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Capital Management Group

News

Double Dollar

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



James Syme Paul Wimborne Ada Chan

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The emerging market equity asset class is highly sensitive to a strong US dollar. This occurs both through 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, where it has a powerful stimulative effect on both emerging economies and their equity markets.

Within emerging markets, the effect is generally thought to have a more positive effect on emerging markets that run current account deficits, as these countries are most sensitive to capital flows. Emerging markets can generally be thought of as existing in four quadrants in terms of their economic development paths: domestic demand-led commodity exporters (Latin America, South Africa); domestic demand-led commodity importers (India, Pakistan, Turkey, Philippines, Egypt); export-led commodity exporters (Saudi Arabia, UAE, Qatar); and export-led commodity importers (China, Korea, Taiwan). It is the first two groups that have historically had the highest sensitivity to the US dollar, for example, during the 'Taper Tantrum' in Q2 2013.

It is important, though, to not underestimate the currency sensitivities of the Asian exporters. The US is a major endpoint for exports from China, Korea and Taiwan, and 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 push up the cost of imported inputs (like commodities and components), putting pressure on company profit margins. The more global competition a company faces, the stronger this pressure becomes. Further, the increase in the 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, so a stronger dollar leads to some degree of financial stress.

These effects can be seen in the structure of market returns. The ten-year correlation of monthly equity market returns to currency moves against the US Dollar is 0.30 for Korea's KOSPI Index, 0.46 for Taiwan's TWSE Index and 0.49 for the MSCI China Index (compared to 0.61 for Brazil's Bovespa Index and -0.10 for Japan's Nikkei 225 Index).

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, while 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 (and creates 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, and our focus within them remains on domestic growth stories in China and global leading-edge technology exporters in Korea and Taiwan.

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