J O Hambro Capital Management Group

Emerging markets and the dollar: why not to be bearish on EM for too long

James Syme, JOHCM Global Emerging Markets Opportunities

- The US dollar and dollar liquidity is a key driver of emerging economies and capital markets;
- When the dollar is strong, as it has been since 2011, EM struggles;
- We think that investors have assumed that this is the new normal;
- Both current positioning of emerging economies and historical return patterns suggest that emerging market equities could deliver very strong returns when the dollar does roll over;
- The timing of this is uncertain, but pressure on the dollar is building;
- Investors should not stay bearish on EM equity for too long.

Introduction

'What is the most crowded trade in your asset class?' That was a recent question from a client. Our response was that the most crowded trade in EM equity is not to own any. Since the extended US dollar rally began in 2011, the consensus global trade has been to be long the dollar and dollar-related assets. This most obviously includes US treasuries in a global asset allocation; within equities that has meant being long US over non-US, and within EM equity (where held at all), it has meant being long the US-listed tech names over anything else.

This paper aims to consider the historical relationship between emerging economies/capital markets and the dollar, to look at how that relationship currently stands, and to consider the prospects for those into 2020 and beyond.

EM and the US dollar

Any discussion of 'Emerging Markets' (EM) must begin by recognising that the term has different meanings in fixed income and equity, and that the constituents of any EM index change in both membership and weighting through time. Overall, though, we can treat emerging markets as existing on a spectrum from high-savings rate/current account surplus/net saver export economies (Korea, Taiwan, China, Russia, the Gulf States, current-day Thailand) through to low-savings rate/current account deficit/net borrower economies with more of a dependence on domestic demand (South Africa, India, Turkey, Brazil, Argentina). As this is a spectrum, there is a group of countries with some characteristics of both ends, such as Indonesia, Mexico, Central Europe, Malaysia and Chile. There are also country-specific conditions that change a country's characteristics (Mexico's large remittances from overseas citizens offset the tendency to run a current account deficit; Russia's endemic capital flight undermines its large trade surplus).

Overall, though, we feel that there is plenty of evidence that EM economies and the EM equity asset class are, as a whole, dependent on capital flows. The domestic demand economies require capital inflows to finance their current account deficits, while the linkages into the export economies include their partial dependence on end-demand from emerging markets (e.g. Korean companies selling to Latin American consumers), international financing of corporate borrowing in export economies (e.g. Russian companies borrowing in dollars), and portfolio flows generally into emerging markets.

When we talk about capital flows, we mean US dollar capital flows. As Mark Carney, Governor of the Bank of England, noted at Jackson Hole in August 2019[1], the dollar represents the currency of choice for at least half of international trade invoices, around five times greater than the US's share in world goods imports, and three times its share in world exports. This gives the US dollar a massively outsized role in the global economy – Carney states that "given the widespread dominance of the dollar in cross border claims, it is not surprising that developments in the US economy, by affecting the dollar exchange rate, can have large spillover effects to the rest of the world via asset markets… **the global financial cycle is a dollar cycle** [emphasis added]." Because ample dollar liquidity means supply of dollars, and because exchange rates are just ratios of supply/demand balances, an easy proxy for global dollar liquidity is the dollar exchange rate (or, rather, all the dollar exchange rates, which can readily be assessed via the broad, trade-weighted US dollar real effective exchange rate).

[1]https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/the-growing-challenges-for-monetary-policy-speech-by-mark-carney.pdf

An EM fairy tale (with apologies to Disney)

What is the mechanism that creates this pattern? Let us consider a hypothetical emerging economy, Arendelle. Arendelle's economic development is constrained by its low savings rate, while the domestically-focused economy tends to run a current account deficit. Now, though, Arendelle faces a weakening US dollar. Global fixed-income investors look at the trend in the dollar and the attractive yields in Arendelle sovereign bonds and chase the carry from the yield spread. Capital inflows into Arendelle pick up, causing the currency (the Elsa?) to strengthen. As the Elsa strengthens, imported prices decline, driving inflation down, and allowing the Arendelle Central Bank to cut policy rates. Arendellean companies start to increase bond issuance, both driving investment in the economy and a consumption boom as banks and non-banks access wholesale funding. With economic growth picking up, tax revenues rise (improving the creditworthiness of the sovereign), while the boom attracts both equity portfolio flows and foreign direct investment. These capital inflows strengthen the Elsa further and accelerate the boom in credit, economic activity and asset prices. ArendEnergy lists GDRs in London. Arendelle Telekom is bought out by a European multinational. 'The Economist' carries a front page story headlined 'Arendelle: Frozen no more'.

This happy fairy tale ends in one of two ways. Either country-specifically, as the Arendellean current account deficit and eventual rise in inflation reach some natural limit, causing investors to baulk at further investment (being sensitive to this is a core part of our country allocation process), or globally, as the dollar starts to strengthen. Either way, the outflows from (predominantly fixed income) capital markets cause both volatility and weakness in the Elsa, at which point the logic of the Arendelle carry trade falls away. As capital flows out, yields rise, the currency falls and foreign

exchange reserves decline. Once this hits the economy, growth slows despite upward inflationary pressures, equity flows reverse, and the whole virtuous circle that worked on the way up becomes a vicious circle on the way down.

EM in the post-Bretton Woods world

To see this story in the real world, consider the history of EM and the dollar. By the late 1960s, the Vietnam War and increased social spending had pushed the US to the point where the current account deficit and inflationary pressures made holding the dollar at a fixed peg of US$35 per ounce of gold no longer achievable. The dollar was unpegged in 1971 and currencies began to float relatively freely from 1973. The 1970s were a time of both a weak US dollar and growing pools of international capital as oil exporters benefited from the high oil price. This capital sought returns, and found them in US dollar loans to emerging markets (then termed Less Developed Countries). These loans grew rapidly through the 1970s, with Brazil and Mexico the two largest borrowers.

The election of Ronald Reagan in 1980 and the appointment of the recently passed monetarist Paul Volcker to the chair of the US Federal Reserve saw US interest rates increased aggressively to beat inflation and a corresponding rise in the dollar. This rapidly placed serious stress on emerging markets that had borrowed dollars, leading to widespread defaults once Mexico had declared itself unable to service its debt in August 1982 (we will see that Latin America is historically particularly exposed to the global dollar cycle).

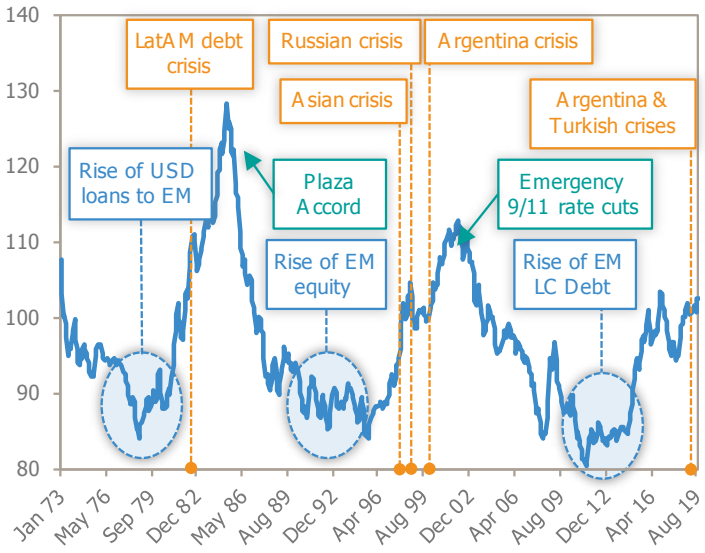
The dollar continued to strengthen until the September 1985 Plaza Accord (aimed to revalue other leading currencies against the dollar). With the late 1980s and early 1990s seeing a weak US dollar, the conditions were in place for the next round of capital flows into emerging markets. With the ends of Soviet communism and apartheid, as well as India joining the WTO, there was a huge move by international investors into emerging markets, with the equity markets particular beneficiaries. The growth of equities really represented the birth of a new asset class (the MSCI Emerging Market Index was launched in December 1987). As before, this led to economic and capital markets booms in various emerging markets, but with growing current account deficits, the vulnerability of the asset class to a stronger dollar was growing.

Once the dollar began to rally on rising US policy rates in August 1995, a series of major economic crises hit emerging markets, including Emerging Asia in 1997, Russia in 1998 (which was particularly serious in the fixed income space), Brazil and Turkey in 1999 and Argentina in 2001. These were some of the key events in the history of the emerging equity asset class, and the chaos and economic damage of those crises have significantly informed some EM policy decisions in more recent years.

The dollar topped out with the end of the tech boom and declined rapidly with the emergency post-9/11 US interest rate cuts. This set the stage for the great emerging market rally of 2002-08, with the prominence of BRICs as a leading idea in equities and the rise of EM local currency debt in fixed income. Boosted by heavy capital flows, emerging markets saw strong credit growth and economic activity, and equity and bond market returns were very, very strong. This was boosted in its last couple of years by soaring commodity prices, but was then dramatically ended by the Global Financial Crisis of 2007-09.

The GFC led to some very rapid cycles in the dollar and global liquidity, with a huge rise in the dollar from July 2008 to March 2009 as extreme risk-aversion kicked in, followed by a powerful decline from March 2009 to July 2011 as emergency policies took effect. These two periods saw, respectively, a freeze and hard landing of emerging markets, followed by a strong recovery rally. If there was a part of the emerging market asset class that was in vogue in the 2009-12 rally, it would be excessive enthusiasm in equities for the prospects for the emerging market consumer.

The history of EM and the US dollar



Source: Federal Reserve/Bloomberg as at 30 September 2019.

Which brings us to the current leg of the cycle. Since 2011, and particularly since the Fed stopped growing its balance sheet in 2014, we have seen a strong rise in the US dollar, with an accompanying tightening of global dollar liquidity. This dollar rally is in its eighth year now, and, indeed, we are again seeing signs of distress in part of the emerging world. Overall, returns on emerging equity markets have struggled, and GDP growth in the emerging world has slowed markedly, with Brazil, Russia, Indonesia, India and China all having disappointing growth environments. Meanwhile, in smaller markets there are absolutely signs of crisis. Turkey has had an economic and currency crisis, Argentina and Lebanon are in the middle of crises (and both are likely to default in the next few months), and political crises have erupted, particularly in Latin America. The broad relationship of emerging markets to the dollar remains unchanged.

The outlook for EM and the dollar

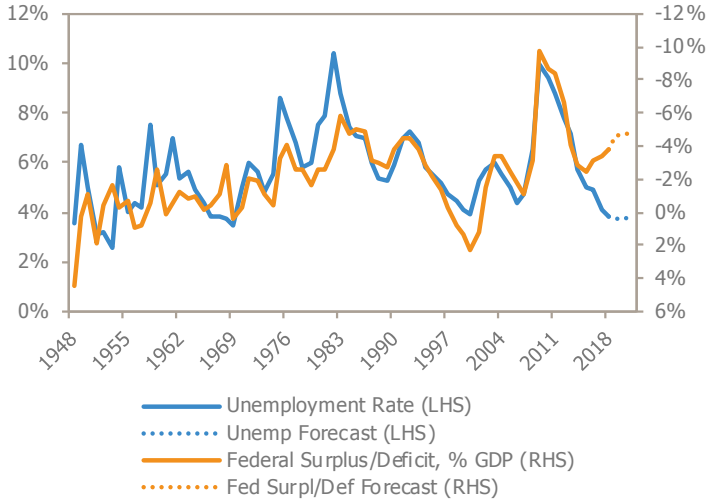
We believe that global markets may be reaching a turning point for the dollar and for global liquidity, where the extended dollar-bullish/liquidity-bearish trend reaches a peak and reverses. The timing of such a turn is uncertain, but we believe that it may well occur in 2020.

As previously mentioned, being long US treasuries has been the global consensus for asset allocation, and this is a rational cyclical investment for slower global growth. The dollar and US treasuries function as safe-havens in these times, while the continued growth surplus of the US over Europe and Japan has kept US equities as the preferred investment destination. Being long the dollar and US treasuries and equities over international and emerging markets is the most crowded trade we see. This consensus is particularly strong because the dollar rally started in 2011, and six to eight years of steady US outperformance is enough to convince the broad mass of investors that these conditions are semi-permanent.

However, we believe that this consensus cyclical investment strategy will inevitably come up against a number of structural trends, particularly the rising US budget deficit, and that these structural trends will overwhelm the cycle. We believe that a weaker US dollar is now inevitable.

As above, one of the main attractions of US assets has been the outperformance of the US economy since about 2013, but this has been significantly driven by fiscal economic stimulus. Historically, a stronger US economy has meant improved US tax revenues, reducing the size of the fiscal deficit. Right now, though, the US government is running a large and expanding fiscal deficit during a period of economic growth. Significantly, there is a parallel with the late 1960s when a similar pattern was seen ahead of the devaluation of the US dollar.

US unemployment and fiscal balance

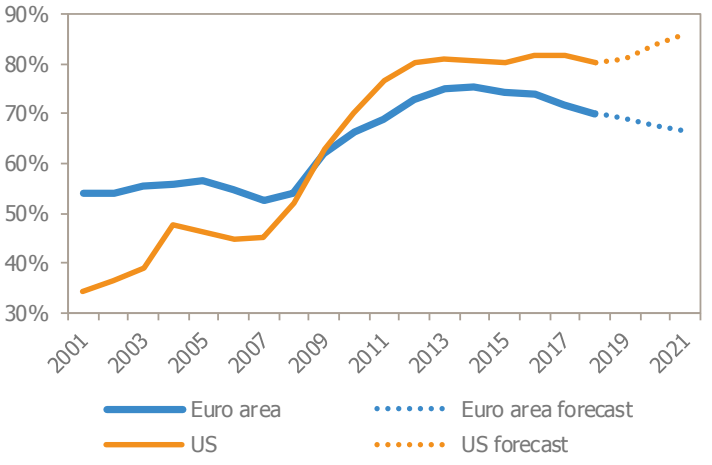


Source: Federal Reserve Bank of St. Louis (historic data), Bloomberg (forecasts). Data as at 30 November 2019.

We observed before that exchange rates are just ratios, and it is also pertinent that the eurozone has focused on austerity, led by Germany. The eurozone member countries have consistently reduced their budget deficits each year so that now, at under 1%, government debt growth approximates nominal GDP growth.

Comparing the US with the eurozone, the differential effects of deficit spending and austerity on government debt/GDP can be seen. This matters not just in terms of the trend, but also the current level, as this forms the starting point for the future. The US is about to undertake pro-cyclical fiscal stimulus (equal to about 5% of GDP) almost without precedent since WW2, and doing that from the highest starting point in terms of debt-to-GDP in the post-war period.

US and eurozone government debt/GDP



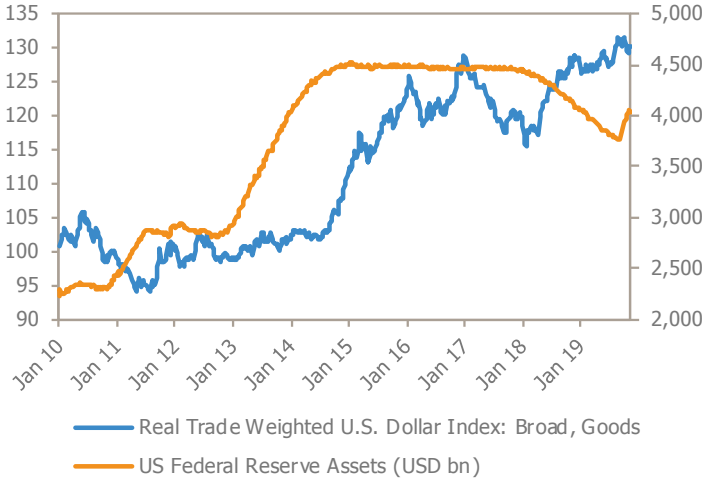
Source: IMF World Economic Outlook database, October 2019.

These differences also apply to monetary policy, which has generally been the other way round. The Bank of Japan and European Central Bank have aggressively pursued unconventional monetary policy, with zero policy interest rates and ongoing quantitative easing. The Federal Reserve has been pursuing an end to unconventional monetary policy, signalling and end to quantitative easing in 2013, actually moving for a while to quantitative tightening and hiking policy interest rates.

The currency implications of this policy divergence have been a major driver of the broad trade-weighted rally in the dollar, and the ability to fund the fiscal deficit has allowed the US to enjoy relatively strong growth at the same time as a stronger currency. The strong currency has helped increase the US current account deficit, so that the country is now running large twin deficits.

Recent history shows the importance of the changing size of the Federal Reserve balance sheet to the dollar. During the Federal Reserve's three rounds of QE, the dollar was held back, and even weakened in this period. Then, when the Fed finished QE in 2014, the trade-weighted dollar was immediately driven higher before stabilising, but was then given another upward impetus by the Fed's shift into shrinking its balance sheet (quantitative tightening, aka QT). Plainly, the most recent datapoints show the balance sheet starting to grow again, as the Fed seeks to address the funding pressures in the US dollar overnight repo market that have emerged in recent months.

Federal Reserve balance sheet and the dollar



Source: Federal Reserve Bank of St. Louis. Data as at 30 November 2019.

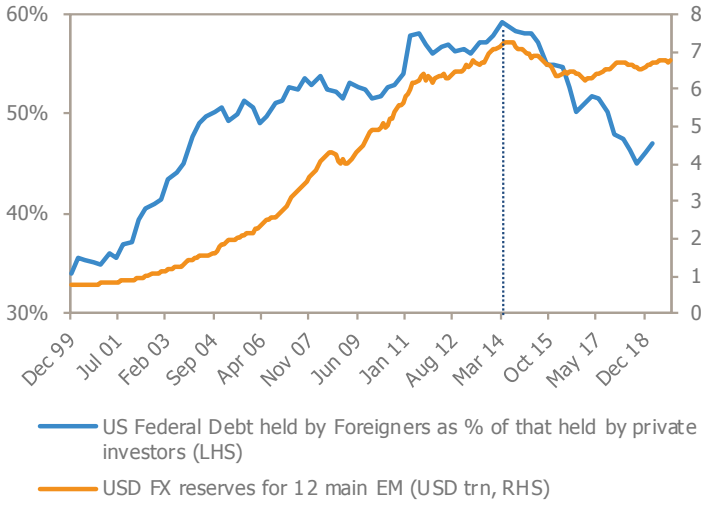
In the modern world, a country (whether developed or emerging) can manage growing twin deficits and rising debt/GDP without needing to resort to monetisation through policies such as QE, but only as long as foreign investors are willing to finance it. The history of foreign financing of US deficits shows a mixed pattern: during the two dollar bull-runs in the 1980s and since 2013, a strong dollar coincided with a steady reduction in the share of US government debt held by foreign investors – in these periods the deficits must be funded either by the US private sector or by the Federal Reserve.

The period from the mid-1990s to 2013 saw a significantly different pattern, though. The share of US government debt held by private investors rose from about 20% to over 60%, before beginning a sharp reversal that continues today. We believe that this move is tightly connected to the rise of emerging markets and their relationship with the dollar.

The emerging crises of the 1990s were genuinely traumatic for the people of those countries. As well as populations losing their bank deposits, industrial empires torn apart and mass unemployment and social dislocation, there were also regime changes, for example in Indonesia and Thailand. In the emerging world, and particularly in emerging Asia, the view was taken that a different economic model had to be adopted – one based on aggressive mercantilism, with exchange rates managed to run current account surpluses, the rapid build-up of sufficient foreign exchange reserves to prevent any repeat of balance of payments problems, and acceptance of the financial repression of domestic private sectors to achieve those policies.

An analysis of the foreign exchange reserves of key emerging markets since 2000 shows the results of this pattern. The accumulation of trillions of dollars in foreign exchange reserves by emerging economies happened alongside a huge increase in foreign ownership of the US treasuries market, and the inflection points in one matched inflection points in the other. China has been the largest buyer of treasuries; the country, of course, was not seriously affected by the Asian crisis, but the lesson was as well learned in Beijing as in Seoul or Brasilia. Within the accumulation of foreign assets, there was only one currency that mattered: the US dollar. And within the US dollar system, there was only one deeply liquid asset: US treasuries.

Foreign holding of US government debt and EM FX reserves



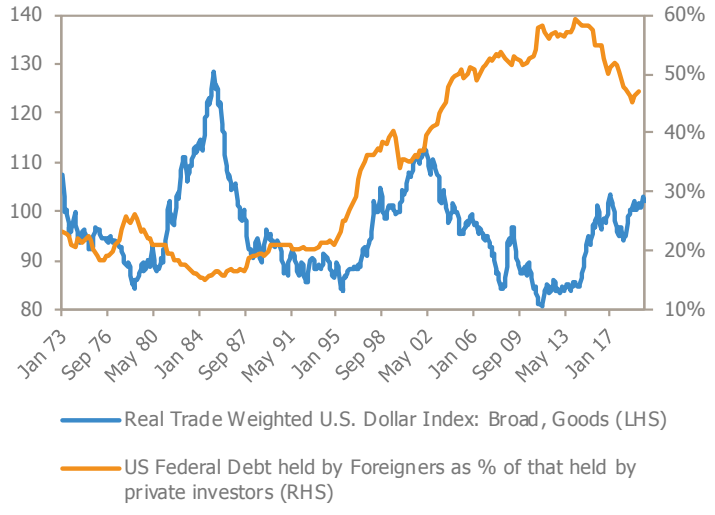
Source: Federal Reserve Bank of St. Louis, Bloomberg. FX Reserve data covers China, Hong Kong, Korea, Taiwan, Indonesia, India, Mexico, Brazil, Russia, Malaysia, Philippines and Thailand. Data as at 30 November 2019.

Country-level reporting of holdings of US treasuries varies and is heavily distorted by both international tax havens and also the widely-assumed practice by the People's Bank of China (PBoC) of booking its US treasury holdings through Belgium[2], but there is no doubt that emerging market central banks and sovereign wealth funds were significant funders of the US government during this period.

So, what changed around the year 2014, and why is foreign funding of the US deficit not assured exactly at the time that it may be needed? As US QE came to an end, the Fed hiked rates and the dollar strengthened, foreigners stopped buying US treasuries. Since 2014, almost all newly-issued US government and agency debt has been bought by domestic US private sector investors.

[2]See https://www.cfr.org/blog/few-words-chinas-holdings-us-bonds for example

Foreign holding of US government debt and the dollar



Source: Federal Reserve Bank of St. Louis (historic data), Bloomberg (forecasts). Data as at 30 November 2019.

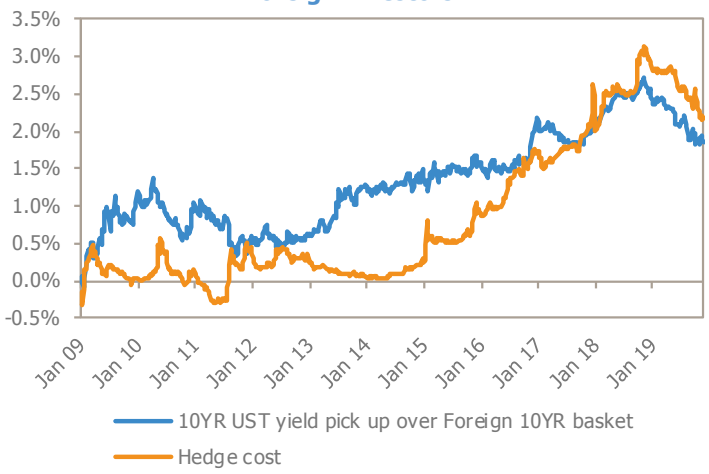
We believe that there were two main causes for the shift around the year 2014: rising hedge costs, and the effects of the weaponisation of the US dollar payments system.

In the first case, with the different monetary policy settings between the US and other major developed economies, a huge yield-based trade took place from about 2009. Global fixed income investors invested heavily in US fixed income (to take advantage of much higher yields), but many chose to hedge the currency risk involved by buying longer maturity bonds and using shorter-dated FX forwards to eliminate the exchange rate risk.

As central bank policy rates diverged, with the Fed hiking while other G10 central banks cut rates (and pursued unconventional monetary policy), the two components of the cost of hedging (covered interest rate parity and crosscurrency basis[3]) rose steadily, undermining the economic logic of the original yield trade. There was no single trigger point, but rather a steady erosion in the willingness of some international investors to buy US treasuries and thereby fund the expanding US deficit.

[3]Cross-currency basis is the extra cost of a currency hedge using a forward over and above that from covered interest rate parity (the short-end interest rate differential). The drivers of cross-currency basis are regulatory differentials, liquidity differentials, behavioural preferences and the credit risks involved in the trade.

US Treasury yield pick up and hedge cost for foreign investors[4]



Source: Bloomberg. Foreign 10 year basket is equally-weighted for EUR, CHF, GBP and JPY basis. Data as at 30 November 2019.

[4]Equally-weighted for EUR, CHF, GBP and JPY basis.

The second driver is very different. The dominant global role of the dollar is not only an economic feature, it is also a geopolitical one. As we discussed recently when reviewing Turkey, the US has an unparalleled ability to punish opponents by restricting access to the global US dollar payment system, cutting off targeted institutions in any such country from the trade and capital markets activity that are denominated in US dollars. It is the most direct expression of the 'exorbitant privilege' that the US enjoys by being the issuer of the global reserve currency.

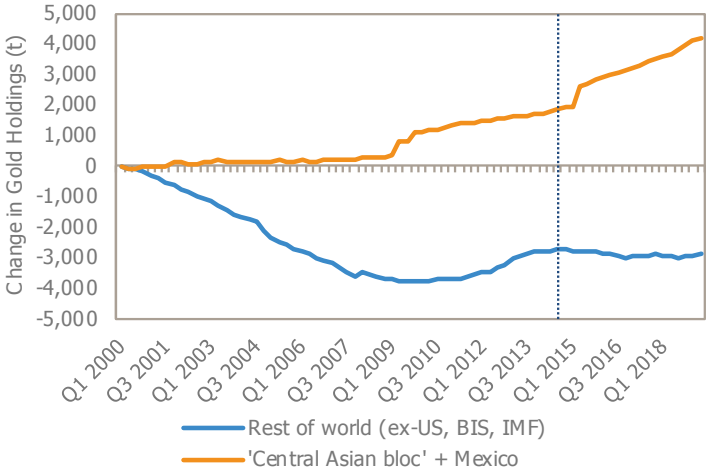
One key part of this power is the US-controlled network SWIFT (Society for Worldwide Interbank Financial Telecommunications). Launched in 1973, SWIFT lets financial institutions transmit financial transaction information securely and reliably. Nearly 12,000 financial institutions in more than 200 countries use SWIFT, allowing the US government a near-immediate and global reach in denying the dollar payments system to targeted individuals and institutions.

However, the US's ability to use the dollar as a geopolitical weapon is finite. Countries and companies use the dollar because it is convenient. As the certainty of that convenience falls, alternatives will be adopted, whether by holding reserves and deposits in gold and other currencies, or by invoicing trade in other currencies, or by building alternative banking settlement systems to SWIFT (such as Russia's SPFS, Iran's SEPAM or China's CIPS). The shift in foreign demand for US treasuries has not only been driven by the changes in the relative hedged yield offered, but also from a conscious effort to diversify reserve holdings by countries whose geopolitical ambitions clash with those of the US.

One of the clear signs of this is the changing pattern of gold holdings at central banks around the world. Overall, since the first quarter of 2009, central bank holdings of gold (excluding the Federal Reserve, the BIS and the IMF) have grown from 18.5kt to 23.2kt, but the drivers of growth have been the central banks of a group of countries clearly not in full geopolitical alignment with the US. Since 2009, the central banks of China, India, Turkey, Russia, the five Central Asian states and Mexico have increased

their gold holdings from 1.7kt to 5.9kt, whereas other central banks collectively have moved from 16.8kt to only 17.3kt. Further, the buying by the 'Central Asian bloc' (plus Mexico) shows a step up in Q1 2015, just as major international reserve holders were stepping away from buying US treasuries.

Change in gold holdings (tonnes) by central bank type



Source: World Gold Council. 'Central Asian bloc' is China, India, Turkey, Russia, Kazakhstan, Kyrgyzstan, Uzbekistan, Tajikistan and Turkmenistan. Data as at 30 November 2019.

Some of these countries have been explicit about their moves. In November 2013 the PBoC said that it was no longer in China's interest to suppress the renminbi by building foreign exchange reserves. In 2018, the Russian finance minister, Anton Siluanov, explained Russia's move to reduce its exposure to dollar-denominated securities holdings and dollar-settled trade: "the dollar is becoming a risky instrument in international settlements… We have decreased to a minimum level and will further cut our investment in the US economy, in US securities."

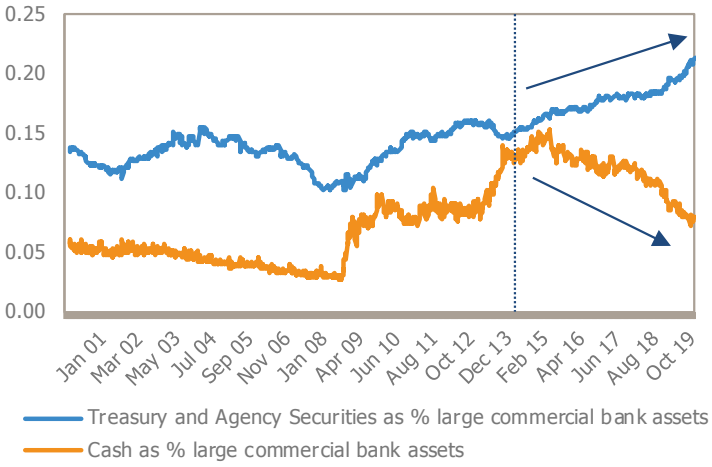
So, we have a set of conditions where the strong dollar and US geopolitical aims have choked off a significant part of the foreign demand for US treasuries, just as the risk arises that a slowing US economy weakens tax revenues and causes a jump in the size of the fiscal deficit.

Can the US private sector fund the deficit? There are two problems here. The first is that if the private sector runs a surplus to offset the government deficit, the required increase in private sectors savings implies a significant shift lower in consumption, thus bringing on a recession and a decline in tax revenues. Essentially, the US tax base is not large enough to support socially- and politically-required spending, and monetisation[5] is going to be the inevitable solution. As Twitter user @EnriqueDiazAlva suggested in October 2018[6], "[Monetisation] is coming (in the US) because people are realizing (in the US) that a civilized welfare state financed with a proper tax base is not doable under the current institutional set up (in the US) so let's crank the imperial privilege up to 1,000 instead and hope it works."

[5]Monetisation: where a government issues bonds to fund its spending commitments and the country's central bank purchases the bonds from the secondary debt markets e.g. banks holding the bonds. The central bank perpetually rolls over this debt, resulting in increased money supply.
[6]https://twitter.com/EnriqueDiazAlva/status/1186987702429929472?s=20

The second problem is that, since foreign appetite for US treasuries began to decline in about 2014, US commercial banks and money market funds have already taken on massive amounts of US government debt. The share of large bank assets held in US treasuries is at the highest level since the post-GFC reforms, while the share held in cash is at the lowest level; regulatory changes mean that the system has reached the limit. Keeping policy interest rates high can keep some ongoing demand here, but at the expense of a strong dollar and a continued drag on both the US economy and foreign demand for dollar assets.

Treasury and cash holdings as a share of large, domestically-chartered US banks



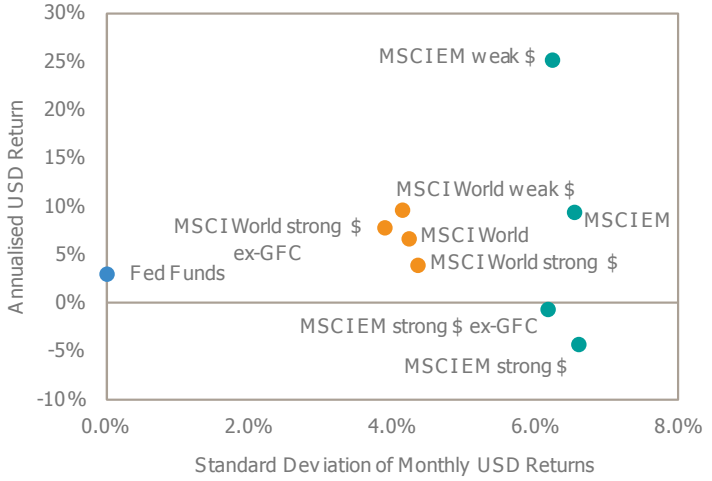
Source: Federal Reserve Bank of St. Louis. Data as at 30 November 2019.

Emerging markets in the coming dollar bear market

A weak dollar environment in coming years has the potential to deliver the stunning emerging market equity returns seen in every previous weak dollar environment, but now forgotten by an investing world with a dangerously short-term memory. We have discussed the mechanisms by which a weak dollar drives emerging economies and capital markets. Let us now look at some of the investment opportunities during previous dollar downward moves, and consider which countries might benefit the most next time around.

In a classic CAPM risk-return chart, we can see (using just over 30 years of monthly data to October 2019) that investors get paid a risk premium to hold global equities over the risk-free rate (using the Fed Funds effective rate as the risk-free rate here), and then get paid an additional risk premium to take on the extra risk of holding emerging market equities. No pain, no premium.

US dollar risk/return of MSCI EM and MSCI World in various dollar regimes



Source: Federal Reserve, Bloomberg, MSCI as at 31 October 2019. Total return indices have been inferred from price return indices for some periods. Period covered is Jan 1989 to Oct 2019.

So far, this is rational. What this data hides is that the emerging market premium varies substantially through time, and these variations are significantly correlated with the strength of the dollar. The average monthly US dollar total return of emerging markets[7] in the whole 30-year plus period is 9.5%. But if that period is divided into strong dollar and weak dollar environments[8], we see just how the EM equity risk premium is. In weak dollar environments, EM equity has returned an annualised 25.4% in dollar terms, whereas in strong dollar environments that falls to -4.3% (and -0.6% if the GFC is excluded).

[7]Source: MSCI, Bloomberg. Geometric mean of total return. Total return indices have been estimated based on MSCI price indices for some early months in this analysis.

[8]Weak dollar environments are the start of the data series in January 1989-August 1995, February 2002-July 2008 and March 2009-July 2011. Strong dollar environments are August 1995-February 2002, July 2008-March 2009 and July 2011-October 2019.

What did this look like at the time? Just before the 30-year data period starts, the abundant global liquidity following the 1985 Plaza Accord famously drove a huge bull market in Japanese equities (and real estate). Emerging equity markets did not really exist as an asset class at the time, with neither the MSCI nor IFC Emerging Market indices in operation, but the equity markets of Asian developing countries can be looked at. From the end of 1985 until the end of the first quarter of 1989, the Korean KOSPI Index rose 713%, or an annualised 90.1% in US dollar terms (this is a price index with no dividends but who's counting?). The Taiwan Stock Exchange Index (again, price only), returned an annualised 119.9% in dollar terms. The Hong Kong Hang Seng Index rose at an annualised 45% from the end of 1985 until the October 1987 crash. All of these performances represent huge outperformance of both US and broad developed market indices over those periods.

Within our 30-year period, we consistently see huge opportunities during periods of dollar weakness. In the January 1989-August 1995 period, the MSCI Latin America index returned an annualised 32.7% in dollar terms, in a period that included the Tequila crisis. The 2002-2008 rally saw Latin America return 31.7% annualised and the 2009-11 period, 37.9% annualised. In fact, in the 2002-2008 period, every market in MSCI Latin America and in MSCI EMEA, plus MSCI indices in China, India, Indonesia, Pakistan and Thailand returned over 20% annualised in dollar terms. Similarly, the bounce back after 2009, when QE is in effect, saw 13 markets compound dollar returns at over 40% per year. Without labouring the point, emerging market equities have, on multiple occasions, delivered stunning returns during periods of dollar weakness, and we think that many investors have forgotten this.

Looking at drivers rather than historical performance, we can consider which emerging equity markets might do best as and when the dollar begins its decline. To be clear, we are not absolutely not recommending that you go and buy these markets, either now or when it seems we have a weak dollar – other factors such as politics and governance, valuation and commodity exposures may be highly relevant. We are simply noting which markets have the characteristics that would attract our interest in a weak dollar environment.

The ideal emerging market for a weak dollar world has a domestically-focused equity market with a relatively low exports/GDP ratio. It has historically run a current account deficit because it is savings deficient, but the slowdown in the economy (and in the credit cycle) has suppressed the current account deficit. It has a floating currency and a liquid equity market. Its economy is focused on the dollar rather than the euro. It has not been the subject of investor enthusiasm in the last, say, five years.

This would be a good description of current day Turkey, although euro exposure there is significant. It would fit Pakistan and India, and Indonesia is a reasonable match. Brazil may have been too popular since investors began pricing in a Bolsonaro victory, and that is reflected in valuations, but Brazil is likely to be a beneficiary of a weak dollar. Mexico, too, is a popular for dollar-based carry trades. Finally, if a change in liquidity leads to last-shall-be-first type market returns, Colombia and South Africa should see the biggest improvements in their external financing conditions and could also be interesting.

What would be a bad decision in a weak dollar world? Well, based on history, the answer is "not owning EM equities", but to be more specific, the higher-savings rate, current account surplus markets and the dollar-pegged markets (Saudi, Qatar and the UAE) seem to offer lower upside, as these countries already have reasonable access to financing and are more dependent on export prices and volumes to drive growth. The historical returns from the euro-dependent markets (Czech, Poland, Hungary and Greece) are varied, but their lower dollar-dependence would also suggest they will benefit less.

Summary

One of the key drivers for emerging economies and capital markets is the US dollar, which has historically moved in reasonably long period cycles. After eight years of a strong dollar, and with the US moving to large fiscal deficits during healthy economic growth, we feel that the prospects are building for a reversal of the strong dollar. Both the current positioning of major emerging economies and historical return patterns suggest that emerging market equities could deliver substantial returns when the dollar does roll over, and yet consensus positioning in the asset class is to be heavily underweight. The timing of this is uncertain, but pressure on the US dollar is building. We think investors should need not stay bearish on EM equity for too long. If our weak dollar thesis is correct, 2020 could prove to be the year when the asset class thaws after years of being frozen.

JOHCM Global Emerging Markets Opportunities Fund
5 year discrete performance (%)

Discrete 12 month performance (%):

	31.12.19	31.12.18	31.12.17	31.12.16	31.12.15
A GBP Class	11.48	-9.82	28.23	26.34	-4.41
Benchmark	14.44	-9.57	25.15	34.03	-10.61
Relative return	-2.59	-0.28	2.46	-5.74	6.94

Source: JOHCM/MSCI Barra/Bloomberg, NAV of Share Class A in GBP, net income reinvested, net of fees as at 31 December 2019. The A GBP Class was launched on 30 June 2011. Benchmark: MSCI Emerging Markets NR (12pm adjusted). Performance of other share classes may vary and is available on request.