EMERGING CURRENCIES: IS PURCHASING POWER PARITY BROKEN?

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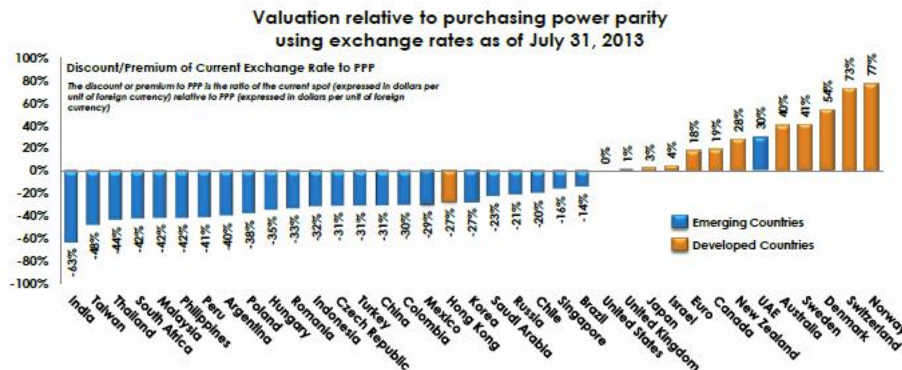
Frequently quoted by international economists as a means of assessing the value of currencies against one another, the basic notion of purchasing power parity (PPP) states that if currencies are in equilibrium (or fairly priced), then converting one currency into another should buy the equivalent amount of goods in another country. Taking a real world example, a Big Mac in the United States should cost the same as in Poland after converting your dollars to zloty. Indeed, the Economist newspaper popularized this way of thinking through their "Big Mac Index," in which they use the menu of the world's largest fast food chain to compare the relative purchasing power of foreign currencies against the U.S. dollar. But with global growth being revised down around the world and concerns about rising interest rates in the U.S., most foreign currencies have depreciated against the dollar in the last few months. As this has occurred, discounts in many emerging market currencies have actually increased versus their long-term target of appreciation. So what role does PPP play in how investors should think about currency risk in their portfolios?



Sources: International Monetary Fund, Bloomberg, WisdomTree As shown in the chart above, for many investors, an attractive element of emerging market currencies versus their developed market counterparts is the fact that they are trading at (sometimes significant) discounts to their long-term purchasing power. The thinking goes that as their economies develop and become more efficient, the prices of similar goods will eventually converge via the exchange rate. However, there is no market guarantee that these discounts can't increase in the short term, should these currencies depreciate, as we've seen in recent risk-off periods. Essentially, PPP represents a basic valuation of comparative exchange rates. In many ways, PPP is similar to the notion of the price/earnings ratio in the equity market. While their valuations appear "cheap" relative to other assets, there is no guarantee that the price will increase, which would lead to investment gains. However, just as in equities, "cheap" valuations can become even "cheaper" during periods of market stress. Indeed, the most recent period has been particularly difficult, as many investors have shunned nearly all emerging market assets in 2013. Absent investment flows, increases in economic growth or a general change in sentiment, foreign currencies and asset prices have remained weak against a domestic equity market

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that has recently touched all-time highs. So what will ultimately reverse the recent period of weakness in foreign currencies? While no silver bullet exists, it is interesting that the vast majority of emerging market countries with “undervalued” currencies are predominantly export-based economies. Therefore, as their currencies depreciate, their goods actually become cheaper to foreign buyers. On the other hand, the price of imported goods increases, which leads to the potential for an increase in inflation. It has long been said that it is important for a larger economy such as China to move up the value chain and transition to a more domestic-consumption-focused economy. While an appreciating currency may make China’s exports comparatively more expensive, it will gradually increase the foreign purchasing power of Chinese consumers. If appreciation occurs in a gradual way, a strengthening currency can be a positive factor for foreign investors and local consumers at the same time. Although the recent period of volatility has proven difficult for many investors, we believe there is potential for long-term value in diversifying the currency risk of their portfolios. At current levels, investors might consider learning more about different ways of altering the currency risk profile of their portfolios through foreign-currency exchange-traded funds.

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Purchasing power parity : Academic concept stating that exchange rates should adjust so that equivalent goods and services cost the same across countries, after accounting for exchange-rate differences.