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Emerging Markets Spotlight

One of the main drivers of global financial markets in 2022 has been the strength of the US dollar (and the weakness of other global currencies), driven by tightening US financial conditions. The dollar is the preferred currency for international trade invoices and cross-border financial claims. The global financial cycle is essentially a dollar cycle, and an aggressively tightening Federal Reserve has a chilling effect on non-US economies and non-US financial markets.

Emerging markets can generally be divided into two broad groups: net exporters that tend to run current account surpluses (such as China, Korea and Taiwan, but also UAE and Saudi Arabia), and net importers that tend to run current account deficits (such as Brazil, Mexico, South Africa and India). Broadly, history has seen that the first group have high sensitivity to global growth and the second to global financial liquidity. As such, it has normally been the second group that has the worst currency and equity market performance in strong dollar/tight liquidity environments. In 2013, the Federal Reserve announced an intention to reduce the buying of US Treasuries, and the hardest-hit emerging markets were Brazil, India, Indonesia, South Africa and Turkey, dubbed the 'fragile five' by one market participant.

2022 has decidedly not followed this pattern. In the first nine months of 2022, the only major EM currencies to strengthen against the dollar were the Brazilian real and the Mexican peso. The Indian rupee and Indonesian rupiah were also relatively strong, declining 6.8% and 9.4% respectively. By comparison, the Korean won fell 20.4%, the Taiwanese dollar 14.7% and the Chinese renminbi 12.0%, despite those economies running large current account surpluses. This pattern is very interesting and points to a real change in leadership within the asset class.

We have previously commented on the positive effect that high commodity prices have on commodity economies like Brazil and, to a lesser extent, Mexico and Indonesia. This continues to play out in economic data – latest Purchasing Managers' Index (PMI) surveys are 51.1 in Brazil and 47.3 in Korea, for example.

The explanation is that there are other drivers at play. One is the Japanese yen. With ongoing monetisation of debt and low inflation, Japanese monetary policy remains very loose, leading to a 25.8% depreciation of the yen against the dollar year-to-date. Given the tight trade relationships between the four large East Asian economies (both as partners and as competitors), this has put significant downward pressure on the currencies of China, Korea and Taiwan.

Another driver is energy balances. The huge moves in oil, gas and coal prices in the last two years have been a boost for energy exporters (or large consumers who also have large domestic production). The value of Indonesia's exports of oil and gas in the last three months were $4.6bn USD, compared with $3.0bn USD for the same period in 2019; by comparison, the cost of Korea's crude oil imports in the third quarter of 2022 was $31bn USD, compared to $17bn USD in the third quarter of 2019. At a broad regional level, North America and the Arab Gulf are in extremely strong positions, while Europe and East Asia face a powerful drag on their external balances and their growth.

Although all four East Asian economies have very substantial ability to use their large foreign exchange reserves to support their currencies, their desire to support exports has meant this has been limited. Japan did intervene last month, but the ongoing economic weakness in both China and Japan mean that major intervention is unlikely. By comparison, both India and Indonesia have intervened, supporting their currencies, reducing imported inflation and facilitating economic growth.

We think that 2022 is a sign of a change in market leadership in emerging markets, with the markets that might be expected to underperform instead being the best performers, and believe that can continue with either a stronger or weaker US dollar.

Source for all data JOHCM/Bloomberg (unless otherwise stated)