

Emerging Markets Cash - What happens when the dollar turns?

May 2008 - Author: Lewis Jones, Research Analyst

The past twelve months have seen a very rapid appreciation of the euro versus the US dollar as the effects of the sub-prime crisis and the subsequent Fed cuts led investors to sell dollars. However, with a weakening economic outlook in Europe and a possible narrowing of the spread between Fed and European Central Bank rates, the dollar is showing signs of reversing this trend. In an extreme case, we could see the euro giving up all of the appreciation seen over the past year (13.9% as at 30-Apr-08).

The following questions arise from this scenario which we will attempt to address in this paper:

- 👑 Will any potential dollar strength be in euro terms only or does it have wider implications for emerging markets?
- 👑 Which countries should benefit and which are most susceptible to downside risk?
- 👑 How will a strong dollar affect returns in emerging markets cash?

How does “Dollar Strength” impact Emerging Markets?

There is little doubt that dollar weakness against the euro has indirectly led to an increased rate of appreciation in a number of currencies recently. Rising commodity prices in dollar terms provided a boost to Latin American exporters and Eastern Europe rose with the euro. Indeed, in the first quarter this year, this latter group of currencies came in as top performers as they tracked the 7% gains in euro.

This was not an entirely one way bet however, as high dollar prices for energy and food have driven inflation levels higher in Asia and put strains on the finances of countries subsidising these products. In addition, price increases for imports of steel and manufacturing equipment in Asian countries is quite negative overall given the huge investment in infrastructure needed.

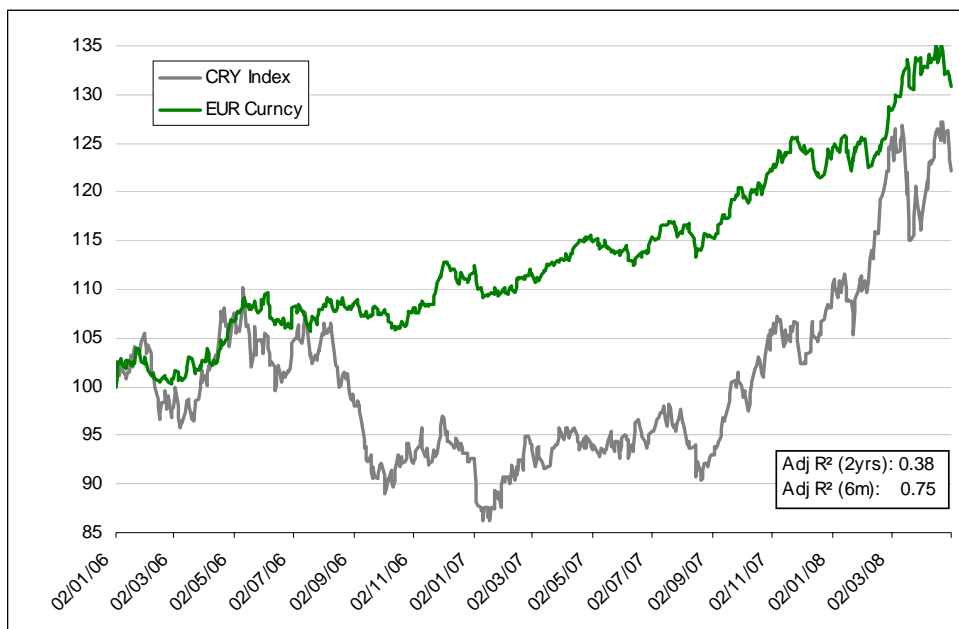
Given that much of the growth in Emerging Markets has been driven by exports and developed capital inflows, it shouldn't be a surprise that a strong dollar will have wide reaching effects on these countries.

Where are the winners and losers?

So should the dollar strengthen significantly, we would expect to see a partial reversal of these trends. Eastern Europe seems the most vulnerable, lacking the large foreign exchange reserves and strong fiscal balance sheets of most of Latin America. As the euro forms the largest part of the basket these currencies are managed against, any losses would be nearly fully passed through, with idiosyncratic risk factors magnifying or softening the resulting loss at the country level.

In Latin America, the effect will be felt through softening commodity prices. As Chart 1 below shows, much of the recent rise in commodity pricing can be seen as an effect of a falling dollar. This relationship has been statistically significant historically but is overshadowed by supply and demand factors in the medium to long term. Over the past six months however, the effect is much more pronounced with variation in the euro explaining 75% of the variation in a broad commodities index. This indirectly affects Latin America exporters through a weakening trade balance but the result in terms of currency losses is far less certain. Firstly, the majority of countries in the region will still post trade surpluses as they have a large cushion. Secondly, foreign direct investment and portfolio flows attracted to the high risk adjusted returns available will sustain currency demand.

Chart 1: RJ/CRB Commodity Price Index vs EUR Index



Source: Bloomberg

Offsetting these potential losses are the Asian currencies. As noted above, the fall in the dollar has been problematic for policy makers in the region. This is most pronounced in countries that maintain a stricter dollar peg such as Hong Kong and Vietnam, but is also felt in others where the central bank targets a steady rate of appreciation against the dollar such as in China and Malaysia. The primary tools to carry out these policies are keeping interest rates low and sterilising capital inflows. Overuse of both leads to rapid money supply growth, rising yields on domestic bonds and inflation. While the China's fiscal balance sheet might be able to handle this pressure for the time being, the region as a whole is facing civil unrest from food prices and budgetary pressures from subsidising necessities. A strengthening dollar should help ease these pressures somewhat.

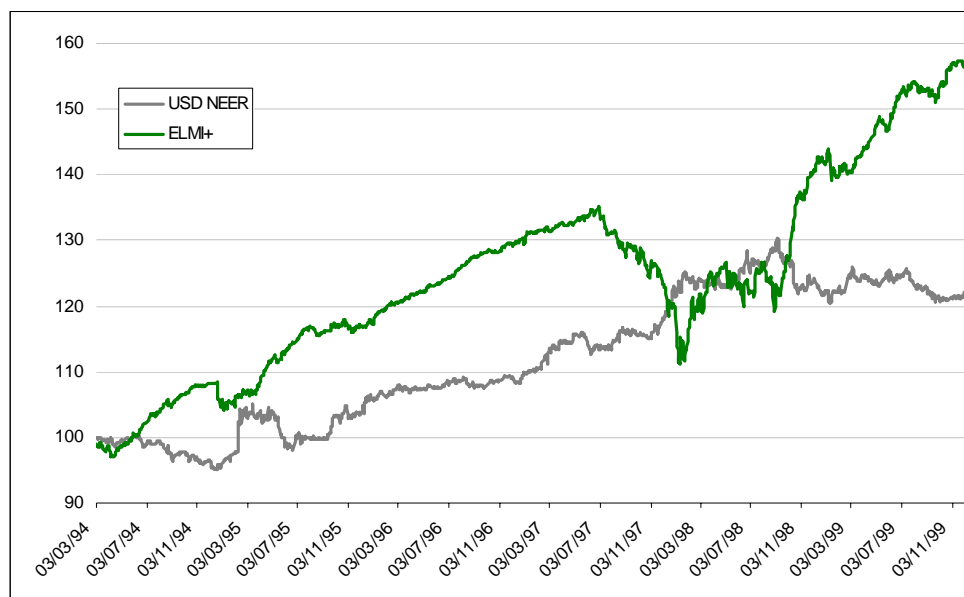
The Effect on the Emerging Markets Cash Asset Class

The overall result of these asymmetric effects on emerging markets cash can be observed by proxy in JP Morgan’s Emerging Local Markets Index Plus (ELMI+), which tracks the money markets of a broad range of Emerging Market countries. To compare, we look back to a prior period of dollar strength against a trade weighted basket of currencies, represented by the Nominal Effective Exchange Rate, and compare to the cash index.

For much of the period shown on Chart 2 below, both the dollar and Emerging Markets cash were showing positive performance. While this may seem somewhat counter intuitive it should be noted that the trade weighted basket is dominated by developed markets so most of the appreciation shown would have been against the G7 countries. In addition, although there are many other factors that influence the index returns, a large part of the dollar appreciation is negated by the higher interest rates available in Emerging Markets.

The relationship breaks down in 1997 with the Asian crisis as we would expect. It was also during this period that the trend strength in the dollar begins to taper off and has reverted to 1994 levels since then. However, by 1999 the cash index was back on its previous trend appreciation path.

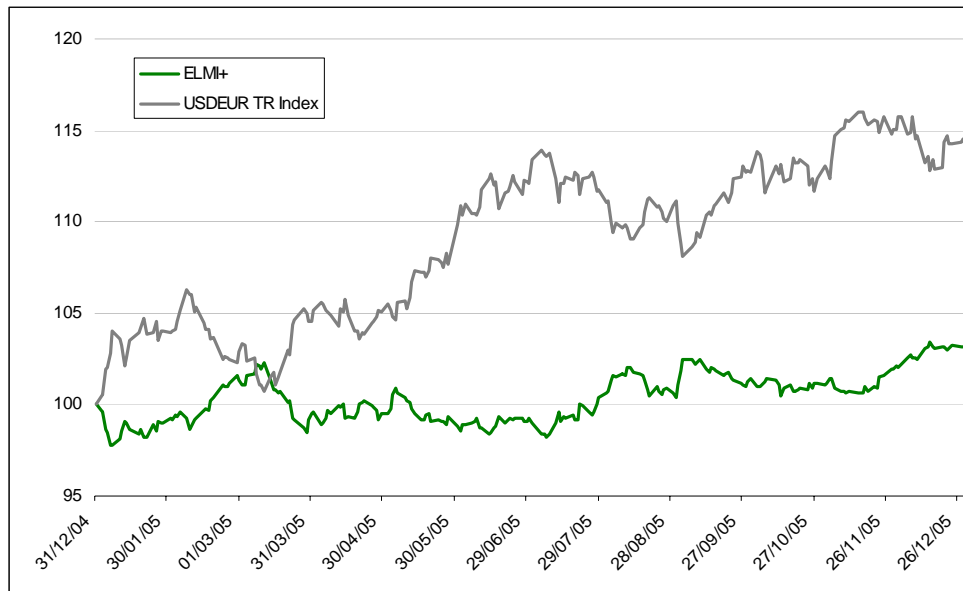
Chart 2: US Nominal Effective Exchange Rate vs ELMI+ (31-Dec-93 to 31-Dec-99)



Source: JP Morgan, Bloomberg

2005 is also a useful period to observe as the dollar strengthened against the euro by 14.5% whereas ELMI+ finished the year up a meagre 3.2%. There was also a lot of regional variation in total returns as we would expect, ranging from a high of 15.4% in Latin America, to -3.3% in the Middle East & Africa.

Chart 3: JP Morgan ELMI+ vs EUR (31-Dec-04 to 31-Dec-05)



Source: JP Morgan, Bloomberg

While the index provided the level of diversification necessary to avoid suffering principal losses, fundamental active management could have captured fairly large gains in both absolute and relative terms while the dollar was steadily appreciating over the year. The conclusion that can be drawn from this analysis is that a strong dollar isn't necessarily a bad thing for Emerging Markets cash. Although currency appreciation would be depressed, the high interest rates available and low regional correlations reinforce the attractiveness of the asset class.