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Emerging Market Equities Performance - It's All About the Dollar!

-Craig Lewis, Chief Investment Strategist

Headlines during the past few months have been full of negative and worrisome articles about emerging markets. Given political unrest in Venezuela and South Africa, a financial crisis in Turkey, or a trade war with China, there is a feeling that a crisis is imminent. We believe these events are cause for concern.

Not surprisingly, local stock market returns in these countries have been negative. These returns are worse when translated into U.S. dollars due to the strength of the U.S. dollar. The MSCI Emerging Markets Index has underperformed the S&P 500 Index by 18% this year through August 17th, compared with outperformance of 17% last year. The U.S. Dollar index (a measure of the U.S. dollar versus a basket of foreign currencies) is up 5% so far in 2018 compared with down 7% last year.[1]

For U.S. dollar-based investors and consumers, when the dollar rises, everything priced in foreign currencies becomes cheaper, including stocks. Furthermore, many emerging markets countries borrow in U.S. dollars due to the depth of the U.S. capital markets. For these borrowers, the debt service (interest payments) increases when the U.S. dollar increases. This is because it takes more units of foreign currency to make the same payment in U.S. dollars. As the local currency falls, import costs rise which could further weaken the currency. This creates a vicious cycle like we are seeing in Turkey and Venezuela, where interest rates and inflation have spiraled out of control. Exacerbating the situation, investors tend to keep their money in U.S. dollar-denominated investments, which are viewed as less risky during times of financial stress which can accelerate the flight of capital from emerging markets.

When we think of emerging markets, most of us think of China. Investors generally look at the MSCI Emerging Markets Index when assessing the performance of emerging markets stocks. China comprises 31% of this index, followed by South Korea at 14%, Taiwan at 12%, and India at 9%.[2] With a high weighting of Asia, any follow-on effects from trade issues with China could be significant to the region. While Turkey, Venezuela and South Africa have dominated recent news flow, they have little weight in the index. Contagion effects from currency declines in these countries are worth monitoring, but their direct effects on the index are minimal. From an investment standpoint, it makes some sense to focus more on the possible effects on China from the institution of tariffs on their exports to the U.S.

The Chinese economy is not as dependent on exports as it used to be, so theoretically the impact of a trade war should be less severe. Consumption accounted for 79% of GDP growth in China in the first half of 2018, up from 45% five years ago.[3] Net exports account for just 2% of GDP versus 9% ten years ago, and only 19% of those exports were to the U.S. during the first half of this year.[4]

While trade restrictions have had a negative impact on Chinese equity markets, they do not fully explain the 19% decline in the Shanghai Composite Index this year. The People's Bank of China's (PBoC) policies have contributed to the market decline. Bank lending now comprises 80% of total credit, up from 48% five years ago[5] as the PBoC has implemented policies to slow credit growth and reduce activities in non-standard (shadow banking) sources of credit. While their policies have reduced systemic risks, the PBoC has acknowledged that small and mid-sized businesses have struggled to access credit.[6] In addition, China has let the yuan decline relative to the dollar in order to make China's export sector more competitive.

From a global standpoint, there is some rationale for taking a tough stance with China on trade. China is now the second largest economy in the world, yet they continue to benefit from asymmetric trade and treaty arrangements set up to aid their transformation into a "modern" economy. One could argue that this transformation is complete and that rules should be altered.

For now, the risk of a trade war is significant. The lack of clarity on both President Trump's objectives and President Xi's response will continue to foster uncertainty that markets loathe. If there was an end to the trade impasse, emerging markets would likely rally. China is likely to wait until after the U.S. mid-term elections to engage in serious trade discussions with the hope that President Trump's negotiating position may be weaker post-elections. Over the past weeks, China has reversed course and begun taking steps to prop up the value of the yuan relative to the dollar, and they appear to be using state-backed funds to buy stocks and stabilize their market.[7] President Trump is again attempting to convince the Federal Reserve not to raise rates (higher rates would have the effect of strengthening the U.S. dollar). Given the importance of the U.S. dollar to emerging market performance, we are standing pat for the moment but remain vigilant to the effects further developments could have on our recommended asset allocations.

ENDNOTES

[1] Factset

[2] MSCI.Com

[3] "China's GDP grows 6.8% in H1," National Bureau of Statistics, July 16, 2018

[4] China Customs Office statistics, July 25, 2018

[5] People's Bank of China and Haver Analytics

[6] "China's Central Bank Expands Collateral for Mid-Term Lending," Bloomberg News, June 1, 2018

[7] "China Stocks Rally After Benchmark Falls Under 2016 Closing Low," Bloomberg News, August 20, 2018