JOHCM Funds

Emerging Markets Spotlight

James Syme
Senior Fund Manager

Paul Wimborne
Senior Fund Manager

Ada Chan
Fund Manager

Emerging Markets Ride Currency Waves

Explore the correlation between currency dynamics, equity market moves, and economic factors to help capitalize on emerging market opportunities.

KEY POINTS

- There have been several drivers of currency support for equity returns lifting our confidence in the markets where our portfolio is overweight.
- We have seen favorable conditions for carry trade investors funding in US dollars and investing in emerging market rates and bond markets.
- Trade fundamentals, both in terms of prices and goods flows, look extremely supportive.
- Attractive economic conditions and strong commitment to monetary orthodoxy attract increasing capital flows from global carry-trade investors.

July 2023 | James Syme

One of the strongest arguments for employing a top-down, country-level approach to EM equity investing (as we do) is the role of currencies in returns and the variance of returns. Emerging market currencies are typically more volatile than developed market currencies. Additionally, currency in emerging markets are typically correlated with equity market moves and economic conditions.

This approach has worked well in the first half of 2023, with some major emerging markets (from the higher beta, more US dollar-sensitive end of the spectrum) experiencing strong returns in both currencies and equities. For example, MSCI Mexico returned 11.6% in MXN terms, while the Mexican peso appreciated by 13.9% against the US dollar, resulting in USD returns for the index of 27.1%. Brazil and Indonesia enjoyed similar return patterns in the first half of the year.

There have been several drivers of this currency support for equity returns, and we believe that these are likely to persist in the second half of 2023, lifting our confidence in the markets where our portfolio is overweight.

Firstly, let's consider the conditions for the US dollar. Exchange rates are merely ratios, and the fundamentals of the US dollar have not been supportive this year. In 2021 and 2022, the US dollar demonstrated significant strength relative to key trade-partner currencies, raising the real effective exchange rate to a thirty-year high. This represented an overshoot relative to the commodity terms of trade, which resulted in negative momentum in late 2022 and the first half of 2023. With a more uncertain outlook, the Federal Reserve may hike or cut interest rates in the second half of 2023, but the interest rate outlook seems less hawkish than that of other global central banks.

Secondly, many emerging market central banks, including in Mexico and Brazil, had hiked interest rates much earlier and far more aggressively than developed market central banks. Despite clear disinflation in their economies, policymakers in these countries have remained cautious. For instance, ex-ante real interest rates in Brazil are approaching 9%. Other central banks, such as those in India and Indonesia, have chosen to deploy excess foreign exchange reserves to support their currencies while avoiding the accommodation of inflation witnessed in many developed markets.

Combining these factors, we have seen very favorable conditions for carry trade investors funding in US dollars and investing in emerging market rates and bond markets. As these flows have stabilized currency volatility, risk-adjusted carry returns have steadily improved. A JP Morgan index of one month volatility in emerging market currencies peaked at 20% during the Covid sell-off, averaged 11.3% in 2022, but declined to 8% in June 2023.[1] Volatility-adjusted carry still appears attractive relative to history.

Lastly, the trade fundamentals, both in terms of prices (terms of trade) and goods flows (trade balances), look extremely supportive. Trade balances and current account balances in Brazil, India, and Indonesia look strong relative to historical levels. In the case of Mexico, the trade deficit is offset by inbound remittances from overseas Mexican workers. Although strong economic and domestic demand growth in these four countries will inevitably lead to rising imports, the starting position remains attractive after weak domestic demand growth in the 2010s and the powerful sell-off in real effective exchange rates in 2020.

For these emerging economies, we see attractive economic conditions and strong commitment to monetary orthodoxy, which attract increasing capital flows from global carry-trade investors. These flows further drive liquidity and growth while stabilizing and strengthening currencies, all of which is highly supportive for equity investors. We remain highly positive on the outlook for these markets in the second half of the year.

1 Bloomberg as of June 30, 2023, JPMorgan EM FX Volatility 1M

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