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DRIEHAUS EMERGING MARKETS

The Outlook for the US Dollar and Implications for Emerging Markets Equities

It is fairly well-known that the U.S. dollar has an outsized impact on emerging market equity markets (EM). There are many reasons for this, which we won't rehash, but a strong dollar has historically weighed heavily on EM returns. While many things have changed in global macro in recent years, the impact of the dollar on EM has only increased (Exhibit 1).

We believe the reasons for that increase in impact are twofold. First, the extreme negativity on China the past two years weighed on the Chinese currency, a main component of the dollar index. Worse sentiment on China, and thereby on EM, actually helped to strengthen the dollar. Secondly, the former relationship between the dollar and some commodities, notably oil, has been changing. As a result of the US' significantly-improved oil production relative to the rest of the world, the inverse relationship between the dollar and the oil price (stronger dollar means lower oil prices) has not been as reliable. In the past year, where oil and gas prices were such a focal point for global macro, this impact was magnified. A large part of Europe's poor performance last year was due to its terms of trade shock due to higher oil, which weighed significantly on the Euro. While there are many parts of EM that are commodity-linked, the biggest markets are oil importers (China, India, Korea, to name a few). As a result of these changes, it's no surprise that the strong dollar has had an even stronger impact on EM equity returns of late.

Exhibit 1. The US Dollar has seen an increased impact on EM equity returns*

*Dollar index is in green and inverted, higher on chart is weaker.
Source: Bloomberg, Driehaus, MSCI.

The dollar has been on a very volatile ride of late and we thought it important to touch base with our current outlook as a result. It's not hyperbole to say the dollar has been volatile; it's been ~3x more volatile in recent months than it was this time a year ago (Exhibit 2). Given that volatility and the heightened impact the currency is having on local returns, it's essential to have informed views on the dollar at this point, not just for what it means for EM equity returns but for global allocation as well.

Currencies are complicated and have infinite moving parts that can up-end a forecast. Our process has always been to simplify those moving parts to three main things: Long-term Valuation, Growth Differentials, Real Rate Differentials.

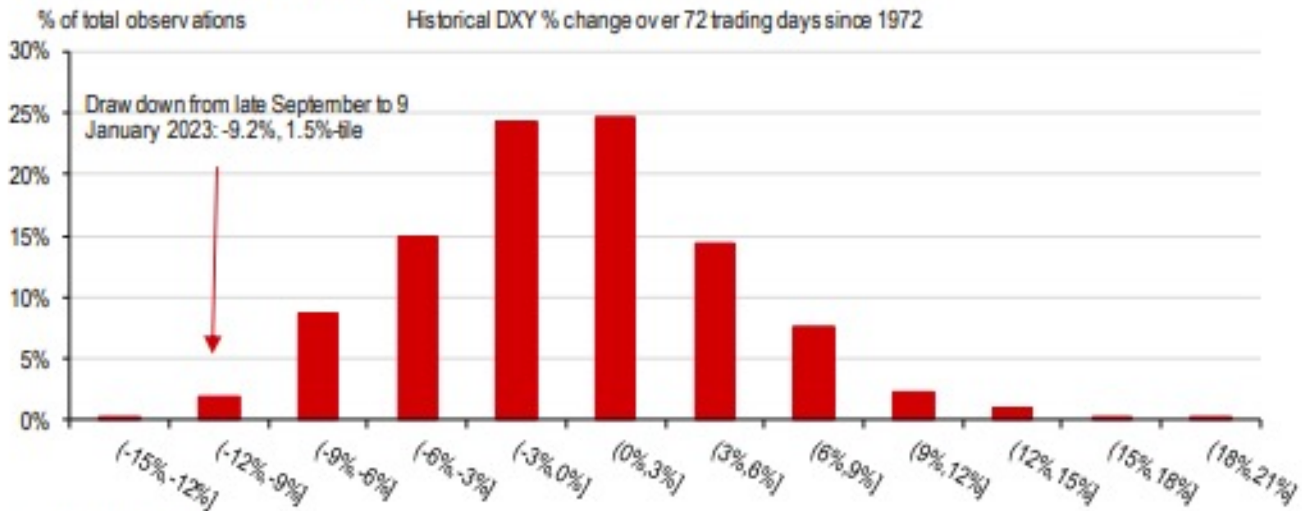
Exhibit 2. The dollar has been trading with significantly more volatility recently, the most volatile in the past decade

Source: Bloomberg, Driehaus

Long-Term Valuation

The extremely overvalued dollar last year made things more simple than usual. We don't buy fair value models meaning much on shorter-term bases but when things are extreme, there's a better chance than not that they will revert. At the end of last year, before China's reopening, the dollar was roughly 20% overvalued on long-term measures. Even if you didn't trust these fancy economic measures, a simple trip to Europe or Japan and you could feel how strong the dollar was. By most measures, the dollar hasn't been that strong since the last few years of Paul Volcker's tenure. Despite the recent depreciation, the dollar remains overvalued, but we would highlight that the aggressive depreciation in recent months has been an anomaly and raises short-term risks (Exhibit 3).

Exhibit 3. The dollar's rapid fall in recent weeks has been an anomaly, but it remains overvalued by most metrics



Source: Bloomberg, HSBC

Growth Differentials

We typically lean more on our expectations for economic growth differentials than other dynamics and that remains firmly supportive of a weaker dollar, in our view. There are likely two large economies in the world that will see faster GDP growth in 2023 than they did last year and those are China and Japan. Relative to the pace of growth in the second half of last year, Europe should also see an economic acceleration both from its improved energy situation and for its higher sensitivity to an Asian rebound. The US has a much harder road to surprise positively and has looming headwinds. Chief among these are the lagged impact of significant monetary tightening, a sharp turn lower in the credit impulse and an increasingly difficult political environment for accommodative fiscal policy.

Rate Differentials

Interest rate differentials and the trajectory of Fed policy tightening has an undeniable impact on all FX as well and here we see a more mixed outlook. We simultaneously believe that we are at or very near the policy peak and that the dollar should have steady down pressure as an easing cycle someday comes. However, the market has already priced some of that in. As of this writing, the market is pricing a Fed Funds rate of 3% in January 2025 (versus today's 4.5% rate), along with continued short-term hikes. That is an unusual dynamic and it's unlikely that the market prices more aggressive cutting until economic data more significantly worsens in the US or the Fed actually does start to cut, which is not imminent whatsoever. As a result, we think the rate differentials lens warrants some caution here and could likely result in some short-term choppiness to major FX. US data getting slightly better than feared or the Fed pumping the brakes on easing expectations could both provide short-term support for the dollar.

In sum, we retain our longer-term more bearish view on the dollar and continue to view that positively for emerging market assets. We do see shorter-term risks that the recent dollar sell-off could stabilize, however. The most obvious triggers would come from rate expectations being too dovish in the US or US economic sentiment improving from very low levels. Further, if the data from China comes in weaker than hoped-for following its reopening, the thesis that the rest of the world will do better than the US this year might be reevaluated by some participants. Beyond the short-term though, we still find support for the view that the dollar has peaked for this cycle. We draw this from the dollar's overvaluation and the highly likely outcome that the rest of the world does better economically in the coming year and beyond. Eventually the Fed will be easing, while places like China will likely be earlier in tightening cycles. The biggest other factors to keep in mind concern politics, specifically the debt ceiling debate in the US, rising treasury issuance, and geopolitical issues with China.

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