Global Insights

Emerging Markets Are Less Sensitive to Dollar Strength Than You Might Think

In our Feb. 23 Global Insights, “Will Emerging Markets Face a Tight Squeeze?” we looked at the past four Federal Reserve tightening cycles and found that the US dollar often appreciated ahead of the first rate hike and declined 4.5%, on average, in the nine months that followed.

Since that publication, the dollar has benefited from disjointed or contradictory actions by global central banks like the European Central Bank and Bank of Japan, slower growth in China, armed conflict in Europe and rising odds of a global recession. Already, the US Dollar Index has risen nearly two standard deviations above its 30-year average.

Historically, a strong dollar has sparked an emerging market selloff while benefiting developed markets, as investors have sought to position more defensively amid tighter financial conditions. This trend appears to have broken down, and investors should beware of conventional wisdom suggesting that developed markets will be more resilient in the face of a stronger greenback.

This edition of Global Insights considers the strength of developed markets relative to emerging markets notwithstanding a significantly stronger dollar.
The US dollar’s recent rise has garnered a lot of attention. The Federal Reserve was slow to recognize how persistent price pressures would be and, as a result, is now facing the highest rate of inflation in over 40 years. Since last year, Fed officials have adopted a more hawkish tone, fearful that inflation expectations may become unanchored. Amid growing signs that they were behind the curve, officials implemented a 75 basis point hike in the federal funds rate—the largest of that magnitude since November 1994—last month.

Since then, five-year, five-year forward inflation expectations—a measure of expected inflation over the five-year period beginning five years from now—have declined nearly 30 basis points. On the surface, it suggests that investors are getting comfortable with the idea that policymakers will act decisively to ensure longer-term price stability (see Exhibit 1).

Fed tightening in response to high inflation has strengthened the US dollar. The logic behind this relationship is straightforward. All else equal, as fed funds increase, rates in other parts of the economy tend to rise as well, thereby attracting capital from foreign investors seeking higher returns on interest-bearing securities. These investors are more likely to sell their local currencies to buy more dollars, which in turn tends to bolster the dollar.

Typically, the US dollar strengthens ahead of the first rate hike. In our Feb. 23 Global Insights, “Will Emerging Markets Face a Tight Squeeze?” we looked at the past four Fed tightening cycles and found that the dollar generally appreciated ahead of the first hike and declined 4.5%, on average, in the nine months that followed. This time, however, once the greenback turned higher, it did not look back. In fact, the US Dollar Index has risen 12% on the year—to a level nearly two standard deviations above its 30-year average level.

The reversal from previously established trends has several potential drivers. First, disjointed monetary policy, such as in the case of the European Central Bank (ECB), and even contradictory monetary policy, as in the case of the Bank of Japan (BOJ), have complicated matters. In fact, the magnitude of the Fed’s monetary pivot versus other major central banks is what drove dollar strength in the first half of the year. Unsurprisingly, both the euro and the yen, which together account for 70% of the US Dollar Index, have tumbled to two-decade lows versus the dollar so far this year (see Exhibit 2).

Second, since the Fed began increasing short-term rates for the first time since 2018, growth has slowed considerably, boosting the odds for recession in the near term. Alongside the prolonged conflict between Russia and Ukraine, and given the greenback’s countercyclical attributes, this has contributed to a strong bid for the dollar.

Finally, ongoing market volatility and downbeat sentiment have prompted investors to shift toward safe-haven assets. In fact, Commodity Futures Trading Commission (CFTC) data reflects increased US dollar bullishness. Currently, net long positioning in US dollar futures contracts stands at the 75th percentile for the last 20 years (see Exhibit 3). What’s more, net longs as a percent of total contracts are greater than those for gold or US Treasuries—assets also known to hold or increase value during times of economic or market stress.
Exhibit 3: Speculative Dollar Bets Have Steadied but Remain Bullish

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of July 12, 2022

On the surface, developed market corporations should benefit from a rising US dollar. According to data from FactSet, the MSCI EAFE Index (developed markets) derives 19% of its revenues from the US—more than from any other country. That means the dollar’s jump should make foreign goods more attractive to US consumers and boost revenue at companies that benefit from favorable currency exchange rates. On the other hand, the MSCI EM Index (emerging markets) derives only 9% of its revenue from the US and should therefore benefit less.

Although the US Dollar Index has not yet reached the eye-watering levels of the early 2000s, our analysis suggests that when it has traded above 100, developed market equities, on average, have outperformed emerging market equities (see Exhibit 4). In fact, Japanese and European outperformance of emerging markets when the dollar is strong has been notable.

Exhibit 4: A Strong Dollar Has Historically Supported Developed Market Outperformance of Emerging Markets

Note: Performance period is Jan. 1990 to June 2022.
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 30, 2022

This relationship played out from 1990 to 2014, as the ratio of developed market equities to emerging markets generally tracked the dollar. When the dollar strengthened, developed markets outperformed, and when the dollar weakened, emerging markets benefited. However, since 2014, that relationship appears to have broken down (see Exhibit 5).

Exhibit 5: The Historical Relationship Between Dollar Strength and Developed Market Equities Has Recently Broken Down

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of July 14, 2022

This may stem from a variety of factors. First, emerging markets have become less commodity oriented and therefore less dependent on the dollar. Over the years, emerging markets have moved away from “old economy” sectors tied to manufacturing and toward “new economy” sectors, which are more domestically oriented. For starters, the energy and materials sectors’ contribution to the MSCI Emerging Markets Index has declined nearly 20% since the Great Financial Crisis. Moreover, the index’s allocation to the technology and consumer discretionary sectors has risen by almost the same amount. In fact, sector weights in emerging markets are currently closer to those of developed markets than conventional wisdom implies (see Exhibit 6).
Second, US dollar debt servicing has become less onerous for emerging economies. Prior to mid-2010, emerging market countries relied heavily on external financing—particularly dollar-denominated debt, given its role as a funding currency for about half of all cross-border loans. Issuing debt in dollars exposes emerging markets to foreign exchange risk because, as local currencies decline against the dollar, servicing dollar-denominated debt becomes more difficult. However, an uptick in bonds denominated in local currencies, along with relatively more stable currency markets (see Exhibit 8), has made emerging economies less vulnerable to dollar swings.

Finally, since 2014, more stable relative growth (see Exhibit 7) and balance sheet improvement have benefited emerging markets. According to the Columbia University Journal of International Affairs, foreign exchange reserves for countries in the JP Morgan Emerging Markets Bond Index, ex-China, have increased from less than $500 billion in 1995 to almost $6 trillion. In essence, balance sheet improvement and more stable relative growth have provided emerging markets with a buffer from the rising dollar, removing the advantage that developed markets have historically held over developing economies.

Investment Implications

The strength of the US dollar could persist for some time. Disjointed or contradictory actions by global central banks like the ECB and BOJ, slower growth in China, armed conflict in Europe and rising odds of a global recession are supporting dollar strength.

Historically, during periods of global stress, investors have shunned the volatility of emerging markets for the perceived safety of developed markets. This time, however, developed markets have proven less defensive. Given significant foreign exchange war chests, reduced dependence on commodities and declining reliance on dollar-denominated financing, emerging markets have demonstrated that they can hold up as well as developed markets.

Investors should beware of conventional wisdom suggesting that developed markets are more resilient in the face of a stronger dollar. It is vital to note that emerging markets are not monolithic, and nuances are important. As such, we prefer active managers and recommend that investors focus on high-quality companies with diverse revenue streams that are equipped to navigate inflationary pressures. Be wary of countries with abnormally high dollar debt balances and low foreign exchange reserves.
Global Insights

Charts You Can't Miss

Exhibit 8: Emerging Market Currencies Are Becoming Less Volatile

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of July 23, 2022

Exhibit 9: Global Inflation Has Accelerated Rapidly and Threatens Prospects for Price Stability

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of July 22, 2022

Exhibit 10: US Looks Expensive Relative to Europe on a Forward P/E Basis


Exhibit 11: European Small-Cap Companies Have Underperformed Large-Cap Companies During Periods of Dollar Strength

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of July 21, 2022
Current Readings From Our Quantitative Framework

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Levels

- Favorable
- Neutral
- Unfavorable

Changes

- Improving
- Unchanged
- Deteriorating


Ongoing Development Spotlight

US consumer prices jumped 9.1% in June—the largest 12-month increase in over four decades. Since then, energy prices have moderated. However, we are not convinced that inflation pressures will ease quickly. In fact, we see evidence that prices could remain elevated for some time. Shelter and medical care services inflation, which taken together are nearly 40% of the Consumer Price Index, are on the rise. These components of inflation tend to be sticky—slow to rise and slow to fall—and could force the Federal Reserve to remain hawkish for longer than anticipated. –Brad Fulton

Exhibit 12: The Drivers of Inflation Are Broadening

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 30, 2022
GLOBAL INSIGHTS

Disclosure Section

Index Definitions

JP MORGAN EMERGING MARKET CURRENCY VOLATILITY INDEX measures the implied volatility in emerging markets currencies.

JP MORGAN G7 CURRENCY VOLATILITY INDEX measures the implied volatility in G7 currencies.

BLOOMBERG WORLD ECONOMY WEIGHTED INFLATION INDEX is a calculation based on the most recent CPI year-over-year reading for each country and its corresponding weight in global GDP on a purchasing power parity basis.

MSCI EUROPE SMALL CAP INDEX tracks the investment results of an index composed of small-capitalization developed market equities in Europe.

MSCI EUROPE INDEX captures large and mid cap representation across 15 developed markets countries in Europe.

For other index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealthinvestmentsolutions/wmir-definitions

Glossary

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Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. Investing in currency involves additional special risks such as credit, interest rate fluctuations, derivative investment risk, and domestic and foreign inflation rates, which can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions. In addition, international investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets and frontier markets, since these countries may have relatively unstable governments and less established markets and economies. Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Treasury Inflation Protection Securities’ (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention. Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies. Technology stocks may be especially volatile. Risks applicable to companies in the energy and natural resources sectors include commodity pricing risk, supply and demand risk, depletion risk and exploration risk. Health care sector stocks are subject to government
regulation, as well as government approval of products and services, which can significantly impact price and availability, and which can also be significantly affected by rapid obsolescence and patent expirations.

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Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

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