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News

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

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As an asset class, emerging equity markets are substantially driven by two broad global drivers: global end-demand and trade, and US dollar interest rates and liquidity. While individual markets will have their own business and credit cycles and political environments, these are always interacting with the main global drivers. One of the challenges for investors in the asset class at the present time is the differing signals these are sending.

Indicators of global demand look supportive for emerging markets. In many key emerging countries, manufacturing PMIs continued to look strong in June, while key Asian exporters Korea, Taiwan and Vietnam are seeing strength in new export orders. June Manufacturing PMIs were 52.0 in Korea, 53.2 in Taiwan and 51.1 in Mexico, with exports growing in all three countries.

In the more domestically-driven emerging economies, recent PMIs were 57.5 for India (May), 52.5 for Brazil (June) and 50.7 for Indonesia (June), all indicating growth. Consumer confidence data in these three markets also looks robust. Elsewhere, China has two PMI data series with some conflicting messages, but both measures show weaker export and domestic orders; in the Gulf, PMIs look very strong, with UAE, Saudi Arabia and Qatar all above 54 for June.

So far so good, but the other half of the story is about the continuing strength of the US dollar and caution about the future direction 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 seen 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 like Brazil and Mexico keeps being pushed out.

Meanwhile, the stronger US dollar has seen corresponding weakness in emerging market currencies like the Brazilian Real (-11.6% against the US dollar in the second quarter), Mexican Peso (-10.6%) and Indonesian Rupiah (-3.3%), which reduces returns to international investors. Although Mexico saw a surprisingly strong election win for the left-wing Morena party in the quarter, the Mexican Peso weakened alongside other similar emerging market currencies.

The strong US economy is good for emerging market exports (and remittances) but less good for US dollar liquidity. In the current environment, we continue to find opportunities in some emerging markets where growth (particularly corporate earnings growth) remains attractive, even if the current US liquidity environment is a headwind. These particularly include Mexico, Brazil and Indonesia - each of these has seen strong upward revisions to corporate earnings expectations year-to-date. Although local currency weakness has been a drag on returns in each of these, we remain confident that US dollar softness, when it comes, will create the conditions for strong returns from these markets.

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