

Global Investment Research | Multi-asset

A stronger US dollar – will EMs feel the pinch?

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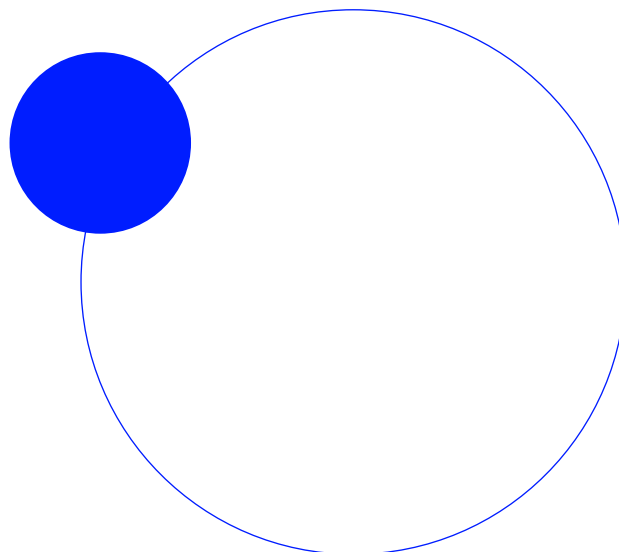


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Highlights

- The US dollar has strengthened notably in 2024 with the shift in market expectations to higher US rates for longer
- For EMs, a stronger US dollar could mean pass-through inflation from higher import prices in local currency terms, lower degrees of freedom in monetary policy implementation and greater vulnerability in external debt servicing
- The impact of a stronger dollar on EM inflation and monetary policy and how they manage it is likely to be idiosyncratic, based on their status as net importer or exporter and existing domestic inflation conditions, which drove EM central bank action ahead of the recent DM central bank tightening cycle
- EMs' buildup of official reserves and the evolution of EM debt to far higher issuance in local currencies are structural factors that improve the resilience of EMs to external vulnerabilities
- Capital flows to EMs have held up during the recent bout of US 10-year treasury yield rise and USD strengthening and is a sign of investor conviction in the EM asset class

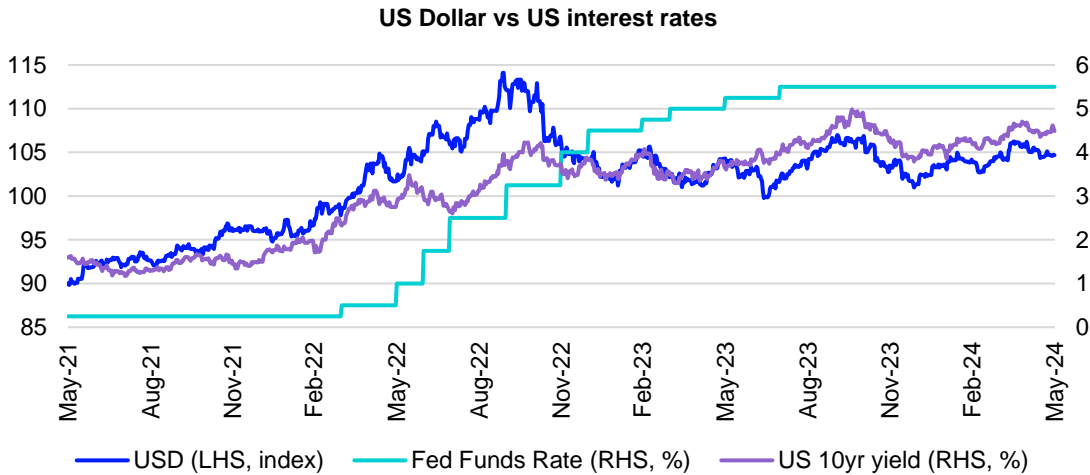


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So far in 2024, sticky US inflation has led markets to expect higher rates for longer in the US. Just at the end of last year, policy rate cuts in the US felt more imminent. As the US Fed has held the Fed Funds rate at its highest in over 15 years, the US 10-year treasury yield rose 62 basis points in 2024 through the end of May, and the US dollar index rose 3.3% alongside (see Exhibit 1). Moreover, markets have recalibrated their rate cut expectations to less than two cuts in 2024 and starting much later in the year. A strong US dollar has wide implications for the global economy and financial assets. Here we explore its consequences for emerging markets (EMs) specifically.

Exhibit 1: US dollar index vs key US interest rates



Source: FTSE Russell/LSEG. Data as of May 31, 2024. The USD index is the DXY US dollar index. The US 10yr yield is the bid yield on the 10-year US treasury benchmark security.

There are several possible sources of vulnerability for EMs from a stronger US dollar. First, a stronger dollar and weaker local currency could lead to imported inflation in EMs when many EMs are themselves still fighting domestic inflation. Second, it could impact EM central banks' monetary policy independence and ability to ease domestic rates especially if they wish to avoid further downward pressure on their currencies. Third, a stronger dollar could increase the local currency cost of servicing external debt for EM sovereigns and corporates and challenge their balance sheets. However, we believe there are several mitigating factors which mean that EMs as an asset class will likely be more resilient to the consequences of a stronger US dollar.

Before we analyse those mitigating factors, it is useful to put the dollar's 2024 move in context. The dollar is known to strengthen both when the US economy is strong relative to the rest of the world and also when there is broad risk-off market sentiment when investors seek safe haven in the dollar. The recent bout of dollar strengthening came against the backdrop, certainly of persistent inflationary pressures and expectations of higher rates for longer, but also of healthy US GDP growth and broader risk-on market sentiment. This is evidenced in historically low credit spreads recently, including in EMs (see also ["Emerging Markets: a changed asset class?"](#)).

Balancing domestic policy drivers with a stronger US dollar's impact

We consider the top five constituents by weight in the FTSE Emerging Index that account for 81% of the index by weight (as of May 2024) in this analysis. Four of them – China, Taiwan, Brazil and Saudi Arabia – are net exporters and India is a net importer. Therefore, the risk that they experience pass-through inflation from a weaker domestic currency relative to the US dollar will vary, with exporters potentially benefitting. More broadly, how these countries navigate a stronger dollar world is likely to be idiosyncratic based on specific domestic conditions and the degrees of freedom their policymakers have. We witnessed these idiosyncrasies in the lead up to the recent rate hiking cycle in developed markets (DMs).

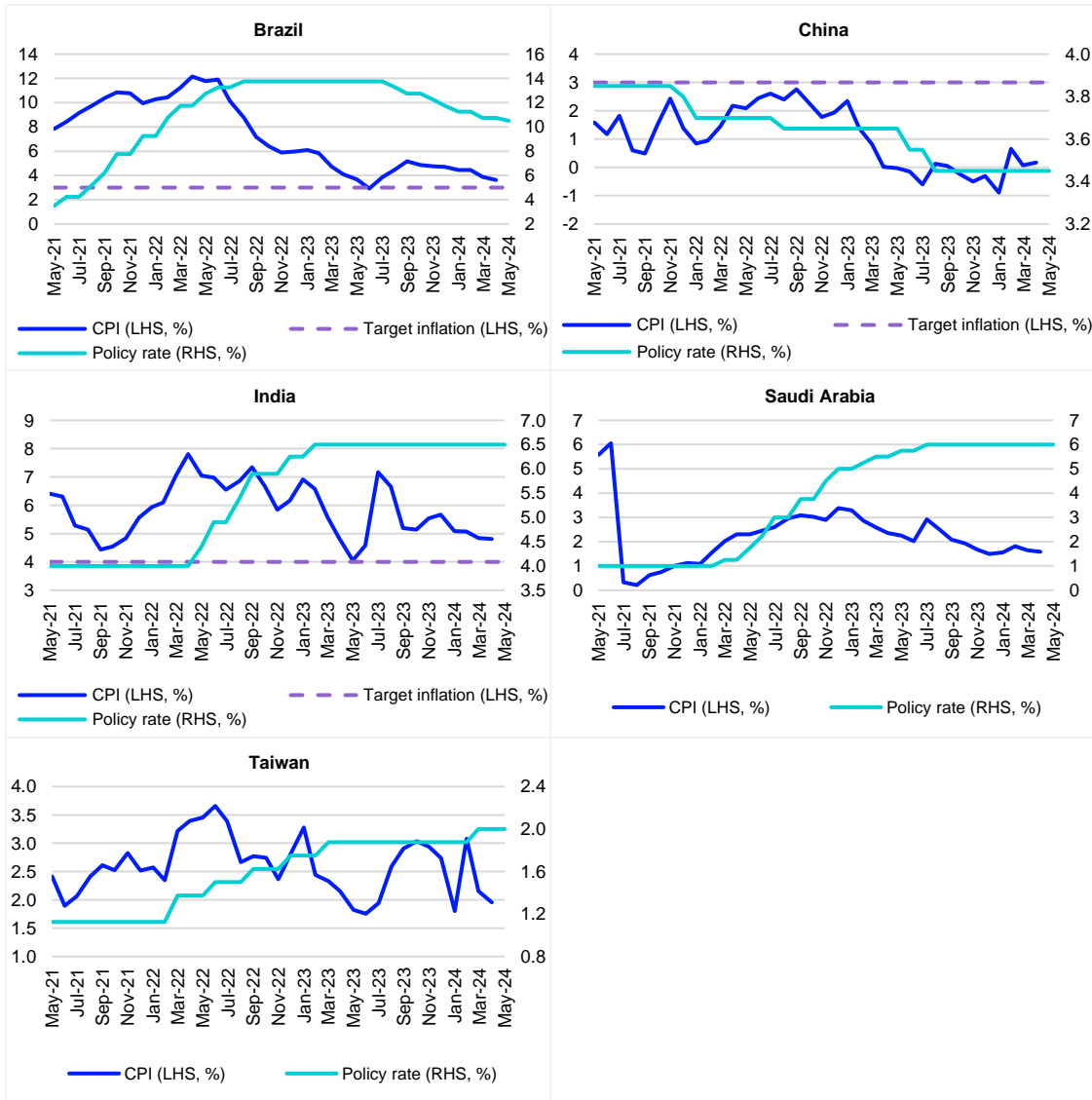
See Exhibit 2 for the trajectory of inflation and policy rates in the top five country constituents of the FTSE Emerging index.

As inflation picked up globally following post-pandemic supply chain disruptions, EMs were quick to hike policy rates when needed, based on their domestic inflation situation. For example, Brazil began raising its short-term policy rate in March 2021 from 2% to 13.75% by August 2022. The US's first hike of the recent tightening cycle was much later in March 2022 (South Africa and Mexico also began monetary tightening ahead of the US. See also "[Why did the Brazilian real and Mexican peso outperform the US dollar this year?](#)"). Taiwan and Saudi Arabia followed suit with policy rate hikes in March 2022 and India in May 2022.

China was and is in a different position from its peers, as policymakers focus on countering deflationary pressures in the economy. As such, Chinese authorities lowered its 1-year loan prime rate starting in December 2021 and continue to support lower rates and easier financial conditions.

Now, near the end of the latest monetary tightening cycle in DMs, EM monetary policy is once again weighing domestic inflation conditions against foreign exchange considerations. Brazil already began easing its policy rate in August 2023 after inflation touched a low of 2.9% (below its 3% target) in June 2023. While the other four EMs in the top five continue to maintain relatively high policy rates, disinflation has been under way in their economies for some time, giving them some room to withstand potential inflationary pressures from a weaker currency.

Exhibit 2: Inflation and policy rates in the top five country constituents of the FTSE Emerging Index

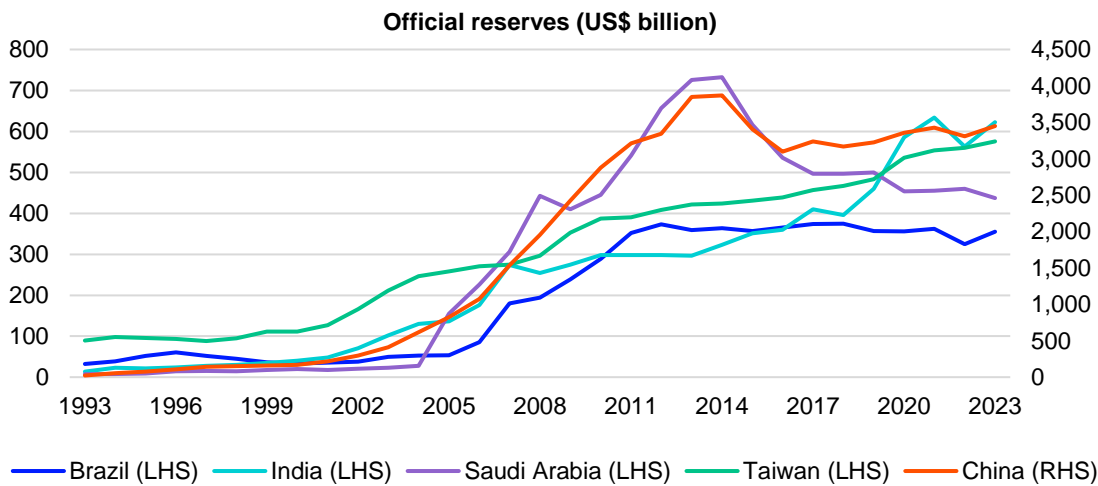


Source: FTSE Russell/LSEG. Data as of May 31, 2024. Saudi Arabia and Taiwan do not report an official target inflation.

Structural strengths and degrees of freedom

One tool that affords EMs the degrees of freedom to be relatively more independent in monetary policy implementation is their stock of foreign exchange reserves. EMs learned the lessons of external vulnerabilities the hard way during the currency crises of the 1990s. They have since boosted their official reserve assets, which allows them to manage and support their local currencies during market stress. Exhibit 3 shows the rise of official reserve assets including gold in the top 5 country constituents of the FTSE Emerging index. The dramatic increase in official reserves starting in the early-2000s and the jump in reserve assets as a percent of GDP (Exhibit 4) are the result of intentional policies to shore up the resilience of these economies.

Exhibit 3: Official reserves of the top five country constituents of the FTSE Emerging Index, 1993-2023, US\$ Billion



Source: IMF International Financial Statistics. Annual data from 1993 to 2023. Data retrieved June 5, 2024.

Exhibit 4: Official reserves as a share of GDP of the top five country constituents of the FTSE Emerging index, 1993 and 2023, Percent

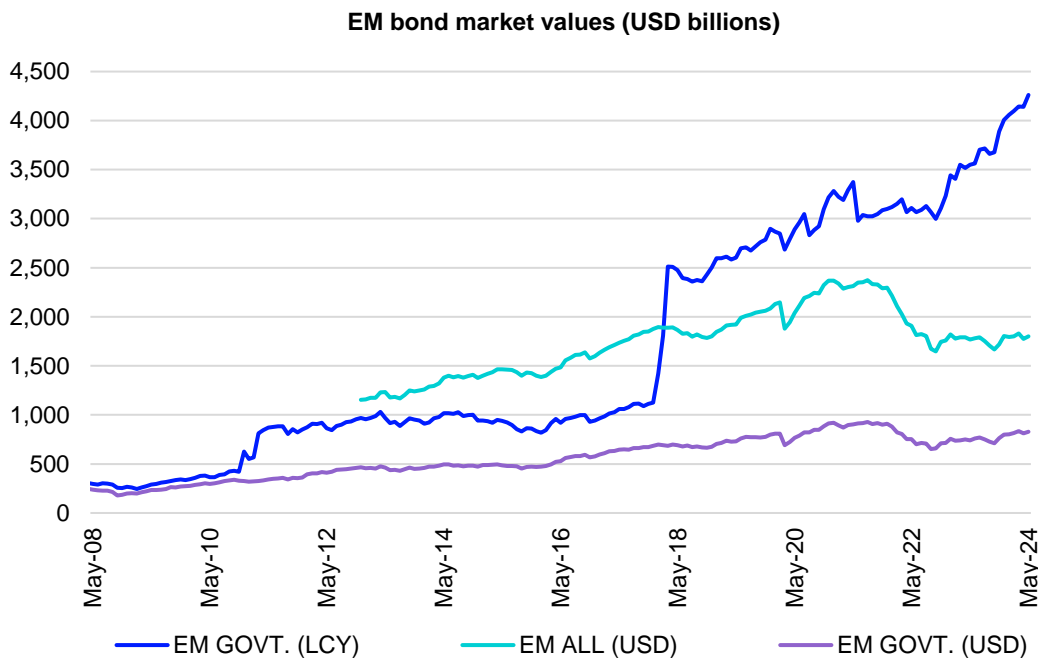
Reserves (% of GDP)	1993	2023
Brazil	8%	16%
China	4%	20%
India	5%	17%
Saudi Arabia	6%	41%
Taiwan	38%	76%

Source: IMF International Financial Statistics. Annual data for 1993 and 2023. Data retrieved June 5, 2024.

A second structural shift in EMs that reduced their external vulnerability is the evolution in the currency composition of their debt.

EMs as a whole have drastically reduced their reliance on hard dollar debt since the currency crises of the 1990s, as can be seen in Exhibit 5. Between 2008 and 2018, the growth in market value of EM sovereign debt in local currencies was faster than that of EM sovereign debt in US dollar. Since February 2018, China’s inclusion into the FTSE Emerging Markets Government Bond Index (EMGBI) has significantly boosted the local currency sovereign bonds’ market values. The rapid growth in EM local currency debt picked up again in October 2022, after some slow down. Currently, a much larger share of EM sovereign bond issuance is in local currency (more than USD 4 trillion), and the upward trend of local currency bond issuance is observed in most of the EM markets within the EMGBI (16 countries), led by China. In the meantime, the share of EM US dollar-denominated sovereign bonds has reduced, as their market values have only modestly increased from about USD 500 billion in 2013 to 800 billion in May 2024.

Exhibit 5: Market value of major EM bond indices, US\$ Billion

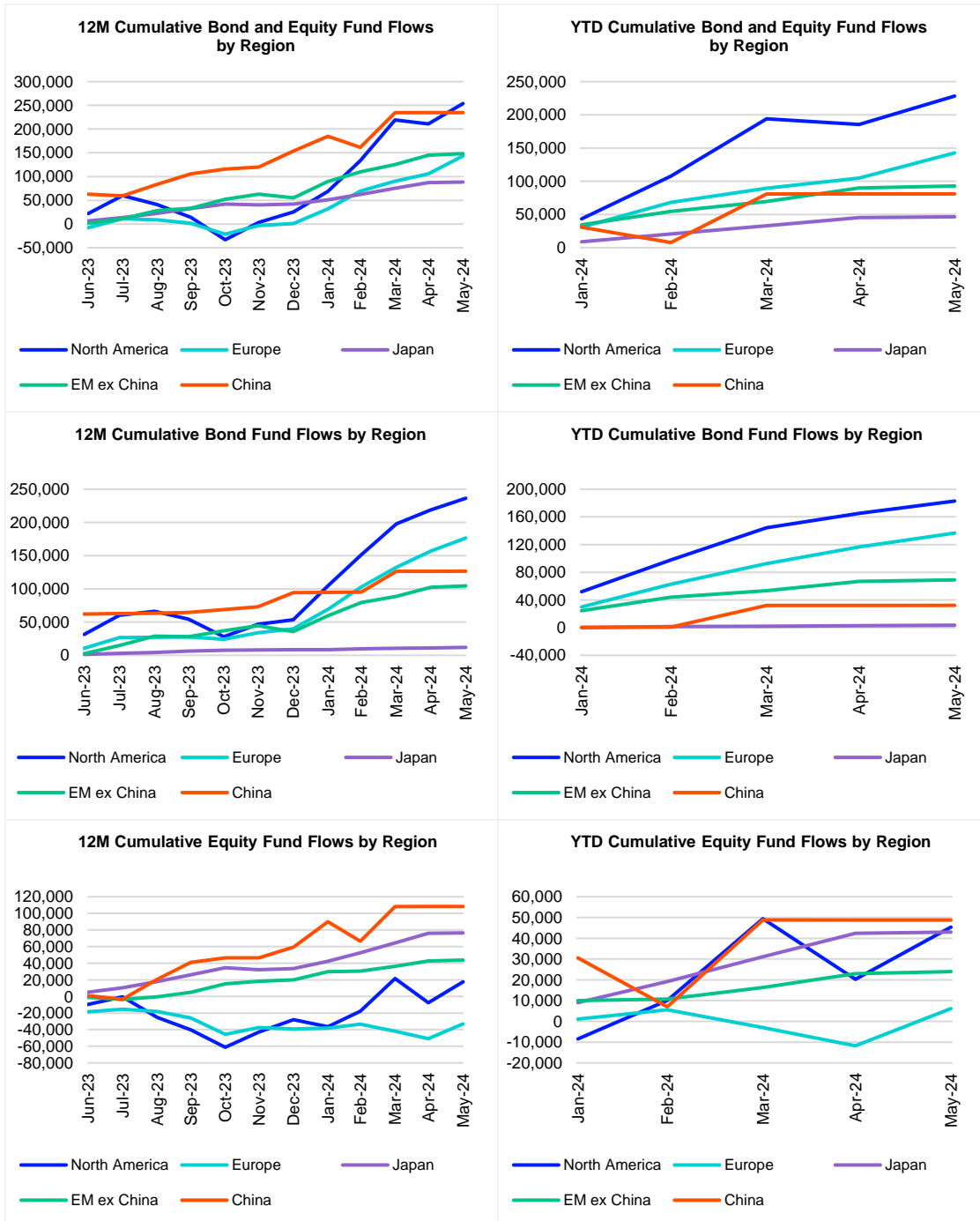


Source: FTSE Russell/LSEG. Monthly data from May 31, 2008, to May 31, 2024.

Less reliance on dollar-denominated debt has made EMs less susceptible to US dollar strengthening, unlike during the Asian Financial Crisis during the late 1990s when their currencies depreciated sharply, making the cost of servicing dollar-denominated debt significantly higher. It has also made EMs less vulnerable to capital outflows, which stem from the anticipation of higher for longer rates in the US, and the resulting speculative currency trades betting against EM currencies. A vicious cycle between such speculative trades and receding investor confidence could intensify the currency depreciation pressures, as was seen during the Asian Financial Crisis.

What we observe thus far in 2024 is the opposite. Exhibit 6 shows cumulative investor flows into EM equity and bond funds during the last year, and in 2024 when the US 10-year yield rose and US dollar strengthened faster. While monthly flows can be choppy, the overall trend in flows to funds domiciled in EM ex China and China have remained positive. It is an indication of investor conviction in these markets and the EM asset class.

Exhibit 6: Cumulative fund flows by region, 12 Months and Year-to-Date (YTD), US\$ Million



Source: FTSE Russell/LSEG. Data as of May 31, 2024. 12M cumulative flows from June 2023 to May 2024. YTD cumulative flows from January 2024 to May 2024.

Conclusion

While EMs may potentially experience vulnerabilities from a stronger US dollar, there are several mitigating factors. A strong dollar's impact on EM inflation and monetary policy implementation is likely to be idiosyncratic, based on a country's status as net importer or exporter and existing domestic inflation conditions, which drove EM central bank action ahead of and concurrent to the recent DM monetary tightening cycle.

EMs' buildup of official reserves and the evolution of EM debt to far higher issuance in local currencies than in hard currencies such as the US dollar are structural factors that improve the resilience of EMs to external vulnerabilities. To be sure, EMs (and DMs) cannot completely ignore the effects of sustained high US interest rates and strength in the US dollar. And there are certain EMs whose structural vulnerabilities and receding investor confidence have led to intensified currency depreciation pressures and runaway inflation. Thus far, these have been isolated.

Capital flows to EMs have held up during the recent bout of US 10-year yield rise and USD strengthening and is a sign of investor conviction in the EM asset class. The combination of many EMs' net exporter status, which makes them less vulnerable to imported inflation, their healthy levels of foreign reserves and larger share of local currency denominated debt mean that EMs as an asset class are likely to be more resilient than in the past to the potential impacts of US dollar strength.

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