Emerging Markets Spotlight

Resilient US Dollar Throws Emerging Market Currencies into a Crunch

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KEY POINTS

- Investors are navigating mixed economic signals from international markets as key emerging economies experience strong corporate earnings growth amid headwinds in the US liquidity environment.
- Strong global demand and manufacturing have created strong growth potential for emerging markets like Indonesia and Brazil, as well as expanded exports in key Asian markets and the Gulf.
- Despite positive indicators, the resurgence of the US dollar is placing increased pressure on foreign currencies, reducing returns for international investors — at least for now.

As an asset class, emerging equity markets are substantially driven by two global drivers: global demand and trade, and US dollar interest rates and liquidity. Whilst individual markets possess their own business and credit cycles — and political environments — they consistently interact with the main global drivers. One of the challenges investors face is how to interpret the mixed economic signals each market is sending.

Global demand indicators look supportive for emerging markets. In many key emerging economies, manufacturing Purchasing Managers' Indexes (PMIs) continued to experience strong growth throughout June, while key Asian exporters Korea, Taiwan, and Vietnam are gaining pace in new export orders. June Manufacturing PMIs were 52.0 in Korea, 53.2 in Taiwan, and 51.1 in Mexico, with expanding exports in all three countries.

In more domestically driven emerging economies, recent PMIs were 57.5 for India (May), 52.5 for Brazil (June), and 50.7 for Indonesia (April)—all indicating growth. Consumer confidence data in these three markets also looks robust. Elsewhere, China has two PMI data series showing conflicting messages, but both sources display weaker export and domestic orders; in the Gulf, PMIs are brawny-looking, with UAE, Saudi Arabia, and Qatar rising above 54 in the index for June. So far, so good.

But there is another side to the story. This largely pertains to the enduring strength of the US dollar amid an air of caution about the future of US monetary policy. Against the DXY basket of developed market currencies, the US dollar has strengthened by 3.5% year to date, while medium- and longer-dated US government bonds have seen yields rise by about 0.4% since the start of the year.

No other major emerging market central bank has yet felt the need to follow Bank Indonesia's surprise 0.25% policy interest rate hike in June, but following the US, yield curves across EM remain higher year-to-date, and the expected timing of policy interest rate cuts in markets such as Brazil and Mexico keep being pushed further out down the line.

Meanwhile, a resurgent US dollar has increased currency pressures in emerging markets, including the Brazilian Real (-11.6% against the US dollar in the second quarter), Mexican Peso (-10.6%), and Indonesian

Rupiah (-3.3%), reducing returns to international investors. Although Mexico's recent election resulted in a landslide victory for the left-wing Morena party, the win sent the Mexican Peso briefly sinking this quarter, alongside other weakening emerging market currencies.

The strong US economy is good news for emerging market exports (and remittances) but less positive for US dollar liquidity. We continue to uncover opportunities in emerging markets where growth remains an attractive attribute (particularly corporate earnings growth), even if the current US liquidity environment is a headwind. These include Mexico, Brazil, and Indonesia — all economies that have benefited from strong upward revisions to corporate earnings expectations year-to-date.

Although local currency weaknesses have produced sluggish returns in each of these markets, we remain confident that the US dollar will continue to soften, creating the conditions to generate strong returns for investors who stay the course.

Source: Bloomberg/MSCI/JOHCM.

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