Emerging Markets Spotlight

Dollar Dynamics in Emerging Market Equities

James Syme, CFA
SENIOR FUND MANAGER

Paul Wimborne
SENIOR FUND MANAGER

Ada Chan
FUND MANAGER

KEY POINTS

- Emerging market equity asset class is highly sensitive to a strong US dollar, impacting weaker currencies and capital flows.
- The impact is particularly felt by countries running current account deficits, with emerging markets categorized into four quadrants based on their economic development paths.
- The US dollar's strength has led to policy interest rate hikes in some countries, creating challenges for East Asia and opportunities in other emerging markets.

The emerging market equity asset class is highly sensitive to a strong US dollar. This impact stems from the direct effect of weaker emerging market currencies on US dollar returns and from a broader effect where a weaker US dollar represents capital flowing from the US dollar system into the rest of the world. These factors have a powerful stimulative impact on emerging economies and their equity markets.

Within emerging markets, the effect is generally thought to positively impact those that run current account deficits, as these countries are most sensitive to capital flows. Emerging markets can typically be categorized into four quadrants based on their economic development paths:

1. Domestic demand-led commodity exporters (Latin America, South Africa)
2. Domestic demand-led commodity importers (India, Pakistan, Turkey, Philippines, Egypt)
3. Export-led commodity exporters (Saudi Arabia, UAE, Qatar)
4. Export-led commodity importers (China, Korea, Taiwan)

The first two groups have historically shown the highest sensitivity to the US dollar, for example, during the 'Taper Tantrum' in Q2 2013.

It is important, though, not to underestimate the currency sensitivities of the Asian exporters. The US is a major endpoint for exports from China, Korea and Taiwan. A strong US Dollar can reflect strong US end demand, as seen in the last few years. However, a strong US Dollar (and hence weak Asian currencies) can also raise the cost of imported materials such as commodities and components, thereby putting pressure on company profit margins. The more global competition a company faces, the stronger this pressure becomes. Further, the increased cost of imported goods puts upward pressure on inflation, leading to tighter monetary policy in East Asia. Finally, the US Dollar remains a funding currency for borrowers and capital markets, even in countries with current account surpluses. Therefore, a stronger dollar leads to some degree of financial stress.

These effects can be seen in the structure of market returns. The correlation[1] between monthly equity market returns and currency moves against the US Dollar over ten-years is 0.30 for Korea's KOSPI Index[2], 0.46 for Taiwan's TWSE Index[3] and 0.49 for the MSCI China Index[4]. In comparison, it is 0.61 for Brazil's Bovespa Index[5] and -0.10 for Japan's Nikkei 225 Index[6].

The strength of the US Dollar and pressure in bond markets led Indonesia to conduct a surprise 0.25% policy interest rate hike last month to support the Indonesian Rupiah. China, Korea and Taiwan face less pressure, but the PBoC held Chinese interest rates steady last month despite slowing credit growth. The Bank of Korea expressed 'serious concerns' about the weakness of the Korean Won. The unusual combination of higher commodity prices with a strong US Dollar increases the challenges for East Asia while creating opportunities in other emerging markets such as Brazil, Mexico, Indonesia and the UAE, all of which we are overweight.

East Asian export-led emerging markets have some protection against a stronger US Dollar, but they still ultimately remain emerging markets. With input price pressure and accelerating competition, we generally remain cautious on this group of markets. Our focus within them remains on domestic growth stories in China and global leading-edge technology exporters in Korea and Taiwan.

Source: Bloomberg/MSCI/JOHCM.

[1] Correlation is a measurement between -1 and 1, which indicates the linear relationship between two variables. If there is no relationship between two variables, the correlation coefficient is 0. If there is a perfect relationship, the correlation is 1. And if there is a perfect inverse relationship, the correlation is -1.

[2] The Korean Composite Stock Price Index (KOSPI) Index is comprised of 200 of the largest and most liquid issues traded on the Korean Stock Exchange The index is market capitalization weighted, meaning that firms with the largest market value have the greatest influence on the KOSPI's returns.

[3] The TWSE Index is a market cap-weighted benchmark to measure the aggregate performance of listed stocks on the Taiwan Stock Exchange and is compiled by the TWSE.

[4] The MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). With 703 constituents, the index covers about 85% of this China equity universe.

[5] The Bovespa Index (Ibovespa) is the main performance indicator of the stocks traded in B3, the Brazilian exchange. This market cap-weighted index includes major companies in the Brazilian capital markets that account for approximately 80% of the number of trades and financial volume on the exchange.

[6] The Nikkei 225 Index is a price-weighted equity index, which consists of 225 stocks in the Prime Market of the Tokyo Stock Exchange chosen based on liquidity and sector balance.