J O Hambro
Capital Management Group

News

Carry On Trading

The sharp unwinding of the yen-dollar carry trade hurts some emerging markets, helps others

James Syme

Paul Wimborne

Ada Chan

09 Aug 2024

July (and the early days of August, up until this piece was written) has seen significant volatility in global financial markets, including emerging markets. The main cause of this is a combination of softer US economic data coinciding with an increase in policy interest rates in Japan. This has led to multiple dislocations in fixed interest and currency markets, as carry trades (funding in a low-yielding currency to invest in a higher-yielding currency) were aggressively unwound, in turn causing a rapid risk-off move across most global financial markets.

In the emerging markets space, this has particularly meant that the segments of markets with the highest exposure to international investors have seen the most volatility and weakness. In emerging market equities, the pain has been concentrated in the information technology sector and in Korea and Taiwan; in currencies, the high-yielding Brazilian real and Mexican peso have seen the sharpest sell-offs.

The key question about these adjustments is: what happens next?

We find it hard to be overly positive about the information technology sector despite the reset in valuations from the market weakness. The entire sector has re-rated substantially in recent years despite essentially soft demand in key end-demand segments such as PCs and mobile phones. This optimism has been attributed to the potential demand shift from widespread adoption of generative AI, but beyond some key semiconductor names held in the portfolio, we have not seen sufficient evidence of this opportunity. From a country view, this translates into ongoing caution towards Korean and Taiwanese equities.

In emerging Asia, some economies have failed to fully close the output gap that the COVID slowdowns created. This has been accompanied by undershoots in inflation and core inflation, but local central banks have been unable to respond with interest rate cuts as they have faced stubbornly high US bond yields and interest rates and a stronger US Dollar. If the Federal Reserve is to move to reducing policy interest rates, emerging Asian central banks can respond more directly to domestic growth and inflation conditions.

Some Emerging Asian central banks have locally-specific issues that may constrain this effect, notably the Bank of Korea's concerns regarding household leverage and the Reserve Bank of India's worries about the growth of unsecured lending. However, we see output gaps, low core inflation, and concerns about currency weakness in both Indonesia and China, and both of these markets, which are held as overweight positions in the portfolio, could see significant monetary stimulus in the next few quarters.

The other markets which look well placed in the medium term are Mexico and Brazil. Firstly, despite the currency weakness caused by market volatility, the interest rate gaps that drove bond market inflows remain and a period of market stability is likely to see a resumption of inflows. Secondly, we believe that the Peso and the Real went into the sell-off with some challenges from weaker export revenues, but in no sense overvalued. Mexico had a trailing current account surplus in the first quarter of 2024, while Brazil's trailing deficit to June was only 1.4% of GDP, small by historical standards. Thirdly, real interest rates in both countries remain very high compared to historical levels, with US rates and yields the dominant constraint on cuts. The faster the Federal Reserve moves to cuts, the faster Banxico and the Brazil Central Bank can follow, which should be highly stimulative for both economies.

Global markets have been challenging, but we believe that the fallout is ultimately positive for emerging equity markets and particularly positive for the markets we hold as overweight positions in the portfolio.

Disclaimer

Professional investors only. This is a marketing communication. Please refer to the fund prospectus and to the KIID / KID before making any final investment decisions. The investment promoted concerns the acquisition of shares in a fund or the investment strategy and not the underlying assets. Past performance is no guarantee of future performance. The value of an investment and the income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested. The information contained herein including any expression of opinion is for information purposes only and is given on the understanding that it is not a recommendation. The information in this article does not constitute, or form part of, any offer to sell or issue, or any solicitation of an offer to purchase or subscribe for any funds or strategies described in this article; nor shall this article, or any part of it, or the fact of its distribution form the basis of, or be relied on, in connection with any contract.

Related Articles

It's the Dollar, Stupid

The strength of the US dollar has impacted emerging market currencies, delayed expected interest rate cuts and reduced returns to international investors

Read More

08 July 2024

Remember Remittances

Remittances have been the largest source of external finance flows to developing countries ex-China

Read More

04 June 2024

Double Dollar

The dollar is stronger than it's been in 20 years. What's the impact on emerging markets?

Read More

09 May 2024

Legal

This website is issued and approved in the UK by J O Hambro Capital Management Limited, which is authorised and regulated by the Financial Conduct Authority. Registered office: Level 3, 1 St James's Market, London SW1Y 4AH. Registered in England and Wales under No: 2176004. Issued in the European Union by JOHCM Funds (Ireland) Limited which is authorised by the Central Bank of Ireland. Registered office: Riverside One, Sir John Rogerson's Quay, Dublin 2, Ireland. J O Hambro is a registered trademark owned by and used under licence from Barnham Broom Holdings Limited. JOHCM® is owned by J O Hambro Capital Management Limited. Telephone calls may be recorded.

© 2022 J O Hambro Capital Management Limited.All rights reserved.