhones if there are fewer people on the planet to buy them? How can Ford sell more F-150 pickups if there are fewer people to drive them?

You've likely seen your home appreciate in value over the past several years. How can home prices continue to rise if there are fewer people to live in them?

Taking this a step further, why would a company expand and build new factories if future demand isn't going to be there? Why would banks lend?

Why would anyone invest in the future if there is no future?

And how do we keep pensions and Social Security solvent when there are fewer people to contribute to them?

The entire model of our global economy depends on *more*. More production to serve an ever growing market. No one really knows what to do when that model breaks down.

In *The Great Demographic Reversal*, Goodhart and Pradhan foresee all of this leading to inflation. Because an aging and shrinking population will have a dearth of labor available, a worker shortage will lead to rising prices of labor, which will flow through to consumer prices.

They're wrong.

There is only one way this goes, and that is *deflation*.

Yes, we will have millions upon millions of retirees, and those retirees consume without producing. And yes, we will absolutely have inflation in certain pockets of the economy, and labor shortages in parts.

But technology can replace a *lot* of labor. Look at a modern car factory or an Amazon distribution facility. Sure, there

are a few humans. But there are a *lot* of robots.

Think about the myriad of tasks you can do on an iPhone app that might have involved a time-consuming phone call with customer service even ten years ago.

And a lot of the labor that can't be fully replaced by automation honestly isn't that critical. You might pay a housekeeper to clean your house once per week. But if that became prohibitively expensive, you'd suck it up and either clean your own house or simply tolerate a little more dust.

Technology will largely solve the problem of labor shortages. But it won't solve the problem of *shopper* shortages. A robot can build a car, but it can't buy one.

I've been writing for months that I worry about inflation from all of the excessive money printing following the pandemic. And I still do.

But let me be clear, I consider inflation to be a risk for the next couple of years at most. The bigger risk remains deflation. Japan has been struggling with deflation for nearly 30 years now, and the rest of the world will be following soon enough.

All of this is a problem for another day. And hey, I did my part to keep the world populated. I had *three* kids. But at any rate, we still have portfolios to build and investments to make.

New Emerging Market Play

Emerging markets haven't exactly had an easy go at it. As a sector, emerging market stocks peaked in late 2007 and really haven't gone anywhere since. More than 13 years later, the iShares Emerging Markets ETF (NYSE: EEM) is still below its old highs.

As for "why," pick a reason. A massive continent-wide political corruption scandal has paralyzed much of South America for the better part of the last decade. Weakness in commodity prices have sapped demand in Southeast Asia and Africa. China is struggling in its transition from a manufacturing-based export economy to an information and consumption-based economy. Weakness in Europe has dampened demand for exports. Incredible growth in U.S. stocks has sapped the desire of investors to look overseas. The list goes on and on.

Source: CEFConnect Figure 1

And of course, this weakness was *before* the COVID pandemic, which hit developing countries far harder than the developed world. Most emerging markets lacked the social safety nets and hospital capacity to get through the pandemic smoothly.

But here's the thing. There comes a point in which the bad news is finally priced in and stocks can move higher. I think we're essentially at that point in emerging markets.

Table 1: Average Valuations by Country

Country	CAPE	CAPD	CAPCF	CAPB	Average Rank
Egypt	8.8	21.5	4.9	1	3
Poland	11.1	26.7	5	1.1	5
Colombia	11.3	21.3	6.7	0.9	5
Turkey	7.8	27.3	6.1	1	6
Russia	8.4	27.4	5.2	1.1	6
Chile	12.4	24.3	6.7	1.1	8
Spain	15.6	20.3	6.8	1.2	9
Singapore	13.7	25.3	10.6	1.2	12
U.K.	15.2	26.3	8.4	1.8	14
Greece	-2.5	26.8	4.8	0.5	14
Malaysia	14.6	28.1	9.4	1.5	14
Italy	22.7	35.1	6.4	1.2	17
Indonesia	14.2	33.1	9.1	2.1	19
South Africa	17.5	32.1	11.3	2.1	23
Germany	20.2	43.5	9.7	2	24
Mexico	19.2	47.5	9	2.1	25
Korea	19.1	97.8	9.8	1.7	26
Brazil	20.4	36	11.7	2.1	26
Australia	21	28.7	13.9	2.3	28
Japan	22.8	66.1	11.2	1.7	28
France	24.3	43.1	12.1	2	28
China	17.6	58.2	13.4	2.2	30
Canada	25	42.9	12.8	2.3	31
Taiwan	30.2	50.5	16.6	3.2	37
Switzerland	29	46.8	21.1	3.6	38
Ireland	36.3	88.1	19.7	2.7	39
Netherlands	33.6	71.1	20.9	3.4	40
India	30	108.6	19	3.8	41
U.S.	37.8	91.4	22.9	5	42
Denmark	42.8	102.5	28	6.1	44

Source: Meb Faber

Meb Faber ranked all the major investable markets of the work by a handful of valuation metrics – cyclically-adjusted price/earnings ratio ("CAPE"), the cyclically-adjusted price/dividend ratio ("CAPD"), the cyclically adjusted price/cash flow ratio ("CAPCF") and the cyclically-adjusted price/book value ratio ("CAPB") – and the gave each a composite score.

As you can see immediately, most of the cheapest countries are emerging markets. And interestingly enough, they hail from the far-flung corners of the globe. Egypt is the cheapest country, but Poland, Colombia, the Czech Republic and Turkey aren't far behind. These countries have little in common other than the fact that they're emerging markets. Their economies are vastly different, and they're not even close to one another on the map.

There are exceptions, of course. Developing India is one of the most expensive markets in the world, for example, and developed Spain one of the cheapest. But by and large there is a clear difference based on development. The average CAPE of all developed markets (excluding the U.S.) is 24, whereas it's 15 for emerging markets.

For what it's worth, there is a large difference even between developed countries, as the United States is vastly more expensive than Canada, Japan and most of Europe.

We already have exposure to emerging market stocks via the **WisdomTree Emerging Market High Dividend ETF (NYSE: DEM).** We also have exposure to European stocks via the **First Trust Dynamic Europe Equity Income Fund (NYSE: FDEU)**. We're up about 11% and 1%, respectively, in each, and I expect more gains to come.

This month I want to take a slightly different direction. I want to invest in emerging market bonds.

You're not going to find yield in the developed-world bond market unless you're willing to buy junk bonds. But in many emerging markets, yields are still decently high. And with the worst of the COVID pandemic now (hopefully) passed, the higher risk of these countries should also start to recede.

A quick trip around the world really drives home the difference. In most of

Europe's large economies, the yields on the 10-year bond are actually negative.

Table 2: 10-Year Bond Yields by Country

Country	Yield
Germany	-0.46%
Switzerland	-0.41%
Netherlands	-0.33%
France	-0.10%
Japan	0.01%
Portugal	0.17%
Spain	0.27%
United Kingdom	0.56%
Greece	0.58%
Italy	0.62%
Hong Kong	0.73%
Australia	1.17%
Canada	1.19%
United States	1.24%
Singapore	1.28%
New Zealand	1.63%
South Korea	1.87%
India	6.20%
Mexico	6.86%
Brazil	9.35%

Source: Bloomberg

And not just in inflation-adjusted terms. We're talking absolute terms. Someone buying a bond in Germany today planning to hold to maturity can expect to lose nearly half a percent per year.

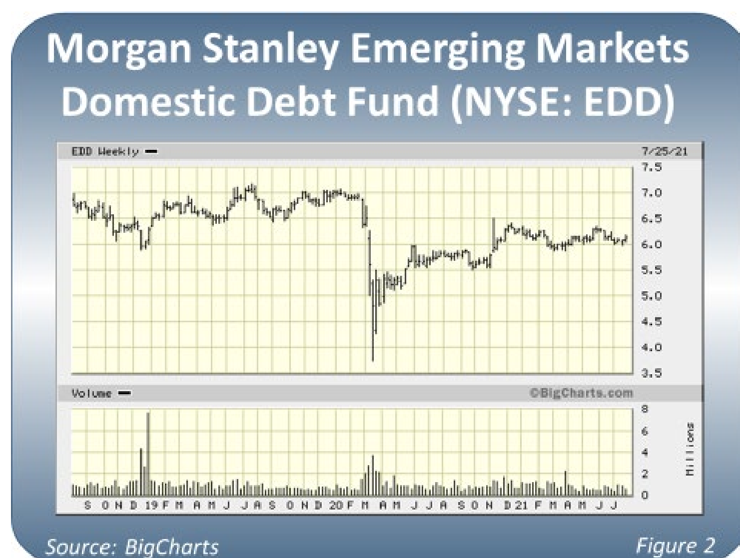
That's not conjecture. It's math. When you buy a bond for over its par value, you will lose money if you hold it to maturity. You're effectively buying something at $105 knowing full and well that it matures at $100.

Yields are higher in developing countries like India, Mexico and Brazil. Of course, those countries have also struggled with currency instability of late, which contributes to that high yield.

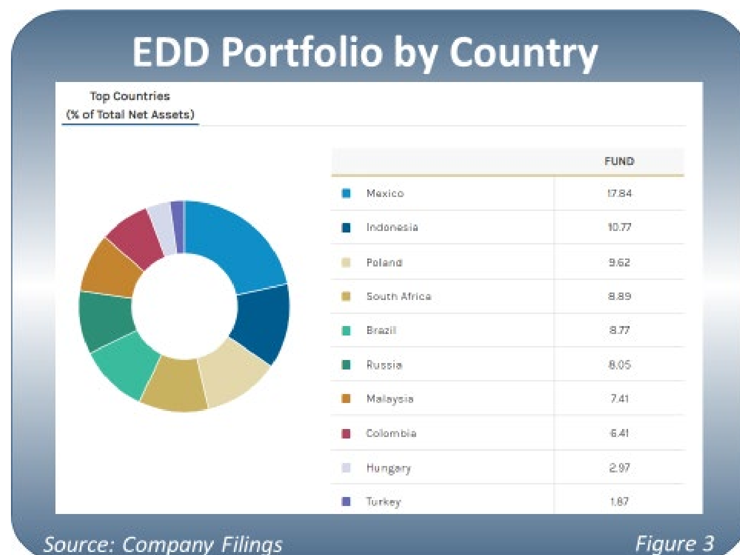
But again, as the world approaches something resembling normal, we should see emerging market currencies firm up a little.

I'm under no illusion that the Indian rupee or the Brazilian real will be hard currencies any time in my lifetime. Let's get serious. But that doesn't mean that they can't enjoy healthy, multi-year bounces from deeply depressed levels.

With all of that said, let's jump into this month's pick: the **Morgan Stanley Emerging Markets Domestic Debt Fund (NYSE: EDD)**.



Source: BigCharts Figure 2



Source: Company Filings Figure 3

EDD owns a portfolio of emerging market bonds dominated in local currencies.

Believe it or not, this is actually *less* risky than owning emerging market bonds denominated in dollars. Most emerging market crises and defaults happen due to funding mismatches. The country borrows in dollars but then, after a currency devaluation, can't pay those dollars back. Borrowing in the local currency, which is often more expensive, eliminates that risk.

Furthermore, after years of getting pounded relative to the dollar, many emerging market currencies are the cheapest they've been in recent memory. Cheap assets can always get cheaper, of course, and calling the exact bottom is next to impossible. But I'm going to be a lot more comfortable buying into emerging market currencies after a crisis than after a long period of stability. Investors already expect the worst and have priced them accordingly.

Digging into the portfolio, the largest country allocation is Mexico, which makes up about 18% of the total. The peso is a case in point about currencies. For years, the currency traded at about 10 pesos to the dollar. After years of slow-motion crisis, the peso weakened to about 20 pesos to the dollar and then slid all the way to 25 to the dollar during the COVID panic. But since April of last year, the peso has been strengthening and is now below 20. We may never see 10 to the dollar again, but the peso's freefall is over. It's reached a stability of sorts, at least for the present.

Indonesia is the second largest holding, and the same basic story is true with the Indonesian rupiah. After struggling for years, the currency has stabilized.

None of these currencies will ever be as sound as Swiss francs. Let's not be ridiculous. But we don't actually need them to be. We simply need them to no longer be in freefall, and that's exactly the situation we see today.

EDD holds a portfolio of cheap assets that are getting less cheap. That's good. But the fund also trades at a discount to net asset value of over 9%.

We're buying already cheap assets at a deep discount… at a time when cheap assets are hard to find.

Income, Income, Income…

Let's talk dividends.

At current prices, EDD yields 6.2%. That's not crazy high by any stretch of the imagination, but remember that the fund owns government bonds. Even in emerging markets, a 6% yield is good these days. You're only going to do better than that by taking more risk (i.e. buying less credit-worthy countries) or by leveraging up.

I'm not interested in doing either. I'll gladly take a 6% yield with the possibility of capital appreciation.

And about that. What kind of capital gains should we expect?

If conditions continue to improve in emerging markets, gains of 10% to 15% on the net asset value should be doable in short order. I think we can easily squeeze out an extra 5% from a shrinkage in the discount to net asset value.

And then, of course, there is the yield itself, which adds another 6%.

Taken together, I believe total returns north of 25% are doable in the next year.

That's not too shabby for a boring bond fund.

So, with no further ado…

Action to take: Buy shares of the Morgan Stanley Emerging Markets Domestic Debt Fund (NYSE: EDD) at market. Set an initial stop loss at $5.42 based on closing prices.

I'm keeping the stop relative tight on this one. I feel like that only makes sense in this environment. While emerging market stocks and bonds are cheap, underowned and priced to deliver outstanding returns in the years ahead, I can't ignore the risk that the entire system blows up if or when the Fed finally gets serious about draining the excess liquidity out of the system.

And I haven't said anything about the delta variant or any of the other potential sparks that could promptly put an end to the bull market.

I still believe we have further to run before this all falls apart. But I also like to prepare for the worst. So, again, we're keeping the stop tight this time around.

That's going to wrap it up for now. We'll pick this up next month.

Until then, stay safe out there, and keep cashing those dividend checks!

P.S.: Apart from writing this newsletter, I run a full-service wealth management firm along with my colleagues. At **Sizemore Capital Management**, we build income portfolios like those I write about in the *Sizemore Income Letter*.

But we also do a lot more than that. We manage a suite of low-volatility strategies offering low correlation to the S&P 500. If you think your portfolio is a little too exposed to the stock market right now, let's talk. I may have some alternatives that can offer competitive returns without the heartburn.

If you'd like for me to take a look at your portfolio and offer some recommendations, contact me at info@sizemorecapital.com.

The Sizemore Income Letter Portfolio

Stock	Ticker	Entry Date	Buy Price	Recent Price	Stop Loss	Yield	Cumulative Dividends	Total Return	IRA Friendly?	Action
Morgan Stanley Emerging Markets Domestic Debt	EDD	7/30/2021	$6.15	$ 6.15	$ 5.42	6.60%	$ -	0.00%	Yes	Buy
Nuveen Real Estate Income	JRS	6/25/2021	$10.77	$ 11.39	$ 8.68	7.06%	$ -	5.76%	Yes	Buy
ClearBridge Energy Midstream Opportunity	EMO	5/26/2021	$21.94	$ 21.75	$17.30	6.86%	$ -	-0.87%	Yes	Buy
First Trust Dynamic Europe Equity Income	FDEU	5/26/2021	$13.68	$ 13.64	$11.76	5.26%	$ 0.12	0.58%	Yes	Buy
Newmont Corporation	NEM	4/27/2021	$65.72	$ 62.72	$55.43	2.97%	$ 0.55	-3.73%	Yes	Buy
BHP Group	BHP	2/25/2021	$78.04	$ 80.24	$61.50	4.27%	$ -	2.82%	Yes	Buy
Vale SA	VALE	2/25/2021	$17.40	$ 22.87	$15.13	5.75%	$ 0.77	35.84%	Yes	Buy
Magellan Midstream Partners	MMP	1/29/2021	$44.41	$ 47.62	$41.78	8.27%	$ 2.06	11.86%	No	Buy
WisdomTree Emerging Markets High Dividend Fund	DEM	12/31/2020	$41.22	$ 44.97	$40.42	4.13%	$ 0.82	11.07%	Yes	Buy
Healthcare Trust of America	HTA	11/20/2020	$26.80	$ 28.62	$23.45	4.61%	$ 0.96	10.37%	Yes	Buy
Physicians Realty Trust	DOC	11/20/2020	$17.80	$ 18.85	$15.19	5.00%	$ 0.69	9.78%	Yes	Buy
AllianceBernstein Holding, LP	AB	11/6/2020	$30.85	$ 48.18	$33.04	6.95%	$ 1.78	61.94%	No	Hold
Main Street Capital	MAIN	9/25/2020	$29.74	$ 41.46	$32.96	5.96%	$ 1.85	45.61%	Yes	Buy
Iron Mountain	IRM	8/25/2020	$30.22	$ 43.44	$35.52	5.66%	$ 2.48	51.94%	Yes	Hold
Starwood Property Trust	STWD	8/25/2020	$15.70	$ 26.32	$18.15	7.66%	$ 1.92	79.87%	Yes	Buy
Dow Inc.	DOW	6/24/2020	$38.45	$ 62.60	$47.25	4.07%	$ 2.80	70.09%	Yes	Buy
Tortoise Essential Assets Income Term Fund	TEAF	6/24/2020	$10.73	$ 14.55	$11.94	6.18%	$ 0.98	44.69%	Yes	Buy
LyondellBasell Industries	LYB	5/22/2020	$60.39	$ 100.53	$79.23	3.76%	$ 5.33	75.29%	Yes	Buy
Invesco Adv. Municipal Income Trust II	VKI	4/23/2020	$10.12	$ 12.30	$11.32	4.78%	$ 0.75	28.95%	No	Hold
Ares Capital Corporation	ARCC	4/23/2020	$11.35	$ 19.85	$15.92	8.27%	$ 2.00	92.51%	Yes	Buy

Disclaimer: Copyright 2021 Sizemore Financial Publishing LLC. This investment newsletter (the "Newsletter") is created and authored by Charles Sizemore (the "Content Creator") and is published and provided for informational and entertainment purposes only. The information in the Newsletter constitutes the Content Creator's own opinions. None of the information contained in the Newsletter constitutes a recommendation that any particular security, portfolio of securities, transaction, or investment strategy is suitable for any specific person. You understand that the Content Creator is not advising, and will not advise you personally concerning the nature, potential, value or suitability of any particular security, portfolio of securities, transaction, investment strategy or other matter. To the extent any of the information contained in the Newsletter may be deemed to be investment advice, such information is impersonal and not tailored to the investment needs of any specific person. From time to time, the Content Creator or its affiliates may hold positions or other interests in securities mentioned in the Newsletter and may trade for their own accounts based on the information presented. The material in this Newsletter may not be reproduced, copied or distributed without the express written permission of Sizemore Financial Publishing LLC.